TABLE OF CONTENTS

THEORY MEETS REALITY: A PRACTICAL LOOK AT U.S. THE INCOME TAXATION OF BENEFICIARIES OF FOREIGN TRUSTS

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I. Introduction

A. The United States has extensive statutes and regulations related to the taxation of trust beneficiaries on distributions from trusts, and these rules generally apply equally to beneficiaries of domestic trusts and foreign trusts.

B. Beneficiaries of foreign trusts, however, are subject to a number of additional rules and regulations that do not apply to beneficiaries of domestic trusts, including the accumulation distribution or "throwback" tax, which ceased to apply to most domestic trusts in 1998. Beneficiaries of foreign trusts are also subject to extensive information reporting requirements that do not apply to beneficiaries of domestic trusts.

C. Although there is a considerable amount of guidance from the IRS and from courts on how to apply the rules of Subchapter J to trust distributions to beneficiaries, most of that authority relates to distributions from domestic trusts. The IRS has issued very little guidance with respect to rules in Subchapter J that specifically apply to foreign trusts, and some of the guidance that the IRS has released is quite out of date. For example, the Treasury Regulations related to the throwback tax have not been updated since 1980 and are replete with references to now-repealed statutes, making the regulations irrelevant and confusing to the uninitiated. The IRS has also failed to issue regulations on a number of statutes related to the taxation of beneficiaries on distributions from foreign trusts. What guidance the IRS has issued in the last several decades tends to be in the form of IRS Notices and instructions to various tax forms, neither of which have been through the administrative process of proposed regulations, comments, hearings, and final regulations.

D. In addition to the lack of contemporary guidance on how to apply the rules of Subchapter J to beneficiaries who receive distributions from foreign trusts, applying the rules that do exist in the case of foreign trusts often raise issues that rarely arise with respect to distributions from domestic trusts. Because some of these issues rarely arise with respect to domestic trusts, advising a beneficiary on tax issues related to distributions from foreign trusts requires analysis of decades-old cases, some predating the 1986 Internal Revenue Code (and even some predating the Internal Revenue Code of 1954). Older cases, however, typically have facts that are much different than contemporary fact situations, so applying those decisions today often requires considerable analytical effort. If you like the history of tax law, you will enjoy advising beneficiaries of foreign trusts.

E. Adding to the complexity in this area is that regulations written by the Treasury and decisions made by U.S. courts in the fiduciary income tax area almost always involve trusts governed by U.S. trust laws and trustees that administer trusts in the United States. Foreign trusts, however, are almost always governed by the trust law of countries other than the United States, which differ considerably from U.S. trust law. Similarly, the way trustees administer trusts outside the United States differs considerably from the way U.S.-based trustees administer trusts. Much of the difference has to do with tax law and regulation of trustees, but some of the differences can be traced to differences in trust law.

F. The differences in trust law and the administration of trusts in countries other than the United States presents significant challenges in advising U.S. citizen and resident beneficiaries of foreign trusts. While the language and many terms are at least the same, there are obvious and nuanced differences that require thinking creatively and by analogy, and often digging up old court decisions and attempting to apply them to contemporary situations. A lawyer advising clients in this area must have a working familiarity with the trust law of other countries and practices in trust administration to work out how to apply the U.S. rules in this situation.

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G. Another set of issues that frequently arise for U.S. advisers to beneficiaries of foreign trusts relates to the taxation of trusts in other countries. The English-speaking "onshore" countries are, of course, familiar with trusts and have developed tax policies related to the taxation of trustees and trust beneficiaries. These rules, however, are frequently different than the U.S. fiduciary income tax rules. A trustee in an "onshore" jurisdiction will frequently administer a trust in a tax-efficient manner under the law of the jurisdiction. For example, under Australian fiduciary income tax rules, trustees have an incentive to distribute the income of a trust on an annual basis rather than accumulate the income. By contrast, under U.S. tax law trusts and individuals are taxed at the same rate, so there is little difference between accumulating and distributing trust income. Another example is that in Canada, the distribution of trust assets from one trust to another may be a disposition for capital gains tax purposes whereas the opposite is true in the United States. Differences of this kind in onshore taxation rules can lead to great complexities in the administration of non-U.S. trusts that have U.S. citizen or resident beneficiaries.

H. This outline addresses a selection of important topics that arise in advising U.S. citizen and resident beneficiaries on federal income tax issues related to distributions and other benefits they receive from foreign trusts. Many of these issues do not routinely arise for beneficiaries of domestic trusts, such as the throwback tax or identifying the grantor of a trust. The issues I have selected to address represent typical situations that arise for U.S. citizen and resident beneficiaries of foreign trusts that in many cases are affected by differences in trust law, differences in practices in trust administration, and differences in tax law in other countries that tax trusts and trustees. The outline will also focus on some of the issues that Congress and the IRS have addressed in some detail, the incidence of which seems few and far between in this area.

II. The Residence of Trusts for Federal Income Tax Purposes

A. *Introduction*

1. Federal tax law classifies trusts as domestic trusts or foreign trusts. Domestic trusts present few unusual federal income tax issues. On the other hand, foreign trusts raise a number of complex substantive federal income tax issues and compliance obligations.

2. It is fairly easy for a trust to be a foreign trust. Under IRC § 7701(a)(31), a trust is a foreign trust if it is not a domestic trust. A trust is a domestic trust if (a) a court within the U.S. is able to exercise primary supervision over the administration of the trust and (b) if U.S. persons have the authority to control all substantial decisions of the trust. IRC § 7701(a)(30)(E). *See also* Treas. Reg. § 301.7701-7. Thus, to be classified as a foreign trust, a U.S. court must not be able to exercise primary supervision over the administration of the trust or a non-U.S. person must have authority to control at least one substantial decision related to the trust.

3. The classification of a trust as foreign or domestic does not in and of itself determine the substantive tax rules that apply to the trust, its grantor, and its beneficiaries. Rather, a number of special rules within Subchapter J apply to foreign trusts, so you have to know how to classify the trust in order to determine whether those special rules apply. The classification of a trust as foreign or domestic also determines the compliance rules that apply to the trust, its grantor, and its beneficiaries; the compliance rules that apply to a foreign trust are much more onerous than the rules that apply to a domestic trust.

B. *Court Test*

1. To be classified as a domestic trust, a court within the United States must be able to exercise primary supervision over the administration of the trust (the "court test"). IRC § 7701(a)(30)(E)(i). According to the regulations, a court is "able to exercise" primary supervision if the court would have authority to render orders or judgments concerning the trust. Treas. Reg. § 301.7701-7(c)(3)(iii). Under the regulations, the term "primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision even if another court has jurisdiction over a trustee, a beneficiary, or trust property. Treas. Reg. § 301.7701-7(c)(3)(iii). If both a U.S. court and a foreign court are able to exercise primary supervision of the trust, the trust will meet the court test. Treas. Reg. § 301.7701-7(c)(4)(i)(1).

2. The legislative history of IRC § 7701(a)(30)(E) indicates that Congress expected the court test "generally will be satisfied by any trust instrument that specifies that it is to be governed by the laws of any State." House Committee Report on H.R. 3286 (P.L. 104-188 – Small Business Job Protection Act of 1996), *reprinted in* 1996 Tax Legislation: Law and Explanation at 675 (CCH 1996). Under the House's view of the statute, a trust would pass the court test as long as the trust instrument provides that the law of one of the states of the United States governs the trust.

3. The Treasury Regulations under IRC § 7701(a)(30)(E), however, take a more restrictive view of the court test: "[T]he terms of the trust instrument *and applicable law* must be applied to determine whether the court test . . . [is] met." Treas. Reg. § 301.7701-7(b) (emphasis added).

4. The regulations provide examples of when a trust will meet the court test:

   a. In case of a lifetime trust, if the trust registers in a Uniform Probate Code ("UPC") jurisdiction that provides for registration of trusts. *See* UPC § 7-101.

   b. If the beneficiaries and fiduciaries take steps with a court within the U.S. that cause the administration of the trust to be subject to the primary supervision of the court.

   c. A testamentary trust will meet the court test if a U.S. court has qualified all the trustees.

   See Treas. Reg. § 301.7701-7(c)(4)(i)(A)-(D). The relatively new Uniform Trust Code ("UTC") did not include a registration provision similar to UPC § 7-101, leaving it to the states that adopt the UTC to either retain UPC § 7-101 when the state replaces Article 7 of the UPC with the UTC or to enact UPC § 7-101. *See* 7C Uniform Laws Ann. (2005 Supp.) at 179.

5. In drafting regulations to implement the court test, the IRS realized that it often be difficult to determine "whether the court of a particular state would assert primary supervision over the administration of a trust if the trust had never appeared before a court." Preamble to Proposed Regulations Under IRC § 7701(a)(30)(E), 1997-25 I.R.B. 5, 5. Many states do not provide for routine court supervision of lifetime trusts or testamentary trusts. Furthermore, many non-UPC states do not provide for a mechanism by which the trust's fiduciaries and beneficiaries could simply submit the trust to the jurisdiction of a court in that state when there is no case or controversy involving the trust.

6. To address this problem, the IRS provided a "safe harbor" for trusts to satisfy the court test. If a trust meets all of the following criteria, it will automatically satisfy the court test:

   a. The trust instrument does not direct that the trust be administered outside of the United States;

   b. The trust in fact is administered exclusively in the United States; and

   c. The trust is not subject to an automatic migration provision described in the regulations.

   Treas. Reg. § 301.7701-7(c)(1).

7. For purposes of the safe harbor, the Treasury Regulations define "administration" as "the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions." Treas. Reg. § 301.7701-7(c)(3)(v). The preamble to the final regulations under IRC § 7701(a)(30)(E) note that an important factor in determining whether a trust passes the court test is where trustee meetings and activities take place. If those activities take place in the United States, even though the trustees are foreign, the trust could satisfy the court test because of its administration in the United States. T.D. 8813, 1999-9 I.R.B. 34, 36. The IRS made this point in response to a request from a commentator on the proposed regulations to make it clear that

trustee activities and meetings in the United States *would not* cause the trust to meet the court test. *Au contraire*, the government said.

8. The safe harbor test, however, does not help a trust pass the court test when some of the trustees are non-U.S. persons or when some of the activities of the trust take place outside of the United States. As noted above, the IRS views the place in which trustees meet and in which trust activities take place as very important to the safe harbor test. A trust with foreign trustees or non-U.S. activities may not satisfy the safe harbor. Instead, the trust would otherwise have to prove that a U.S. court could exercise primary supervision over the administration of the trust.

   a. A trust without a connection to a UPC state cannot register the trust in a UPC state. The UPC trust registration provisions limit registration to trusts with their "principal place of administration" in the state. UPC § 7-101. According to § 7-101, the "principal place of administration" of a trust is "the trustee's usual place of business where the records pertaining to the trust are kept, or at the trustee's residence if he has no such place of business." Thus, the ability to register a trust is of little assistance for a trust without a trustee that resides or conducts business in a UPC state.

   b. State law may provide for jurisdiction over a trust without taking any of the affirmative steps suggested in Treas. Reg. § 301.7701-7(c)(4).

      (i) Under New York law, for example, the Surrogate's Court has jurisdiction over a trust established by a settlor who was domiciled in New York when he or she established the trust. Under Surrogate's Court Procedure Act § 207, the Surrogate's Court of any county has jurisdiction over a lifetime trust the grantor of which was a New York domiciliary at the time proceedings are commenced.

      (ii) A trustee could also voluntarily submit himself or herself to jurisdiction in a U.S. state by filing a petition related to the trust in a U.S. state court. To the extent no one objects, then the court could issue an appropriate order. *See, e.g.*, *Rasmuson v. Walker Bank & Trust Co.*, 625 P.2d 1098 (Idaho 1981)(trustee defendants in a trust related case consented to court's personal jurisdiction so those defendants could not later raise lack of jurisdiction as a defense on appeal). *See generally*, *Bania v. Royal Lahaina Hotel*, 347 N.E.2d 106 (Ill. App. 1975) (describing Illinois law related to a nonresident's consent to personal jurisdiction).

C. *Control Test*

1. The second test a trust must meet to be a domestic trust is that one or more United States persons must have the authority to control all substantial decisions of the trust (the "control test"). IRC § 7701(a)(30)(E)(ii).

2. An individual is a "United States" person for control test purposes is either a U.S. citizen or a resident alien under either the green card test or the substantial presence test. *See* Treas. Reg. § 301.7701-7(d)(1)(referring to the definition of "U.S. person" in IRC § 7701(a)(30)). A domestic corporation can also be a U.S. person for control test purposes.

3. Treasury Regulation § 301.7701-7(d)(1)(ii) provides the following nonexclusive list of "substantial decisions" with respect to a trust:

   a. Whether and when to distribute income or principal;

   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; however, if a United States person under section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor’s power to make investment decisions at will.

4. Note that not all the “substantial decisions” may be made by fiduciaries, such as trustees. A trustee remover, for instance, may act in a nonfiduciary capacity. The fact that a person does not act in a fiduciary capacity, however, is not relevant for purposes of the control test. *See* Treas. Reg. § 301.7701-7(d)(1)(iii). Furthermore, the IRS considers powers to make substantial decisions held by grantors and beneficiaries when applying the control test. T.D. 8813, 1999-9 I.R.B. at 36. (“The final regulations . . . count all powers held by grantors and powers held by beneficiaries including those that affect solely the portion of the trust in which the beneficiary has an interest.”). *See, e.g.,* PLR 200243031 (a revocable trust established under the laws of one of the U.S. states by a nonresident alien is a foreign trust because of the settlor’s power to revoke the trust, which was a “substantial decision” related to the trust).

5. Under the regulations, U.S. persons will control all substantial decisions if U.S. persons have “the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions.” Treas. Reg. § 301.7701-7(d)(1)(iii). Thus, if a U.S. person and a non-U.S. person share authority to make a substantial decision and they must act jointly, then the non-U.S. person has the power to veto a substantial decision. This means that the non-U.S. person controls a substantial decision of the trust, which will cause the trust to flunk the control test.

6. According to the IRS, “control should be defined to mean full power over the trust consistent with a trustee’s traditional role in trust administration.” T.D. 8813, 1999-9 I.R.B. at 37. As a consequence of this principle, the IRS takes the position that a trust cannot avoid foreign status if a U.S. person who is not a trustee can veto a foreign trustee’s decisions. *Id.* On the other hand, if a foreign person can veto the decisions of a U.S. trustee, the IRS will treat the trust as a foreign trust. *Id.*

7. By contrast, if a non-U.S. person controls a “ministerial” decision related to the trust, the trust will not flunk the control test, all other things being equal. According to the regulations, “ministerial decisions” include “decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions.” Treas. Reg. § 301.7701-7(d)(1)(ii).

8. Note, however, that the safe harbor for the court test requires that the trust be administered exclusively in the U.S. Treas. Reg. § 301.7701-7(c)(1). The broad definition of administration in the court test regulations suggests that some ministerial decisions could fall within the category of “administration.” Thus, if a foreign person makes these ministerial decisions for a trust, that trust would pass the control test but not qualify for the safe harbor under the court test. In this situation, the clients may need to make steps to otherwise qualify the trust under the court test.

D. *Inadvertent Migrations*

1. The government recognized that a domestic trust could inadvertently become a foreign trust through changes in the identity of persons who make substantial decisions related to the trust. For instance, assume a trust designated a non-U.S. citizen residing in Canada as a successor trustee following the death or resignation of the initial trustee. If the initial trustee was a U.S. citizen, his or her death or resignation would trigger the appointment of the Canadian resident as successor trustee. At that point the trust would "flunk" the control test because a Canadian resident would control substantial decisions of the trust. *See* IRC § 7701(a)(30)(E)(ii).

2. The Treasury Regulations provide that if the "death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust" would cause the trust to flunk the control test and the change in personnel was not intended to cause the trust to migrate, the trust has 12 months from the change in personnel to "cure" the inadvertent migration. Treas. Reg. § 301.7701-7(d)(2)(i).

3. The trust can cure the inadvertent migration by either replacing the foreign person who caused the change in status or by having the foreign person can become a U.S. person in the 12-month cure period. Treas. Reg. § 301.7701-7(d)(2)(i). The regulations under IRC § 684 provide that if a trust takes advantage of the cure provisions following an inadvertent migration, the deemed disposition tax will not apply to the migration. Treas. Reg. § 1.684-4(c).

