

ESTATE AND INCOME TAX PLANNING  
FOR NON-U.S. CITIZENS

U.S. Taxation of Foreign Trusts

June 2004

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1) **Introduction.**

- a) Historically, foreign trusts have been very useful tools for sophisticated estate planners. However, they have also been the focus of great suspicion and scrutiny by the IRS.
- b) Before 1976, properly designed foreign trusts created in low tax jurisdictions provided significant income tax deferral and, in some cases, complete income tax avoidance, even where both the grantor and current trust beneficiaries were US persons.
- c) Over the years, Congress has repeatedly attempted to discourage the use of foreign trusts by US individuals by passing legislation that has gradually reduced the tax benefits accruing from such trusts. Such legislation has included the following:
  - i) Revenue Act of 1962.<sup>1</sup>
  - ii) Tax Reform Act of 1976.<sup>2</sup>
  - iii) Revenue Reconciliation Act of 1990.<sup>3</sup>
  - iv) The Small Business Job Protection Act of 1996.<sup>4</sup>
  - v) Taxpayer Relief Act of 1997.
- d) As a result of the aforementioned legislative changes, the tax and other benefits flowing from foreign trusts to US persons have been greatly eroded. Notwithstanding this, foreign trusts continue to be very useful in certain circumstances.

2) **What constitutes a foreign trust?**<sup>5</sup>

- a) **Importance of classification of trust as “foreign” or “domestic.”**
  - i) **Generally.** Classification of a trust as “foreign” or “domestic” has significant tax consequences.
  - ii) **Domestic trusts.** Domestic trusts are both:
    - (1) Treated as US persons, and
    - (2) Are subject to tax on worldwide income.
  - iii) **Foreign trusts.** Foreign trusts are both:

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<sup>1</sup> P.L. 87-834, § 7, 87<sup>th</sup> Cong. 2d Sess. (1962).

<sup>2</sup> P.L. 94-455, 94<sup>th</sup> Cong., 2d Sess., 90 Stat. 1928 (1976).

<sup>3</sup> P.L. 101-508, § 11343.

<sup>4</sup> P. L. 104-188, 110 Stat. 1755 (1996).

<sup>5</sup> Classification of an entity as a foreign trust requires that it first be classified as a “trust” and, then, that it be treated as a “foreign” entity. This outline only addresses the second issue. See Howard Zaritsky, *US Tax’n of Foreign Estates, Trusts and Beneficiaries*, 854-2<sup>nd</sup> Tax Mgmt. Portfolio III.A-B (2002), for a discussion of what characteristics an entity must possess to be treated as a “trust” for tax purposes.

- (1) Treated as nonresident aliens (“NRAs”), and
- (2) Are subject to tax only on US source income or income effectively connected with a US trade or business.<sup>6</sup>

iv) **Other effects of classification.** Classification of trust also impacts:

- (1) Whether a grantor will be treated as the owner of the trust for income tax purposes under the grantor trust rules.
- (2) Whether gain must be recognized upon transfers to the trust.
- (3) The application of certain withholding provisions.

b) **What makes a trust a “foreign trust?”**

i) **Generally.**

- (1) A different set of rules applies to determine whether a trust constitutes a foreign trust, as opposed to a domestic trust, depending on whether the amendments enacted as part of the Small Business Job Creation Act of 1996 (the “1996 Act”) apply to the trust. The 1996 Act generally applies to tax years beginning after December 31, 1996, and at the trustee’s election to tax years ending after August 20, 1996.
- (2) Before the enactment of the 1996 Act, a subjective analysis was required to determine whether the US treated a trust as domestic or foreign for US tax purposes. The 1996 Act changed the classification scheme to one that determines a trust’s nationality based on a set of objective criteria.
- (3) **Note.** The situs of a trust for tax years beginning before January 1, 1997 may be relevant, among other things, because that situs may determine the character of accumulated trust income that will be taxed when ultimately distributed to a US beneficiary.

ii) **Definition of foreign trust before the 1996 Act.**

- (1) **Statutory Rule - IRC § 7701(a)(31).** For tax years beginning before January 1, 1997, IRC § 7701(a)(31) provided that a foreign trust was one “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) **Application of the Rule.**

- (a) Essentially, the pre-1996 Act version of IRC § 7701(a)(31) provided for a subjective analysis of whether the trust was more comparable to a resident or a nonresident alien individual.<sup>7</sup>

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<sup>6</sup> IRC § 641(b); Treas. Reg. § 301.7701-7(a)(3).

<sup>7</sup> Rev. Rul. 60-181, 1960-1 C.B. 257, citing *B.W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), *aff’d*, 132 F.2d 914 (4<sup>th</sup> Cir. 1943).

- (b) Generally, the pre-1996 Act version of IRC § 7701(a)(31), by itself, provided no guidance as to how to determine whether a trust would be classified as domestic or foreign.
- (c) Judicial and administrative authority partially filled the void left by the pre-1996 Act version of IRC § 7701(a)(31) by providing for a test that required a weighing of a trust's foreign contacts against its US contacts.<sup>8</sup>
- (d) The cases and rulings provided that the following six major factors in were to be considered determining the situs and nationality of a trust:
  - (i) The country under whose laws the trust was created.
  - (ii) The situs of the trust's corpus.
  - (iii) The nationality and residence of the trustee.
  - (iv) The situs of the trust administration.
  - (v) The nationality and residence of the grantor.
  - (vi) The nationality and residence of the beneficiaries.
- (e) Where the various indicia were inconsistent, this test was extremely difficult to apply.
- (f) Courts and the IRS tended to place more weight on the following factors:
  - (i) The situs of the trust's corpus.
  - (ii) The nationality and residence of the trustee.
  - (iii) The situs of the trust administration.<sup>9</sup>

**iii) Current (i.e., Post-1996 Act).**

**(1) Generally.**

- (a) **General Rule.** For tax years beginning after December 31, 1996, a trust is a US trust if both:
  - (i) A court within the US is able to exercise primary supervision over the trust's administration ("Court Test"); and

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<sup>8</sup> See, e.g., *Maximov v. United States*, 373 US 49 (1963); *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 US 948 (1960); Rev. Rul. 60-181, 1960-1 C.B. 257.

<sup>9</sup> See, e.g., *Maximov v. United States*, 373 US 49 (1963) (Supreme Court held that trust created under Connecticut law, which was administered in the US by a US trustee for the benefit of foreign beneficiaries was a domestic trust); *B. W. Jones Trust v. Commissioner*, 132 F.2d 914 (4th Cir., 1943) (Fourth Circuit held that trust created by a foreign grantor for the benefit of foreign beneficiaries, which was governed by foreign law, but whose corpus consisted primarily of US securities held in a safe deposit box in New York, where three trustees were foreign and one was US, was a US trust); Rev. Rul. 60-181, 1960-1 C.B. 257 (IRS ruled that testamentary trust created under laws of a foreign country, with corpus consisting primarily of US securities, with a US trustee, was a domestic trust).

(ii) One or more US persons have authority to control all substantial decisions of the trust (“Control Test”).<sup>10</sup>

1. **Note 1.** A trust that does not satisfy both of these tests will constitute a foreign trust.<sup>11</sup>

2. **Note 2.** For purposes of the foreign trust definition:

- a. A trust is a US person on any day that the trust meets both the court test and the control test.
- b. A domestic trust means a trust that constitutes a US person.
- c. A foreign trust means any trust other than a domestic trust.<sup>12</sup>
- d. Treasury regulations apply the terms of the trust instrument and applicable law to determine whether the court test and the control test are met.<sup>13</sup>

**(b) Background – Rationale for enactment of the post-1996 Act Rule.**

(i) Congress’s primary objective was clearly to provide an objective test, rather than the prior subjective test.<sup>14</sup>

(ii) In addition, it appears that one of the principal objectives for the post-1996 definition of foreign trusts was to level the competitive playing field for trust administration business between US and foreign institutions. The pre-1997 rule effectively acted as an incentive for a foreign person to avoid using a US financial institution as trustee because of the significant risk that this would cause the trust to be taxed as a US domestic trust. Under the post-1996 Act rule, a foreign person can easily use a US financial institution without creating a domestic trust.<sup>15</sup>

**(c) Effective Date.** The post-1996 Act rule applies to tax years beginning after December 31, 1996, and at the election of the trustee, to tax years ending after August 20, 1996.

**(d) Example 1.** Ms. Havisham, a US citizen who resides in Maryland, creates a trust for her children, all of whom are US citizens. She names the Dickens Trust Company, a Delaware corporation, and

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<sup>10</sup> IRC § 7701(a)(30)(E), (31)(B); Treas. Reg. § 301.7701-7(a)(1).

<sup>11</sup> IRC § 7701(a)(31).

<sup>12</sup> Treas. Reg. § 301.7701-7(a)(2).

<sup>13</sup> Treas. Reg. § 301.7701-7(b).

<sup>14</sup> Treasury Department, *General Explanation of the Administration’s Revenue Proposals 25* (Feb. 7, 1995). See also IRS Notice 96-65, 1996 C.B. 232.

<sup>15</sup> Treasury Department, *General Explanation of the Administration’s Revenue Proposals 25* (Feb. 7, 1995). See also IRS Notice 96-65, 1996 C.B. 232.

her brother, Pip, a Bermuda citizen and resident, as co-trustees. The trust instrument (a) gives Pip the right to determine the ages at which each child receives its share of the trust fund, and (b) directs that the trust funds be maintained in the US in the custody of the Dickens Trust Company, and that Maryland law governs the trust's administration. Here, the trust will be treated as a foreign trust because a foreign person will possess control over a substantial trust decision.

**(2) Court test.**

**(a) Generally.** The court test is one of the two tests that a trust must satisfy in order to be classified as a domestic trust.

**(b) General Rule.** To satisfy the court test, a court within the US must be able to exercise primary supervision over the trust's administration.<sup>16</sup>

**(c) Safe Harbor.** Under Treasury Regulations, a trust satisfies the court test if:

(i) The trust instrument does not direct that the trust be administered outside of the US;

(ii) The trust in fact is administered exclusively in the US; and

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

**(d) Example 2.**<sup>17</sup> Charles creates a trust for the equal benefit of his two children, Biddy and Pip, called the Dickens Trust. The trust instrument provides that DC, a Virginia corporation, is the trustee of the Dickens Trust. DC administers the trust exclusively in Virginia and the trust instrument is silent as to where the Dickens Trust is to be administered. In addition, the Dickens Trust is not subject to an automatic migration provision. Here, the Dickens Trust satisfies the court test.

**(e) Definitions.** The following definitions apply for purposes of the court test:

(i) **Court.**<sup>18</sup> "Court" means any federal, state, or local court.

(ii) **The United States.**<sup>19</sup> "United States" is used in a geographical sense. Thus, for court test purposes, the United States includes only the States and the District of Columbia.

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<sup>16</sup> IRC § 7701(a)(30)(E), (31)(B).

<sup>17</sup> Treas. Reg. § 301.7701-7(c)(2).

<sup>18</sup> Treas. Reg. § 301.7701-7(c)(3)(i).

<sup>19</sup> Treas. Reg. § 301.7701-7(c)(3)(ii).

1. **Caution.** A court within a territory or possession of the United States (*e.g.*, Puerto Rico) or within a foreign country is not a court within the United States.
- (iii) **Is able to exercise.**<sup>20</sup> “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.
- (iv) **Primary supervision.**<sup>21</sup> “Primary supervision” means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. Note that a court may have primary supervision under this definition notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.
- (v) **Administration.**<sup>22</sup> “Administration” of the trust 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.
- (f) **Bright line rules for satisfying or failing the Court Test.**  
Treasury regulations provide the following bright line rules for determining when a trust will satisfy or fail the court test, which are not intended to be an exclusive list:<sup>23</sup>
  - (i) **Uniform Probate Code.**<sup>24</sup> A trust satisfies the court test if an authorized fiduciary registers the trust in a court within the US pursuant to a state statute containing provisions substantially similar to Uniform Probate Code, Article VII, Trust Administration.
  - (ii) **Testamentary trust.**<sup>25</sup> A testamentary trust created by a will probated within the US (other than ancillary probate) will satisfy the court test if all fiduciaries of the trust have been qualified as trustees by a court within the US.
  - (iii) **Inter vivos trust.**<sup>26</sup> For inter vivos trusts, if the fiduciaries and/or beneficiaries take steps with a court within the US that

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<sup>20</sup> Treas. Reg. § 301.7701-7(c)(3)(iii).

<sup>21</sup> Treas. Reg. § 301.7701-7(c)(3)(iv).

<sup>22</sup> Treas. Reg. § 301.7701-7(c)(3)(v).

<sup>23</sup> Treas. Reg. § 301.7701-7(c)(4)(i).

<sup>24</sup> Treas. Reg. § 301.7701-7(c)(4)(i)(A).

<sup>25</sup> Treas. Reg. § 301.7701-7(c)(4)(i)(B).

<sup>26</sup> Treas. Reg. § 301.7701-7(c)(4)(i)(C).

cause the trust's administration to be subject to the primary supervision of such court, the trust will satisfy the court test.

(iv) **A US court and a foreign court are able to exercise primary supervision over the administration of the trust.**<sup>27</sup> If both a US court and a foreign court can exercise primary supervision over the trust's administration, the trust satisfies the court test.

(g) **Automatic migration (i.e., flight) provisions.**<sup>28</sup> A court within the US is not considered to have primary supervision over a trust's administration if the trust instrument provides that a US court's attempt to assert jurisdiction or otherwise supervise the trust's administration, directly or indirectly, will cause the trust to migrate from the US. Such provisions are commonly referred to as "flight provisions," "migration provisions," and "duress provisions." This rule will not apply, however, if the trust instrument provides that the trust will migrate from the US only in the case of foreign invasion of the US or widespread confiscation or nationalization of property in the US.

(h) **Example 3.**<sup>29</sup> Oliver, a US citizen, creates a trust for the equal benefit of his two children, both of whom are US citizens. The trust instrument provides that the Dickens Trust Company, a US corporation will serve as trustee and the trust shall be administered in Bermuda. The Dickens Trust Company maintains a branch office in Bermuda with personnel authorized to act as trustees there. The trust instrument provides that Maryland law governs the trust. Assume that under Bermuda law, a Bermuda court may exercise primary supervision over the trust's administration. Pursuant to the trust instrument, a Bermuda court applies the Maryland law to the trust. However, under the terms of the trust instrument, the trust is administered in Bermuda, and no court within the US is able to exercise primary supervision over its administration. Here, the trust fails to satisfy the court test. Therefore, it constitutes a foreign trust.

(i) **Example 4.**<sup>30</sup> Estelle, a US citizen, creates a trust for her own benefit and the benefit of her spouse, Pip, a US citizen. The trust instrument provides that the trust is to be administered in Maryland, by Copperfield Corporation, a Maryland corporation. The trust instrument further provides that if a creditor sues the trustee in a US court, the trust will automatically migrate from Maryland to Gibraltar, a foreign country, so that no US court will have jurisdiction over the trust. Here, a court within the US is unable to exercise primary supervision over

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<sup>27</sup> Treas. Reg. § 301.7701-7(c)(4)(i)(D).

<sup>28</sup> Treas. Reg. § 301.7701-7(c)(4)(ii).

<sup>29</sup> Treas. Reg. § 301.7701-7(c)(5), Example 1.

<sup>30</sup> Treas. Reg. § 301.7701-7(c)(5), Example 2.



the trust's administration because of the flight provisions. Therefore, the trust fails to satisfy the court test from the time of its creation and constitutes a foreign trust.

**(3) Control Test.**

**(a) Generally.** The control test is one of the two tests that a trust must satisfy in order to be classified as a domestic trust.

**(b) General Rule.** To satisfy the control test:

- (i)** One or more US persons
- (ii)** Must have authority to control
- (iii)** All substantial decisions of the trust.<sup>31</sup>

**(c) Definitions.**

**(i) US person.** The term “United States person” means a US person within the meaning of IRC § 7701(a)(30).<sup>32</sup> For example, a domestic corporation is a US person, regardless of whether its shareholders are US persons.<sup>33</sup>

1. **Note.** The control test, as originally enacted in the Small Business Job Protection Act of 1996, required that one or more “US fiduciaries” have the authority to control all substantial decisions of the trust in order for the trust to be treated as a domestic trust.<sup>34</sup> Treasury regulations use the term “persons” as defined in IRC § 7701(a)(30), which includes US citizens and residents, and domestic corporations and partnerships.<sup>35</sup> As a technical correction to the Small Business Job Protection Act

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<sup>31</sup> IRC § 7701(a)(30)(E), (31)(B); Treas. Reg. § 301.7701-7(a)(1).