4. A trust can request the district director to give it additional time to make the necessary modifications to cure the inadvertent migration. The trust must show reasonable cause for its failure to modify the trust within the 12-month period. The regulations suggest that reasonable cause would exist if the trust took reasonable actions to prevent the migration but could not complete the necessary actions due to "circumstances beyond the trust's control." Treas. Reg. § 301.7701-7(d)(2)(ii).

III. Who is the Settlor of a Foreign Trust?

A. *Introduction*

1. Identifying the settlor or grantor of a foreign trust for U.S. federal income tax purposes is usually the first step in the analysis of U.S. income tax issues related to the settlor, the trust, and its beneficiaries. In particular, you must know who the grantor of a trust is to evaluate whether the trust is a grantor trust. This in turn affects the taxation of the grantor and the trustee on U.S.-source income as well as the beneficiaries on trust distributions.

2. Unlike in the United States, the name of the true settlor – the person who made a gratuitous transfer of funds to the trust – will not necessarily appear on the face of a trust deed or agreement established under the laws of a country other than the United States.

   a. It is not uncommon, for example, for a nominal or accommodation settlor to establish a trust in a country other than the United States.

   b. In other situations, a trustee may simply declare a trust without reference to the settlor. This can occur because the trust established to receive a distribution from another trust or for privacy reasons.

   c. In Australia, for example, it is customary for an unrelated person, such as the settlor's lawyer, to settle a trust that will ultimately be funded by the settlor.

      (i) One reason for this is that under Australian income tax law, if income of a trust can be distributed or accumulated (or the trust deed can be amended by the creator so as to allow distribution or accumulation) for the benefit of the "creator" of the trust or a minor child of the creator, additional income tax is payable. If, however, the trust has a creator unrelated to the parent for whose family the trust is created, then later settlement of funds on the trust by the parent will not be subject to additional income tax if the funds are distributed to or accumulated for the benefit of the parent or any minor child.

(ii) Another reason, at least in New South Wales, is that there is a concern that if a trust deed includes the named settlor of the trust as a beneficiary, then subsequent changes in trustee of the trust may incur a stamp duty based on the value of the entire trust fund.

3. The U.S. tax laws are written from the perspective that it is generally easy enough to identify the settlor or grantor of a trust. However, in the case of a foreign trust it is not necessarily so easy, which requires lawyers who work in this area to have a thorough understanding of U.S. tax law related to identifying the grantor of a trust. This part of the outline describes those rules, which are a combination of regulations and court decisions.

B. *Trusts Established After August 9, 1999*

1. For trusts established after August 9, 1999, the "grantor" of a trust is the person who makes a "gratuitous transfer" to the trust. Treas. Reg. § 1.671-(2)(e)(1). A trust can have more than one grantor if more than one person makes a gratuitous transfer to the trust, which will result in the "portion" rule applying such that each person is treated as the grantor of a proportionate part of the trust. *See* Treas. Reg. § 1.671-3(a)(2).

2. A "gratuitous transfer" is "any transfer other than for fair market value." The regulations provide that a transfer of property to a trust may be considered to be a gratuitous transfer without regard to whether the transfer was treated as a gift for federal gift tax purposes. Treas. Reg. § 1.671-2(e)(2)(i).

3. If the trustee of a trust makes a transfer to another trust, such as pursuant to a decanting power, the settlor of the first trust will be treated as the settlor of the second trust. On the other hand, if a beneficiary of a trust has a general power of appointment over a trust and exercises the power by appointing assets to another trust, the beneficiary will be treated as the grantor of the new trust. Treas. Reg. § 1.671-2(e)(5).

4. If a corporation or partnership makes a gratuitous transfer to a trust for a business purpose, then the corporation or partnership will be treated as the grantor of the trust. On the other hand, if a partnership or corporation makes a gratuitous transfer to a trust that is for the personal purposes of one or more of the partners or shareholders of the transferor, the funding of the trust is treated as a two-step transaction: the partnership or corporation will be deemed to have made a distribution to the partner or shareholder, and the partner or shareholder will be deemed to have made the gratuitous transfer to the trust. Treas. Reg. § 1.671-2(e)(4).

5. If one person creates and funds a trust on behalf of another person, both persons will be treated as the grantors of the trust. If, however, a person settles a trust on behalf of another person and does not transfer any assets to the trust, only the true settlor will be treated as the grantor. A similar rule applies if the true settlor reimburses the nominal settlor for funds he or she settled on the trust. Treas. Reg. § 1.671-2(e)(1).

C. *Trusts Established Before August 10, 1999*

1. While Treas. Reg. § 1.671-2 applies to transfers in trust made on or after August 10, 1999, the IRS suggested that the regulation was reflective of existing law. *See* 62 Fed. Reg. 30785, 30787 (June 5, 1997). For transfers before August 10, 1999, identifying the grantor of a trust depends on facts and circumstances of the situation.

2. Under general principles of U.S. federal income tax law that applied before August 10, 1999, the "grantor" of a trust was the person who in substance makes a gratuitous transfer to the trustee. *See Smith v. Commissioner*, 56 T.C. 263, 289-90 (1971) ("That the true settlor of a trust may be someone other than the one who appears in form as the settlor has been well established in a long line of cases beginning at least as far back as [1940] . . . ."). If a person settled a trust for a nominal sum in connection with a series of related transactions in which another person ultimately provides substantially all the settled funds, the nominal settlor was not treated as the "true" or

“ultimate” grantor of the trust. *See, e.g., Amabile v. Commissioner*, T.C. Memo. 1986-180 (1986) (“There may be times when someone other than the actual creator of the trust is its grantor.”).

3. While there is no hard and fast rule on when a court will ignore a nominal settlor in favor of the ultimate settlor of the trust, these facts are important:

- The transfer of nominal capital to the trust by the named settlor in comparison to the amounts ultimately transferred into the trust arrangement;
- The settlement of the trust and the transfer of property to the trust by the ultimate settlor in close proximity of time;
- Whether the ultimate settlor orchestrated the overall arrangement; and
- The named beneficiaries of the trust are the descendants or otherwise the natural objects of the bounty of the ultimate settlor.

Stern v. Commissioner, 77 T.C. 614, 647 (1981).

4. All of this is part of a more general approach in U.S. tax law to focus on the substance of a trust arrangement, rather than its form, to determine the tax consequences of a trust-related transaction:

> “Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct must not frustrate an examination of the facts in the light of the economic realities.”

Lazarus v. Commissioner, 58 T.C. 854, 864 (1972) (citing *Helvering v. Clifford*, 309 U.S. 331, 334 (1940)).

5. In *Stern*, for example, a lawyer recommended that the taxpayer create a foreign trust and sell appreciated assets to the trustee in exchange for an annuity. In order to ensure that the trust was a foreign trust, the lawyer suggested the taxpayer ask a nonresident alien of the United States to settle a trust for his benefit.

a. The taxpayer asked a lawyer in the Cayman Islands whom the taxpayer had met in passing at a hotel in Miami a few years earlier if he could settle the trust, and the Cayman lawyer agreed. The Cayman lawyer transferred $5,000 to a trust for the benefit of the taxpayer and the taxpayer’s family. As planned, the taxpayer later sold appreciated property to the trustee in exchange for an annuity with an actuarial value equal to the transferred property.

b. The IRS took the position that the taxpayer was the grantor of the trust, that the trust was a grantor trust, and that the sale had no tax effect. The taxpayer argued that the Cayman lawyer was the “grantor” of the trust. The court had little patience with this argument, pointing out that the Cayman lawyer barely knew the taxpayer, settled the trust as part of a series of transactions orchestrated by the taxpayer and his U.S. lawyer, and that the settled amount was nominal compared with the amount actually transferred to the trusts. The court also pointed out that the trust reflected the taxpayer’s wishes with respect to his estate plan, not the settlor’s wishes.

c. The Ninth Circuit Court of Appeals later reversed *Stern* on the issue of whether the trust was in fact a grantor trust, concluding that the trust was nongrantor trust. The court, however, did not consider the question of who was the grantor of the trust, leaving that part of the Tax Court’s decision undisturbed. Notwithstanding the reversal, the Tax Court’s decision is representative of many cases in which the courts have determined that under the facts and circumstances of a particular case, the nominal settlor of a trust should not be treated as the grantor of the trust for purposes of the grantor trust rules.

E.g., *Bixby v. Commissioner*, 58 T.C. 757 (1972) (also involving alleged private annuities); *Estate of Schwartz v. Commissioner*, 9 T.C. 229 (1947).

IV. U.S. Income Tax Treatment of Foreign Grantor Trusts

A. *The Benefits of Foreign Grantor Trusts*

1. Grantor trust status is very valuable when planning for U.S. clients who may receive gifts from outside the United States. Distributions of income and capital from a grantor trust to someone other than the grantor are gifts for U.S. federal income tax purposes rather than trust distributions. Because gifts are not ordinarily included in a U.S. citizen's or resident's income, a distribution from a grantor trust usually is not taxable to the recipient. *See* IRC § 102.

2. The tax-advantaged status of distributions from a grantor trust applies to distributions from domestic grantor trusts and foreign grantor trusts. Grantor trust treatment is particularly useful when a nonresident alien settles a trust, directly or indirectly, for the benefit of U.S. citizen or resident beneficiaries. As discussed above, under general principles of U.S. federal income tax law, when a U.S. citizen or resident beneficiary receives a distribution from a nonresident trust, that distribution may be subject to a penalty tax and interest charge if the trust has accumulated income and realized capital gains. Also, it is possible that a U.S. citizen or resident beneficiary may be deemed indirectly or constructively to own shares of foreign companies owned by the trustee of a nonresident trust under the U.S. controlled foreign corporation and passive foreign investment company rules.

3. If, however, the nonresident trust in question is a grantor trust as to a nonresident alien, distributions to U.S. citizen or resident beneficiaries while the grantor is living are not subject to tax at all; they are treated as gifts that are excluded from income. Furthermore, the indirect and constructive ownership rules under the U.S. corporate antideferral rules treat the grantor as the owner of any foreign company shares owned by the trustee, not the U.S. citizen or resident beneficiaries. These are two very important benefits of a foreign grantor trust and make the status very valuable for a family with connections to countries other than the United States.

4. The value of grantor trust treatment in this situation led Congress in 1996 to limit the application of the grantor trust rules to trusts settled by nonresident aliens. The grantor trust rules now apply only to the extent their application results in income being taken into account in computing the income of a U.S. citizen or resident individual or a domestic corporation. IRC § 672(f)(1). In other words, the grantor trust rules generally do not apply to treat a nonresident alien as the owner of a trust's items of income, gain, and loss for U.S. federal income tax purposes. Under certain limited circumstances, however, a nonresident alien may be treated as the owner of a trust's income, gain, and loss.

B. *Qualifying a Foreign Trust as a Grantor Trust – Power to Revest*

1. The first circumstance is when the grantor has the power to revest title to the trust property in himself or herself that is exercisable solely by the grantor, either without the approval of another person or with the consent of a related or subordinate party who is subservient to the grantor. IRC §§ 672(f)(2)(A)(i); Treas. Reg. § 1.672(f)-3(a)(1).

2. A grantor can hold a power to revest directly, through a power of revocation, a power to withdraw, or a power as trustee to distribute property to himself or herself.

   a. Congress has long tied grantor trust status to a settlor's power to "revest" the trust property in himself or herself, which means that there is an extensive body of law that interprets the term "revest" in the grantor trust context. Because IRC § 672(f)(2)(A)(i) uses the term "revest," court decisions and IRS rulings that interpret other Code sections that use the term "revest" should apply to the interpretation of "revest" as it is used in IRC § 672(f)(2)(A)(i).

b. If the grantor has the power to revoke a trust with the effect that the trust property returns to the grantor, that is a power to revest. *See* Treas. Reg. § 1.676(a)-1.

c. Similarly, if the grantor is acting as trustee and has the power to invade the trust property for his or her benefit, that is a power to revest the trust property in the grantor. *See Koehrer v. Commissioner*, 4 CCH TCM 219 (1945); Rev. Rul. 57-8, 1957-1 C.B. 204. Of course, if the grantor is a beneficiary of an irrevocable trust and a person other than the grantor is acting as trustee, then the grantor will not be deemed to have a power to revest the trust property in himself or herself under IRC § 672(f)(2)(A)(i) because the grantor does not possess the power to make distributions. Treas. Reg. § 1.672(f)-3(a)(3), Example 4.

d. Similarly, if the grantor is acting as a trustee and has the power to add himself or herself as a beneficiary, that is a power to revest the trust property in himself or herself. *See Helvering v. Stuart*, 317 U.S. 154 (1942).

e. The common thread in these cases and rulings is that a grantor should be treated as having the power to revest the trust property in the grantor directly or indirectly, in substance or in form:

> "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed . . . income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."

Corliss v. Bowers, 281 U.S. 376, 378 (1930).

3. Another way that a grantor may be deemed to have a power to revest the trust property in himself for purposes of IRC § 672(f)(2)(A)(i) is if he has the power to remove a trustee and appoint himself or a related or subordinate party as trustee.

a. The Treasury Regulations under IRC § 672(f)(2)(A)(i) do not directly address whether a grantor's unlimited power to remove and replace a trustee with himself or a related or subordinate party is a power to revest when the grantor is a beneficiary.

b. In one example in the regulations the IRS took the position that if a trustee of a trust that is not a related or subordinate party as to the grantor and the grantor may revoke with the trustee's consent and the grantor may remove and replace the trustee for any reason, the grantor will not be deemed to have the power to revest the trust property in himself or herself. Treas. Reg. § 1.672(f)-3(a)(3), Example 3. The example does not say whether there are any limitations on the grantor appointing himself or herself as trustee, which makes the example incomplete. If the grantor could appoint himself or herself as trustee, he or she should be deemed to have the powers of the trustee and, therefore, the power to revest the trust property in himself or herself.

c. Other parts of the grantor trust rules confirm that if a grantor has the power to remove and replace a trustee and appoint himself or herself as trustee, the grantor will be treated as having the powers of the trustee. For example, IRC § 674(a) generally provides that if a grantor possesses a "power of disposition" over trust property, the grantor will be deemed to own that property under the grantor trust rules. The general rule of IRC § 674(a), however, does not apply if the "power of disposition" is held by a trustee other than the grantor and no more than half of whom are related or subordinate to the grantor. The regulations under IRC § 674, however, provide that if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the IRC § 674(c) exception to IRC § 674(a) will not apply. Treas. Reg. § 1.674(d)-2(a). In other words, the grantor will be deemed to have the powers of the trustee when he or she can remove and appoint himself or herself as trustee. A similar rule applies to the exception to IRC § 674(a) for a power held by a trustee other than the grantor the exercise of which is limited to a reasonably definite external standard. *Id.*

d. A similar rule applies for estate tax and gift tax purposes, subject to the limitation for estate tax purposes a settlor of a trust will not be deemed to have the powers of the trustee if the settlor can remove a trustee but may only appoint a person who is not a related or subordinate party to the settlor within the meaning of IRC § 672(c) as a successor trustee. Rev. Rul. 95-58, 1995-2 C.B. 191.

4. It is not uncommon for foreign trusts to have privately owned trustee companies acting as trustee. This raises a question of the extent to which the grantor will be deemed to have the powers of the trustee if he or she controls or owns the trustee company. It is possible, however, that a grantor may not own a trustee company but instead controls the trustee company in some other manner, such as being a director of the trustee company or a trustee of a trust that owns the shares of a trustee company. This raises the question of to what extent powers of a grantor other than as the owner of a trustee company will result in the grantor being deemed to hold the powers of the trustee.

a. In an example under IRC § 672(f)(2)(A)(i), the IRS describes a trust created by a nonresident alien for the benefit of his children, although the settlor can revest the trust property in himself with the consent of the trustee. In the example, the settlor and his brother own the trustee company. According to the example, "there are no facts to assume that [the trustee company] is not subservient" to the grantor. For this reason, the grantor will be deemed to have a power to revest the trust property in himself with the consent of a related or subordinate party who is subservient to his wishes. Treas. Reg. § 1.672(f)-3(a)(3), Example 1. The example does not explain how the trustee company is a "subordinate party" as to the grantor other than a suggestion that the grantor owned the trustee company with his brother.

b. The example in the regulations address only a situation in which a grantor owns a trustee company, and then only describes the trustee company as a subordinate party subservient to the grantor's wishes. The example does not provide that in fact the grantor is deemed to possess the powers of the trustee company. There is, however, substantial authority to impute the powers of a trustee controlled in one way or another by a grantor to the grantor for purposes of determining whether the grantor is taxable on the trust's items of income, gain and loss.

c. Before 1954, when Congress codified the grantor trust rules, courts routinely considered whether a settlor of a trust exercised so much dominion and control over a trust to justify ignoring the trust and treating the settlor as the owner of the trust's income. Among these cases are a number in which courts considered whether a taxpayer had so much control over an entity acting as trustee as to treat the taxpayer as having the powers of the trustee. These decisions are no longer of precedential value in light of the codification of the grantor trust rules. Nevertheless, the decisions remain good authority in other areas of federal income tax where a trust settlor's level of control is important for determining the income tax attributes of the trust and its property.

d. An early decision in this area is *Phipps v. Commissioner*, 137 F.2d 141 (2d Cir. 1943).