<sup>32</sup> IRC § 7701(a)(30) provides “that the term “United States person” means –

- (A) a citizen or resident of the United States
- (B) a domestic partnership,
- (C) a domestic corporation,
- (D) any estate (other than a foreign estate, within the meaning of paragraph (31), and
- (E) any trust if –
  - (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and
  - (ii) one or more United States persons have the authority to control all substantial decisions of the trust.

<sup>33</sup> Treas. Reg. § 301.7701-7(d)(1)(i).

<sup>34</sup> Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1907(a)(1).

<sup>35</sup> Treas. Reg. § 301.7701-7(d)(1)(i).

of 1996, the Taxpayer Relief Act of 1997 substituted the term “US persons” for “US fiduciaries.”<sup>36</sup>

(ii) **Substantial decisions.**

1. **Definition under Treasury Regulations.** Treasury regulations define “substantial decisions” as non-ministerial decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law.<sup>37</sup>
2. **Ministerial decisions.** Ministerial decisions, which do not constitute “substantial decisions,” include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions.<sup>38</sup>
3. **Non-exclusive list of substantial decisions.**<sup>39</sup> Treasury regulations provide the following non-exclusive list of substantial decisions:
  - a. Whether and when to distribute income or corpus;
  - b. The amount of any distributions;
  - c. The selection of a beneficiary;
  - d. Whether a receipt is allocable to income or principal;
  - e. Whether to terminate the trust;
  - f. Whether to compromise, arbitrate, or abandon claims of the trust;
  - g. Whether to sue on behalf of the trust or to defend suits against the trust;
  - h. Whether to remove, add, or replace a trustee;
  - i. Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and
  - j. Investment decisions

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<sup>36</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1601(i)(3)(A).

<sup>37</sup> Treas. Reg. § 301.7701-7(d)(1)(ii).

<sup>38</sup> Treas. Reg. § 301.7701-7(d)(1)(ii).

<sup>39</sup> Treas. Reg. § 301.7701-7(d)(1)(ii).

- i. **Note.** With respect to investment decisions, if a US person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the US person if the US person can terminate the investment advisor's power to make investment decisions at will.

(iii) **Control.**<sup>40</sup>

1. Treasury regulations define “control” as having 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 substantial decisions.
2. In order to determine if US persons have control, it is necessary to consider **ALL** persons who have authority to make substantial decisions of the trust, not only the trust fiduciaries.
3. **Note.** A trust can have a foreign fiduciary and still be a domestic trust, if the foreign fiduciary can be outvoted by domestic fiduciaries. For example, if the trust has one foreign trustee, two domestic trustees, and the trust instrument provides for a majority vote for trustee decisions, the trust satisfies the control test as a domestic trust.<sup>41</sup>

- (d) **Safe harbor for certain employee benefit trusts and investment trusts.** Certain employee benefit trusts will be deemed to satisfy the control test as long as US fiduciaries control all of the substantial decisions to be made by trust fiduciaries.<sup>42</sup>

- (e) **Example 5.**<sup>43</sup> The Sherlock Trust is a testamentary trust with three fiduciaries, Holmes, Watson, and Doyle. Holmes and Watson are US citizens, and Doyle is an NRA. No persons except the fiduciaries have authority to make any trust decisions (*e.g.*, no Protector, Trust Advisor, etc.). The trust instrument provides that no substantial decisions of the trust can be made unless there is unanimity among the fiduciaries. Here, the control test is not satisfied because US persons lack control over all of the substantial decisions of the trust because no substantial decisions can be made without Doyle’s agreement.

- (f) **Example 6.**<sup>44</sup> The same facts as Example 5, except that the Sherlock Trust instrument provides that all substantial decisions of the

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<sup>40</sup> Treas. Reg. § 301.7701-7(d)(1)(iii).

<sup>41</sup> Treas. Reg. § 301.7701-7(d)(1)(v), Example 2.

<sup>42</sup> Treas. Reg. § 301.7701-7(d)(1)(iv).

<sup>43</sup> Treas. Reg. § 301.7701-7(d)(1)(v), Example 1.

<sup>44</sup> Treas. Reg. § 301.7701-7(d)(1)(v), Example 2.

trust are decided by majority vote among the fiduciaries. Here, the trust satisfies the control test because a majority of the fiduciaries are US persons and, therefore, US persons control all the substantial decisions of the trust.

- (g) **Example 7.**<sup>45</sup> The same facts as Example 6, except that the Sherlock Trust instrument directs that Doyle makes all of the investment decisions, but that Holmes and Watson may veto Doyle's investment decisions. Holmes and Watson cannot act to make the investment decisions on their own. Here, the control test is not satisfied because the US persons, (*i.e.*, Holmes and Watson), do not have the power to make all of the substantial decisions of the trust.
- (h) **Example 8.**<sup>46</sup> The same facts as in Example 7, except Holmes and Watson may accept or veto Doyle's investment decisions and can make investments that Doyle has not recommended. Here, the control test is satisfied because the US persons control all substantial decisions of the trust.
- (i) **Reversing an unintended change in trust status due to inadvertent changes in persons with authority to make a substantial decision of the trust – 12-month grace period.**
- (i) **General rule.**<sup>47</sup> If an inadvertent change occurs with respect to any person possessing the power to make substantial trust decisions, which causes the trust's residency to change (*i.e.*, from domestic to foreign residency, or vice versa), treasury regulations give the trust a grace period for making the required changes to avoid such residency change. Specifically, treasury regulations allow the trust 12 months from the date of the change to make necessary changes either with respect to the persons who control the substantial decisions or with respect to the residence of such persons to avoid a change in the trust's residency.
- (ii) **Inadvertent changes.**<sup>48</sup> For purposes of the 12 month grace period, an inadvertent change includes the death, incapacity, resignation, change in residency or other change with respect to a person with a power to make substantial trust decisions, which would cause a change to the trust's residency, which was not intended to change the trust's residency.
- (iii) **Effect of changes made within grace period.**<sup>49</sup> If the necessary change is made within 12 months, the trust is treated as

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<sup>45</sup> Treas. Reg. § 301.7701-7(d)(1)(v), Example 3.

<sup>46</sup> Treas. Reg. § 301.7701-7(d)(1)(v), Example 4.

<sup>47</sup> Treas. Reg. § 301.7701-7(d)(2)(i).

<sup>48</sup> Treas. Reg. § 301.7701-7(d)(2)(i).

<sup>49</sup> Treas. Reg. § 301.7701-7(d)(2)(i).

retaining its pre-change residency during the 12-month period. If the necessary change is not made within 12 months, the trust's residency changes *as of the date of the inadvertent change*.

(iv) **Request for extension of time.**<sup>50</sup> If reasonable actions are taken to make necessary changes to prevent a change in trust residency, but due to circumstances beyond the trust's control the trust is unable to make such the modification within 12 months, the trust may request an extension of time to make the required change. The decision about whether to grant an extension is in the sole discretion of the IRS District Director. If granted, the extension may contain such terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the district director does not grant an extension, the trust's residency changes as of the date of the inadvertent change.

(j) **Automatic migration provisions.** Automatic migration provisions (*i.e.*, flight clauses) will cause a trust to fail the control test. Specifically, under treasury regulations US persons will not be considered to control all substantial trust decisions, and thus the trust will fail the control test, if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust causes one or more substantial decisions of the trust to no longer be controlled by US persons.<sup>51</sup>

#### **(4) Election Available for Trusts in Existence on August 20, 1996.**

(a) **Generally.** The Taxpayer Relief Act of 1997 permitted nongrantor trusts in existence on August 20, 1996, which were treated as domestic trusts on August 19, 1996 to elect to continue to be treated as US trusts notwithstanding the new criteria for qualification as a US trust.<sup>52</sup> For this purpose, a trust is considered to have been treated as a domestic trust on August 19, 1996 if:

- (i) The trustee filed on behalf of the trust a Form 1041 (US income tax return for estates and trusts), and not a Form 1040NR (US nonresident alien income tax return), for the period that includes August 19, 1996; and
- (ii) The trust had a reasonable basis (within the meaning of IRC § 6662) under IRC § 7701(a)(3), before amendment by the 1996 Act, for reporting as a domestic trust for that period.<sup>53</sup>

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<sup>50</sup> Treas. Reg. § 301.7701-7(d)(2)(ii).

<sup>51</sup> Treas. Reg. § 301.7701-7(d)(3).

<sup>52</sup> P.L. No. 105-34, 111 Stat. 788 (1997) § 1161.

<sup>53</sup> The final regulations supersede Notice 98-25, 1998-18 I.R.B. 11, which provided guidance as to the application of § 1161 of the Taxpayer Relief Act of 1997.

- (b) **Grantor Trusts.** Trusts that were treated as wholly owned grantor trusts on August 20, 1996 could not make this election. However, a trust could make this election if only a part of the trust was treated as owned by the grantor on August 20, 1996, in which case the election would be effective for the entire trust.<sup>54</sup>
  - (c) **Trusts with no Form 1040/Form 1040NR-filing requirement.**

Trusts that were not required to file either the Form 1041 or the Form 1040NR were treated as domestic trusts on August 19, 1996 if they satisfied the second criteria and if they had a reasonable basis for filing neither form.
  - (d) **Election procedure.** Treas. Reg. § 301.7701-7(f)(3) details the procedure that was required to make the election to remain a domestic trust. Once the election was made, it could only be revoked with IRS consent. 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 IRC § 7701(a)(30).
- c) **Creation of and transfer of property to a foreign trust by a US person.**
- i) **Tax consequences of creation and transfer.**
    - (1) **Creation of foreign trust.**
      - (a) **No tax imposed.** Generally, the US does not impose any tax upon the creation of a foreign trust by a US person.
      - (b) **Reporting obligation imposed.**
        - (i) IRC § 6048 requires that a US person report his/her creation of a foreign trust. This requirement applies regardless of whether or not the trust has US beneficiaries.<sup>55</sup>
        - (ii) A US person who creates a foreign trust or who transfer property to a foreign trust (other than a transfer for full value) must report the creation or transfer on Form 3520, Annual Return to Report Transfer With Foreign Trusts and Receipt of Certain Foreign Gifts.
        - (iii) Form 3520 is due at the same time that the US person's income tax return is due for the year in which the creation of the foreign trust occurs.<sup>56</sup>
    - (2) **Transfer of property to foreign trust.**
      - (a) **Immediate income recognition by US transferor upon transfer.**
        - (i) **Generally.**

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<sup>54</sup> Treas. Reg. § 301.7701-7(f).

<sup>55</sup> IRC § 6048(a)(3)(A)(i).

<sup>56</sup> IRC § 6677(a)

1. Any transfer of property by a US person<sup>57</sup> to a foreign trust is treated as a sale or exchange for an amount equal to the property's fair market value, and the transferor must recognize as gain the excess of that fair market value over the transferor's adjusted basis.<sup>58</sup>
  2. The amount of gain recognized is determined on an asset-by-asset basis.<sup>59</sup>
  3. **Note.** See exception for transfers to grantor trusts, discussed below.
- (ii) **No loss recognition.** The taxpayer may not recognize any loss on the transfer.<sup>60</sup>
- (iii) **Caution/Planning Pointer.**
1. A US person may not offset gain realized on the transfer of an appreciated asset to a foreign trust or foreign estate by a loss realized on the transfer of a depreciated asset to the foreign trust or foreign estate.<sup>61</sup>
  2. To avoid harsh implications of this rule, planners who desire to transfer a mixed portfolio of assets to a foreign trust, which includes both property with built in gains and built in losses, should sell the assets with built in losses rather than transferring them in kind to the foreign trust. This would allow the losses recognized on such sales to be offset against the gains recognized on the transfer in kind of the assets with built in gains to the trust.
  3. **Example 9.** Lestrade transfers Blackacre, with a fair market value of \$1,000,000, and Whiteacre, with a fair market value of \$2,000,000, to the Doyle Trust, a foreign trust. At the time of the transfer, Lestrade's adjusted basis in Blackacre is \$700,000, and his adjusted basis in Whiteacre is \$2,200,000. Here, Lestrade recognizes the \$300,000 of gain attributable to Blackacre, but he does not recognize the \$200,000 loss attributable to Whiteacre. Therefore, Lestrade may not offset that loss against the gain attributable to Blackacre.

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<sup>57</sup> For this purpose, the term "US person" means a United States person as defined in IRC § 7701(a)(30), and includes an NRA individual who elects under IRC § 6013(g) to be treated as a US resident. Treas. Reg. § 1.684-1(b)(1).

<sup>58</sup> Treas. Reg. § 1.684-1(a)(1).

<sup>59</sup> Treas. Reg. § 1.684-1(a)(1).

<sup>60</sup> Treas. Reg. § 1.684-1(a)(2).

<sup>61</sup> Treas. Reg. § 1.684-1(a)(2).

- 4. Example 10.** Same facts as Example 9, except that Lestrade sells Whiteacre for \$2,000,000, and transfers the \$2 million sales proceeds to the Doyle Trust. Here, Lestrade may offset the \$200,000 capital loss realized on the sale of Whiteacre against the \$300,000 gain recognized upon the transfer of Blackacre to the Doyle Trust. Assuming a 15 percent capital gains tax rate, this saves Lestrade \$30,000.

**(iv) Transfers triggering gain recognition.**

1. **Generally.** For purposes of the IRC § 648 gain recognition rules, treasury regulations take the position that direct, indirect, and constructive transfers will all trigger the IRC § 648 gain recognition.<sup>62</sup>
2. **Transfers by grantor trusts to foreign trusts.** If a trust (or part of a trust), for which a US person is treated as the owner under the grantor trust rules, transfers property to a foreign trust, that transfer is treated as a transfer from the US owner for purposes of the IRC § 648 gain recognition rules.<sup>63</sup> For example, if a domestic revocable trust of a US individual transfers property to a foreign trust, this transfer triggers IRC § 648 gain recognition.

**(b) Exceptions to immediate income recognition by US transferor upon transfer.**

**(i) Transfers to grantor trusts.**

1. IRC § 684 gain recognition does not apply to property transfers by US persons to foreign trusts to the extent that such trust is treated as a grantor trust.<sup>64</sup>
2. **Caution.** IRC § 684 gain recognition occurs when a grantor trust ceases to be a grantor trust whose income is taxable to a US grantor. If this occurs during the grantor's lifetime, a capital gains tax will arise.<sup>65</sup>

**(ii) Transfers to charitable trusts.** IRC § 684 gain recognition does not apply to property transfers by US charitable trusts.<sup>66</sup>

**(iii) Certain transfers at death.**

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<sup>62</sup> Treas. Reg. § 1.684-2.

<sup>63</sup> Treas. Reg. § 1.684-2(d).

<sup>64</sup> Treas. Reg. § 1.684-3(a).

<sup>65</sup> Treas. Reg. § 1.684-2(e).

<sup>66</sup> Treas. Reg. § 1.684-3(b).



1. **General Rule.** IRC § 684 gain recognition does not apply to testamentary property transfers of US transferors if the property is property's basis in the hands of the foreign trust is determined under IRC § 1014(a).<sup>67</sup>
  2. **Example 11.**<sup>68</sup> In 2001, Adam transfers property with a \$1 million fair market value and an adjusted basis of \$400,000 to Foreign Trust.. Adam dies on July 1, 2004. The fair market value at his death of all property transferred to Foreign Trust by Adam is \$1,500,000. The basis in the property is \$400,000. Adam retained the power to revoke Foreign Trust, thus, the value of all property owned by Foreign Trust at Adam's death is includible in his gross estate for US estate tax purposes. Here, Adam is not required to recognize gain under IRC § 684 because the basis of the property in the hands of the foreign trust is determined under IRC § 1014(a).
  3. **Example 12.**<sup>69</sup> Same facts as Example 11 except Adam retains no power over Foreign Trust, and Foreign Trust's basis in the property transferred is not determined under IRC § 1014(a). Here, Adam is treated as having transferred the property to Foreign Trust immediately before his death, and must recognize \$1,100,000 of gain at that time.
- (iv) **Transfers for fair market value to unrelated trusts.** IRC § 684 gain recognition does not apply to any property transfer at fair market value to a foreign trust that is not a related foreign trust as defined in Treas. Reg. § 1.679-1(c)(5).<sup>70</sup>
- (v) **Transfers to which section 1032 applies.** IRC § 684 gain recognition does not apply to any stock transfer by domestic corporations to a foreign trust if the domestic corporation is not required to recognize gain on the transfer under IRC § 1032. IRC § 1032 generally provides that a corporation does not recognize gain/loss on receiving money or property in exchange for its stock.
- (c) **Outbound migrations of domestic trusts.**
- (i) **General Rule.** If a US trust becomes a foreign trust, that trust is treated as having transferred, immediately before becoming a foreign trust, all of its assets to a foreign trust. IRC § 684 gain recognition is then triggered at that time.<sup>71</sup>

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<sup>67</sup> Treas. Reg. § 1.684-3(c).

<sup>68</sup> Treas. Reg. § 1.684-3(g), Example 2.

<sup>69</sup> Treas. Reg. § 1.684-3(g), Example 3.

<sup>70</sup> Treas. Reg. § 1.684-3(d).

<sup>71</sup> Treas. Reg. § 1.684-4.

**(ii) Inadvertent outbound migrations.** Treasury regulations provide relief provisions for inadvertent outbound migrations.<sup>72</sup>

**ii) Tax treatment during life of US creator/transferor.**

**(1) Grantor Trust Rules - Overview of grantor trust rules.**

- (a)** IRC §§ 671-679 set forth the grantor trust rules. The grantor trust rules provide that under certain circumstances, the IRC will ignore a trust for income tax purposes and will treat all or part of its income, deductions and credits as being included directly in the grantor's personal tax calculations.<sup>73</sup>
- (b)** The grantor trust rules generally treat a grantor that retains certain interests in or powers over the trust income or corpus as the owner of the trust's assets, and taxes the grantor directly on the trust's income to the extent of such ownership. If the grantor is a US citizen/resident grantor, the grantor trust rules tax him/her on worldwide trust income. If the grantor is an NRA, the grantor trust rules tax him/her only on trust income either derived from US sources or effectively connected with a US trade or business.
- (c)** As a general matter (*i.e.*, not limited to the foreign trust context), the grantor rules generally apply in the following situations:
  - (i)** Where the grantor retains a reversionary interest in either the trust's corpus or income, if at the inception of that part of the trust, the value of that interest exceeds 5 percent of the value of such portion.<sup>74</sup>
  - (ii)** Where the grantor retains the power to control the beneficial enjoyment of the trust without the consent of a nonadverse party.<sup>75</sup>
  - (iii)** Where the grantor, the grantor's spouse, or any other nonadverse person holds certain administrative powers.<sup>76</sup>
  - (iv)** Where the grantor, the grantor's spouse, or any other nonadverse party holds the power, exercisable without an adverse party's consent, to revoke the trust.<sup>77</sup>
  - (v)** Where the trust's income is or may be distributed (or held for future distribution) to the grantor or grantor's spouse, or may be

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<sup>72</sup> Treas. Reg. § 1.684-4(c).

<sup>73</sup> IRC § 671.

<sup>74</sup> IRC § 673.

<sup>75</sup> IRC § 674.

<sup>76</sup> IRC § 675.

<sup>77</sup> IRC § 676.

used to pay the premiums on life insurance policies on the grantor or the grantor's spouse, without an adverse party's consent.<sup>78</sup>

(vi) Where the trust is a foreign trust, which has, or could have, directly or indirectly, a beneficiary who is a US citizen or resident alien.<sup>79</sup>

(d) **Grantor trust rules applied to foreign trusts – prior law.** Before the 1996 Act, the grantor trust rules applied without regard to whether the grantor was a US or foreign person. Therefore, when a foreign person was treated as owner of a trust under the grantor trust rules, US beneficiaries were not subject to US tax on distributions from the trust. Rather, the distributions were treated as non-taxable gifts.<sup>80</sup> Further, if the trust income was not US source income or connected with a US trade or business, the income would not be subject to US income tax in the hands of the foreign grantor. The 1996 Act amended the grantor trust rules to significantly limit the circumstances in which a foreign person may be treated as the owner of trust property for US income tax purposes.

**(2) IRC § 679 – Grantor trust treatment for US creator/transferor to foreign trust with US beneficiaries.**

(a) **Generally.** If a US person<sup>81</sup> transfers property to a foreign trust, he is treated as the owner of the portion of the trust attributable to the property transferred if there is a US beneficiary of any portion of the trust.<sup>82</sup>

(b) **Interaction with other grantor trust rules (*i.e.*, IRC §§ 673-678).**

(i) IRC § 679 applies without regard to whether the US transferor retains any power or interest described in IRC §§ 673 through 677.<sup>83</sup>

(ii) If a US transferor would be treated as the owner of part of a foreign trust under IRC § 679 and another person would be treated as the owner of the same portion under IRC § 678 (*i.e.*, person other than grantor treated as substantial owner), then the US transferor is treated as the owner and the other person is not treated

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<sup>78</sup> IRC § 677.

<sup>79</sup> IRC § 679.

<sup>80</sup> Rev. Rul. 69-70, 1969-1 C.B.182.

<sup>81</sup> The term US person means a US person as defined in IRC § 7701(a)(30), an NRA individual who elects under IRC § 6013(g) to be treated as a US resident, and an individual who is a dual resident taxpayer within the meaning of Treas. Reg. § 301.7701(b)-7(a).

<sup>82</sup> Treas. Reg. § 1.679-1(a).

<sup>83</sup> Treas. Reg. § 1.679-1(b).

as the owner.<sup>84</sup> In other words, IRC § 679 will override the other grantor trusts rules where there is a conflict.

**(c) Trusts with US Beneficiaries.**

**(i) Existence of US beneficiary.**

1. **Test.** A foreign trust is treated as having a US beneficiary unless during the US transferor's tax year:
  - a. No part of the trust's income or corpus may, directly or indirectly, be paid or accumulated to/for the benefit of a US person; and
  - b. If the trust is terminated at any time during the tax year, no part of the income or corpus of the trust could, directly or indirectly, be paid to/for the benefit of a US person.<sup>85</sup>
2. **Annual determination.** The determination of whether a foreign trust has a US beneficiary is made annually.
3. **Benefit to a US person.**
  - a. **Generally.** For purposes of this test, income or corpus may be paid or accumulated to/for a US person's benefit during a US transferor's tax year if during that year, directly or indirectly:
    - i. Income may be distributed to, or accumulated for a US person's benefit, or
    - ii. Corpus may be distributed to, or held for the future benefit of, a US person.<sup>86</sup>
  - b. **Note.** This determination is made without regard to whether:
    - i. Income or corpus is actually distributed to a US person during that year, and
    - ii. A US person's interest in the trust income or corpus is contingent on a future event.<sup>87</sup>
  - c. **Certain unexpected beneficiaries.** Treasury regulations provide that for purposes of this determination, persons who are not named as beneficiaries and are not members of a class of beneficiaries as defined under the trust instrument are not considered if the US transferor demonstrates to IRS

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<sup>84</sup> Treas. Reg. § 1.679-1(b).

<sup>85</sup> Treas. Reg. § 1.679-2(a)(1).

<sup>86</sup> Treas. Reg. § 1.679-2(a)(2).

<sup>87</sup> Treas. Reg. § 1.679-2(a)(2).

satisfaction that the person's contingent interest in the trust is so remote as to be negligible. To illustrate, a class of beneficiaries generally does not include heirs who will benefit from the trust under intestacy if the named beneficiaries have all passed away. This exception, however, does not apply to persons to whom distributions could be made pursuant to a grant of discretion to the trustee or any other person.

**(ii) Changes in beneficiary's status.**

1. **Generally.** The possibility that a non-US beneficiary could become a US beneficiary does not cause that person to be treated as a US beneficiary for IRC § 679 purposes until that person actually becomes a US person.<sup>88</sup>
2. **Exception.** If a non-US beneficiary becomes a US beneficiary for the first time more than 5 years after a transfer to a foreign trust by a US transferor, that beneficiary is not treated as a US beneficiary for IRC § 679 purposes with respect to that transfer.<sup>89</sup>
3. **Example 12.** In 2001, Adam, a resident alien, transfers property to a foreign trust. The trust instrument provides that all income shall be distributed currently to Adam's daughter, Charlotte, an NRA, and that, upon the trust's termination, all corpus will be distributed to Charlotte. Here, the foreign trust is not treated as having a US beneficiary during the years that Charlotte remains an NRA. If Charlotte first becomes a resident alien in 2004, the trust is treated as having a US beneficiary beginning in 2004.
4. **Example 13.** Same facts as Example 12, except that Charlotte first becomes a resident alien in 2007. Here the foreign trust is not treated as having a US beneficiary with respect to the property transferred by Adam, even after Charlotte becomes a US beneficiary.
5. **Example 14.** Same facts as Example 13, except that Charlotte had previously been a US person during a prior period. Here, the 5-year exception does not apply, and the trust is treated as having a US beneficiary in 2007.

**(iii) Rules of Construction.** Treasury regulations provide that, even if, based on the trust instrument, a foreign trust is not treated as having a US beneficiary under the foregoing analysis, the IRS

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<sup>88</sup> Treas. Reg. § 1.679-2(a)(3).

<sup>89</sup> Treas. Reg. § 1.679-2(a)(3).

may nevertheless reclassify the trust as having a US beneficiary based on the following:

1. All written and oral agreements and understandings relating to the trust.
2. Memoranda or letters of wishes.
3. All records that relate to the actual distribution of income and corpus.
4. All other documents that relate to the trust, whether or not of any purported legal effect.
5. The following factors:
  - a. If the trust instrument allows the trust to be amended to benefit a US person, all potential benefits that could be provided to a US person pursuant to such an amendment must be considered;
  - b. If the trust instrument does not allow the trust to be amended to benefit a US person, but the law applicable to the trust may require payments or accumulations of income or corpus to/for the benefit of a US person (by judicial reformation or otherwise), all potential benefits that could be provided to a US person pursuant to the law must be taken into account, unless the US transferor demonstrates to IRS satisfaction that the law is not reasonably expected to be applied or invoked under the facts and circumstances; and
  - c. If the parties to the trust ignore the trust instrument's terms, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a US person must be considered.

**(iv) Attribution Rules.**

1. For IRC § 679 purposes, an amount is treated as paid or accumulated to or for the benefit of a US person if the amount is paid to or accumulated for the benefit of:
  - a. A controlled foreign corporation.
  - b. A foreign partnership, if a US person is a partner of such partnership.
  - c. A foreign trust or estate, if such trust or estate has a US beneficiary.<sup>90</sup>

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<sup>90</sup> Treas. Reg. § 1.679-2(b)(1).

2. An amount is also treated as paid or accumulated to or for the benefit of a US person if the amount is paid to or accumulated for the benefit of a US person through an intermediary, such as an agent or nominee, or by any other means where a US person may obtain an actual or constructive benefit.<sup>91</sup>

**(v) Treatment of US transferor upon foreign trust's acquisition or loss of US beneficiary.**

**1. Trusts acquiring a US beneficiary.**

- a. **General Rule.** If a foreign trust to which a US person has transferred property is treated as not having a US beneficiary for a tax year of the transferor, but then it is treated as having a US beneficiary in any subsequent year, the US transferor is treated as having additional income in his/her first such tax year in which the trust is treated as having a US beneficiary.<sup>92</sup>

**b. Amount of additional income.**

- i. The amount of additional income equals the trust's undistributed net income<sup>93</sup> at the end of the US transferor's immediately preceding tax year.<sup>94</sup>
- ii. Such additional income is subject to IRC § 668, which provides for an interest charge on accumulation distributions from foreign trusts.<sup>95</sup>

**2. Trusts ceasing to have a US beneficiary.**

- a. **General Rule.** If a foreign trust that received property from a US transferor ceases to be treated as having a US beneficiary, the US transferor ceases to be treated as the owner of that part of the trust attributable to the transfer beginning in the first tax year that follows the US transferor's last tax year during which the trust is treated as having a US beneficiary (unless the US transferor is treated as an owner thereof pursuant to the IRC §§ 673-677 grantor trust rules).

**b. Impact of change.**

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<sup>91</sup> Treas. Reg. § 1.679-2(b)(2).

<sup>92</sup> Treas. Reg. § 1.679-2(c)(1).

<sup>93</sup> See IRC § 665(a).

<sup>94</sup> Treas. Reg. § 1.679-2(c)(1).

<sup>95</sup> Treas. Reg. § 1.679-2(c)(1).

- i. The US transferor is treated as making a property transfer to the foreign trust on the first day of the first tax year that follows the US transferor's last tax year during which the trust was treated as having a US beneficiary.
  - ii. The amount of the deemed property transfer to the trust is the portion of the trust attributable to the prior transfer for which the US transferor was treated as having a US beneficiary.
  - iii. In addition, the grantor must recognize gain on the deemed transfer of appreciated property to the foreign trust under IRC § 684, which is discussed above.
3. **Example 15.** In 2001, Adam, a resident alien, transfers stock with a fair market value of \$100,000 to a foreign trust. The stock has an adjusted basis of \$50,000 at this time. The trust instrument provides that income may be paid currently to, or accumulated for the benefit of Adam's son, Bob, and that, on the trust's termination, all income and corpus must be distributed to Bob. At the time of this transfer, Bob is an NRA and Adam is not treated as the owner of any portion of the foreign trust under IRC § 673-677. The trust accumulates \$30,000 of income during the 2001 through 2003. In 2004, Bob moves to the US and becomes a resident alien. Here, Adam is treated as receiving an accumulation distribution in the amount of \$30,000 in 2004 and immediately transferring that amount back to the trust. This accumulation distribution is subject to the IRC § 668 rules providing for interest charges on accumulation distribution. In addition, beginning in 2005, Adam is treated as the owner of the portion of the foreign trust attributable to the stock Adam transferred to the foreign trust in 2001, including the portion attributable to the accumulated income deemed to be retransferred in 2004.
4. **Example 16.** Assume the same facts as in Example 15. In 2008, Bob becomes an NRA. When Bob becomes an NRA, the stock transferred by Adam to the foreign trust in 2001 has a fair market value of \$125,000 and an adjusted basis of \$50,000. Here, beginning in 2009, the foreign trust is not treated as having a US beneficiary, and Adam is not treated as the owner of the portion of the trust attributable to the prior transfer of stock.

**(d) Transfers.**



- (i) **Generally.** For IRC § 679 purposes, a transfer means a direct, indirect, or constructive transfer.<sup>96</sup>
- (ii) **Transfers by grantor trusts.** If a US person is treated as owning part of a grantor trust (e.g., a revocable trust),<sup>97</sup> then transfers of property from that part of the grantor trust to a foreign trust are treated as transfers from the US grantor to the foreign trust.<sup>98</sup>
- (iii) **Indirect transfers.** Treasury regulations broadly define indirect transfers to include transfers made by a US person through an intermediary if the US 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 US person cannot demonstrate that:
1. The intermediary had a relationship with a beneficiary that establishes a reasonable basis for the intermediary making a gratuitous transfer to the trust;
  2. The intermediary acted independently of the US person;
  3. The intermediary is not an agent of the US person; and
  4. The intermediary timely complied with the foreign trust information reporting requirements of IRC § 6048.<sup>99</sup>
- (iv) **Constructive transfers.** IRC § 679 also applies if a US person makes a constructive transfer to a foreign trust.<sup>100</sup> To illustrate, for this purpose, a constructive transfer includes an assumption or satisfaction of a foreign trust's obligation to a third party. A US 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.<sup>101</sup> For this purpose, 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.<sup>102</sup>

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<sup>96</sup> Treas. Reg. § 1.679-3(a).

<sup>97</sup> Treas. Reg. § 1.679-3(b)(2).

<sup>98</sup> Treas. Reg. § 1.679-3(b)(1).

<sup>99</sup> Treas. Reg. § 1.679-3(c).

<sup>100</sup> Treas. Reg. § 1.679-3(d).

<sup>101</sup> Treas. Reg. § 1.679-3(e).

<sup>102</sup> Treas. Reg. § 1.679-3(e).

(v) **Transfers to entities owned by a foreign trust.** Transfers by US 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 US person is not related to a trust beneficiary or the US person demonstrates that the transfer is attributable to the US person's ownership interest in the entity.<sup>103</sup> For example, if a foreign trust and a US person jointly fund a corporation, each taking back stock proportionate to their transfers, IRC § 679 does not apply.