(i) In *Phipps* the taxpayer created a trust for his family with a corporate trustee as a co-trustee with he and his wife. The taxpayer later resigned as trustee, leaving only the corporate trustee and the taxpayer's wife as trustees. Shares in the company serving as corporate trustee were held by the petitioner and his siblings. Additionally, the taxpayer was the director of the trust company since its inception and had begun to serve as vice-present of the corporation some six years later.

(ii) The Board of Tax Appeals held that under all the facts and circumstances, the taxpayer had practical control of the corporate trustee and was, in essence, serving as trustee of the trust.

(iii) On appeal, the Second Circuit agreed with that analysis. The Second Circuit, however, ultimately did not agree that the income of the trust was attributable to the taxpayer under section 22(a) of the Internal Revenue Code of 1939 because the taxpayer's spouse was a co-trustee with an interest in the trust and was deemed to have sufficient independence from the taxpayer and would not necessarily act in accordance with the wishes of the taxpayer. Nonetheless, the *Phipps* decision provides some guidance as to what extent an officer or director has effective control of a corporate trustee such that the individual cannot be treated independently of the corporate trustee.

e. In *McCutchin v. Commissioner*, 159 F.2d 472 (5th Cir. 1947), the petitioner taxpayer created four irrevocable trusts and appointed a corporation to serve as trustee of those trusts. The petitioner taxpayer was president of this corporation. The Tax Court determined that the taxpayer actually had full management of the corporation and determined that the corporation was the "alter ego" of taxpayer. *McCutchin v. Commissioner*, 4 T.C. 1242 (1946). As a result, in the case of two of the trusts, the income of those trusts was taxable to the taxpayer under section 22(a) of the Internal Revenue Code of 1939 because it was income derived from property owned by the taxpayer. The taxpayer appealed, and Fifth Circuit agreed with the Tax Court, holding that the taxpayer was "for all practical purposes the active manager and trustee" of the trusts. Through the entity trustee, the taxpayer was found to have broad discretionary powers and could withhold or distribute the trust's income to the named beneficiaries. As a result of these powers, the taxpayer's economic position "was not materially changed by the creation of the trusts."

f. Another older case that touches on this issue is *Corning v. Commissioner*, 24 T.C. 907 (1955). *Corning* involved a taxpayer's protest of the government's decision to tax him personally on the income of a trust based on his powers over who could act as trustee. The taxpayer claimed his powers, which included the power to substitute trustees without cause, were not so extensive as to warrant him being taxable on the trust's income. The Tax Court disagreed with the taxpayer that his powers to substitute trustees were limited to simply appointing a successor corporate trustee in the event of a vacancy and found for the IRS. The court noted that even if the taxpayer's powers were limited to the appointment of a successor corporate trustee, he could appoint a corporate trustee that he controlled:

> "[the power] would not prevent petitioner from appointing as trustee a corporation in which he was the sole shareholder and from exercising control in this manner."

The Tax Court ultimately determined that the taxpayer's power to substitute trustees without cause gave him sufficient dominion and control to justify taxing him personally on the trust's income and gains. While dicta, the court's comment on the appointment of a controlled trust company is relevant to the discussion at hand.

g. In a number of private letter rulings, the IRS has considered the federal income tax consequences of a number of different private trust company structures. While the structures of the trust companies and the governing provisions highlighted by the IRS in each letter ruling analysis are not identical, a common approach to the analysis can be distilled that is consistent with the approach based on the *Rifkind* decision described above. In these private rulings, the private trust company commonly has a committee that makes certain tax-sensitive decisions on behalf of the trust company. In these rulings, the IRS has treated a decision making committee as the de facto trustee when analyzing tax consequences of a private trust company as trustee. *See* PLR 200531004; PLR 200546053; PLR 200523003; PLR 200410015; PLR 200406040; PLR 200345006.

h. Courts and the IRS have also considered the issue of indirectly held powers in the estate tax context. Because the estate tax is a different tax than the income tax, courts have traditionally been reluctant to rely on decisions involving the estate tax in income tax cases and vice versa. *E.g.*, *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812, 814 (2d Cir. 1947). However, because the estate tax cases are important in this context because they reach conclusions very similar to the conclusions reached by courts in the income tax cases. To this extent, the estate tax decisions complement the income tax decisions and add to the likelihood that an individual taxpayer would be deemed to possess the powers of an entity acting as trustee that the taxpayer controls; *See, e.g.*, *Rifkind v. United States*, 54 A.F.T.R.2d 84-6453 (Cl. Ct. 1984); Rev. Rul. 72-552, 1972-2 C.B. 525.

i. The IRS's treatment of a decision making committee as a de facto trustee also is consistent with the general approach adopted by the IRS in Notice 2008-63, 2008-31 I.R.B. 261. The Notice is a draft revenue ruling regarding the income, estate, gift, and GST tax consequences of situations where family members create a private trust company to act as the trustee of trusts having family members as grantors and beneficiaries. Notice 2008-63 is a proposed ruling and cannot be relied upon as authority but is instructive because it adopts the approach of *Rifkind* and Revenue Ruling 72-552 of looking through the entity to the holders of its powers to analyze the income and transfer tax consequences of owning and operating a private trust company. In general, Notice 2008-63 states that the IRS intends that the ruling, when final, will confirm certain tax consequences that are not more restrictive than the consequences that could have been achieved by a taxpayer directly, but without permitting a taxpayer to achieve tax consequences through the use of a private trust company that could not have been achieved had the taxpayer acted directly.

5. In addition, the individual must hold the revesting power for at least 183 days in the tax year in question. Treas. Reg. § 1.672(f)-3(a)(2). If the individual does not hold the power for at least 183 days during the tax year, the trust will not be treated as a grantor trust as to the individual for the year in question.

6. The regulations also provide that a trust will be treated as a grantor trust if in the event of the individual's incapacity his or her "revesting" power can be exercised "by a guardian or other person who has unrestricted authority to exercise such power on the [individual's] behalf." Treas. Reg. § 1.672(f)-3(a)(1).

a. This rule suggests that if an individual is incapacitated, he or she will not be deemed to have the power unless a guardian or other person has unlimited authority to exercise the power.

b. That rule is in contrast to the general principle of federal tax law that an individual is deemed to possess a power even if he cannot exercise it because of a mental or physical disability. *See, e.g*. Rev. Rul. 83-25, 1983-1 C.B. 116 (minor treated as owner of trust created by the court for his benefit from personal injury suit proceeds; court had power to revoke the trust); Rev. Rul. 81-6, 1981-1 C.B. 385 (trust revocable by minor or minor's guardian was a grantor trust); Rev. Rul. 75-350, 1975-2 C.B. 366 (decedent who was mentally ill and therefore could not exercise a testamentary general power of appointment nevertheless possessed the general power for estate tax inclusion purposes). *See also*, *e.g*., *Penn. Bank & Trust Co. v. United States*, 597 F.2d 382 (3d Cir. 1979) (decedent's incapacity and resulting inability to exercise a general power of appointment did not mean that the decedent did not at her death have a general power of appointment for federal tax purposes); Tech. Adv. Mem. 8623004 (fact that decedent was mentally incompetent at his death was irrelevant for estate tax purposes; decedent possessed legal power to dispose of his property at his death); PLR 8942083 (adult incapacitated by gunshot treated as owner of trust created for her benefit from proceeds of personal injury lawsuit filed on her behalf; trustee considered non-adverse); PLR 8449016 (minors treated as owners of accounts created from proceeds of wrongful death suit of their father; bank and mother trustees).

C. *Qualifying as a Foreign Grantor Trust – Sole Benefit Trusts*

1. The second circumstance is when the only amounts distributable during the grantor's lifetime are to the grantor or the grantor's spouse. IRC § 672(f)(2)(A)(ii).

2. The Treasury Regulations add little to the statutory language, though they make it clear that the requirement that the grantor or his or her spouse be the sole beneficiaries at all times during the grantor's lifetime. Treas. Reg. § 1.672(f)-3(b)(1).

3. Neither the Code nor the Treasury Regulations, however, specifically require that the trustee be a nonadverse party in order for the trust to qualify for this exception. This contrasts with IRC § 677(a)(1), which provides that a trust of which the grantor or the grantor's spouse are beneficiaries will be a grantor trust only if distributions can be made to the grantor or the grantor's spouse at the direction of the grantor alone or with the consent of a nonadverse party. However, as discussed below, if the trustee is an adverse party, it is likely that the trust will not be a grantor trust under IRC § 677(a), which means that satisfying the "sole benefit" exception does not mean that the trust will actually be a grantor trust.

D. *No Beneficiary-Held Powers Will Qualify a Foreign Trust as a Grantor Trust*

1. Under the general grantor trust rules, when a beneficiary has the power, acting alone, to vest trust property in himself or herself, he or she will be deemed to be the owner of the income, gain, and loss from the portion that he or she can vest in himself or herself. IRC § 678.

2. If, however, such a beneficiary is a nonresident alien but is not the grantor of the trust, he or she will not be deemed to be owner of the trust property under the grantor trust rules.

   a. Under IRC § 672(f), a nonresident alien will be deemed to be the owner of a trust's income, gain, and loss under the grantor trust rules only if he or she, as the *grantor*, has the right to vest the trust property in himself or herself alone or with the consent of a subordinate party. *See* IRC § 672(f)(2)(referring to the "grantor" of a trust with respect to all relevant exceptions to nongrantor trust treatment of foreign trusts).

   b. Unless a beneficiary with a power to withdraw trust assets is also the grantor of the trust, by its terms the exception in IRC § 672(f)(2)(A)(i) does not apply because it requires the "grantor" to have the power to vest the trust property in himself or herself. As discussed above, the "grantor" of a trust is the person who made gratuitous transfers to the trust. Therefore, unless the beneficiary made a gratuitous transfer to a trust, he or she will not be the grantor, and his or her withdrawal power will not satisfy the IRC § 672(f)(2)(A)(i) limitation. *See* Treas. Reg. § 1.672(f)-3(b)(3), Example 2.

3. If, however, a trust beneficiary has a general power of appointment and exercises that power of appointment to establish a new trust, the trust beneficiary will be treated as the grantor of that trust. Treas. Reg. § 1.671-2(f)(5). If the beneficiary is a nonresident alien, that new trust will be a grantor trust if it meets one of the two exceptions of IRC § 672(f)(2).

E. *Actually Qualifying as a Grantor Trust*

1. If a trust qualifies under either exception of IRC § 672(f)(2), the next step is to determine whether the trust is in fact a grantor trust under the general provisions of the grantor trust rules. *See* IRC 672(f)(1). This should be a fairly simple exercise, with one exception.

2. If the grantor can revest the trust property in himself or herself alone or with the consent of a related or subordinate party, the trust should qualify as a grantor trust under IRC § 676. Under IRC § 676, a trust will be treated as a grantor trust to the extent the grantor can revest the trust property in himself or herself alone or with the consent of a nonadverse party. A related or subordinate party is by definition a nonadverse party, which means that if the grantor can revest

the trust property in himself or herself with the consent of related or subordinate party, the trust will qualify as a grantor trust under IRC § 676.

3. If the trust is for the exclusive lifetime benefit of the grantor or the grantor's spouse, the trust would qualify as a grantor trust under IRC § 677(a)(1) unless the consent of an adverse party is necessary for such a distribution. In the latter case, the trust would not be a grantor trust under IRC § 677 even if the trust met the requirements of IRC § 672(f)(2)(A)(ii). In this situation, the trust would need to qualify as a grantor trust under some other provision of the grantor trust rules, such as IRC § 674.

F. *Qualifying as a Grantor Trust Under the Effective Date Rules*

1. If a trust was in existence on September 19, 1995, a nonresident alien grantor of the trust may be treated as the owner of the trust's income, gain, and loss under the grantor trust rules even if the trust did not meet one of the two tests described in the immediately preceding paragraphs if it qualifies under the following effective date exception:

> The amendments made by this section shall not apply to any trust—
>
> (A) which is treated as owned by the grantor under section 676 or 677 (other than subsection (a)(3) thereof) of the Internal Revenue Code of 1986, and
>
> (B) which is in existence on September 19, 1995.

P.L. 104-188, 110 Stat. 1755, § 1904(d)(2). Congress provided that this preferred treatment for such a trust does not extend to the portion of the trust attributable to a transfer to the trust by a nonresident alien after September 19, 1995. *Id*.

2. It is not entirely clear from the statutory language whether this rule requires that the trust in question to have qualified as a grantor trust under IRC § 676 or IRC § 677 on both September 19, 1995, and the later date on which grantor trust status is an issue, or just the later date. With respect to IRC § 676, the IRS has taken the position that the trust must so qualify on both dates:

> Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of §1.672(f)-1 does not apply to any portion of a trust that was treated as owned by the grantor under section 676 on September 19, 1995, *as long as the trust would continue to be so treated thereafter*.

Treas. Reg. § 1.672(f)-3(a)(3)(emphasis added). The IRS takes a similar view of trusts that qualify as grantor trusts under IRC § 677:

> Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of §1.672(f)-1 does not apply to any portion of a trust that was treated as owned by the grantor under section 677 (other than section 677(a)(3)) on September 19, 1995, *as long as the trust would continue to be so treated thereafter*.

Treas. Reg. § 1.672(f)-3(b)(3)(emphasis added).

3. The IRS interpretation of the effective date rules to require the trust to have been a grantor trust on September 19, 1995 raises a question as to whether the trust must have been a grantor trust under IRC § 676 or IRC § 677 on September 19, 1995, or whether the trust might qualify under the effective date rules even if it did not qualify as a grantor trust under IRC § 676 or IRC § 677 on September 19, 1995, but did so on a later date.

a. The enacting legislation requires only that a trust must have been in existence on September 15, 1985 and "which is treated" as a grantor trust under IRC § 676 or IRC § 677.

b. The reference in the enacting legislation to a trust "which is treated" as a grantor trust under IRC § 676 or IRC § 677 can be read to refer to the date on which a determination of the trust's grantor trust status is made, which could of course be after September 19, 1995. If so, then a trust that was in existence on September 19, 1995, but that became a grantor trust under IRC § 676 or IRC § 677 after September 19, 1995, may qualify for the effective date exception for a year in which it is a grantor trust.

c. On the other hand, the legislative history for the effective date rules provides that the exception to the rule of IRC § 672(f)(2) applies to "certain trusts in existence as of September 19, 1995 provided that such trust is treated as owned by the grantor under section 676 or 677 (other than sec. 677(a)(3))." House Report 104-737 (Conference Report), 104th Congress, 2d Session, at 332. This language suggests that the trust in question must have been a grantor trust under IRC § 676 or IRC § 677 on September 19, 1995.

4. In both cases the Treasury Regulations have complicated rules for accounting for transfers to a grandfathered trust after September 19, 1995 and provide that if there is no separate accounting, the general rule disallowing grantor trust treatment will apply to the entire trust. Treas. Reg. §§ 1.672(f)-3(a)(2)(ii), 1.672(f)-3(b)(2)(ii).

V. Distributions to U.S. Citizen and Resident Beneficiaries of Foreign Nongrantor Trusts

A. *Background: U.S. Taxation of Foreign Nongrantor Trusts*

1. A foreign trust must generally compute its income in the same manner that a U.S. individual would compute his or her income except as otherwise provided in Subchapter J of the Internal Revenue Code. IRC § 641(b). For purposes of applying this rule, a nonresident trust is treated as a nonresident alien who is not present in the United States on any day of the year. IRC § 641(b). As a result, a nonresident trust must generally apply the rules of Part II of Subchapter N of the Internal Revenue Code to compute its income. Those rules provide that a nonresident trust is subject to U.S. income tax on its U.S.-source income. The rules also limit various deductions that a nonresident trust can take against its U.S.-source income.