(e) **Exceptions to IRC § 679 grantor trust treatment.**

(i) **Generally.** IRC § 679 does not apply to the following:

1. Transfer of property to a foreign trust because of the transferor's death.<sup>104</sup>
2. Transfers to certain compensatory foreign trusts.<sup>105</sup>
3. Transfers to certain charitable foreign trusts.<sup>106</sup>
4. Transfers of property to a foreign trust to the extent the transfer is for fair market value.<sup>107</sup>

(ii) **Transfers for fair market value.**

1. **Generally.**

- a. A transfer is not a gratuitous transfer if it was made for full fair market value.<sup>108</sup>
- b. For purposes of determining whether full fair market value has been received, if the transferor is the grantor or a trust beneficiary (or a person related within the meaning of IRC § 643(i)(2)(B) to any grantor or trust beneficiary), any obligation issued by the trust (or by certain related persons) is disregarded, except as provided in regulations.<sup>109</sup>

2. **Qualified obligations.**

- a. Treasury regulations provide that certain "qualified obligations" will be recognized as consideration.<sup>110</sup>

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<sup>103</sup> Treas. Reg. § 1.679-3(f).

<sup>104</sup> IRC § 679(a)(2)(A); Treas. Reg. § 1.679-4(a)(1).

<sup>105</sup> Treas. Reg. § 1.679-4(a)(2).

<sup>106</sup> Treas. Reg. § 1.679-4(a)(3).

<sup>107</sup> IRC § 679(a)(2)(B); Treas. Reg. § 1.679-4(a)(4).

<sup>108</sup> Treas. Reg. § 1.679-4(b).

<sup>109</sup> IRC § 679(a)(3)(A)(i).

<sup>110</sup> Treas. Reg. § 1.679-4(d).

- b. 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 US 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 IRC § 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin);
  - v. The US transferor 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 US 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 Treas. Reg. § 301.6501(c)-1(d); and
  - vi. The US transferor reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.<sup>111</sup>

**iii) Tax treatment at death of US owner of foreign trust.**

**(1) General Rule – no gain recognition at death of US transferor.**

- (a) **Prior concern re IRC § 684 gain recognition.** At one time there was concern among commentators that IRC § 684 (which requires that any transfer of property by a US person to a foreign trust be treated as a sale or exchange for an amount equal to the property's fair market value, thus requiring recognition of unrealized gains) triggered gain

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<sup>111</sup> Treas. Reg. § 1.679-4(d).

recognition upon the death of a US transferor to a foreign trust.<sup>112</sup>  
The issuance of final treasury regulations under IRC § 684 disposed of this concern for the most, with the exception noted below.

**(b) General Rule – no IRC § 684 gain recognition at US transferor's death.**

IRC § 684 gain recognition does not apply to testamentary property transfers of US transferors if the property's basis in the hands of the foreign trust is determined under IRC § 1014(a).<sup>113</sup>

- (i) Therefore, transfers by will of US decedents to a foreign nongrantor trust will generally not trigger gain recognition under IRC § 684 because the foreign nongrantor trust will take a stepped up basis under IRC § 1014.

**(2) Exception to General Rule.**

- (a) Some commentators argue that there may be IRC § 684 gain recognition upon deaths of US transferors to foreign trusts, which occur in 2010. The argument in favor of this result is as follows:<sup>114</sup>
  - (i) Until the US person's death, such person is treated as the owner of the property for US income tax purposes under IRC § 671.
  - (ii) The US grantor's death terminates the trust's grantor trust status.
  - (iii) 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.<sup>115</sup> If this rule applies to IRC § 684, and if it applies to terminations caused by death, the deceased US person will be treated as making a transfer to a foreign trust at death.
  - (iv) Treasury regulations under IRC § 684 confirm this tax treatment for US owners, except that they provide that transfers to the foreign trust are treated as occurring immediately before the US owner's death.<sup>116</sup>
  - (v) Treas. Reg. § 1.684-3(c) provides an exception to this gain recognition rule where the basis of the assets of the property in the hands of the foreign trust is determined under IRC § 1014(a).
  - (vi) The Economic Growth and Tax Relief Reconciliation Act repeals or suspends IRC § 1014 in 2010 when the federal estate tax is not in effect.

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<sup>112</sup> See Henry Christensen, III, *International Estate Planning* § 4.04[1] (2002);

<sup>113</sup> Treas. Reg. § 1.684-3(c).

<sup>114</sup> See Ellen K. Harrison, et al., *US Tax'n of Foreign Trusts, Trusts With Non-US Grantors and Their US Beneficiaries*, in *Sophisticated Estate Planning Techniques* (ALI-ABA Course No. SJ016 Sept. 2003).

<sup>115</sup> See also *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev Rul. 77-402, 1977-2 C.B. 222.

<sup>116</sup> Treas. Reg. § 1.684-2(e), Example 2.

(vii) Therefore, if the grantor of a foreign trust dies in 2010, this exception will not apply.

(b) **Planning Pointer.** Planners can avoid the risk that gain will be recognized upon the US transferor's death by giving a US person, the right to withdraw the foreign trust's property immediately before the death of the US person. The withdrawal power would give the deceased US person the protection of IRC § 684(b). IRC § 684(b) excepts transfers to trusts to the extent such trusts are owned by any person (other than a foreign nongrantor trust) under IRC § 871.<sup>117</sup>

iv) **Tax treatment after death of US person.** After the death of the US person who has made transfers to a foreign trust, the trust will no longer be subject to IRC § 679. Thereafter, the foreign trust will be treated as a foreign nongrantor trust.

v) **Treatment of trusts that become foreign trusts – outbound migrations.**

(1) **Impact under IRC § 679 grantor trust rules.**

(a) A US person, who transfers property to a domestic trust that thereafter becomes a foreign trust while the US transferor is still alive, is treated as US transferor to a foreign trust and is deemed to transfer the property to the foreign trust on the date the domestic trust becomes a foreign trust.<sup>118</sup>

(b) The property deemed transferred to the trust when it becomes a foreign trust includes both the original transfer and the undistributed net income, as defined by IRC § 665(a), attributable to the property previously transferred. Undistributed net income for periods before the migration is taken into account only for purposes of determining the portion of the trust that is attributable to the property transferred by the US person.

(c) **Example 17.** On January 1, 2002, Alex, a resident alien, transfers property to a domestic trust, for the benefit of Ben, Alex's son, who is also a resident alien. On January 1, 2003, the domestic trust acquires a foreign trustee who has the power to determine whether and when distributions will be made to Ben. Here, the trust becomes a foreign trust on January 1, 2003. In addition, Alex is treated as transferring property to a foreign trust on January 1, 2003. The property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in IRC § 665(a), attributable to the property deemed transferred.<sup>119</sup>

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<sup>117</sup> See Ellen K. Harrison, et al., *US Tax'n of Foreign Trusts, Trusts With Non-US Grantors and Their US Beneficiaries*, in *Sophisticated Estate Planning Techniques* (ALI-ABA Course No. SJ016 Sept. 2003).

<sup>118</sup> Treas. Reg. § 1.679-6(a).

<sup>119</sup> Treas. Reg. § 1.679-6(c).

**(2) Impact under IRC § 684 gain recognition rules.**

**(a) Outbound migrations of domestic trusts.**

**(i) General Rule.** If a US trust becomes a foreign trust, that trust is treated as having transferred, immediately before becoming a foreign trust, all of its assets to a foreign trust, and subject to IRC § 684 gain recognition at that time.<sup>120</sup>

**(ii) Inadvertent outbound migrations.** Treasury regulations provide relief provisions for inadvertent outbound migrations.<sup>121</sup>

**d) Creation of foreign trust by non-US person.**

**i) Generally.**

(1) Neither IRC § 684(a) nor IRC § 679 applies to transfers to a foreign trust by a non-US person. Consequently, no US income tax is imposed on such transfers.

(2) The trust's income will be treated for US income tax purposes as if earned by a foreign nongrantor trust (unless IRC §§ 672(f) applies to the trust).

(3) Prior to the 1996 Act, trusts created by non-US persons were subject to the “grantor trust” rules to the same extent as trusts created by US persons. As a result, this application of the grantor trust rules shifted the trust's income, for virtually all US income tax purposes, from the trust to its non-US grantor. As discussed below, IRC § 672(f) denies grantor trust status to trusts with non-US grantors unless:

(a) 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

(b) The only amounts permitted to be distributed from the trust during the grantor's life are amounts distributable to the grantor or her spouse.<sup>122</sup>

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<sup>120</sup> Treas. Reg. § 1.684-4.

<sup>121</sup> Treas. Reg. § 1.684-4(c).

<sup>122</sup> IRC § 672(f).

### **3) Tax treatment of foreign nongrantor trust (“FNGT”).**

#### **a) Generally.**

##### **i) Overview.**

(1) The income tax rules governing FNGTs are a combination of the income tax rules governing domestic trusts and NRAs. Trust income may be entirely taxable to the FNGT, the FNGT’s beneficiaries, or partly to each. Under IRC §§ 651 and 661, trusts may deduct amounts properly paid or credited to beneficiaries. Therefore, trusts are treated as conduits to the extent of distributed income, and as separate taxable entities to the extent of undistributed income.

(a) **Note.** Foreign grantor trusts, as noted elsewhere in this outline, are treated as owned entirely by the trust’s grantor and deemed not to exist for income tax purposes. Therefore, the rules discussed in this section (*i.e.*, the rules governing the taxation of FNGTs) do not apply to foreign grantor trusts.

(2) In very general terms, the steps required to analyze the taxation of FNGTs may be thought of as follows:

(a) FNGT pays tax (at FNGT level) on the FNGT’s gross income from within the US **less** DNI distribution deduction, in a manner similar to that in which NRA individuals are taxed (without the DNI distribution deduction). In addition, there is typically withholding on FDAP income (*i.e.*, fixed or determinable annual or periodic gains, profits, and income from US sources) that is paid to the FNGT.

(b) US beneficiaries are taxed on income distributed to them, to the extent of DNI, which reflect the FNGT’s worldwide income.

(c) NRA beneficiaries are taxed on income distributed to them, to the extent of DNI, which reflects the FNGT’s US source income.

##### **ii) Income taxed to trust, beneficiaries, or partly to each – DNI.**

##### **(1) Generally.**

(a) Income of FNGTs are taxed to the trust, the beneficiaries, or partly to each.

(b) The concept of DNI, along with its limitation on the trust’s distribution deduction, is the mechanism through which the IRC allocates income between the FNGT and its beneficiaries.

(c) The concept of DNI is discussed in below.

##### **(2) Simple versus complex trusts.**

(a) **Importance of distinction.** By means of different DNI calculations, the IRC and treasury regulations thereunder divide

nongrantor trusts (both foreign and domestic) into two basic types, simple and complex, which the IRC taxes differently.

**(b) Simple trust.**

**(i) Definition.** A FNGT constitutes a “simple” trust if it satisfies all of the following requirements:

1. All income must be distributed currently.
2. No amounts may be paid, permanently set aside for, or used for a charitable beneficiary.
3. No distributions are made other than of current income (*i.e.*, no distributions of accumulated income or corpus).<sup>123</sup>

**(ii) Tax treatment.** All of a simple FNGT’s income is taxed to the beneficiaries. In turn the FNGT receives a deduction for its current income, which it must pay to the beneficiaries, regardless of whether it actually distributes such income.<sup>124</sup> The amounts that the beneficiaries must include in their gross income, along with the trust’s deduction, are limited by the trust’s DNI.<sup>125</sup>

**(c) Complex trust.**

**(i) Definition.** A FNGT constitutes a “complex” trust if **any** of the following are true:

1. It is not required to distribute all income currently;
2. It distributes accumulated income or principal; or
3. It has a charitable beneficiary.<sup>126</sup>

**(ii) Tax treatment.**

**1. Trust.** A complex FNGT receives a deduction for that portion of its current income that it must distribute, plus that portion of its current income that the trustee actually distributes to the beneficiaries pursuant to the trust instrument.<sup>127</sup> The trust’s deduction is limited to the amount of its DNI.<sup>128</sup>

**2. Beneficiaries.**

- a.** Beneficiaries of a complex FNGT must include in their gross income all income that the trust is required to

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<sup>123</sup> IRC § 651(a); Treas. Reg. § 1.651(a)-1.

<sup>124</sup> IRC §§ 651(a), 652.

<sup>125</sup> IRC §§ 651(b), 652(a).

<sup>126</sup> IRC § 661(a); Treas. Reg. § 1.661(a)-1.

<sup>127</sup> IRC § 661(a); Treas. Reg. § 1.661(a)-1.

<sup>128</sup> IRC § 661(a).



distribute and all income actually distributed to the beneficiaries pursuant to the trust instrument.<sup>129</sup>

- b. Each beneficiary must include in his gross income an amount equal to his pro rata share of the trust's DNI.<sup>130</sup>
- c. Distributions that exceed the FNGT's DNI are treated either as nontaxable distributions of principal or as distributions of accumulated income from prior years, which are taxable under the throwback rule (discussed below).<sup>131</sup>

**b) Tax at the FNGT level.**

- i) **Generally.** Unlike the gross income of domestic trusts, which includes the domestic trust's worldwide gross income, the gross income of an FNGT, for purposes of taxation imposed on the trust (as opposed to tax imposed on the trust beneficiaries), consists only of:

- (1) **Non-trade/business US source gross income.** Gross income derived from sources within the US that is not effectively connected with the conduct of a trade or business within the US; and

- (2) **Trade/business within US.** Gross income that is effectively connected with the conduct of a trade or business within the US.<sup>132</sup>

- (a) **Note.** FNGTs generally are not subject to US income taxation on undistributed foreign source income because of a lack of a nexus between the US and the FNGT for income tax purposes. However, foreign source income of an FNGT that is distributed to US beneficiaries may be taxed to such beneficiaries.<sup>133</sup>

- ii) **Imposition of US income tax - generally.**

- (1) Income earned by a foreign nongrantor trust ("FNGT"), which as mentioned above is taxed as an NRA, will generally fall into one of two taxing regimes. For FNGTs "engaged in a trade or business" in the US, the US taxes the net income that is "effectively connected" with the conduct of such trade or business in the same manner as net income earned by a US resident.<sup>134</sup> In contrast, fixed or determinable annual or periodical gains, profits, and income from US sources (commonly referred to as "FDAP" income), which an FNGT earns is typically taxed on a gross

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<sup>129</sup> IRC § 662(a).

<sup>130</sup> IRC § 662(a)(2).

<sup>131</sup> IRC §§ 662(a)(2), 665-668.

<sup>132</sup> IRC §§ 641(b), 872(a).

<sup>133</sup> Howard Zaritsky, *US Tax'n of Foreign Estates, Trusts and Beneficiaries*, 854-2<sup>nd</sup> Tax Mgmt. Portfolio V.C.2. (2002),

<sup>134</sup> IRC § 871(b).

basis at a flat 30 percent rate.<sup>135</sup> In other words, the IRC taxes trade or business income on a **net** basis at **graduated** rates. In contrast, the IRC taxes non-business income on a **gross** basis, without the benefit of deductions, at a **flat rate of thirty percent**.

- (2) From an analytical standpoint, planners must first determine whether an FNGT in question is engaged in a US trade or business at anytime within the tax year. If yes, then the planner must determine whether the FNGT has any income that is “effectively connected” with such US trade or business. After conducting the foregoing analysis, the planner must determine if the FNGT has any US source income that is not effectively connected with a US trade or business, but which the US subjects to taxation, typically at the 30 percent flat rate.

**iii) Is FNGT engaged in a trade or business within the US?**

**(1) Generally.**

- (a) A FNGT engaged in a business within the US is treated as an NRA engaged in a US trade or business. In other words, the trust’s worldwide effectively connected income is subject to US income tax.<sup>136</sup>
- (b) **Caution.** It may be dangerous for a foreign trust to engage in business in the US because:
- (i) This may impact its characterization as a trust; and
  - (ii) This may impact its status as a foreign as opposed to a domestic trust.<sup>137</sup>
- (c) **Note.** As a practical matter, most well advised FNGT’s that engage in US business activities, will do so through a corporation, rather than directly. They will do this both in order to limit the FNGT’s liability exposure and to avoid any inference that the trust or its beneficiaries are engaging directly in a US business activity. Typically, the FNGT will own a US corporation, which in turn may be owned by a foreign corporation that is directly owned by the trust.

**(2) Facts and Circumstances Test.**

- (a) The IRC applies a facts and circumstances test to determine if an FNGT is engaged in a trade or business within the US. The only guidance to planners with respect to this determination is case law, of which there is a substantial amount, and which far exceeds the scope

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<sup>135</sup> IRC § 871(a).