2. Because a foreign trust is a non-resident alien for U.S. tax purposes, it is not subject to U.S. income tax on its non-U.S. source income. Capital gains on the disposition of U.S. assets (other than real estate) and interest on bank accounts held in the United States are deemed for tax purposes to have a source outside of the United States, which means those two items are not subject to U.S. income tax. In addition, interest paid on most bonds issued by U.S. companies and governmental entities that are publicly traded in the United States is not subject to withholding tax, which means that that interest is effectively exempt from U.S. income tax.

3. U.S.-source income on which the trust will be taxed falls into two categories. The first category is "fixed annual periodic or determinable income," and includes dividends from U.S. companies, royalties from U.S. payors, and interest paid by U.S. payors on nonregistered (i.e. nonpublicly traded) debt securities. U.S. income tax on these kinds of income will be withheld by the payor at a rate of 30% and remitted to the U.S. government. The trust will be deemed to have paid the withheld tax and will have no further obligation with respect to the tax.

4. The second category of U.S.-source income is income effectively connected with U.S. trade or business. Income allocated to a trust from a U.S. partnership or limited liability company is usually classified as "effectively connected income." In addition, rent from U.S. real estate is usually treated as effectively connected income, as are gains from the disposition of U.S. real estate. In certain circumstances, income tax will be withheld on this kind of income, but not always. If a trust has income of this kind, it will be required to file a U.S. income tax return disclosing the income and paying any required tax.

B. *What Is a Distribution from a Foreign Nongrantor Trust?*

1. The general rules of Subchapter J apply to beneficiaries of foreign trusts who receive distributions from foreign trusts. Therefore, each beneficiary who receives a distribution from a foreign trust may be required to include some or all of the distributed amount in his or her gross income based on the rules in Subchapter J, even though the trust is a foreign trust.

2. Under IRC § 662, a trust beneficiary's income includes a ratable share of the amount specified in IRC § 661 that is paid, credited, or required to be distributed to the beneficiary by a trustee.

   a. An amount should be treated as "properly" paid if authorized by the governing instrument and applicable local law and common law principles. *See*, *e.g.*, Rev. Rul. 71-335, 1971-2 C.B. 250 ("state law is determinative of the disposition of income from property during the period of administration" in the absence of testamentary provisions to the contrary).

   b. To be paid, there must be an actual payment, which is a question of fact. *McCauley v. United States*, 61-1 U.S.T.C. ¶ 9108 (E.D. Ark. 1960). An amount is not "paid" within IRC § 661 or 662 unless paid to a beneficiary. *See* Treas. Reg. §§ 1.661(a)-1(d), 1.662(a)-4 (regarding amounts used in discharge of a legal obligation as being treated as amounts properly paid or credited to a beneficiary).

   c. Trustees of foreign trusts in onshore jurisdictions, such as Australia, often "credit" a beneficiary with income of a trust but do not distribute that income. Instead, the credited income becomes an "unwithdrawn entitlement." This raises a question of whether the "crediting" is a distribution for U.S. income tax purposes.

      (i) If an amount is not paid but instead "credited" to a beneficiary, then it should also be treated as a distribution under IRC §§ 661 and 662.

      (ii) The regulations are silent as to the meaning of "credited," stating only the following:

      > An amount which is credited is included in the gross income of a beneficiary whether or not it is actually distributed.

      Treas. Reg. §1.662(a)-3(a).

   d. To be properly credited, an amount must be subject to immediate enjoyment by the beneficiary. *See Freuler v. Helvering*, 291 U.S. 35, 42 (1934) ("The test of taxability to the beneficiary is not the receipt of income but the present right to receive it"). In *Commissioner v. Stearns*, 65 F.2d 371 (2d Cir. 1993), *cert*. *denied*, 290 U.S. 670 (1933), the court held that an income distribution from an estate to a beneficiary was not "credited" while a third party creditor had laid a claim on the residuary estate:

   > To be credited, [t]he income must be so definitely allocated to the legatee as to be beyond recall; "credit" for practical purposes is the equivalent of "payment." Therefore, a mere entry on the books of the fiduciary will not serve unless made in such circumstances that it cannot be recalled.

   Id. at 373.

3. Some payments to beneficiaries are not actually "distributions" for tax purposes.

   a. A distribution of a specific item of property, such as a residence, a particular security, or an item of tangible personal property, pursuant to the terms of the "governing instrument" is not a distribution. IRC § 663(a)(1). As a result, such a distribution does not result in income to the recipient beneficiary.

b. A distribution of a specific sum of money required to be made under the terms of the governing instrument is also not a "distribution" that triggers income inclusion under IRC § 662 provided the sum of money is paid or credited in three or fewer installments. *Id*. For example, if a trust instrument requires a trustee to distribute $1 million to a beneficiary in a single installment, the beneficiary will not include the $1 million in his or her income under IRC § 662.

4. A loan from a trustee of a foreign trust to a U.S. citizen or resident beneficiary may be treated as a distribution.

a. Under IRC § 643(i), except as provided in regulations a loan of cash or marketable securities by the trustee of a foreign trust to a U.S. beneficiary, or to a U.S. person related to the beneficiary, is treated as a distribution from the trust to the beneficiary. A person is "related" to a beneficiary of a trust when their relationship is one that would cause a disallowance of a loss between them under IRC § 707(b) or IRC § 267. IRC § 643(i)(2)(B)(i).

b. The IRS has not issued any regulations under IRC § 643(i), so for the time being there appear to be no exceptions other than the statutory exception for compensated use in IRC § 643(i)(2)(E). The IRS, however, informally set forth rules on when a loan from the trustee of a foreign trust to a beneficiary would not be treated as a loan in Notice 97-34, 1997-1 C.B. 422.

(i) Under Notice 97-34, a loan from a foreign trust to a U.S. beneficiary or to a U.S. person "related" to the U.S. beneficiary will be treated as a loan and not a distribution as long as the loan is a "qualified obligation." A loan must meet the following criteria to be considered a qualified obligation:

(a) The loan is in an "express" writing;

(b) The term of the loan is five years or less;

(c) Payments are denominated in U.S. dollars;

(d) The yield to maturity is not less than 100% of the IRC § 1274(d) rate and not greater than 130% of that rate on the date of issuance of the loan;

(e) The lender extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the loan is outstanding, to a date not earlier than three years after the maturity date of the obligation; and

(f) The lender reports the status of the loan, including principal and interest payments, on an IRS Form 3520 for every year that the loan is outstanding.

Notice 97-34, § V(A). The notice has a number of other rules related to qualified obligations, including a rule that treats the renegotiation of the loan as a new loan. *See id*. *See also* Treas. Reg. § 1.679-4(d)(5)(providing similar rules for loans from U.S. citizen and resident grantors to foreign trusts).

c. Any loan that is not a qualified obligation is treated as a distribution to the beneficiary. Notice 97-34, § V(A). The amount of the distribution will be the "issue price" of the loan as determined under Treas. Reg. §§ 1.446-2(d)(1), 1.1273-2 or section 1.1274-2, whichever is applicable. Similarly, if a loan starts out as a qualified obligation but ceases to be a qualified obligation, the beneficiary is deemed to have received a distribution on the date the failure occurs "in an amount equal to the original obligation's adjusted issue price (within the meaning of section 1.1275-1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of section 1.1273-1(c)) as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation." Notice 97-34, § V(A).

5. A below-market loan from a foreign trust to a *nonresident alien* beneficiary, on the other hand, is not a distribution from the trust unless the loan is not a bona fide loan.

a. Trustees of foreign trusts often make interest-free loans to beneficiaries. As discussed above, an interest-free loan from the trustee of a foreign trust to a U.S. citizen or resident beneficiary is a distribution under IRC § 643(i). If an interest-free loan to a beneficiary who is not a U.S. citizen or resident is also a distribution, then the interest-free loan could reduce the trust's distributed net income and potentially undistributed net income or "UNI" (discussed in more detail below). On the other hand, if such an interest-free loan is not a distribution, then the trust's DNI and UNI would not be reduced by the amount of the loan unless and until the loan is forgiven or written off.

b. Ordinarily a loan from a trustee to a beneficiary is not a distribution, which is why it was necessary for Congress to enact IRC § 643(i). However, there is a significant body of tax law that treats transactions that are nominally loans as other than loans under certain circumstances, particularly in the case of demand loans with no fixed maturity date and no apparent intent to seek repayment. *See, e.g., Wood Preserving Corp. of Baltimore, Inc., v. U.S.*, 347 F.2d 117 (5th Cir. 1965); *See, e.g., Jaeger Auto Fin. Co. v. Nelson*, 191 F. Supp. 693 (E.D. Wis. 1961); *Dixie Diaries Corp. v. Commissioner,* 74 T.C. 476 (1980); *Gooding Amusement Co. Inc. v. Commissioner,* 23 T.C. 408 (1954); IRS Notice 94-47, 1994-1 CB 357.

c. Only one court decision or ruling addresses whether a loan from a trust is a distribution or a loan.

(i) In *Bohan v. United States*, 326 F. Supp. 1356 (W.D. Mo. 1971), the executor of a decedent's estate distributed property to the sole residuary beneficiary in advance of the final settlement of the estate. Under local law, the court could recall the distribution. The IRS asserted that the payments were taxable distributions to the residuary beneficiary in the year of receipt to the extent of the estate's distributable net income (for which the estate was allowed corresponding deductions) because the executor had "properly paid" the distribution. The taxpayer argued, among other things, that the payments were not "properly paid" because local law prohibited a final distribution from an estate until all debts of the estate were paid. The taxpayer also pointed out that because the estate's debts exceeded the estate's net income earned in the year of payment, the payments were in fact nontaxable advances of corpus, properly paid only when the residuary estate was finally distributed in a later year.

(ii) The court decided in favor of the taxpayer, finding that the property was not "properly paid" within the meaning of IRC §§ 661 and 662 at the time of payment because under local law all "distributions" from an estate made before payment of debts were subject to recall. The court relied on the conditional nature of the payments and the fact that the property could be recalled, in whole or in part, based on the estate's debts.

(iii) The court's decision was upheld by the United States Court of Appeals, Eighth Circuit. *See Bohan v. United States*, 456 F.2d 851 (8th Cir. 1972). The IRS declared it would not follow the decision, though the issue appears to have not arisen again in a reported case. *See* Rev. Rul. 72-396, 1972-2 CB 312.

d. Given the lack of court decisions and rulings related to the character of loans in the fiduciary income tax context, if this issue arises it will be helpful to consider general rules in this area because the IRS or a court may consider those rules when evaluating whether a loan is really a loan for tax purposes.

e. If you conclude that an interest-free loan to a beneficiary is not in fact a distribution, the question remains as to whether the IRS would treat an otherwise bona fide loan from a foreign trust to a non-U.S. beneficiary as a distribution if the loan was not in qualified obligation form based on the spirit of IRC § 643(i). The answer appears to be no.

(i) In the first instance, IRC § 643(i) refers only to loans to beneficiaries who are U.S. citizens and residents. To this extent, the plain language of IRC § 643(i) indicates that its principles do not apply to loans to beneficiaries who are not U.S. citizens or residents. Accordingly, interest-free loans from a foreign trust to beneficiaries who are not U.S. citizens or residents should not be treated as distributions to those beneficiaries simply by reason of IRC § 643(i).

(ii) Principles of statutory construction support this limited view of IRC § 643(i). Courts have historically relied on the maxim *expressio unius est exclusio alterius*, or the inclusion of one exception to a rule should be interpreted to exclude any further exceptions to the rule, in interpreting Internal Revenue Code provisions that articulate exceptions to general rules. *E.g.*, *Debough v. Commissioner*, 142 T.C. 297 (2014); *Rand v. Commissioner*, 141 T.C. 376 (2013); *Hewlett-Packard Company, et al. v. Commissioner*, 139 T.C. 255 (2012). A court cannot rely on the maxim, however, to interpret a statute in a way that frustrates Congressional intent. *E.g.*, *Burns v. United States*, 501 U.S. 129, 136 (1991) (the maxim is not a rigid rule and will not apply if the result "is contrary to all other textual and contextual evidence of congressional intent"); *Neuberger v. Commissioner*, 311 U.S. 83, 88 (1940)("The maxim '*expressio unius est exclusio alterius*' is an aid to construction not a rule of law. It can never override clear and contrary evidences of Congressional intent." (quoting *United States v. Barnes*, 222 U.S. 513 (1912))).

(iii) In the case of IRC § 643(i), Congress articulated an exception to the general rule that a loan is not a trust distribution. To this extent, using the maxim to determine whether IRC § 643(i) applies to loans to beneficiaries who are not U.S. citizens and not U.S. residents is appropriate and indicates that loans to such beneficiaries that not in the form of a qualified obligation are not distributions. Furthermore, this interpretation does not contradict Congressional intent. The House and Senate reports enacting IRC § 643(i) were silent on its application to loans to non-U.S. persons. This suggests, at a minimum, that Congress did not have an affirmative intent for the exception articulated in IRC § 643(i) to apply to loans to trust beneficiaries who are not U.S. citizens or U.S. residents.

6. Under another special rule, a U.S. beneficiary's use of property of a foreign trust without the payment of the fair rental value of the property constitutes a distribution to the U.S. beneficiary from the foreign trust in an amount equal to the fair market value of the use of the property. *See* IRC § 643(i). If, however, the beneficiary pays the trustee the fair market value for the use of the property, such as rent, within a reasonable time of the use, the use will not be a distribution. IRC § 643(i)(2)(E).

7. The rules for determining the amount of an actual or deemed distribution depend on the nature of the property distributed.

a. In general, the amount of a distribution of a cash distribution is the amount of the cash. If a trustee distributes foreign currency to a U.S. citizen or resident beneficiary, the beneficiary must report the amount of the distribution in U.S. currency.

b. If a trustee distributes property, the amount of the distribution is the lesser of the beneficiary's basis in the property or the fair market value of the property. *See* IRC §

643(e)(2). The beneficiary's basis in the property is generally the trustee's basis in the property unless the trustee elects under IRC § 643(e) to recognize gain or loss on the distribution of the property to the beneficiary, in which case the beneficiary's basis in the property is its fair market value. *See* IRC § 643(e)(1).

C. *Taxation of Distributions from Foreign Nongrantor Trusts - Basics*

1. Distributions from foreign trusts are taxable in the hands of U.S. citizen and resident beneficiaries under the general principles of Subchapter J. In other words, if the trust has distributable net income or "DNI" in the year of the distribution, the beneficiary will receive a ratable share of the DNI in the usual manner. *See generally* IRC § 662.

2. Under general principles of U.S. federal income tax law, a foreign trust's DNI is the sum of its worldwide income less appropriate deductions, all computed as if the trust was a U.S. resident trust. *See* IRC § 643(a)(6)(A). Of course, a foreign trust is not subject to U.S. federal income tax on its non-U.S. source income. The purpose of the DNI computation for a foreign trust is to determine the extent to which U.S. citizen and resident beneficiaries are subject to U.S. federal income tax on the trust's current income and realized gains allocated or distributed to the beneficiaries as well as accumulated income and realized gains distributed to beneficiaries. The DNI computation is also important for determining whether the trustee or the non-U.S. beneficiaries will be taxable on the U.S.-source income of the trust for a particular year.

3. Unlike a domestic trust, however, a foreign trust's DNI includes the trust's realized capital gains. IRC § 643(a)(6)(c). As a nonresident alien, a foreign nongrantor trust is not subject to U.S. income tax on its capital gains from the sale of U.S. assets or any other assets, other than U.S. real property interests. The inclusion of the trust's realized capital gains in its DNI, however, will effectively make the trust's worldwide capital gains subject to U.S. income tax to the extent the trustee makes a distribution to a U.S. beneficiary.

4. Under a special rule, if the trust's fiduciary accounting income exceeds the trust's DNI and the trustee distributes an amount greater than its DNI but less than the trust's accounting income, the beneficiary can treat the excess as a nontaxable distribution. *See* IRC § 665(b); Treas. Reg. § 1.665(b)-1A(c)(2). Recall, however, that the definition of DNI of a foreign trust includes its realized capital gains, so under general fiduciary accounting principles it is unlikely that a distribution of accounting income will exceed a foreign trust's DNI for a year absent a lot of deductible expenses charged to principal.

5. If the trustee of a foreign trust pays tax on items included in the trust's DNI, those taxes do not reduce DNI. Instead, the beneficiary is treated as having received a proportionate share of the gross amount of income subject to the tax and as having paid a proportionate amount of the tax. This principle applies to both foreign taxes paid by the trustee as well as U.S. tax paid by the trustee on U.S.-source income that is included in DNI.

   a. For example, a Canadian resident trust generally receives its Canadian-source income free from Canadian tax. The trustee of such a trust, however, must withhold tax on the distribution of that income to a U.S. resident beneficiary at a 15% rate (for dividends deemed distributed). The trust's DNI will include the gross amount of the Canadian-source income.

   b. If the trustee makes a distribution of the Canadian source income to a U.S. beneficiary on which the trustee withholds tax, the beneficiary will be deemed to have received the gross amount of the distribution and be deemed to have paid the withheld tax. As a result, the U.S. beneficiary will be able to take a credit for the Canadian tax paid, subject to certain limitations under U.S. law.

   c. Similarly, if the trustee of a foreign trust makes a distribution in a year in which the trust had U.S.-source income, any U.S. citizen or resident trust beneficiaries will be deemed to have paid the U.S. tax paid by the trustee. Ordinarily the trustee will have paid tax through withholding at the source by a U.S. payor, and in that situation the beneficiary will be deemed to have paid a pro-rata share of the withheld tax.

6. When a trustee makes a distribution in kind, i.e. a distribution of property other than cash, the amount of the distribution for fiduciary income tax purposes is the lower of the fair market value of the property or its adjusted basis for federal income tax purposes.

   a. This means that when the trustee of a foreign trust makes an in-kind distribution, both the trustee and the beneficiary must know the trust's adjusted basis in the property in order to determine how much DNI the distribution carries out to the beneficiary.

   b. Under IRC § 643(e)(3), a trustee can make an election on a trust's federal income tax return to recognize gain on a distribution of appreciated property, which in the domestic trust context causes the trust to recognize any built in gain and carries out DNI in an amount equal to the fair market value of the property. The beneficiary then has a basis in the property equal to its fair market value on the date of distribution.

   c. It is unclear whether a trustee of a foreign trust may make such an election or would even want to.

      (i) Under IRC § 643(e), the election must be made on a tax return filed by the trustee of a trust. Ordinarily a trustee of a foreign trust would not file a U.S. federal income tax return unless the trust had U.S.-source income.

      (ii) Even if the trustee of a foreign trust could make an election under IRC § 643(e), it may be counterproductive because the gain resulting from the deemed disposition will be included in the trust's DNI, thereby causing the beneficiary to effectively be taxed on some or all of the gain. *See* IRC § 643(a)(6)(c). Any gain deemed not distributed would become undistributed net income, which would greatly increase the tax cost of a later accumulation distribution (discussed in more detail below). If the trustee simply distributed low basis property in kind, the beneficiary would receive a smaller share of DNI and would be able to later sell the trust property and pay tax at normal U.S. capital gains tax rates.

7. The separate share rule of IRC § 663(c) frequently comes up with foreign trusts and can have a substantial impact on the taxation of distributions to U.S. beneficiaries.

   a. Under IRC § 663(c), a trustee of a trust with more than one beneficiary must allocate DNI pro rata among the trust beneficiaries to the extent that the trust instrument provides for substantially independent and separate shares for the beneficiaries. For example, if a trust instrument provides for the payment of the trust income in equal shares to three beneficiaries those beneficiaries have separate and independent shares. In that situation, the separate share rule requires the trustee to effectively treat the shares as separate trusts for purposes of allocating DNI among trust beneficiaries, even though the trustee files only one income tax return.

   b. The separate share rule does not apply in the case of a discretionary trust where the trustee can select among a class of beneficiaries to whom to distribute income and principal. In that case, the trust cannot be analogized to separate trusts maintained for each beneficiary. Treas. Reg. § 1.663(c)-3(a).

   c. The only purpose of the separate share rule is as a guide for the allocation of DNI among trust beneficiaries. It does not result in the separation of trusts for other purposes of Subchapter J. Treas. Reg. § 1.663(c)-1(b).

   d. The separate share rule is not elective; a trustee must use it when separate shares are present. Treas. Reg. § 1.663(c)-1(d).

e. The separate share rule applies equally to domestic trusts and foreign trusts. If a foreign trust has separate and independent shares for beneficiaries and the trustee makes a distribution to one beneficiary but not another, the distribution would only carry out a ratable share of the trust's DNI and UNI to the distributee.

f. The separate share rule can have unfortunate consequences when a foreign trust has U.S. citizen or resident beneficiaries and non-U.S. citizen or resident beneficiaries. For example, trustees of foreign discretionary trusts often make large distributions to non-U.S. citizen or resident beneficiaries to clean out the trust's DNI and UNI, followed by a distribution to U.S. citizen or resident beneficiaries in later years (a "cleansing" distribution). If, however, the separate share rule applied to the trust, the cleansing distribution would clean out only a fraction of the trust's DNI and UNI. A later distribution to the U.S. beneficiaries would carry out their share of the trust's DNI and UNI.

8. It is important to note that the separate share rule is not an absolute rule; sometimes separately administered shares under a trust instrument may in fact be separate trusts.

a. In some on-shore trust law jurisdictions such as Canada and the United Kingdom, trustees administer trusts for the benefit of multiple beneficiaries as a single trust with one trustee but with one or more "funds" for particular beneficiaries. The reason for this form of administration typically has to do with avoiding capital gains tax consequences of dividing trusts and administering trusts as truly separate trusts.

b. This practice of administering separate "funds" as a single trust for onshore tax purposes raises a question for U.S. tax purposes as to whether the funds are separate shares or separate trusts. If the funds are separate shares, the trustee must compute its DNI and UNI on a trust-wide basis and allocate the DNI and UNI among the funds on a ratable basis. On the other hand, if the trusts are separate trusts, the trustee must compute the DNI and UNI of the trusts on a trust-by-trust basis. This puts a premium on the trustee knowing whether it is administering one trust with separate shares or several separate trusts. The answer, of course, may be different for U.S. tax law purposes than it is for the tax law purposes of another country.

c. There is no hard and fast rule to determine when a trust composed of separate funds is subject to the separate share rule or is a series of separate trusts. The leading court decision in this area is *Robert L. Moody Trust v. Commissioner*, 65 T.C. 932 (1976).

(i) In *Moody's Trust*, the issue was whether a single trust instrument created four trusts or four separate shares. The trust instrument was not explicit on the point, and the trustee did not maintain separate accounts for the four shares for the children. Instead, the trustee maintained one bank account; the trust's other asset was certificated shares of a corporation. At the time of the IRS examination, the trustee had not made any distributions to any of the beneficiaries. The trustee, however, always filed separate fiduciary income tax returns for each of the four shares or funds, treating each of them as a separate trust.

(ii) The issue before the Tax Court was whether there was one trust with four separate shares or four separate trusts. The court characterized the issue as one involving the interpretation of the trust document, the intent of the settlor, and the "practical construction given to the instruments by the trustees." *Id*. at 937.

(iii) The court concluded that based on all the facts and circumstances, the four shares or funds were in fact separate trusts. The court thought that a "fair reading" of the trust instrument "as a whole" was that the settlor intended to create four separate trusts, one for each child. *Id. at 939.* The court considered the fact that ever since the settlor's second child was born, the trustee filed separate fiduciary income tax returns for each trust. In fact, the settlor was himself the initial trustee, which the court said demonstrated how the settlor himself viewed the arrangement and that was "of great significance in construing an ambiguous trust instrument." *Id*. at 940 (quoting *Helfrich's Estate v. Commissioner*, 143 F.2d 43 (7th Cir. 1944)).

(iv) Although the IRS appears to have complained that the trustee never physically divided the trust property or set up separate bank accounts, the court pointed out that "there was simply no reason" to do. *Id*. at 940. The trustee could easily determine the value of each fund or trust by dividing the assets held by the trustee by four; the trustee did the same when preparing income tax returns with respect to the income from the assets held by the trustee. The court cited other facts in reaching its conclusion.

d. The Tax Court reached a similar decision in *John L. Dickinson Testamentary Trust v. Commissioner*, T.C. Memo. 1993-62 (1993), which involved the question of whether a decedent's will created one trust or nine separate trusts, with the IRS prevailing on its argument that the will created nine separate trusts. *See also* Tech. Adv. Mem. 8220006 (will created seven separate trusts for beneficiaries despite ambiguities in will).

e. It is possible, however, that the IRS could determine that trusts that are separate trusts for trust law purposes are in fact a single trust for federal income tax purposes.

(i) Under IRC § 643(f), the IRS may treat multiple trusts as a single trust if the trusts have "substantially the same grantor or grantors" and "substantially the same primary beneficiary or beneficiaries" and a principal purpose of the establishment of both trusts was the avoidance of U.S. income tax. The effect of such a characterization would be to treat the U.S. beneficiaries of one trust having received a share of the DNI and UNI of another trust if the trusts are treated as a single trust.

(ii) Congress' purpose in enacting IRC § 643(f) was to prevent taxpayers from taking advantage of multiple personal exemptions and the progressive rate structure applicable to trusts by creating multiple trusts:

> Because of the progressive tax structure, it would be possible to significantly reduce income taxes by establishing multiple trusts having the same grantor and the same or similar beneficiaries. For example, if instead of establishing one $1,000,000 trust a taxpayer establishes ten essentially identical $100,000 trusts, the taxpayer will be able to secure a significantly lower marginal tax rate for the undistributed income of the trusts.
>
> The committee is concerned that, without the restrictions of the existing Treasury regulations persons would be able to significantly reduce the taxation of investment income through the creation of multiple trusts. Accordingly, the committee believes that rules similar to the rules contained in the existing regulations should be legislated by the Congress.

H.R. Rep. No. 98-432, 98th Cong., 2d Sess. 1239.

(iii) The IRS had attempted to make such a rule by regulation, but the United States Tax Court declared the regulation to be invalid. *Stephenson Trust v. Commissioner*, 81 T.C. 283 (1983). Although Congress directed the Treasury to issue regulations that directed how IRC § 643(f) would apply, the Treasury has issued neither proposed nor final regulations that direct how to apply IRC § 643(f).

(iv) Absent regulations, the legislative history of IRC § 643(f) provides some guidance on what Congress had in mind. According to the legislative history, if there are "substantial independent purposes" for multiple trusts and "tax purposes are not a principal purpose of the existence of separate trusts," the aggregation rules of IRC § 643(f) will not apply. For example, the legislative history provides an example of when IRC § 643(f) would apply:

> A establishes, with the principal purpose for the avoidance of Federal income tax, trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and trust 4 for the benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.

H.R. Rep. No. 98-432, 98th Cong., 2d Sess. 1240. The legislative history also provides an example of when IRC § 643(f) would not apply:

> X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.

Id.

(v) It is not enough that the grantor or primary beneficiaries of multiple trust be the same or substantially similar in order to trigger consolidation under IRC § 643(f). The IRS can collapse multiple trusts under IRC § 643(f) only if a primary purpose of the multiple trust arrangement is the avoidance of income tax. IRC § 643(f)(2) As mentioned above, the IRS has not issued any regulations that describe when a taxpayer's actions in establishing multiple trusts has as a primary purpose the avoidance of income tax. I did not find any court decisions that addressed the rule either.

(vi) The IRS, on the other hand, has addressed the tax avoidance issue in private letter rulings when multiple trusts met the criteria of the same grantor or same primary beneficiary, though the IRS's approach has been inconsistent. In some of the rulings in which taxpayers asked the IRS to rule on the tax avoidance issue, the IRS refused to rule. For example, in PLR 199929021, the taxpayer represented that tax avoidance was not a primary purpose of establishing multiple trusts. The IRS, however, demurred on this question:

> Determining whether avoidance of income tax is a primary purpose of the [trusts] is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office of the District Director having examination jurisdiction over the tax returns.

PLR 199929021. In some of the rulings the trusts in question clearly had different primary beneficiaries, but the IRS nevertheless refused to rule on the tax avoidance question. *E.g.*, PLR 200433011; PLR 200432005; PLR 200209007. In other rulings, also involving trusts with different primary beneficiaries, the IRS ruled that IRC § 643(f) did not apply without even discussing the tax avoidance issue. *E.g.*, PLR 200516001; PLR 200448040; PLR 199912034; PLR 9411033; PLR 8926028.

(vii) In at least two rulings, however, the IRS did take on the question of whether the primary purpose of the division of a single trust into multiple trusts was tax avoidance. PLR 9004007; PLR 8902045. In these rulings the IRS, relying apparently on the legislative history of IRC § 643(f), focused on whether or not the mitigation of the progressive tax structure appeared to be the principal purpose of the division of the trusts. In each ruling the IRS concluded that the divisions did not have such a purpose. *See also* PLR 8726027 (analyzing the facts and circumstances of a division of a trust pursuant to the settlement of litigation and concluded that avoidance of tax was not a principal purpose of the division of the trust).

(viii) The few IRS rulings that have addressed the tax avoidance issue suggest that one should look at the legislative history to determine what sort of "tax avoidance" motive concerned Congress to analyze whether the IRS might be able to collapse multiple trusts. As discussed above, Congress was concerned about the use of multiple trusts to take advantage of the progressive rate structure of the federal income tax. In fact, the regulations that the Tax Court invalidated in *Stephenson Trust* penalized only those taxpayers who had a principal purpose of avoiding or mitigating the "progressive rates of tax (including mitigation as a result of deferral of tax)" or the alternative minimum tax. Based on these facts, it appears Congress intended the reference to a "tax avoidance purpose" to mean the purpose of avoiding the progressive rate structure of the federal income tax.

(ix) Congress enacted IRC § 643(f) in 1984, when trusts typically had lower tax rates than individuals, which gave families an incentive to spread income around multiple trusts. In the Tax Reform Act of 1986, however, Congress decided to tax trusts at the same rate as individuals, although trusts get to the top brackets more quickly than individuals. This change in the law meant that there was no federal income tax benefit to spreading income across multiple trusts. In fact, planning of this kind would be counterproductive. However, it is possible that the IRS might use the doctrine to attempt to collapse multiple foreign trusts that are created to isolate DNI from capital such that a trust with no DNI and only capital makes distributions to U.S. beneficiaries.

9. The combination of these rules effectively requires the trustee of a foreign trust to prepare a DNI computation based on U.S. tax accounting principles as well as a fiduciary accounting based on applicable legal principles and in U.S. currency.

a. Keeping track of receipts and disbursements on an item-by-item basis is particularly important for a trustee because of the "character rule" that treats each beneficiary as having received a ratable share of each and every item of income included in a foreign trust's DNI. Because the U.S. has different tax rates for different kinds of income, including a zero rate on some kinds of income, a beneficiary must know what a distribution is deemed to include. The trustee can give this information to the beneficiary if the trustee has kept a proper U.S. tax account.

b. A proper income and capital account will be very helpful to the trustee in maintaining a U.S. tax account, but it is not a substitute. Many items are treated differently for tax accounting purposes and fiduciary accounting purposes. For example, many kinds of distributions from companies are classified as dividends for U.S. income tax purposes while they may be capital receipts for fiduciary account purposes. Similarly, receipts from partnerships and other unincorporated entities might not be included in a trust's U.S. income tax account but could be treated as income for fiduciary accounting purposes.

D. *Throwback Tax on Accumulation Distributions*

1. If the distribution from a foreign nongrantor trust exceeds the greater of the trust's DNI or accounting income for the year of distribution, the distribution may be an "accumulation distribution" for U.S. income tax purposes, which triggers the "throwback tax." IRC § 665(b).

2. Although Congress repealed the throwback tax on accumulation distributions from domestic trusts in 1997, the tax still applies to accumulation distributions to U.S. citizens and residents from foreign nongrantor trusts and domestic nongrantor trusts that were once foreign trusts. *See* IRC § 665(c). The purpose of the throwback tax as applied to distributions from foreign nongrantor trusts is to capture the U.S. tax that would have been paid had the trust distributed the accumulated DNI to the U.S. beneficiary on a current basis.