<sup>136</sup> IRC § 871(b).

<sup>137</sup> Christenson, *International Estate Planning*, § 4.06 (2002).

of this outline.<sup>138</sup> However, the following discussion provides a brief summary of the issues presented.

- (b) Generally, the facts and circumstances test examines the nature and extent of an FNGT's economic activities and contacts within the US.<sup>139</sup> A US trade or business does not include isolated and nonrecurring transactions by an FNGT in the US absent a profit motive.<sup>140</sup> The FNGT taxpayer must, during some substantial part of the tax year, have been regularly and continuously transacting a substantial portion of its ordinary business in the US.<sup>141</sup>
  - (c) Owning real property in the US does not constitute a US trade or business unless other activities are present in addition to ownership.<sup>142</sup> To illustrate, if an FNGT taxpayer leases and manages property through rental agents, he will engage in a US trade or business.<sup>143</sup> Having said this, special FIRPTA rules apply in the real estate context, which are discussed in more detail below.
- (3) **Personal Services.** A US trade of business includes performing personal services at any time during the tax year.<sup>144</sup>
- (4) **Investors.**
- (a) Generally, the IRC treats a foreign individual, corporation or trust that trades in stocks, securities or commodities in the US as not conducting a US trade or business if that person does not have an office in the US through which, or under the direction of which, the securities transactions are effected.<sup>145</sup> Under the IRC § 864(b)(2)(A)(ii) safe harbor, a foreign individual, corporation or trust is not treated as

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<sup>138</sup> For a detailed discussion of court decisions and rulings regarding whether an NRA is engaged in a trade or business within the US, see 156 TM, *Foreign Corporations – US Income Taxation*. See also Garelik, *What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or a Foreign Corporation*, 18 Tax L. Rev. 423 (1963).

<sup>139</sup> *US v. Balanovski*, 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 US 968 (1957), *reh'g denied*, 352 US 1019 (1957); *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6<sup>th</sup> Cir. 1960).

<sup>140</sup> *Continental Trading, Inc. v. Commissioner*, T.C. Memo. 1957-164, *aff'd*, 265 F.2d 40 (9<sup>th</sup> Cir. 1959), *cert. denied*, 361 US 827 (1959).

<sup>141</sup> *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6<sup>th</sup> Cir. 1960); *Consolidated Premium Iron Ores, Ltd. v. Commissioner*, 28 T.C. 127 (1957); *Continental Trading, Inc. v. Commissioner*, T.C. Memo. 1957-164, *aff'd*, 265 F.2d 40 (9<sup>th</sup> Cir. 1959), *cert. denied*, 361 US 827 (1959); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9<sup>th</sup> Cir. 1955).

<sup>142</sup> *De Amodio v. Commissioner*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3<sup>rd</sup> Cir. 1962).

<sup>143</sup> *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9<sup>th</sup> Cir. 1955); *De Amodio v. Commissioner*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3<sup>rd</sup> Cir. 1962); *Reiner v. US*, 222 F.2d 770 (7<sup>th</sup> Cir. 1955).

<sup>144</sup> IRC § 864(b); Treas. Reg. § 1.864-2(a).

<sup>145</sup> IRC § 864(b)(2)(A)(i).

conducting a US trade or business provided the transactions are for the taxpayer's own account, even if:

- (i) The trading is conducted by the foreign taxpayer or its agent or employee.
- (ii) Such agent or employee has discretionary authority to make decisions in effecting the transactions.

(b) **Planning Pointer.** An FNGT can generally substantiate trading for its own account by trading through an independent stockbroker, commission agent or custodian. This holds true regardless of whether the agent had discretionary authority.<sup>146</sup>

(5) **Partnerships.**<sup>147</sup>

(a) If an FNGT is a partner in a partnership engaged in a trade or business within the US, the IRC treats an FNGT partner of that partnership as engaged in a trade or business within the US.<sup>148</sup> Generally, the fact that the partnership is organized under US or foreign law will be irrelevant for this analysis.

(b) If the partnership is engaged in a trade or business within the US, the partner will be taxed on this distributive share of the partnership's effectively connected income, after reduction for the partnership's allocable deductions and the FNGT's allowable deductions under IRC § 873. The test to determine if a partnership is engaged in a US trade or business is the same as for an NRA individual.<sup>149</sup>

(c) **Caution.** In partnership cases, IRC § 1446 requires that the partnership withhold and deposit tax on each foreign partner's distributive share of partnership income, whether that income is actually distributed to foreign partners or not. The FNGT then credits the withholding tax at the end of the year against its actual tax for the year. Special withholding tax rules apply if a partnership makes a distribution to an FNGT of items of fixed or determinable annual or periodical gains, profits, and income.

(6) **Deemed Status of Engaging in US Trade or Business.** Under some circumstances, the IRC will deem an FNGT as engaging a US trade or business. These situations are discussed below.

(a) **FIRPTA Rules For Gain On Sales Of US Real Property.** Gains and losses realized by FNGTs from the disposition of US real property

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<sup>146</sup> Treas. Reg. § 1.864-2(c)(2)(i)(C).

<sup>147</sup> For a detailed discussion of foreign partners and partnerships, see 910 T.M., *Foreign Partnerships and Partners*.

<sup>148</sup> IRC § 875(a); Treas. Reg. § 1.875-1.

<sup>149</sup> Treas. Reg. § 1.875-1.

interests are treated as effectively connected with a US trade or business.<sup>150</sup> Transferees are required to withhold tax on such transfers.<sup>151</sup> These provisions are generally known as FIRPTA, which is the acronym for the Foreign Investment in Real Property Tax Act.<sup>152</sup>

- (b) **Payments Deferred Into A Year That FNGT Is Not Engaged In A US Trade Or Business.** If payments that the IRC would treat as effectively connected with a US trade or business in one year are deferred to another year in which the FNGT is not engaged in a US trade or business, the IRC taxes such payments as if they are effectively connected with a US trade or business in the year received.<sup>153</sup>

- (c) **Sale Of Assets From A US Trade Or Business In Subsequent Year.**  
If a foreign person has property that it uses in a US trade or business, which that person sells within ten years after it ceases to be used in the business, the US may tax any gain on such sale as being effectively connected with a US trade or business.<sup>154</sup>

- (d) **Real Property Net Election Under IRC § 871(d).** IRC § 871(d) allows an FNGT to elect to treat rental income from his/her US real property rental activities as effectively connected with a US trade or business. This allows the FNGT to avoid the uncertainty of the facts and circumstances test as to whether its activity constitutes engaging in a US trade or business. This would allow the FNGT to be able to deduct expenses associated with its US real property rental activity, rather than to pay a flat 30 percent tax on a gross basis.

iv) **Taxation of FNGT Not Engaged in US Trade or Business – FDAP Income.**

(1) **Generally.**

- (a) IRC §§ 871 and 881 tax NRAs, and therefore, FNGTs, at a flat 30 percent tax on several types of nonbusiness income. The tax is imposed at a flat 30 percent rate without any deductions or other allowances for costs incurred in producing the income and is typically collected through withholding.<sup>155</sup> This tax applies to interest, dividends, rents, royalties and other “fixed or determinable annual or periodical” income (“FDAP” income) if such income is: (1) includible

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<sup>150</sup> IRC § 897.

<sup>151</sup> IRC § 1445.

<sup>152</sup> Pub. L.No. 96-499, 96<sup>th</sup> Cong. 2d Sess. (Dec. 5, 1980).

<sup>153</sup> IRC § 864(c)(6).

<sup>154</sup> IRC § 864(c)(7).

<sup>155</sup> For a complete discussion of the withholding rules, see Charles M. Bruce, New US Withholding Tax Rules: A Practical Guide (2002).

in income; (2) from US sources; and (3) not effectively connected in the conduct of a US trade or business.

- (b) FDAP income from sources outside the US is generally not taxable when received by an FNGT. FDAP income from sources within the US that is effectively connected with the conduct of a US trade or business is taxed in the manner described above.
- (c) Generally, FDAP income includes interest (other than OID interest), dividends, rent, salaries, wages, premiums (other than insurance premiums),<sup>156</sup> annuities, compensation, remunerations, and royalties,<sup>157</sup> and may include certain commission<sup>158</sup> and alimony payments.<sup>159</sup>

**(2) Interest.**

**(a) Original Issue Discount (“OID”).**

- (i) OID is the difference between the issue price and the stated redemption price at maturity (as defined in IRC § 1273) of a bond or other evidence of indebtedness (“OID Obligation”). Generally, the IRC treats OID as if interest payments were actually paid by the borrower to the lender, and then are loaned back to the borrower. In the FNGT context, however, OID accrued by an FNGT lender is not subject to the 30 percent tax on investment income until the debt instrument is sold, exchanged or retired.<sup>160</sup> For this purpose, only OID accruing during the time the FNGT holds the OID Obligation is subject to tax.<sup>161</sup> In addition, the tax cannot exceed the amount of the payment less any part of the payment that represents expressly stated interest.<sup>162</sup>
- (ii) OID taxed on a payment is not taxed subsequently on the sale or exchange of the OID obligation.<sup>163</sup> Upon disposition of an OID obligation, all untaxed OID accruing during the time the obligation was held by the FNGT is taxed, even if the accrued amount exceeds the gain on disposition.

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<sup>156</sup> Rev. Rul. 80-222, 1980-2 C.B. 211.

<sup>157</sup> IRC § 871(a)(1)(A); Treas. Reg. § 1.871-7(b).

<sup>158</sup> Treas. Reg. § 1.1441-2(a)(2).

<sup>159</sup> *Trust of Welsh v. Commissioner*, 16 T.C. 1398 (1951), *aff’d*, 194 F.2d 708 (3d Cir. 1952), *cert. denied*, 344 US 821 (1952).

<sup>160</sup> IRC § 871(a)(1)(C).

<sup>161</sup> IRC § 871(a)(1)(C).

<sup>162</sup> IRC §§ 871(a)(1), 881(a)(3)(B).

<sup>163</sup> IRC §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

(b) **Portfolio Interest.** Portfolio interest on certain types of obligations, which is paid to an FNGT, is not subject to the 30 percent tax.<sup>164</sup>

(c) **Interest on Bank Deposits.** Interest received by FNGTs or foreign corporations on deposits with banks, savings institutions or insurance companies are exempt from tax if they are not effectively connected with the recipient's US trade or business.<sup>165</sup>

(3) **Gain on Sale of Capital Asset.** If an FNGT is not engaged in the conduct of a US trade or business, then the FNGT's US source non-real estate capital gains will not be subject to US federal income tax. This results because (1) FNGTs are taxed as NRAs not present in the US at any time,<sup>166</sup> and (2) in order for the capital gains of an NRA (which an FNGT is treated as) to be subject to US federal income tax, the NRA must be physically present in the US for at least 183 days.<sup>167</sup>

(a) **Note.** An FNGT's US capital gains will be subject to US income tax at the beneficiary level if the FNGT distributes them to a US beneficiary.

**v) Source Rules.**

(1) **Generally.** An FNGT is subject to income tax on income from US sources, including both US source passive income (*i.e.*, FDAP)<sup>168</sup> and income that is effectively connected with the conduct of a trade or business in the US.<sup>169</sup> Because FNGTs are taxed only on income from US sources, it is critical to know the source of the FNGT's income.

(2) In very general terms, the IRC statutorily provides the following source rules:

(a) **Interest.** Interest is generally sourced by reference to the payer's residence. Therefore, interest from US borrowers; except for interest from US bank deposits (unless effectively connected with a US trade or business) and portfolio interest, is treated as US source income.<sup>170</sup>

(b) **Dividends.** Dividends paid by a US corporation are US source income. If a foreign corporation is engaged in a US trade or business, a portion of any dividend payment may be treated as US source

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<sup>164</sup> IRC § 871(h)(1).

<sup>165</sup> IRC §§ 871(i), 881(d).

<sup>166</sup> IRC § 641(b).

<sup>167</sup> IRC § 871(a)(2); Treas. Reg. § 1.871-7(c).

<sup>168</sup> IRC § 871(a)(1).

<sup>169</sup> IRC §§ 871-872. For a detailed discussion of the source of income rules, see 905 TM, *Source of Income Rules*.

<sup>170</sup> IRC §§ 861(a)(1), 871(h)-(i).

income. Specifically, if 25 percent or more of the foreign corporation's gross income for the three preceding years is US business income, the portion of the dividend attributable to the corporation's US business income will be treated as US source income.<sup>171</sup>

- (c) **Personal service income.** Income from the performance of personal services in the US is US source income, subject to the de minimis exception, discussed above.<sup>172</sup>
- (d) **Rental income.** Rental income from property located in the US is US source income.<sup>173</sup>
- (e) **Royalty income.** Royalty income generated in the US is US source income.<sup>174</sup>
- (f) **Real property sales.** Income from the sale of real property located in the US is US source income.<sup>175</sup>
- (g) **Income from personal property dispositions.**
  - (i) In the NRA context, income from the disposition of personal property generally follows the seller's residence. Therefore, sales by a US resident are generally sourced in the US, and sales by an NRA are generally sourced outside the US.<sup>176</sup> However, income from the disposition of personal property by an FNGT will be treated as US source income under any of the following circumstances:
    - 1. The personal property is inventory to be sold in the US.
    - 2. The disposition is attributable to a US office.
    - 3. The personal property is US timber.<sup>177</sup>
- (h) **Miscellaneous rules.**
  - (i) **Depreciable tangible property.** Gain from the disposition of depreciable tangible property by an FNGT may have a US source if depreciation was allowable as a deduction for US tax purposes.<sup>178</sup>

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<sup>171</sup> IRC § 861(a)(2)(A)-(B).

<sup>172</sup> IRC § 861(a)(3).

<sup>173</sup> IRC § 861(a)(4).

<sup>174</sup> IRC § 861(a)(4).

<sup>175</sup> IRC §§ 861(a)(5), 897(c).

<sup>176</sup> IRC § 865(a).

<sup>177</sup> IRC § 865(a), (b), (e).

<sup>178</sup> IRC § 865(c)(1)(A).



- (ii) **Intangible property.** Gain from the sale of intangible property such as a patent, trademark, goodwill or franchise may have a US source if the gain is contingent on use or productivity in the US.

**c) Deductions and credits.**

**i) Deductions related to income effectively connected with US trade or business.**

**(1) Generally.**

- (a) In computing an FNGT's taxable income that is effectively connected with the conduct of a trade or business within the US, the FNGT is entitled to reduce its gross income so connected (or treated as so connected) by the deductions that are "connected" with such income.<sup>179</sup> The proper apportionment and allocation of deductions for this purpose is determined in accordance with Treas. Reg. § 1.873-1.
- (b) In addition, the FNGT is also entitled to deduct against its effectively connected income the following:
  - (i) The deduction for losses allowed by IRC §§ 165(c)(3) if the loss occurred with respect to property located in the US;
  - (ii) The deduction for charitable contributions allowed by IRC § 170; and
  - (iii) The deduction for personal exemptions allowed by IRC § 151.<sup>180</sup>

**(2) Distributions to beneficiaries.** In addition to the foregoing, distributions to beneficiaries made by either a simple trust<sup>181</sup> or a complex trust<sup>182</sup> are deductible. However, this merely shifts the taxability for such amounts from the trust to the beneficiaries.

**ii) Deductions related to other income.** No deductions are permitted against US source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a US trade or business.

**iii) Foreign Tax Credit.** A FNGT engaged in a trade or business within the US 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 US income tax liability.<sup>183</sup> Alternatively, it may deduct such taxes.<sup>184</sup>

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<sup>179</sup> IRC § 873(a).

<sup>180</sup> IRC § 873(b).

<sup>181</sup> IRC § 651.

<sup>182</sup> IRC § 661.

<sup>183</sup> IRC § 901(b)(4), 906(a).

<sup>184</sup> IRC § 164(a)(3).

**d) Applicable tax rates.**

- i) **Income effectively connected with a US trade or business.** For FNGTs “engaged in a trade or business” in the US, the US taxes the net income that is “effectively connected” with the conduct of such trade or business in the same manner as net income earned by a US resident.<sup>185</sup> In other words, this type of income is subject to the normal tax rates applicable to trusts under IRC § 1(e).<sup>186</sup>
  - ii) **FDAP income.** In contrast to income effectively connected with a trade or business, fixed or determinable annual or periodical gains, profits, and income from US sources, which an FNGT earns is typically taxed on a gross basis at a flat 30 percent rate.<sup>187</sup> In other words, the IRC taxes trade or business income on a **net** basis at **graduated** rates. In contrast, the IRC taxes non-business income on a **gross** basis, without the benefit of deductions, at a **flat rate of thirty percent**.
- (1) **Caution.** The 15 percent maximum tax rate applicable to dividend income does not apply to income received by FNGTs.
- e) **Withholding.**<sup>188</sup> FNGTs are subject to withholding, which are set forth in very detailed and extensive treasury regulations, and which are too extensive to cover in detail in this outline. However, it is important for practitioners to be aware that these rules exist.