3. An accumulation distribution subject to the throwback tax will occur if a trust has undistributed net income ("UNI") and makes a distribution to a U.S. beneficiary in excess of the greater of the trust's DNI or accounting income for the year.

   a. If a foreign trust has DNI in a given year and the distributions, if any, from the trust do not fully carry out that DNI, the undistributed DNI becomes UNI. As noted above, a foreign trust's DNI includes its realized gains. As a result, a foreign trust that buys and sells investments could have substantial amounts of UNI, which means a later accumulation distribution could be quite large. However, accumulation distributions also have the effect of reducing UNI, so it is important for trustees to track distributions on an annual basis and keep track of the ups and downs of UNI.

   b. If a distribution is an accumulation distribution because it exceeds the greater of the trust's DNI or fiduciary accounting income, the U.S. beneficiary must allocate or "throw back" the average amount of UNI for the preceding years in which the trust had UNI to three of the five preceding taxable years. The beneficiary must then compute the average increase in his or her taxes for those three years to which the average amount was thrown back. Finally, the beneficiary multiplies the average increase in tax by the number of preceding years in which the trust had UNI. The product is the throwback tax. Thus, under the accumulation distribution rules the receipt of an accumulation distribution in effect triggers an income tax for previous years even though the beneficiary may never have received anything from the trust in those years.

   c. All the rules discussed above in relation to determining when a trust makes a distribution of DNI apply to when a trust makes a distribution of UNI. For example, the separate share rule will be very important in determining how much UNI is distributed to a U.S. citizen or beneficiary. Similarly, the amount of a distribution of UNI will be based on general fiduciary income tax principles, such as the rule that distributions in kind carry out property at basis and interest-free loans from foreign trusts are distributions.

   d. The throwback tax computations are quite complex. The throwback tax is a rough approximation of the tax that the beneficiary would have had to pay had she included the income of the trust in previous tax years, though not necessarily the years in which the income was earned.

      (i) One important feature of the throwback tax is that it does not split out the UNI between capital gains, interest, dividends, and the like; all UNI is taxed at the beneficiary's top marginal rate that applies to ordinary income. In this way the beneficiary loses the benefits of preferential rates on dividends and capital gains that apply to distributions of current income.

      (ii) For a simple example, assume a foreign nongrantor trust had DNI of $1 million in each of 2013, 2014, 2015, 2016, and 2017, all of which was non-U.S. source dividends that were taxable at capital gains tax rates in the United States (i.e. as "qualified dividends"). If the trustee had distributed the dividends to U.S.

beneficiaries, they each would have paid tax at a top rate of 20% on those dividends plus the net investment income tax, if applicable. The trustee, however, made no distributions from 2013 through 2016 but decided to make a cash distribution to a U.S. beneficiary in 2017 of $3 million. The trust's DNI is $1 million for 2017, so the distribution is deemed to consist of $1 million of DNI and $2 million of UNI. The $2 million is an accumulation distribution. Because 2013 was the first year in which the trustee accumulated DNI, the first $1 million of DNI is thrown back to 2013 and the second $1 million of DNI is thrown back to 2014.

(iii) The years to which the DNI is actually thrown back is technically important only for interest computations, which are discussed below. In order to compute the throwback tax on the accumulation distribution, the beneficiary must first determine the average amount of the accumulation distribution, which is the ratio of the total UNI deemed distributed to the number of years to which the UNI is thrown back. In our example the UNI was $2 million and the number of years to which the UNI is thrown back is two, so the average annual distribution is $1 million.

(iv) The next step is to determine the average annual increase in her income tax that would have occurred had she received the average distribution in three of the five immediately preceding tax years (even though these years are not the years to which the distribution is thrown back). In this example, the beneficiary would determine the average increase in her income tax if she had an additional $1 million included in her income in three of the five preceding taxable years, throwing out the year in which her income was the lowest and the year in which her income was the highest. Assume the increase in tax in year one is $400,000, the increase in tax in year two is $392,000 and the increase in tax in year three is $396,000. You sum the increases in tax for those three years to get a total increase in tax of $1,188,000. You then divide that total increase in tax by three to obtain the average increase in tax, which is $396,000.

(v) The foregoing example assumed that the trustee paid no foreign taxes and no U.S. taxes on the income the trustee accumulated. If the trustee paid foreign taxes on the income, those taxes are factored into the computations and effectively reduce the amount of the throwback tax; the beneficiary can effectively take a foreign tax credit for those taxes. Also, the beneficiary may reduce the throwback tax by the amount of U.S. income taxes paid on accumulated income.

(vi) Because there were two "thrown back" distributions, you next have to multiply the average increase in tax by two, which is $792,000 ($396,000 x 2). Therefore, the accumulation distribution tax (or penalty tax) is $792,000. The total tax on the $3 million distribution is $992,000, assuming a 20% tax rate on the DNI portion of the distribution, which were qualified dividends. Even though the trust's income consisted entirely of qualified dividends, the accumulation and later distribution of cash effectively resulted in those dividends being taxed at 39.6%, without taking the net investment income tax into account.

2. The U.S. beneficiary will effectively receive a credit for any foreign taxes or U.S. taxes paid on DNI that ends up in UNI. *See* IRC §§ 665(a), 665(d). This is consistent with the purpose of the throwback tax to penalize the distribution of previously untaxed income. If the income in question has been subject to tax, whether foreign or U.S., it would not further the purpose of the throwback tax to apply the tax to the distribution without taking account of those tax payments.

3. Because the purpose of the throwback tax is to capture unpaid income tax on accumulated income that should have been distributed when it was earned income, the tax bears interest. *See generally* IRC § 668.

a. Before January 1, 1996, the throwback tax bore simple interest at a rate of 6%.

b. In 1996, however, Congress imposed an interest charge on the throwback tax based on the interest rate imposed on underpayments of federal income tax under IRC § 6621(a)(2), which is compounded daily. The law includes a complicated formula to determine the period for which interest is charged using the federal underpayment rate. IRC § 668(a).

c. The sum of the throwback tax and the interest charge cannot exceed 100% of the accumulation distribution. *See* IRC § 668(b).

4. It is unclear how the throwback tax applies to an accumulation distribution when a foreign trust has UNI for years in which a beneficiary was not a U.S. taxpayer. There is no clear provision of the Code or the Treasury Regulations that deals with such a situation. The purpose of the throwback tax is to simulate the tax that the beneficiary would have paid if it the trust's income was distributed to him in the year earned rather than accumulated. *See* Treas. Reg. 1.665(a)-0A(a)(1). Because a nonresident alien would generally not be subject to U.S. income tax on a distribution from a foreign trust, the exclusion of income accumulated during years when the beneficiary is a nonresident alien makes sense. One way to think about this situation is that there could be no increase in the beneficiary's tax for years to which UNI is thrown back that are years in which the beneficiary was a nonresident alien, assuming the trust had no U.S.-source income. *See* Ellen K. Harrison, Elyse Kirchner, and Carlyn McCaffrey, *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their Beneficiaries* (ALI CLE November 2017) at 87-89. and Ellen Harrison, Even if the beneficiary is subject to throwback tax on an accumulation distribution of such income, the cost would be mitigated because there is no interest charge applicable to any year in which the beneficiary was not a U.S. taxpayer. *See* IRC § 668(a)(4).

5. In general, distributions of income accumulated before the beneficiary was born or before his or her 21st birthday (including amounts accumulated before the beneficiary's birth) are not "accumulation distributions." IRC § 665(b). This rule, however, does not apply to distributions from foreign trusts. *Id*. Logically, of the way the throwback tax is calculated, UNI should at least not be thrown back to years before a beneficiary was born because he or she would not have been subject to tax in those years. However, the negative implication of IRC § 665(b)'s exclusion of distributions of pre-birth and pre-age 21 accumulated income from the definition of an "accumulation distribution" from a domestic trust is that the exclusion does not apply to what would otherwise be an accumulation distribution from a foreign trust.

E. *Effect of Charitable Distributions on UNI*

1. Many foreign trusts include charitable organizations as permissible beneficiaries. This raises a question of the extent to which distributions to charitable organizations and for charitable purposes affect a foreign trust's DNI and its UNI and therefore, the taxation of distributions of current distributions and accumulation distributions to the trust's beneficiaries.

2. IRC § 642(c) specifically provides that the rules of that section, and not the rules of IRC § 170, which apply to individual charitable contributions, apply to charitable contributions by domestic trusts. The rules of IRC § 642(c) are specific exceptions to the rule of IRC § 641(b) that requires a trust to compute its income in the same manner as an individual taxpayer.

3. Because IRC § 642(c) is a specific exception to IRC § 641(b), a foreign trust's charitable deduction should also be governed by IRC § 642(c). Under IRC § 642(c), a trust may take a deduction for any amount included in the trust's gross income that the trustee is required by the terms of the governing instrument to distribute for charitable purposes. Unlike the individual charitable income tax deduction, the IRC § 642(c) deduction is not limited to contributions to U.S. charities; a trust may deduct contributions to non-U.S. charities under certain circumstances.

4. Trust distributions to charitable organizations can be deducted from a trust's income only if the distributed item of income was included in the trust's gross income for U.S. federal income tax

purposes. Treas. Reg. § 1.642(c)-3(b)(1). For example, a trust is not allowed to take an IRC § 642(c) deduction for tax-exempt interest distributed to a charity. Unlike an estate, a trust cannot take a deduction for amounts of gross income permanently set aside for charitable purposes; the trust must actually distribute the income for charitable purposes to receive a deduction.

5. When a trust makes a distribution to a charitable organization or for a charitable purpose and also makes distributions to noncharitable beneficiaries, the amount allowable as a charitable contribution deduction reduces each item of DNI deemed distributed to the noncharitable beneficiaries on a ratable basis. *See* IRC § 661(b); Treas. Reg. § 1.661(c)-2. This means that if a foreign nongrantor trust makes a distribution for charitable purposes and makes a distribution to noncharitable beneficiaries, then those noncharitable beneficiaries will indirectly receive the benefit of the charitable contribution deduction. As noted above, however, a trust can take a charitable contribution deduction only for amounts of gross income distributed for charitable purposes. As a result, if a foreign trust distributes principal for charitable purposes, it will not receive a charitable contribution deduction and the noncharitable beneficiaries' ratable shares of DNI deemed received by them will not be reduced.

6. If a foreign trust has UNI and makes a distribution for charitable purposes from principal, that distribution does not reduce the trust's UNI for purposes of computing the throwback tax on a later accumulation distribution to a U.S. citizen or resident beneficiary.

   a. Ordinarily an accumulation distribution reduces a foreign trust's UNI. *See* Treas. Reg. § 1.666(a)-1A(d)(when allocating an accumulation distribution to a preceding taxable year, the UNI allocated to the preceding taxable year is reduced by the amount of any accumulation distribution of UNI for that year that was deemed to have been distributed in a prior accumulation distribution).

   b. Under Treas. Reg. § 1.665(b)-1A(c)(2), any amount paid for a purpose specified in IRC § 642(c) "is not an accumulation distribution even though no charitable contribution deduction is allowed under such section with respect to such payment." The reference to a nondeductible payment for charitable purposes takes account of the fact that many distributions for charitable purposes may be made from principal, which would not give rise to a deduction under IRC § 642(c).

   c. Because a distribution for charitable purposes is not an accumulation distribution, it means that the distribution cannot reduce a foreign trust's UNI under Treas. Reg. § 1.666(a)-1A(d). As noted above, that regulation requires an accumulation distribution to have been made in order to reduce a trust's UNI for purposes of computing the throwback tax on a later accumulation distribution.

   d. Of course, if a trustee makes a distribution to a charity from principal, the trust's principal will be reduced, which necessarily means any later distribution to a noncharitable beneficiary will be less than it would have been had the trustee not made the charitable distribution. The throwback tax and interest charge cannot exceed the amount of an accumulation distribution, so in this way a charitable distribution indirectly reduces UNI. On the other hand, the charitable distribution could be seen as a 100% tax because the noncharitable beneficiaries will not receive the amount distributed for charitable purposes.

F. *Distributions Through Intermediaries*

1. When a U.S. citizen or resident beneficiary receives an indirect distribution from a foreign trust, that beneficiary is subject to tax as though he or she received the distribution directly. IRC § 643(h). The regulations describe such an indirect distribution as a U.S. person's receipt of property from another person who in turn has received property from a foreign trust pursuant to a plan with a principal purpose of tax avoidance. Treas. Reg. § 1.643(h)-1(a)(1). The intermediary may be a U.S. or foreign person, however there is likely less scrutiny applied to circumstances where a U.S. person acts an intermediary because that person would have the same tax liability for receiving the

distribution as the ultimate recipient (as well as being subject to gift tax if a U.S. citizen or domiciliary). *See* Treas. Reg. § 1.643(h)-1(g), Example 7. It is also worth noting that tax avoidance need not be the sole purpose of the plan leading to the indirect distribution. Such a plan may have other goals, but as long as tax avoidance is deemed to be one of them, it will fall under the regulation.

2. The transfer will be deemed to have been made pursuant to a plan with a principal purpose of tax avoidance if the U.S. person meets three tests under Treas. Reg. § 1.643(h)-1(a)(2):

    (a) The U.S. person must be related to the grantor of the foreign trust or there must be another relationship that creates a reasonable basis that the grantor would make a gift to the U.S. person. "Related" is defined the same way as when determining whether or not a loan from a foreign trust is a distribution but using a 10% ownership threshold rather than 50% in determining relationships with entities. Treas. Reg. § 1.643(h)-1(e);

    (b) The U.S. person receives property from the intermediary that is either the property distributed from the foreign trust to the intermediary, proceeds from the sale of that property, or "property in substitution for such property," within two years before or after the intermediary receives the distribution; and

    (c) The U.S. person "cannot demonstrate to the satisfaction of the Commissioner that" (i) the intermediary doesn't have a relationship with the U.S. person that would provide a reasonable basis for making such a gift, (ii) the intermediary acted independently of the grantor and the trustee of the foreign trust, (iii) the intermediary is not an agent of the US person under principals of U.S. agency law (regardless of the law of the country in which the intermediary is resident), and (iv) the U.S. person timely reported the receipt of property from the intermediary, for example, on a Form 3520, if the intermediary is a foreign person.

3. The practical application of this regulation means that if a U.S. person receives a gift from another person (the "intermediary") within two years before or after the intermediary receives a distribution of a trust created by someone related to the U.S. person, the U.S. person will be deemed to have received the distribution directly from the foreign trust unless he can prove all of the factors described above, in subsection 2(c).

4. On the other hand, even if the above factors are not present to establish a deemed plan with a principal purpose of tax avoidance, the IRS may still assert that the transfer was made for tax avoidance purposes, but would have the burden of proof in establishing it. This means that, for example, a U.S. person who receives property from an intermediary who held it for longer than two years after receiving it from a foreign trust would not have the benefit of any safe harbor against the IRS seeking to prove the existence of a plan of tax avoidance.

5. The indirect distribution rules do not apply if the grantor of the distributing foreign trust is the intermediary or if any of the transfers in the chain are not gratuitous transfers under Treas. Reg. 1.671-2(e)(2), i.e., if they are transfers for fair market value. Treas. Reg. 1.643(h)-1(b). The rules also do not apply to any U.S. person who receives less than $10,000 from foreign trusts (directly or indirectly) in a year. Treas. Reg. 1.643(h)-1(d).

6. It is worth noting that both the grantor as intermediary and the non-gratuitous transfer exceptions are absolute, meaning that if the intermediary-related distribution falls within one of those exceptions, there is no need to consider whether or not a plan with a principal purpose of tax avoidance exists. In other words, the grantor may receive a distribution and then give that property to a U.S. person without the anti-intermediary rule applying even if the sole purpose of avoiding the tax consequence of a direct distribution to that U.S. person. Also, this rule applies whether the distributing trust is a grantor trust or a nongrantor trust.

7. Making distributions to the grantor followed by a gift to a U.S. recipient may provide a tax-efficient alternative to making distributions to U.S. beneficiaries from a foreign nongrantor trust while the grantor is still alive, assuming that the grantor will not incur adverse tax consequences from receiving distributions from the trust. This may be an acceptable alternative when it is impossible or impractical for a foreign trust to qualify as a grantor trust. If in-kind distributions are made from the foreign trust, it may be possible to obtain a step up in basis to fair market value in the grantor-intermediary's hands if the trustee makes a section 643(e)(3) election to treat the distribution as a sale.