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<sup>185</sup> IRC § 871(b).

<sup>186</sup> IRC § 871(b).

<sup>187</sup> IRC § 871(a).

<sup>188</sup> For a complete discussion of the withholding rules, see Charles M. Bruce, New US Withholding Tax Rules: A Practical Guide (2002).

#### 4) Tax treatment of beneficiaries of FNGTs.

**a) Generally.** As noted above, FNGT income may be entirely taxable to the FNGT, the FNGT's beneficiaries, or partly to each. Under IRC §§ 651 and 661, trusts may deduct amounts properly paid or credited to beneficiaries. Therefore, trusts are treated as conduits to the extent of distributed income, and as separate taxable entities to the extent of undistributed income. Because DNI is so critical to the tax consequences of distributions to FNGT beneficiaries, this outline next discusses DNI.

#### **b) Distributable Net Income ("DNI").**

##### **i) Simple versus complex trusts.**

##### **(1) Simple trust.**

**(a) Definition.** A FNGT will constitute a "simple" trust if it satisfies **all** of the following requirements:

- (i)** all income must be distributed currently.
- (ii)** no amounts may be paid, permanently set aside for, or used for a charitable beneficiary.
- (iii)** no distributions are made other than of current income (*i.e.*, no distributions of accumulated income or corpus).<sup>189</sup>

**(b) Tax treatment.** All of a simple FNGT's income will be taxed to the beneficiaries. In turn the FNGT will receive a deduction for its current income, which it must pay to the beneficiaries, regardless of whether such income is actually distributed or not.<sup>190</sup> The amounts that the beneficiaries must include in their gross income, along with the trust's deduction, are both limited by the trust's DNI.<sup>191</sup>

##### **(2) Complex trust.**

**(a) Definition.** A FNGT will constitute a "complex" trust if **any** of the following are true:

- (i)** It is not required to distribute all of its income currently.
- (ii)** it distributes accumulated income or principal
- (iii)** or it has a charitable beneficiary.<sup>192</sup>

**(b) Tax treatment.**

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<sup>189</sup> IRC § 651(a); Treas. Reg. § 1.651(a)-1.

<sup>190</sup> IRC §§ 651(a), 652.

<sup>191</sup> IRC §§ 651(b)(652(a).

<sup>192</sup> IRC § 661(a)Treas. Reg. § 1.661(a)-1.

- (i) **Trust.** A complex FNGT receives a deduction for that portion of its current income that it must distribute plus that portion of its current income that the trustee actually distributes to the beneficiaries pursuant to the trust instrument.<sup>193</sup> The trust's deduction is limited to the amount of its DNI.<sup>194</sup>

**(ii) Beneficiaries.**

- 1. Beneficiaries of a complex FNGT must include in their gross income all income that the trust is required to distribute plus all income actually distributed to the beneficiaries pursuant to the trust instrument.<sup>195</sup>
- 2. Each beneficiary must include in its gross income an amount equal to his pro rata share of the trust's DNI.<sup>196</sup>
- 3. Distributions that exceed the FNGT's DNI are treated either as nontaxable distributions of principal or as distributions of income accumulated from prior years, which are taxable under the throwback rule, which is discussed later in this outline.<sup>197</sup>

**ii) Computation of DNI.**

- (1) Generally.** A trust's DNI generally equals its taxable income computed with the following modifications:

- (a) There is no deduction for distributions to beneficiaries.
- (b) There is no personal exemption deduction.
- (c) The trust's taxable income is increased by any tax-exempt income (net of allocable expenses).<sup>198</sup>

- (2) Modifications to DNI for FNGT.** The DNI of a FNGT is calculated in the same manner as for a domestic trust, with the following modifications:

**(a) Worldwide income.**

- (i) A FNGT's DNI begins with its worldwide taxable income, including both US and foreign source income, without any distribution deduction or personal exemption, and increased by net tax-exempt income, as with a domestic trust.<sup>199</sup>

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<sup>193</sup> IRC § 661(a); Treas. Reg. § 1.661(a)-1.

<sup>194</sup> IRC § 661(a).

<sup>195</sup> IRC § 662(a).

<sup>196</sup> IRC § 662(a)(2).

<sup>197</sup> IRC §§ 662(a)(2), 665-668.

<sup>198</sup> IRC § 643(a).

<sup>199</sup> IRC § 643(a)(6), (a)(5).

(ii) The FNGT's DNI specifically includes gross income from sources outside the US, reduced by disbursements allocable to such income that would have been deductible were it not for the IRC § 265(a)(1) limitation, which disallows certain deductions with respect to tax-exempt income.<sup>200</sup>

(iii) The FNGT's DNI also includes US source gross income, determined without regard to IRC § 894, which otherwise extends to taxpayers the benefits of an US income tax treaties.<sup>201</sup> In other words, income that is exempt from tax by treaty must nevertheless be taken into account in computing the FNGT's DNI.<sup>202</sup>

(iv) The two foregoing adjustments are reduced proportionately to the extent that the FNGT is allowed a deduction for charitable distributions or set asides.<sup>203</sup>

**(b) Capital gains.** Unlike domestic trusts, for which DNI generally does not include capital gains, the DNI of FNGTs includes capital gains, regardless of whether they are allocated to income or to corpus under either the governing law or instrument, and regardless of whether they are currently distributed.<sup>204</sup> Capital losses reduce such capital gains to the extent that they do not exceed capital gains.<sup>205</sup> If a FNGT recognizes both capital gains and ordinary income in one tax year, then distributions to US beneficiaries will include a proportionate share of both ordinary income and capital gains, based on the relative inclusion of both in the FNGT's DNI.

**c) Taxation of current distributions.**

**i) Generally.** FNGT beneficiaries are taxed on the trust's income to the extent such income is either distributed or required to be distributed.<sup>206</sup> However, the exact US income tax treatment of income distributed to FNGT beneficiaries depends on the following:

- (1) Whether the distribution is of current income (*i.e.*, DNI) or accumulated income (*i.e.*, UNI).
- (2) Whether the beneficiary is a US or foreign person.
- (3) Whether the FNGT's income is from within the US or from outside the US.

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<sup>200</sup> IRC § 643(a)(6)(A).

<sup>201</sup> IRC § 643(a)(6)(B).

<sup>202</sup> Treas. Reg. § 1.643(a)-6(a)(3)(i).

<sup>203</sup> Treas. Reg. § 1.643(a)-5(b).

<sup>204</sup> IRC § 643(a)(6)(C); Treas. Reg. § 1.643(a)-6(a)(3)(iii).

<sup>205</sup> Treas. Reg. § 1.643(a)-6(a)(3)(ii).

<sup>206</sup> IRC §§ 652(a), 662(a); Treas. Reg. § 1.652(a)-1.

**ii) Distributions to US beneficiaries.**

**(1) Generally.** US beneficiaries of FNGTs must include the following in their gross income:

- (a) From simple trusts:** The amount of any trust income required to be distributed to such beneficiary in the year in question, regardless of whether such income is actually distributed, but limited to the extent of that beneficiary's share of the trust's DNI for that year;<sup>207</sup>
- (b) From complex trusts:** Both:
  - (i)** The amount of any trust income required to be distributed to such beneficiary in the year in question, regardless of whether such income is actually distributed, but limited to the extent of that beneficiary's share of the trust's DNI for the year;<sup>208</sup> and
  - (ii)** Any other amount (1) required to be distributed to such beneficiary, regardless of whether such amount is actually distributed, or (2) that is properly and actually distributed to such beneficiary, to the extent of such beneficiary's share of the trust's DNI for the year in question.<sup>209</sup>

**(2) Determining the beneficiaries' share of DNI.**

**(a) Simple trusts.**

- (i)** If the amount of income required to be distributed currently to beneficiaries exceeds the FNGT's DNI, each beneficiary includes in his gross income his proportionate share of such DNI.
- (ii) Example 18.** Adam, a beneficiary of Simple FNGT, a simple trust, is to receive two-thirds of the trust income. Bob is to receive one-third. The income required to be distributed currently is \$99,000. Here, Adam will receive \$66,000 and Bob will receive \$33,000. However, if the DNI is only \$90,000, Adam will include two-thirds (\$60,000) of the DNI in his gross income, and Bob will include one-third (\$30,000) in his gross income.

**(b) Complex trusts.<sup>210</sup>**

- (i) Generally.** The IRC breaks income from complex trusts into two (2) groups (or tiers) of income. However, the amount of income that can be taxed to a beneficiary is limited to the trust's DNI.

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<sup>207</sup> IRC § 651.

<sup>208</sup> IRC § 662(a)(1).

<sup>209</sup> IRC § 662(a)(2).

<sup>210</sup> IRC § 662.

- (ii) **DNI > Tier 1 income.** If the entire amount of income in tier 1 (*i.e.*, income required to be distributed currently) is less than the trust's DNI, then the entire amount of the trust's income is taxable to the trust's beneficiaries.
  - (iii) **DNI < Tier 1 income.** If the entire amount of income in tier 1 is more than DNI, then each beneficiary is taxable only to the extent of his proportionate share of DNI.
  - (iv) **Tier 2 distributions.** Tier 2 distributions (*i.e.*, other amounts properly paid, credited or required to be distributed to beneficiaries for the tax year) are taxed to beneficiaries only if the trust's DNI exceeds distributions falling into tier 1. If DNI exceeds distributions falling into tier 1, distributions are taxable to a beneficiary to the extent that they do not exceed his proportionate share of the trust's DNI after reduction for amounts required to be distributed currently.
- (3) **Tax character of income.** The tax character of distributions that a beneficiary receives in a year proportionately reflects the character of the trust's income for that year.<sup>211</sup> If the trust agreement or local law requires the trust to allocate particular types of trust income to particular beneficiaries, then the character of distributions to such beneficiaries will reflect that allocation if it has economic significance independent of the tax consequences.<sup>212</sup>
- (4) **Credit for US income tax withheld at source.**
- (a) FNGT beneficiaries may claim a credit against their US income tax for US income taxes withheld at the source on US source income paid to the FNGT (*e.g.*, withholding on FDAP income or FIRPTA withholding).<sup>213</sup>
  - (b) The withholding tax is treated as if it were paid by the beneficiary.
  - (c) **Note.** To claim the credit, however, the beneficiary must report as his income from the trust the sum of the tax withheld in addition to the amount actually distributed to him.<sup>214</sup>
- (5) **Credit for foreign taxes paid by FNGT.**
- (a) Although most FNGTs are established in a low/no tax jurisdictions, the FNGT may nevertheless incur foreign taxes or it may be established in a foreign country that does impose taxes upon the trust.

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<sup>211</sup> IRC §§ 652(b), 662(b).

<sup>212</sup> IRC §§ 652(b), 662(b); Treas. Reg. § 1.652(b)-2(a); Treas. Reg. § 1.662(b)-1.

<sup>213</sup> Treas. Reg. § 1.1462-1(b).

<sup>214</sup> IRC § 1462; Treas. Reg. §§ 1.1441-3(f), 1.1462-1(b).

- (b) If an FNGT pays foreign taxes, its US beneficiaries who receive income distributions 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.<sup>215</sup> Alternatively, such beneficiaries may deduct such taxes as an itemized deduction.<sup>216</sup>
- (c) To claim the credit, however, it appears that the beneficiary must report as his income from the trust the sum of the foreign taxes paid in addition to the amount actually distributed to him.<sup>217</sup>

**iii) Distributions to NRA beneficiaries.**

- (1) Foreign source income.** NRA beneficiaries of FNGTs are generally not subject to US income tax on an FNGT's foreign source income. This results because there is no US nexus on which to tax such income to the foreign beneficiary.
- (2) US source income.**
  - (a)** NRA beneficiaries of FNGTs are subject to US income tax on such FNGT's US source income. Generally, such beneficiaries are liable for US income taxes on the lesser of (1) the income the FNGT actually distributes or is required to distribute, or (2) the FNGT's DNI.
  - (b)** The character of the FNGT's US income (*i.e.*, as either effectively connected with a US trade or business, or as FDAP income) establishes the beneficiary's US tax liability in the same manner that it establishes the FNGT's tax liability on undistributed income.<sup>218</sup>
- (3) Withholding.** As a practical matter, most of an NRA's US tax liability stemming from an FNGT with US source income may be paid in the form of withholding.<sup>219</sup>

**d) Taxation of Accumulation Distributions.**

**i) Generally.**

- (1)** If an FNGT makes distributions that exceed its DNI in any particular year, the US beneficiaries receiving such distributions must apply the throwback rule, which may subject such distributions to both taxation and an interest charge.

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<sup>215</sup> IRC §§ 901, 666, 667.

<sup>216</sup> IRC § 164(a)(3).

<sup>217</sup> See Howard Zaritsky, *US Tax'n of Foreign Estates, Trusts and Beneficiaries*, 854-2<sup>nd</sup> Tax Mgmt. Portfolio V.D.1. (2002),

<sup>218</sup> See *Isidro Martin-Montis Trust v. Commissioner*, 75 TC 381 (1980), *acq.* 1981-2 C.B. 21, *acq.* 1981-2 C.B. 21; Rev. Rul. 81-244, 1981-2 C.B. 151, *amplified by* Rev. Rul. 86-76, 1986-1 C.B. 284).

<sup>219</sup> For a complete discussion of the withholding rules, see Charles M. Bruce, *New US Withholding Tax Rules: A Practical Guide* (2002).



- (2) Generally, the IRC allocates a foreign trust's income for income tax purposes each year between the trust and the trust beneficiaries by means of its DNI.<sup>220</sup> To the extent that DNI is either actually distributed or required to be distributed, (a) the trust deducts such DNI from its taxable income,<sup>221</sup> and (b) the beneficiaries are taxed on such DNI.<sup>222</sup>
- (3) If a trust does not distribute all of its DNI in any year, the amount of its DNI that it does not distribute becomes "undistributed net income" ("UNI"),<sup>223</sup> to which the throwback rule may apply in a future year. [In other words, UNI is the excess of the amount available from DNI for distribution to trust beneficiaries over the amount that the trust actually distributes to such beneficiaries.] In any year that the trust makes a distribution to its beneficiaries that exceeds its DNI for such year, if it has UNI from prior year(s), the IRC will treat the trust as making an "accumulation distribution." As noted above, the IRC then applies the throwback rule, which may subject such distributions to both taxation and an interest charge.
- (4) The throwback rule is designed to impose on trust beneficiaries approximately the same income taxes that would have been imposed had the trust distributed all of its income on a current basis.
- (5) Application of the throwback rule involves the following concepts:
  - (a) The mechanics of the throwback rule.
  - (b) Definition of "accumulation distribution."
  - (c) Definition of "undistributed net income" ("UNI").
  - (d) Computation of the interest charge imposed on accumulation distributions from foreign trusts.
  - (e) Application of the character rule.

**ii) Throwback rule mechanics.**

- (1) **Step 1 – Determine number of preceding tax years of trust to which distribution attributable.**
  - (a) Determine the number of preceding taxable years of the trust to which the distribution is attributable. The years to which the distribution is attributed are the earliest years of the trust in which the trust had UNI.<sup>224</sup> These are the actual years in which the income was accumulated based on the trust records.

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<sup>220</sup> IRC § 643.

<sup>221</sup> IRC §§ 651, 661.

<sup>222</sup> IRC §§ 652, 662.

<sup>223</sup> IRC § 665.

<sup>224</sup> IRC § 666(a).

- (b) **Caution.** If the trust's records are insufficient to establish which years have UNI, the accumulation distribution will be allocated to the earliest year that the trust was in existence.<sup>225</sup>
- (c) If the amount of the trust's UNI in one of the accumulation years is less than 25 percent of the average annual accumulation, (*i.e.*, the total accumulation distribution divided by the number of years of accumulation) that year is disregarded in determining the number of years in which the distribution has been accumulated. However, amounts accumulated in any such disregarded year still are considered part of the total accumulation distribution.<sup>226</sup>
- (d) **Example 19-A.** Chandler creates the Chandler trust, an FNGT, in 2000. In 2004, the Chandler trust distributes \$35,000 to its beneficiary, Marlowe, when it has DNI of \$10,000. The Chandler trust had the following amounts of UNI: 2000 - \$8,000; 2001 - \$10,000; 2002 - \$7,000, and 2003 - \$18,000. Here, the accumulation distribution would be attributed to three years (*i.e.*, 2000, 2001, and 2002).