8. Because an intermediary is defined as a person and not an individual, a trust or estate (as well as a corporate entity) could be an intermediary. Would the estate of the grantor of a foreign trust fall under the grantor exception in the case where a U.S. person received property from the estate that was previously distributed from a foreign trust? If the distribution was paid or credited to the grantor within the meaning of IRC § 661(a)(2) before the grantor's death, the grantor exception should apply without question. However, what if the trustee of the foreign trust made a distribution that was paid or credited to the estate following the death of the grantor? The answer is unclear, but a successful argument to fall under the exception would likely rely upon establishing that the estate is the alter ego of the grantor based on the executor of the estate having no further agency or discretion to make distributions other than those mandated by the grantor's will.

G. *Compliance Issues for U.S. Beneficiaries of Foreign Nongrantor Trusts: IRS Form 3520*

1. A U.S. citizen or resident beneficiary who receives a distribution from a foreign trust must report the receipt of the distribution to the IRS on the individual's Form 3520 for the year of distribution. IRC § 6048(c). There is no reporting threshold for distributions from foreign trusts. The beneficiary must file the Form 3520 at the same time he or she files his or her individual income tax return. The taxpayer files his or her Form 3520 with the IRS Ogden Service Center regardless of where the taxpayer files his or her individual income tax return.

2. Although Congress enacted IRC § 6048(c) in its current form in 1996, the IRS has not issued any regulations under that section. To date, the only guidance taxpayers have with respect to foreign trust reporting is IRS Notice 97-34, 1997-1 C.B. 422, which the IRS issued on June 3, 1997. Because of the lack of regulations or much other guidance for that matter, there is scant authority on issues related to Form 3520.

3. The reporting requirements apply equally to distributions from foreign grantor trusts and foreign nongrantor trusts. This is true even though a distribution from a grantor trust will be treated as a gift for U.S. income tax purposes and will not carry out DNI or UNI to the beneficiary. IRS Notice 97-34, § VI(A).

4. When a U.S. beneficiary receives a distribution from a foreign trust, the IRS presumes that the distribution is an accumulation distribution and, therefore, is subject to the throwback tax and interest. IRC § 6048(c)(2).

5. The beneficiary can avoid accumulation distribution treatment by demonstrating to the IRS that the distribution was not an accumulation distribution.

   a. If the trustee provides the beneficiary with a "Foreign Grantor Trust Beneficiary Statement" the beneficiary can treat the distribution as a gift for U.S. income tax purposes, which is not subject to income tax. IRS Notice 97-34, § V(B). The foreign grantor trust statement must include the name of the trust, the address of the trustee, and an explanation of why the trust is a grantor trust. The statement must also include the amount distributed according to U.S. tax principles even though the distribution is not taxable.

   b. If the beneficiary receives a "Foreign Nongrantor Trust Beneficiary Statement" that indicates the exact composition of the distribution, then the beneficiary need not treat the distribution as an accumulation distribution. IRS Notice 97-34, § V(B). The statement, for instance, may indicate that the distribution did not exceed the trust's DNI or accounting income for the year in question. As noted above, the throwback tax does not apply to a distribution that does not exceed the greater of the trust's DNI or accounting income. Ideally the statement will provide U.S. tax-related information to help the beneficiary complete his or her tax return, such as information that would be on a K-1. It may be, however, that all the beneficiary receives is a statement saying that the distribution was from income, which means the beneficiary must treat the distribution as ordinary income.

6. If the beneficiary did not receive a Foreign Grantor Trust Statement or a Foreign Nongrantor Trust Statement that indicates that the distribution was not an accumulation distribution, the beneficiary must determine how to compute the throwback tax. The beneficiary, however, may not receive sufficient information from the trustee of the foreign trust to make the computations required under the accumulation distribution rules. In this situation, the government has established a "default" method of computing the throwback tax. The default method generally allocates a distribution in a given year to the current year and to the three preceding years, taking prior distributions into account. *See* 2016 Instructions to IRS Form 3520 at 9. The IRS effectively made up the default method in the instructions to Form 3520; Notice 97-34 does not address the default method. Of course, the throwback tax computations in the Internal Revenue Code are themselves not an exact method, so the Form 3520 default method is really a "default to the default method" of reporting.

7. When reporting the amount of a distribution, the beneficiary must use the federal income tax rules related to the amount of the distribution. In the case of cash, this is simple. If the beneficiary receives property, the beneficiary must report the amount of the distribution as the lesser of the trustee's adjusted cost basis in the property or the fair market value of the property. Finally, if the beneficiary received the use of trust property without paying rent or with paying a below-market rent, the beneficiary must report the value of the use or the bargain element, as the case may be. All of these value reporting rules apply whether the trust is a nongrantor trust or a grantor trust, even though in the case of a grantor trust the distribution is not taxable.

8. In addition to reporting distributions from a foreign trust, a beneficiary of a foreign trust must also report whether the beneficiary borrowed funds from the trustee in the form of a qualified obligation. Included in Form 3520 is the agreement to extend the statute of limitations that Notice 97-34 requires in order for a loan from a trustee of a foreign trust to a beneficiary to be a "qualified obligation."

9. A trust beneficiary files a Form 3520 on a trust by trust basis, which is a nuisance if the beneficiary receives a distribution from more than one foreign trust.

H. *Compliance Issues for U.S. Beneficiaries of Foreign Nongrantor Trusts: IRS Form 8938*

1. In 2010 Congress added a new section, IRC § 6038D, that requires individual U.S. citizens and residents who meet certain thresholds to disclose their interests in "specified foreign financial assets" to the IRS on Form 8938. For individual U.S. taxpayers, there are a variety of filing thresholds depending on whether the individual is married and filing a joint return and whether the individual is living inside or outside of the United States. In general, the filing thresholds are higher for individuals who reside outside of the United States. The filing thresholds are based on the value of the taxpayer's "specified foreign financial assets" on one of two dates: the end of the taxable year and any day during the taxable year. Treas. Reg. § 1.6038D-2(a)(1). If the taxpayer meets one of the two filing thresholds, he or she must file the Form 8938.

2. The definition of a foreign financial asset for IRC § 6038D purposes includes an interest in a foreign trust. *See* IRC § 6038D(b)(2); Treas. Reg. § 1.6038D-3(d). A taxpayer has an interest in a foreign financial asset if the taxpayer must include income from that asset on his or her "annual return." For individuals, an "annual return" for this purpose means an income tax return and not an informational return, such as an IRS Form 3520. *See* Treas. Reg. § 1.6038D-1(a)(11).

Therefore, this definition appears to not cover interests in foreign *grantor* trusts because the receipt of a distribution from such a trust will not affect a beneficiary's U.S. income tax return for the year of the distribution, even though the beneficiary must report the distribution to the IRS on a Form 3520.

3. A taxpayer must disclose an interest in a trust, however, only if he or she knows of the interest or "has reason to know based on readily accessible information of the interest." Treas. Reg. § 1.6038D-3(c). If a U.S. citizen or resident beneficiary knows of the interest in a discretionary trust, the regulations in effect provide that the value of that interest for a given year is the sum of the distributions from the trust to the beneficiary for that year. *See* Treas. Reg. § 1.6038D-5(f)(2)(i)(A). Under the regulations, a taxpayer's receipt of a distribution from a foreign estate or a foreign trust constitutes actual knowledge for IRC § 6038D purposes. *Id*.

4. The requirement that U.S. citizen and resident beneficiaries disclose their interests in foreign trusts on Form 8938 raises the question of how to value an interest in a trust, which is something of a novel exercise in U.S. tax law.

    a. Valuing an interest in a trust is important for two reasons:

        (i) To determine whether the taxpayer's collective foreign financial assets meet the Form 8938 filing threshold; and

        (ii) To determine the value of an interest in a trust for purposes of completing Form 8938.

    b. If the beneficiary receives a distribution from a foreign discretionary trust, he or she must disclose the receipt of that distribution to the IRS on an IRS Form 3520. *See* IRC § 6048(c). The beneficiary may or may not be required to also disclose the interest in the trust on a Form 8938. Such a disclosure will be required only if the beneficiary meets the filing threshold.

    c. If the beneficiary received no distributions from a discretionary trust in a particular year, under the regulations the beneficiary may value his or her beneficial interest in the trust at zero for purposes of determining whether he or she meets the filing threshold for that year. Because the regulations tie the maximum value of an interest in a discretionary trust to the distributions from the trust, if a beneficiary knows of the existence of the interest but has not received any distributions in that tax year, he or she must nevertheless disclose the interest on Form 8938 for that tax year if the beneficiary otherwise files the form for that tax year but with a zero value.

    d. If a U.S. citizen's or resident's only beneficial interest in a foreign trust is a right to receive mandatory distributions from the trust, such as distributions of income, the maximum value of the person's interest in the trust is its actuarial value under IRC § 7520. Treas. Reg. § 1.6038D-5(f)(2)(i)(B). In essence, IRC § 7520 directs a taxpayer to value income interests, remainders, and reversions based on actuarial tables that have factors tied to an IRS-assumed interest rate that changes on a monthly basis. The IRC § 7520 interest rate for November 2017, for example, was 2.4%, which means that the actuarial value of a 35-year old's life income interest in a trust with $1 million of assets in November 2017 was $624,770. The tables are unisex; they make no differentiation between men and women. Only rarely do the tables not apply to the valuation of "mandatory" interests.

    e. The regulations assume that a beneficiary of a trust from which he or she has a right to receive mandatory distributions knows the value of the principal of the trust and the nature of his or her interest in the trust. The regulations do not address a situation in which a beneficiary of such a trust knows of his or her interest but lacks information to compute the value of that interest, such as the value of the trust capital, the nature of other beneficial interests, and all of the relevant terms of the trust deed.

f. The value of a person's beneficial interest in a trust in which he or she has a mandatory income and discretionary capital interest is the sum of the actuarial value of the income interest and the amount of the capital distributions to him or her during the reporting year.

VI. U.S. Income Tax Issues Raised by Variation and Modification of Foreign Nongrantor Trusts

A. *Introduction*

1. In contrast to the historic rigidity of trusts under American trust law, trust law in most English-speaking jurisdictions give settlors, trustees, and beneficiaries considerable flexibility in modifying and amending trusts.

2. For example, as a matter of English trust law if all the trust beneficiaries and the trustee are *sui juris*, together they can agree to terminate a trust under the rule in *Saunders v. Vautier* [1841] EWHC J82. This is in contrast to the American common law of trusts, which allows such a termination only if the all the substantial purposes of the trust have been accomplished. *See Tod v. Barton* [2002] EWHC 264 (Ch.)(contrasting the English rule to the American rule).

3. As a result, variations and modifications of trusts are not uncommon in jurisdictions outside of the United States. The variation or modification of a trust, however, can have an impact on how U.S. citizen and resident beneficiaries are taxed on distributions from a foreign trust.

B. *Variations to "Grantorize" Nongrantor Foreign Trusts*

1. As discussed in detail above, it is far better for a U.S. citizen or resident beneficiary to receive a distribution from a trust that is a grantor trust as to a nonresident alien than from a foreign nongrantor trust. If the actual grantor of the trust is living, it would seem possible to modify a nongrantor trust to make the trust a grantor trust by varying the trust so that the trust qualifies for one of the exceptions described in IRC § 672(f)(2)(A).

2. As discussed above, one way a trust can be a grantor trust as to a nonresident alien grantor is if he or she has the power to revest the trust property in himself or herself either alone or with the consent of a related or subordinate party. *See* IRC § 672(f)(2)(A)(i). Is it possible to give such a power to a nonresident alien grantor of a nongrantor trust to make the trust a grantor trust?

   a. The government appears to believe that it is not possible to "regrantorize" a foreign nongrantor trust by varying the trust to give the grantor the power to revest the trust property in himself or herself either alone or with the consent of a related or subordinate party who is subservient to the wishes of the grantor.

      (i) Under the Treasury Regulations, if a trust "fails to qualify" for the exception of IRC § 672(f)(2)(A)(i) for a particular taxable year, the trust will be subject to the general rule precluding the application of the grantor trust rules to the trust for the taxable year of the failure "and all subsequent taxable years of the trust." Treas. Reg. § 1.672(f)-3(a)(1).

      (ii) When the IRS first issued proposed regulations under IRC § 672(f), it did not include the limitation on grantor trust treatment in subsequent years. *See* Reg. 252487-96, 1997-25 I.R.B. 9 (June 23, 1997). The IRS added the limitation in the final regulations on the grounds that it was necessary to prevent abuse:

      > The final regulations also clarify that, consistent with the principle that statutory exceptions should be construed narrowly, if a trust fails to qualify for the revocable trust exception in a particular year, the exception cannot apply in a later year even if the requirements would otherwise be satisfied in such later year.

      T.D. 8831, 1999-34 I.R.B. 264, 266.

(iii) While the scope of the rule of Treas. Reg. § 1.672(f)-3(a)(1) is not entirely clear, it suggests that the government would take the position that a trust that was never a grantor trust cannot later become a grantor trust by reason of giving the grantor an appropriate revesting power because the trust would have previously failed to meet the requirements for the exception because the grantor did not have the power. The rule also suggests that if a trust did qualify as a grantor trust by reason of the grantor holding a revesting power but that power lapsed or otherwise terminated, the trust cannot again become a grantor trust by reason of the grantor reacquiring a revesting power.

(iv) The rule prohibiting "regrantorization" appears to be based on the rule that was in both the proposed and final regulations that requires a grantor to hold the revesting power for at least 183 days during a taxable year. *See* Treas. Reg. § 1.672(f)-3(a)(1). However, adding a rule that "clarifies" this by adding a permanent moratorium on the trust ever being a grantor trust by reason of a revesting power is not simply a clarification; it is an entirely new rule. The IRS did not seek any comments on the new rule; it just added it to the final regulations. The rule seems overly harsh and inconsistent with the statute itself, which does not have such a temporal limitation in its language.

(v) In any event, the "never more a grantor trust" rule is mostly an academic one because a trustee can reach the same result by distributing the trust assets to the grantor who can settle an entirely new trust over which he or she has an appropriate revesting power, although this may raise tax issues in another country for the grantor.

3. Another option to "grantorize" a foreign trust would be for the trustee to vary the trust to make the grantor or the grantor's spouse the sole beneficiary of the trust. The regulations under IRC § 672(f)(2)(A)(ii) have no limitation on treatment of a trust as a grantor trust in this manner as they do with the "revesting" power described above. For this reason, varying a trust to be a "sole benefit" trust may provide a way to turn a nongrantor trust into a grantor trust as to a nonresident alien. This strategy, however, may be of limited utility if a goal of the arrangement is to make distributions on a tax-free basis to U.S. citizen or resident beneficiaries because only the grantor and his or her spouse will be beneficiaries. To the extent that the trustee makes a distribution to the grantor or the grantor's spouse, the grantor or the grantor's spouse can make gifts to U.S. citizen or resident beneficiaries, though in the case of a spouse making such a gift, the anti-intermediary rule, discussed above, may apply. However, the trustee could not directly make distributions to U.S. citizen or resident beneficiaries.

4. It is more complicated to make a nonresident alien *beneficiary* of a foreign nongrantor trust the grantor or owner of the trust's items of income, gain, and loss for U.S. federal tax purposes.

a. The trustee could, of course, distribute the trust property to such a beneficiary who could create a new trust that is a grantor trust as to the beneficiary by reason of the trust being a sole benefit trust or by reason of the beneficiary (now grantor) retaining an appropriate revesting power.

b. A less extreme way to grantorize a nongrantor trust is for a beneficiary to receive a presently exercisable general power of appointment and exercise that power in favor of a new trust. *See* Treas. Reg. § 1.671-2(b)(5). A trustee's inherent authority under the relevant trust law to make a distribution for the benefit of a beneficiary may be sufficient to allow the trustee to give the power of appointment. A trustee could also potentially exercise a power to vary a trust to give the beneficiary the power or could petition a court to modify the trust to grant the general power.

c. The IRS did not define a "general power of appointment" for purposes of Treas. Reg. § 1.671-2(b)(5), nor is there a general income tax definition of "general power of appointment." The conventional wisdom is that a general power of appointment for federal income tax purposes is the same as a general power of appointment for federal gift and estate tax purposes. *See* IRC §§ 2041, 2514. There is little actual authority to support this position. The best authority is in IRC § 1014(b)(4), which provides that property will receive a new basis by reason of a decedent's death if the decedent possessed a "general power of appointment" over the property and exercises it by will. In the regulations under IRC § 1014(b), the IRS directs taxpayers to IRC § 2041 for the definition of a general power of appointment. Treas. Reg. § 1.1014-2(b)(4).