**(2) Step 2 – Determine beneficiary's average years.**

- (a) Determine the beneficiary's average years. This is determined by examining the beneficiary's taxable income for the five immediately preceding tax years and then ignoring the high and low years.
- (b) **Example 19-B.** Marlow has the following amounts of taxable income in the five years preceding the 2004 accumulation distribution:
  - (i) 2003. \$100,000.
  - (ii) 2002. \$10,000.
  - (iii) 2001. \$75,000.
  - (iv) 2000. \$75,000.
  - (v) 1999. \$65,000.

Here, Marlowe's average years are 2001, 2000, and 1999.

**(3) Step 3 – Determine the average annual accumulation.**

- (a) Determine the average annual accumulation, which is calculated by dividing the total accumulation distribution (including any taxes that the trust paid on the such amounts) by the number of years in which such accumulation distribution was accumulated.
- (b) Note - the number of years in which the accumulation distribution was accumulated was determined in step 1.

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<sup>225</sup> IRC § 666(d).

<sup>226</sup> IRC § 667(b)(3).

(c) **Example 19-C.** Here, the average annual accumulation equals \$8,333.33. This amount is calculated by dividing the total accumulation distribution of \$25,000 by the number of years in which that accumulation distribution was accumulated, which was three.

**(4) Step 4 – Add average annual accumulation to beneficiary’s average years.**

(a) The average annual accumulation, calculated in Step 3, is added to each of the beneficiary’s (three) average years, determined in Step 2.

(b) **Example 19-D.** Here, this step would yield the following adjusted amounts of taxable income for Marlowe:

(i) 2001. \$83,333.

(ii) 2000. \$83,333.

(iii) 1999. \$73,333.

**(5) Step 5 – Compute the average additional tax.**

(a) Compute and average the increase in the beneficiary’s tax caused by the addition of the average annual accumulation in each of the beneficiary’s average years.<sup>227</sup> If the beneficiary is an NRA during some or all of the applicable years, this should be reflected by a change in the additional tax in such years.

(b) **Example 19-E.** Assume that this step yields the following increase in Marlowe’s tax for each of his average years:

(i) 2001. \$2,531.

(ii) 2000. \$2,573.

(iii) 1999. \$2,573.

This yields an average increase in tax of \$2,559.

**(6) Step 6 – Calculate the partial tax on the accumulation distribution.**

(a) Determine the partial tax on the accumulation distribution by multiplying the average additional tax (computed in Step 5) by the number of years of accumulation.<sup>228</sup>

(b) **Example 19-F.** Here, ignoring the credit for taxes paid on the distribution, the partial tax would be \$7,677, which equals \$2,559 (average additional tax) multiplied by 3 (number of years of accumulation).

**(7) Step 7 – Subtract credit for the taxes paid on the UNI being distributed.**

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<sup>227</sup> IRC § 667(b)(1)(D).

<sup>228</sup> IRC § 667(b)(1).

- (a) Subtract from the partial tax, determined in Step 6, a credit for the taxes paid on the UNI by the trust.<sup>229</sup>
- (b) **Note.** Because the beneficiary is given a credit for the taxes paid by the FNGT, the accumulation distribution must be grossed up to reflect such taxes. In other words, such taxes must be added to the accumulation distribution.
- (c) **Note.** If a beneficiary receives accumulation distributions from more than two trusts, he/she can only subtract a credit for the taxes paid by the first two trusts. Taxes by any additional trusts are ignored for purposes of this step.<sup>230</sup>
- (d) **Example 19-G.** Assume that the Chandler Trust paid \$2,000 of tax on the UNI that it distributes to Marlowe as part of the accumulation distribution. Here, the partial tax is reduced by \$2,000.

### iii) Character Rule.

- (1) **Generally.** Under IRC § 667, the IRC taxes accumulation distributions that FNGT beneficiaries receive as ordinary income, regardless of the character of the income that the trust itself receives, with certain exceptions.<sup>231</sup>
- (2) **Exceptions.**
  - (a) **Tax-exempt income.** This rule does not apply to tax-exempt income, which does retain its character in the hands of the beneficiary in the form of an accumulation distribution.<sup>232</sup>
  - (b) **NRA.** Accumulation distributions that an FNGT makes to NRA beneficiaries retain the character of such income as recognized by the trust.<sup>233</sup>
- (3) **Capital gains.** Since capital gains are included in DNI, if they are not distributed currently, but instead are distributed to a US beneficiary as part of an accumulation distribution, such capital gains will be taxed at ordinary income tax rates when the US beneficiary receives them.
- (4) **Elimination of character rule is not limited as to types of character of income to which it applies.** The elimination of character rule does not limit the character of income to which it applies. Therefore, among other things, it results in the following types of implications:

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<sup>229</sup> IRC §§ 666, 667.

<sup>230</sup> IRC § 667(c)(1).

<sup>231</sup> IRC §§ 667(a), 662(a)(2).

<sup>232</sup> IRC §§ 667(a), 662(b).

<sup>233</sup> IRC § 667(e).

- (a) **Foreign tax credit.** Because a US beneficiary of an FNGT cannot treat any part of the foreign income included in an accumulation as foreign income, such beneficiary loses the benefits of the foreign tax credit.
- (b) **Passive activity income.** If passive activity income is included in an accumulation distribution, the beneficiary cannot use such income to offset passive activity losses.
- (c) **Tax preference items.** If tax preference items are included in an accumulation distribution, the beneficiary does not have to take such items into account for alternative minimum tax purposes.

**iv) Interest charge.**

**(1) Generally.**

- (a) IRC § 668 imposes a nondeductible “interest” charge on an FNGT beneficiary’s tax, which the IRC imposes on accumulation distributions from the FNGT.<sup>234</sup>
- (b) The IRC imposes the interest charge in addition to any other tax liabilities of the beneficiary of such FNGT.
- (c) The interest charge is imposed on the amount of additional tax imposed on the beneficiary because of the accumulation distribution, but after reduction for any credit for any taxes that the FNGT paid on such distributed income.

**(2) Pre-1996 interest charge.** Under pre-1996 law, the interest rate was a simple 6 percent per year rate.

**(3) Post-1995 interest charge.** The 1996 Act changed the interest rule. Under rules enacted by the 1996 Act, the following rules apply:

- (a) Simple interest accrues at the rate of 6 percent through December 31, 1995.<sup>235</sup>
- (b) Compound interest accrues, beginning January 1, 1996, using the monthly underpayment rate.<sup>236</sup> This compound rate also applies to the total simple interest that accrues for pre-1996 periods.
- (c) The accumulation distribution is allocated proportionately to prior trust years in which the trust has UNI (as opposed to the earliest of such years), and is treated as reducing UNI from prior years proportionately from each year.<sup>237</sup>

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<sup>234</sup> IRC § 668.

<sup>235</sup> IRC § 668(a)(6).

<sup>236</sup> IRC § 668(a).

<sup>237</sup> IRC § 668(a)(5).

**(4) Limit on interest charge.**

- (a) IRC § 668(b) provides that the interest charge, when added to the federal tax imposed on the accumulation distribution (*i.e.*, under the throwback rules described above), cannot exceed the amount of the accumulation distribution itself.
- (b) To illustrate, if you arrived at an additional tax of \$70 and an interest charge of \$50 on an accumulated distribution of \$100, the interest charge would be limited to \$30, and after taxes and the interest charge, you would be left with \$0 (*i.e.*, rather than being worse off by \$20).

**(5) Not deductible.** The IRC § 668 interest charge is not deductible.<sup>238</sup>

- v) **Planning to avoid throwback rule and interest charge.** Commentators have suggested the following methods of avoiding taxation of accumulation distributions under the throwback rules.

**(1) Specific gifts.**<sup>239</sup> Distributions in satisfaction of a gift of a specific sum of money or of specific property described in IRC § 663(a)(1) do not constitute an accumulation distribution. Therefore, such distributions will not trigger the throwback rules. For this purpose, a specific sum of money or of specific property described in IRC § 663(a)(1) is 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 such beneficiary all at once or in no more than three installments.<sup>240</sup>

**(2) Distributions in kind.**<sup>241</sup> FNGT trustees can distribute appreciated securities in kind, but not claim a distribution deduction for the value distributed that exceeds the FNGT's adjusted basis.<sup>242</sup> This defers the tax until the US beneficiary recognizes the capital gain and, therefore, will distribute greater value to the beneficiary without exceeding DNI.

**(3) Use of holding company.**<sup>243</sup> If an FNGT holds investments through a holding company, the trust will have not DNI (and therefore no UNI) until the holding company pays dividends to the FNGT. This allows the trust to accumulate income at the holding company level and ensure that all distributions to FNGT beneficiaries constitute current distributions.

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<sup>238</sup> IRC § 668(c).

<sup>239</sup> Howard Zaritsky, *US Tax'n of Foreign Estates, Trusts and Beneficiaries*, 854-2<sup>nd</sup> Tax Mgmt. Portfolio V.E.2.e. (2002); Ellen K. Harrison, et al., *US Tax'n of Foreign Trusts, Trusts With Non-US Grantors and Their US Beneficiaries*, in *Sophisticated Estate Planning Techniques* (ALI-ABA Course No. SJ016 Sept. 2003).

<sup>240</sup> IRC § 663(a)(1).

<sup>241</sup> See Henry Christensen, III, *International Estate Planning* § 4.09[5][b] (2002).

<sup>242</sup> IRC § 643(e).

<sup>243</sup> See Henry Christensen, III, *International Estate Planning* § 4.09[5][a] (2002).

**(a) Caution.** This strategy runs the risk of running afoul of the following tax regimes, each of which has negative tax consequences:

(i) Passive foreign investment company, which subjects US beneficiaries to the PFIC tax.<sup>244</sup>

(ii) Foreign personal holding company.<sup>245</sup>

(iii) Controlled foreign corporation.<sup>246</sup>

**(4) Investment in high yield securities.**<sup>247</sup> Because the throwback rules only apply to accumulation distributions after the current year's DNI is exhausted, one effective way to avoid the throwback rule is to change the FNGT's investment mix in years that distributions are desired to increase DNI. If DNI equals or exceeds the contemplated distribution, there should be no accumulation distribution.

**e) Loans to US beneficiaries treated as distributions.**

i) **Generally.** IRC § 643(i) provides that, if a foreign trust loans cash or marketable securities directly or indirectly to any US grantor or beneficiary, or any US person who is related to such grantor or beneficiary, then the amount of such loan is treated as a distribution by that trust to such grantor or beneficiary.

ii) **Definitions and special rules.** For purposes of this rule, the following definitions and special rules apply.

(1) **Cash.** Cash includes foreign currencies and cash equivalents.<sup>248</sup>

(2) **Related person.** For purposes of this rule, a person is related to another person if the relationship between them would cause a loss disallowance under IRC § 267 (but applying IRC § 267(c)(4) as if the family of an individual includes the spouses of the members of the family) or IRC § 707(b).<sup>249</sup>

(3) **Trust not treated as simple trust.** A trust that is treated as making a distribution under this rule is treated as a complex trust.<sup>250</sup>

(4) **Subsequent transactions regarding loan principal.** IRC § 643(i)(3) provides that this rule applies, then "any subsequent transaction between the trust and the original borrower regarding the principal of the

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<sup>244</sup> IRC §§ 1291-1298.

<sup>245</sup> IRC §§ 551-558.

<sup>246</sup> IRC §§ 951-964.

<sup>247</sup> See Henry Christensen, III, *International Estate Planning* § 4.09[5][b] (2002).

<sup>248</sup> IRC § 643(i)(2)(A).

<sup>249</sup> IRC § 643(i)(2)(B).

<sup>250</sup> IRC § 643(i)(2)(C).

loan (by way of complete or partial repayment, satisfaction, cancellation, discharge, or otherwise) shall be disregarded for purposes of this title.”

- iii) **Note re loans of marketable securities.** As noted above, under IRC § 643(e), unless the trustee elects otherwise, the amount of a distribution other than cash is the lesser of (a) the trust's basis in the distributed property or (b) its fair market value. Therefore, it appears that if an FNGT trust lends marketable securities with a fair market value that exceeds its basis, the deemed distribution under this rule will be the amount of the basis unless the trustee elects to recognize gain on the distribution.
- f) **Intermediary rule - distributions through intermediaries.**
  - i) **General Rule.** The IRC treats a US person (*i.e.*, recipient) who receives property from another person (*i.e.*, an intermediary) who received such property from a foreign trust as having received the property directly from such trust if the property the recipient receives was derived directly/indirectly from such foreign trust.<sup>251</sup>
  - ii) **Exception for grantors.** This rule does not apply if the person from whom the recipient receives the property is the grantor of the foreign trust.
  - iii) **Treasury regulations – limit rule to tax avoidance transactions.**

Treasury regulations only apply this intermediary rule if the transaction in question has a principal purpose of avoiding US tax. (Note, the IRC itself does not make tax avoidance a prerequisite to application of the intermediary rule).<sup>252</sup>
  - iv) **Tax avoidance purpose.** Treasury regulations deem tax avoidance motivation to exist for purposes of the intermediary rule if **all** the following requirements are satisfied:<sup>253</sup>
    - (1) **Relationship.** The US recipient is related<sup>254</sup> to a grantor of the foreign trust, or has another relationship with a grantor that establishes a reasonable basis to or conclude that the grantor would make a gratuitous transfer to such recipient;
    - (2) **Time frame.** The US recipient receives from the intermediary, within the period beginning twenty-four months before and ending twenty-four months after the intermediary receives the property from the foreign trust, either:
      - (a) The property the intermediary received from the foreign trust;
      - (b) Proceeds from such property; or

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<sup>251</sup> IRC § 643(h).

<sup>252</sup> Treas. Reg. § 1.643(h)-1(a)(1).

<sup>253</sup> Treas. Reg. § 1.643(h)-1(a)(2).

<sup>254</sup> For this purpose, “related” means related within the meaning of Treas. Reg. § 1.643(h)-1(e).



- (c) Property in substitution for such property; and
- (3) **Lack of alternate explanation.** The US recipient cannot prove to IRS satisfaction that:
  - (a) The intermediary has a relationship with the US recipient that establishes a reasonable basis to conclude that the intermediary would make a gratuitous transfer to such recipient;
  - (b) The intermediary acted independently of the grantor and the trustee of the foreign trust;
  - (c) The intermediary is not an agent of the US recipient under generally applicable United States agency principles; and
  - (d) The US recipient timely complied with the reporting requirements of IRC § 6039F (notice of large gifts from foreign persons, which is filed on Form 3520), if applicable, if the intermediary is a foreign person.
- v) **Exceptions.** The intermediary rule does not apply in the following cases.
  - (1) **Non-gratuitous transfers.** The intermediary rule does not apply to the extent that either the transfer from the foreign trust to the intermediary or the transfer from the intermediary to the US recipient does not constitute a gratuitous transfer within the meaning of § 1.671-2(e)(2).<sup>255</sup>
  - (2) **Grantor as intermediary.** The intermediary rule does not apply if the intermediary is the grantor of the portion of the trust from which the transferred property that is derived.<sup>256</sup>
- vi) **Effect of application of intermediary rule.**
  - (1) **General rule.** If the intermediary rule applies, then:
    - (a) The intermediary is treated as an agent of the foreign trust.
    - (b) The property is treated as transferred to the US recipient in the year the property is transferred, or made available, by the intermediary to the US recipient (as opposed to when the trust transfers the property to the intermediary).
    - (c) The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the US recipient.
  - (2) **Alternative treatment.** If the IRS determines, or if the taxpayer can prove to IRS satisfaction, that the intermediary is the US recipient's agent (rather than the foreign trust's agent), then:
    - (a) The IRS will treat the property as transferred to the US recipient in the year the foreign trust transfers the property to the intermediary.

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<sup>255</sup> Treas. Reg. § 1.643(h)-1(b)(1).

<sup>256</sup> IRC § 643(h); Treas. Reg. § 1.643(h)-1(b)(1).

(b) The fair market value of the property transferred will be determined on the transfer date from the foreign trust to the intermediary.<sup>257</sup>

(3) **Intermediary's taxation.** If the intermediary rule applies to cause the property to be treated as transferred directly by the foreign trust to a US recipient, the intermediary does not take into account such property's fair market value in computing his/her gross income.<sup>258</sup>

vii) **De minimis rule.** The intermediary rule does not apply if, during the US recipient's tax year, the aggregate fair market value of all property transferred to such person from all foreign trusts either directly or through one or more intermediaries does not exceed \$10,000.

viii) **Related parties.** For purposes of the intermediary rule, a United States recipient is treated as related to a foreign trust grantor trust if the US recipient and the grantor are related for purposes of IRC § 643(i)(2)(B), with the following modifications:

(1) For purposes of applying IRC § 267 (other than IRC § 267(f)) and IRC § 707(b)(1), "at least 10 percent" is used instead of "more than 50 percent" each place it appears; and

(2) The principles of IRC § 267(b)(10), using "at least 10 percent" instead of "more than 50 percent," apply to determine whether two corporations are related.

## 5) Tax treatment of US beneficiaries of foreign grantor trusts ("FGTs").

### a) Background.

- i) Prior to the 1996 Act, trusts created by non-US persons were subject to the "grantor trust" rules to the same extent as trusts created by US persons. As a result, the grantor trust rules shifted such a trust's income, for virtually all US income tax purposes, from the trust to its non-US grantor.
- ii) Where a foreign person was treated as the owner of the income because of the grantor trust rule, then (i) the foreign grantor-owner was taxed on such income only under the limited rules for taxing NRA individuals and foreign corporations; and (ii) distributions from the trust to US beneficiaries were treated as gifts from the foreign grantor-owner. Such gifts generally were not taxable to the US beneficiary as income.<sup>259</sup> Gift tax would frequently not be imposed (*e.g.*, where the subject matter of the gift was situated outside the US).
- iii) Today, IRC § 672(f) generally denies grantor trust status to trusts with non-US grantors.

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<sup>257</sup> Treas. Reg. § 1.643(h)-1(c)(2).

<sup>258</sup> Treas. Reg. § 1.643(h)-1(c)(3).

<sup>259</sup> Rev. Rul. 69-70, 1969-1 C.B. 182.

**b) General rule – no grantor status for foreign grantors.**

- i) IRC § 672(f)(1) provides that the grantor trust rules apply only to the extent that they cause an amount to be currently taken into account (directly or through one or more entities) in computing the income of a US citizen/resident or a domestic corporation. Accordingly, they apply to the extent that any part of a trust, upon application of the grantor trust rules without regard to IRC § 672(f), is treated as owned by a US citizen or resident, or domestic corporation.
- ii) The grantor trust rules specifically do not apply to any part of a trust to the extent that, upon application of the grantor trust rules without regard to IRC § 672(f), that part would be treated as owned by a non-US citizen or resident, or a foreign corporation.
- iii) Any portion of the trust that is not treated as owned by a grantor or another person is treated as a nongrantor trust.
- iv) For purposes of this rule, the determination of the part of a trust treated as owned by the grantor or other person is made based on the trust terms, application of the grantor trust rules, and IRC § 671 and the regulations thereunder.<sup>260</sup>
- v) **Example 20.**<sup>261</sup>

- (1) Chandler, an NRA, funds an irrevocable domestic trust, DTrust, for the benefit of his son, Marlowe, a US citizen, with X Corporation stock. Chandler's brother, Raymond, also a US citizen, contributes Y Corporation stock to the Dtrust for Marlowe's benefit. Chandler has a reversionary interest within the meaning of IRC § 673 in the X stock, which would cause him to be treated as the owner of the X stock upon application of the grantor trust rules without regard to IRC § 672(f). Raymond has a reversionary interest within the meaning of IRC § 673 in the Y stock that would cause Raymond to be treated as the owner of the Y stock upon application of the grantor trust rules without regard to IRC § 672(f). The trustee has discretion to accumulate or currently distribute income of DTrust to Marlowe.
- (2) Here, because Chandler is an NRA, the grantor trust rules (ignoring IRC § 672(f)) would not cause the portion of the trust consisting of the X stock to be treated as owned by a US citizen/resident. Therefore, Chandler is not treated as an owner of the portion of the trust consisting of the X stock under the grantor trust rules. However, because Raymond is a US citizen, the foregoing rule does not apply to him, and he is treated as the owner of the portion of the trust consisting of the Y stock under the grantor trust rules.

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<sup>260</sup> Treas. Reg. § 1.672(f)-1(a)(2).

<sup>261</sup> Treas. Reg. § 1.672(f)-1(b).

**c) Exceptions to the General Rule.**

**i) Certain revocable trusts.**

- (1) The IRC § 672(f) foreign nongrantor trust rule does not apply to any part of a trust if the grantor retains the power to revest<sup>262</sup> absolutely in him/herself title to such part, and such power is exercisable solely by the grantor without the approval or consent of any other person.<sup>263</sup>
  - (a) This exception is satisfied if, in the event of the grantor's incapacity, this power is exercisable by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf.<sup>264</sup>
  - (b) This exception is also satisfied if the grantor can exercise such power only with the approval of a related or subordinate party who is subservient to the grantor.<sup>265</sup>
- (2) **Grandfather rule for certain revocable trusts in existence on September 19, 1995.** The IRC § 672(f) foreign nongrantor trust rule does not apply to any part of a trust that was treated as owned by the grantor under IRC § 676 (revocable trusts) on September 19, 1995, if it would continue to be so treated thereafter. However, this exception does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995. This exception also is subject to certain rules relating to separate accounting for gratuitous transfers to the trust after September 19, 1995, under Treas. Reg. § 1.672(f)-3(d).<sup>266</sup>
- (3) **Example 21.**<sup>267</sup> Dashiell, a foreign person, creates and funds a revocable trust, Hammett Trust, for the benefit of his children, who are resident aliens. The trustee is a foreign bank, Maltese Bank, which is owned and controlled by Dashiell and Nick, who is Dashiell's brother. The power to revoke the Hammett Trust and revest absolutely in Dashiell title to the trust property is exercisable by Dashiell, but only with the approval or consent of Maltese Bank. The trust instrument contains no standard that Maltese Bank must apply in determining whether to approve or consent to the revocation of the Hammett Trust. There are no facts that would

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<sup>262</sup> For purposes of this rule, the grantor is treated as having a power to revest for a taxable year of the trust only if the grantor has such power for a total of 183 or more days during the taxable year of the trust. If the first or last taxable year of the trust (including the year of the grantor's death) is less than 183 days, the grantor is treated as having a power to revest for purposes of paragraph (a)(1) of this section if the grantor has such power for each day of the first or last taxable year, as the case may be. Treas. Reg. § 1.672(f)-3(a)(2).

<sup>263</sup> Treas. Reg. § 1.672(f)-3(a)(1).

<sup>264</sup> Treas. Reg. § 1.672(f)-3(a)(1).

<sup>265</sup> Treas. Reg. § 1.672(f)-3(a)(1).

<sup>266</sup> Treas. Reg. § 1.672(f)-3(a)(3).

<sup>267</sup> Treas. Reg. § 1.672(f)-3(a)(4), Example 1.

suggest that Maltese Bank is not subservient to Dashiell. Therefore, the revocable trust exception applies to the Hammett Trust.

- (4) **Example 22.**<sup>268</sup> Assume the same facts as in Example 21, except that Dashiell dies. After Dashiell's death, Nick has the power to withdraw the assets of the Hammett Trust, but only with the approval of Maltese Bank. There are no facts that would suggest that Maltese Bank is not subservient to Nick. However, the revocable trust exception is no longer applicable, because Nick is not a grantor of Hammett Trust.
- (5) **Example 23.**<sup>269</sup> Assume the same facts as in Example 21, except that neither Dashiell nor any member of Dashiell's family has any substantial ownership interest or other connection with Maltese Bank. Dashiell can remove and replace Maltese Bank at any time for any reason. Although Dashiell can replace Maltese Bank with a related or subordinate party if Maltese Bank refuses to approve or consent to Dashiell's decision to revest the trust property in himself, Maltese Bank is not a related or subordinate party. Therefore, the revocable trust exception does not apply.

ii) **Trusts that can distribute only to the grantor or grantor's spouse.**

- (1) **In general.** The IRC § 672(f) foreign nongrantor trust rule does not apply to a trust of which, at all times during the grantor's lifetime the only amounts distributable from such trust are amounts distributable to the grantor or the grantor's spouse.<sup>270</sup> For purposes of this exception, payments of amounts that are not gratuitous transfers do not constitute amounts that are distributable.

(a) **Note.** This exception may also apply to only part of a trust.<sup>271</sup>

(2) **Amounts distributable in discharge of legal obligations.**

- (a) **Generally.** A trust will not fail this exception solely because amounts are distributable from the trust to discharge a legal obligation of the grantor or the grantor's spouse. For this purpose, an obligation is considered a "legal obligation" if it is enforceable under the local law of the jurisdiction where the grantor or his/her spouse resides.<sup>272</sup>

(b) **Obligations to related parties.**

- (i) **Generally.** For purposes of this exception, obligations to related persons do not constitute legal obligations unless they are either:

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<sup>268</sup> Treas. Reg. § 1.672(f)-3(a)(4), Example 2.

<sup>269</sup> Treas. Reg. § 1.672(f)-3(a)(4), Example 3.

<sup>270</sup> Treas. Reg. § 1.672(f)-3(b).

<sup>271</sup> Treas. Reg. § 1.672(f)-3(b).

<sup>272</sup> Treas. Reg. § 1.672(f)-3(b)(2)(i).

1. Contracted bona fide and for adequate and full consideration in money or money's worth; or
2. The related person is legally separated from the grantor under a decree of divorce or separate maintenance; or
3. The obligation is to support an individual who both: (a) would be treated as the grantor's (or his spouse's) dependent under IRC § 152(a)(1)-(9) (without regard to the requirement that over half of the individual's support be received from the grantor or the spouse of the grantor); and (b) is either permanently and totally disabled, or less than 19 years old.<sup>273</sup>

iii) **Compensatory trusts.** The IRC § 672(f) foreign nongrantor trust rule does not apply to a certain compensatory trusts. Specifically, treasury regulations provide that it does not apply to any part of

- (1) A nonexempt employees' trust described in IRC § 402(b), including a trust created on behalf of a self-employed individual;
- (2) A trust, including a trust created on behalf of a self-employed individual, that would be a nonexempt employees' trust described in IRC § 402(b) but for the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of Treas. Reg. § 1.83-3(e); and
- (3) Any additional category of trust that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin.

d) **Recharacterization of certain purported gifts.** IRC § 672(f)(4) provides that direct or indirect transfers from a partnership or foreign corporation that are treated as gifts by the transferee may be recharacterized in the manner that the Treasury Department deems appropriate to prevent the avoidance of the IRC § 672(f) rules. The preamble to the proposed regulations under IRC § 672(f)(4) indicated that this provision was intended as a backstop to IRC § 672(f) and was intended to “prevent taxpayers from avoiding the general rule of section 672(f) by using a partnership or foreign corporation as a substitute for a trust.”<sup>274</sup>

e) **Trusts created by certain foreign corporations.**

- i) IRC § 672(f)(3) and the regulations thereunder provide that the IRC § 672(f) foreign nongrantor trust rule does not apply to controlled foreign corporations (“CFC”), passive foreign investment companies (“PFICs”), or foreign personal holding companies (“FPHCs”). This prevents CFCs, PFICs, and FPHCs from using foreign trusts to avoid US tax.

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<sup>273</sup> Treas. Reg. § 1.672(f)-3(b)(2).

<sup>274</sup> Preamble to Prop. Treas. Reg. § 1.672(f)-4, 62 Fed. Reg. 30,785, 30,788 (June 5, 1997), referring to Staff of the Joint Committee on Taxation, 104<sup>th</sup> Cong., 2d Sess., “General Explanation of the Tax Legislation Enacted in the 104<sup>th</sup> Congress,” at 271 (1996) (Committee Print).

- ii) **Note.** Although IRC § 672(f)(3) treats CFCs, PFICs and FPHCs as domestic corporations for grantor trust rule purposes, IRC § 674(f)(4) (discussed above) gives the IRS authority to recharacterize purported gifts to US persons that are made directly or indirectly from foreign corporations. The regulations treat gifts to US persons that are made from a trust funded by a foreign corporation as if made indirectly by such corporation if that incurs more US tax.
- f) **Recharacterizing beneficiary as grantor of inbound trust.**
  - i) **Generally.** If a foreign person is treated as owning part of a trust, any US beneficiary of such trust is treated as grantor to the extent he directly/indirectly transferred property<sup>275</sup> to such foreign person in excess of transfers to the US beneficiary from the foreign person.<sup>276</sup> This rule applies without regard to whether such beneficiary was a US beneficiary at the time of any transfer.<sup>277</sup>
  - ii) **Exception.** This recharacterization rule does not apply to the extent the US beneficiary can prove to IRS satisfaction that his/her transfer to the foreign person was wholly unrelated to any transaction involving the trust.
  - iii) **Example 24.** Dashiell, an NRA, contributes property to the Maltese Corporation, a foreign corporation that is wholly owned by Dashiell. Maltese Corporation creates a foreign trust, Maltese Trust, for the benefit of Dashiell and his children. Maltese Trust is revocable by Maltese Corporation without the approval or consent of any other person. Maltese Corporation funds Maltese Trust with the property received from Dashiell. Dashiell and his family move to the US. Under the recharacterization rule of IRC § 672(f)(5), Dashiell is treated as a grantor of Maltese Trust.
    - (1) **Note.** Dashiell may also be treated as an owner of Maltese Trust under IRC § 679(a)(4).
  - iv) **Example 25.** Nick, a US citizen, makes a gratuitous transfer of \$1 million to his aunt, Nora, an NRA. Nora creates a foreign trust, the Charles Trust, for the benefit of Nick and his children. Charles Trust is revocable by Nora without the approval or consent of any other person. Nora funds the Charles Trust with the property that she received from Nick. Under the recharacterization rule of IRC § 672(f)(5), Nick is treated as a grantor of the Charles Trust.
    - (1) **Note.** Nick also would be treated as an owner of the Charles trust as a result of IRC § 679.

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<sup>275</sup> For purposes of this rule, the term property includes cash, and a transfer of property does not include a transfer that is not a gratuitous transfer (within the meaning of Treas. Reg. § 1.671-2(e)(2)). In addition, a gift is not taken into account to the extent such gift would not be characterized as a taxable gift under IRC § 2503(b). Treas. Reg. § 1.672(f)-5.

<sup>276</sup> Treas. Reg. § 1.672(f)-5.

<sup>277</sup> Treas. Reg. § 1.672(f)-5.

**g) Pre-immigration trusts.**

- i) **Generally.** If an NRA becomes a US person and has a residency starting date within five years after transferring property to a foreign trust (the “Original Transfer”), the IRC treats him as having transferred to the trust on the residency starting date an amount equal to the portion of the trust attributable to the property he transferred in the Original Transfer.<sup>278</sup>
- ii) **Cessation of application of grantor trust rules.** If an NRA who is treated as owning any part of a trust under the grantor trust rules, subsequently ceases to be so treated, he/she is treated as making the original transfer to the foreign trust immediately before the trust ceases to be treated as owned by him/her.
- iii) **Treatment of undistributed income.** For purposes of the pre-immigration trust rules, the property deemed transferred to the foreign trust on the residency starting date includes undistributed net income, as defined in IRC § 665(a), attributable to the property deemed transferred. However, undistributed net income for periods before the individual's residency starting date is taken into account only for purposes of determining the amount of the property deemed transferred. In other words, an NRA who immigrates to the US within five years of creating a foreign trust is deemed to have transferred to the trust both (a) the amounts previously transferred, plus (b) the undistributed income and appreciation in the assets held by the trust and attributable to the original transfers, on the date that the NRA becomes a US resident.

**6) Reporting requirements.**

- a) Form 3520: Annual return to report transactions with foreign trusts and receipt of certain foreign gifts.
- b) Form 3520-A: Annual information return of foreign trust with US owner.
- c) Form 1040 NR: US nonresident alien income tax return.
- d) Form 4970: Tax on accumulation distributions of trusts.
- e) Form TD F 90-22.1: Report of foreign bank and financial accounts.
- f) FIRPTA reports.

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<sup>278</sup> IRC § 679(a)(4); Treas. Reg. § 1.679-5(a).