C. *Amendments to Add Specific Distributions*

1. As discussed above, a distribution of a pecuniary amount from a foreign trust is not a "distribution" from the trust that carries out DNI or UNI to a U.S. citizen or resident beneficiary. *See* IRC § 663(a)(1).

2. The trustee of a foreign trust may be tempted to amend the trust instrument to give a beneficiary the right to receive a pecuniary amount with the expectation that the beneficiary will receive the distribution free from U.S. income tax. *See* Treas. Reg. § 1.665(b)-lA(c) (a gift of a specific sum of money or of specific property described in Section 663(a)(1) is not an accumulation distribution).

3. The Treasury Regulations under IRC § 663(a)(1), however, provide that to qualify as a pecuniary distribution under that section, the "amount of money or the identity of the specific property must be ascertainable under the . . . terms of an inter vivos trust instrument as of the date of the inception of the trust." Treas. Reg. § 1.663(a)-1(b)(1). Accordingly, amending a trust to give a beneficiary a right to receive a specific distribution of property or a particular pecuniary amount will not result in the beneficiary escaping tax on a ratable share of DNI or on an accumulation distribution.

D. *Effect of Reversals of Trustee Exercises of Discretion Due to Mistake*

1. Historically a court applying English law would not void a voluntary trust distribution or other trustee decision if the trustee had made a mistake that led to the distribution or the decision having an unforeseen tax consequence. From 2000 to 2013, however, an English court could void a trustee's discretionary decision that led to an unforeseen tax consequence if the decision was "manifestly unreasonable" in the sense that in reaching its decision the trustee had failed to consider things which it ought to have considered or considered things which it ought not to have considered. The so called "rule in *Hastings-Bass* [1975] Ch. 25" effectively provided a "get out of jail free card" to trustees and their professional advisers where they had failed to properly consider the tax consequences of a trustee's decision. The rule allowed a trustee who realized that a decision had an unforeseen adverse tax consequence to apply for a court order which would void the trustee's exercise of discretion. The U.K. government was typically the only loser in decisions in which a court applied the rule in *Hastings-Bass* because the government lost out on the tax revenue that would have otherwise resulted from the trustee's decision.

2. Several years ago, however, the U.K. tax authorities challenged the application of the *Hastings-Bass* principle in two cases, *Pitt v. Holt* and *Futter v. Futter* [2013] UKSC 26. In 2013, the U.K. Supreme Court significantly limited the rule in *Hastings-Bass* by holding that a fiduciary decision is voidable (as opposed to void and thus only prospective in effect rather than retrospective for various tax purposes) on the petition of a beneficiary but only when the trustee was in breach of fiduciary duty. As a result, if a trustee followed proper procedures in obtaining professional advice and relying on that advice, an English court will no longer reverse the trustee's exercise of discretion.

3. However, the Supreme Court also revisited the law of mistake in respect of voluntary distributions and concluded that if an error as to the tax consequences of a decision was a breach of trust, it would be unconscionable for equity to leave the mistaken disposition uncorrected. Thus, if a trustee breaches its fiduciary duty by failing to obtain proper professional advice or unreasonably relying on professional advice, an English court may reverse the trustee's decision. The court is also free to choose from remedies other than voiding the decision, such as surcharging the trustee. On the other hand, if the trustee did not breach its fiduciary duty in making the mistake, such as in

a case where the professional advisers gave incorrect tax advice but the trustee properly relied on the advice, the trustee may have to look to the professional advisors for damages.

4. The decisions in *Pitt* and *Futter* are binding only on the courts in England and Wales and not to other English trust law jurisdictions. However, many of the offshore financial centers have as their final court of appeal the Judicial Committee of the Privy Council, which has the same judges as the English Supreme Court. As a result, it stands to reason that if the Privy Council were presented with a case out of an offshore financial center with facts similar to *Pitt* or *Futter*, the Privy Council would likely reach the same decision as it did in *Pitt* and *Futter*. However, in a recent Isle of Man decision, AB v CD, Isle of Man High Court June 30, 2016, the court indicated no assumption should be made that the Manx courts would follow English law in respect of the comments made therein about artificial tax avoidance as the decisions in *Pitt* and *Futter* were largely driven by U.K. policy, which should not influence Manx jurisprudence.

5. The uncertainty around the effect of the *Pitt* and *Futter* decisions outside of England has led to a few jurisdictions to enshrine the *Hastings-Bass* principle in legislation with retrospective effect, such as in Jersey and Bermuda. *See* The Trusts (Amendment No. 6) (Jersey) Law 2013; Trustee Amendment Act 2014 (Bermuda). Interestingly, Guernsey has not codified the Hastings-Bass principle.

6. By reason of the statutory preservation of the *Hastings-Bass* principle in some of the offshore financial center jurisdictions, it is possible that a trustee of an English law trust with U.S. beneficiaries may seek judicial relief to invalidate a distribution to the U.S. beneficiary due to a lack of the trustee's proper understanding of the U.S. tax consequences of the decision. I was unable, however, to find any published U.S. court decisions or IRS rulings related to the application of the *Hastings-Bass* principle to a situation when a U.S. citizen or resident beneficiary returns a distribution that was based on an erroneous exercise of discretion by a trustee.

7. As a general matter, if a trustee makes an erroneous distribution and the beneficiary returns the distribution to the trustee, the beneficiary is entitled to a refund of any tax he or she has paid with respect to the distribution, provided the beneficiary timely files the claim for refund. *See, e.g.*, *De Vilbiss v. United States*, 41-2 U.S.T.C. ¶ 9552 (N.D. Ohio 1941). *See also, e.g.*, *Salonstall v. Hassett*, 32 F. Supp. 583 (D. Mass. 1940).

8. The *De Vilbiss* decision involved a distribution the trustee made by a mistake that was not permitted by the trust instrument. In other words, the trustee never had the authority to make the distribution. However, in a *Hastings-Bass* situation, the trustee will not have violated the trust instrument. Instead, the trustee will have made a mistake by failing to consider all the relevant factors the trustee should have considered in making a decision. To this extent, the *De Vilbiss* decision does not fully answer the question as to whether the IRS or a U.S. court would recognize the effect of a *Hastings-Bass* type judgment reversing a trustee's exercise of discretion.

9. One preliminary question that will arise under U.S. tax law in the case of a reversal of a trustee decision under a *Hasting-Bass* approach is whether the related "annual accounting period" and "completed transaction" doctrines prohibit a U.S. citizen or resident beneficiary from seeking a tax refund based on a voided and returned distribution.

    a. The two doctrines generally provide that the tax effects of a transaction are determined at the end of a tax year and that a rescission changing the effect of the transaction in a later year has no effect for tax purposes. For example, in Revenue Ruling 80-58, 1980-1 C.B. 181, the IRS considered a situation in which a taxpayer sold land to buyer in 1978 subject to a condition that allowed the buyer to reconvey the land to the taxpayer within a one-year period if the buyer was unable to have the land rezoned for business purposes. Under the facts of the ruling, the buyer determined that would be unable to rezone the property in 1979 and therefore reconveyed the land to the seller in that year and the seller refunded the purchase price. The IRS ruled that the reconveyance in 1979 had no effect on the 1978 transaction, with the result that the seller had to treat the sale as a completed transaction in 1978 with the attendant tax consequences.

b. In reaching its decision in Revenue Ruling 80-58, the IRS relied on a 1940 decision of the United States Court of Appeals for the Fourth Circuit, *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940).

(i) In *Penn*, a company's board of directors established an "employee stock benefit fund" without shareholder approval. One employee received credits under the fund in 1930 and 1931, which resulted in taxable income to the employee. In 1931, however, the shareholders sued the company for establishing the fund without shareholder approval, which resulted in the company rescinding the plan.

(ii) The employee in question, through his executor, then relinquished his 1930 and 1931 credits related to the plan and returned the funds he had earned to the company. The IRS examined the taxpayer's 1930 and 1931 returns. The IRS concluded that because the taxpayer had returned his 1931 earnings related to the plan in the same year he had earned them, his income for the year did not include the earnings. The IRS, however, determined that the taxpayer's 1930 income did include the income that his estate returned to the company. *Id*. at 175 ("The only unusual feature of this case is that it now appears, from developments subsequent to 1930, that the transaction really was invalid and was rescinded in 1931, but these later developments may not properly affect the determination of the income tax for 1930.").

c. In a more recent articulation of the annual accounting period doctrine, the IRS stated that two conditions are necessary for a rescission to be effective for tax reasons. The first is that the parties must restore each other to the same position as before the rescinded transaction. The second is that the restoration must take place in the same taxable year as the transaction. PLR 200923010.

d. In wealth transfer-related tax cases, courts typically rely on a variation of the annual accounting period doctrine called the "completed transaction" doctrine to limit the tax effects of retroactive reformations of transactions. *See, e.g.*, *Estate of Kraus v. Commissioner*, 875 F.2d 597 (7th Cir. 1989) (upholding IRS refusal to recognize state court reformation); *Sinopoulo v. Jones*, 154 F.2d 648 (10th Cir. 1946) (holding that state court retroactive reformation of trusts did not affect the rights of the government that attached under its tax laws); *Estate of Simpson v. Commissioner*, T.C. Memo. 1994-359 (holding Florida circuit court decision issued after the decedent's death not binding on Tax Court); *Estate of Bennett v. Commissioner*, 100 T.C. 42, 61 (1993) ("a valid reformation of a trust instrument may have retroactive effect under local law as between the parties to the instrument but not as to third parties, including [the federal government], who had previously acquired rights under the instrument"); *Estate of Nicholson v. Commissioner*, 94 T.C. 666 (1990) (holding that a state court order may have retroactive effect for state law purposes but has no effect on the government's right to collect federal taxes on a completed transaction); TAM 9127008 (advising that the state court rescission of trust termination to obtain an IRC § 1014 step up in basis would not change the federal tax consequences of the termination).

10. The annual accounting period and the completed transaction doctrines, however, are not absolute, which leaves open the possibility of a *Hastings-Bass* type court decision being given retroactive effect.

a. As a general matter, whether the IRS or a court will give effect to a state court decision concerning a matter of trust law that has a federal tax effect depends on a variety of factors.

b. The IRS' and the courts' view of the effectiveness of court decisions with retroactive effect stems in large part from a view that lower-level court decisions may reflect collusion or incorrect application of the law. Along these lines, there is an important doctrine in United States tax law that state court reformation actions that are not heard by the highest court in the state where the claim originated are not controlling or binding on the IRS or the federal courts unless (a) the finding is consistent with applicable state law, as would be determined by the highest court of the state, or (b) the IRS was a party to the state court proceeding. *Commissioner v. Bosch's Estate*, 387 U.S. 456, 87 S. Ct. 1776 (1967).

c. A federal court will determine whether to follow a state court ruling after applying the laws of the state as if it were the highest court in the jurisdiction:

> The determinations of lower state courts may be given some weight but they are not controlling when the highest court of the state has not ruled on the point as the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the State.

Id., 87 S. Ct. at 1783. *See also Estate of La Meres v. Commissioner*, 98 T.C. 294, 311-12 (1992) ("This and other courts have generally disregarded the retroactive effect of State court decrees for Federal tax purposes… While we will look to local law in order to determine the nature of the interests provided under a trust document, we are not bound to give effect to a local court order which modifies the dispositive provisions of the document after [the federal government] has acquired rights to tax revenues under its terms.").

d. Although reformation actions typically do not relate back to the date on which a document was created or an action taken, some lower court reformation or rescission decisions carry some weight with the IRS depending upon the circumstances.

(i) The IRS is less likely to follow a lower court decision if it is merely a "rubber stamp" of the parties' prior agreed-upon decision. *See Harris v. Commissioner*, 461 F.2d 554 (5th Cir. 1972) (denying recognition of trust amendment to qualify the trust for IRC § 2503(b) gift tax exclusion where the attorney who drafted document stated in opening statement that the trust was intended to qualify for the gift tax annual exclusion but he did not testify as a fact witness at the trial); *Van Den Wymelenberg v. United States,* 397 F.2d 443, 445 (7th Cir. 1968), *cert. denied*, 393 U.S. 953 (1968) (in denying recognition of an amendment to an irrevocable trust to qualify the trust for the IRC § 2503(b) gift tax exclusion, the court opined that retroactive reformation would (1) promote "collusive" state court actions for the sole purpose of reducing federal tax liabilities and (2) cause federal tax liabilities to remain unsettled for years); *American Nuserymen Publishing Co. v. Commissioner*, 75 T.C. 271 (1980) (holding that state court rescission of stock transfer which voided a corporation's S-corporation status may have retroactive effect as between the parties to the instrument, but not as to third parties who previously acquired rights under the instrument, such as the U.S. government).

(ii) The IRS is more likely to respect a lower court reformation or rescission ruling if it came about as a result of an adversarial proceeding and there is an extensive record evidencing the court's consideration of the matter. *See* PLR 200045004 (accepting a state court's correction of a testamentary trust based on the drafter's error involving the amount of a formula disposition); PLR 200211412 (ruling that a state court-ordered rescission of a charitable remainder trust would be recognized as effective as of the date the trust was created, where the charity had incorrectly represented the tax treatment of the transfer to the trust).

(iii) Taxpayers have had the most success in the case of scriveners' errors. For example, in *Dodge v. United States*, 413 F.2d 1239 (5th Cir. 1969), the court relieved the taxpayer of gift tax liability on the ground that there existed a right to reformation under applicable state law upon the requisite proof that an error had been made where a deed conveyed more property than the grantor intended due to a scrivener's error. Similarly, in *Touche v. Commissioner*, 58 T.C. 565

(1972), the donor's attorney prepared a deed incorrectly calculating the percentage of property to be transferred and the court held that the donor's transfer was incomplete, and therefore not subject to gift tax to the extent that the transfer was unintended.

(iv) Federal courts have also shown some compassion with respect to mistakes of law by a settlor. For example, in *Berger v. United States*, 487 F. Supp. 49 (W.D. Pa. 1980), a settlor seeking to enter public service transferred his assets to irrevocable trusts on his mistaken belief that the irrevocable transfers were required in order for him to comply with the president's policy on conflict of interests. The court later reformed the trusts to make them revocable based on clear, precise, and convincing evidence of the settlor's mistake at the time the trusts were created. Also, in *Neal v. United States*, 187 F.3d 626 (3rd Cir. 1999), the court held that a settlor's rescission of a release of a GRIT interest based on a later-repealed tax statute relieved the settlor of gift tax liability.

e. Apart from the above-referenced cases, the IRS does not often veer from the position put forth in *Bosch*, and most taxpayers are not successful in obtaining IRS blessing of state court reformations or rescissions. The only way to ensure that the IRS will respect a state court holding is to obtain a decision from the highest court of the state, which in most cases is not possible, practical, or desirable.

f. Without a court decision or IRS ruling, it is unclear how all of this authority will affect a U.S. beneficiary of a trust for which a court issues a *Hastings-Bass* rescission. If the rescission occurs within the same taxable year as a distribution, the taxpayer will be in the best position to claim that under the annual accounting period doctrine, he or she never received the distribution. If on the other hand the tax effects of a distribution are not discovered until a few years after the fact and the trustee seeks to rescind the distribution through a *Hastings-Bass* application, the IRS and the courts will likely scrutinize the facts of the situation to determine whether collusion existed. Unfortunately, though, the cases in which courts have been sympathetic to undoing mistakes involve mistakes by individual taxpayers, rather than fiduciaries. To this extent, the IRS may not be so friendly to trustee mistakes, particularly if the trustees did obtain professional advice related to the distribution but the advice was simply wrong.

VII. U.S. Income Tax Issues on the Termination of Foreign Nongrantor Trusts

A. *Introduction*

1. Foreign trusts may cease to exist by their terms, through exhaustion of assets by distribution, or by reaching the end of the applicable perpetuities period. In the case of a termination of a foreign trust with an outright distribution to beneficiaries, the final distribution will be treated like any other distribution and carry out DNI (and UNI to the extent that the final distribution is an accumulation distribution).

2. In addition, notwithstanding the potential of a long-lived foreign trust, a U.S. beneficiary may prefer that the "foreign" status of that trust be terminated, and the trust assets be held in a domestic trust instead.

3. A U.S. person may no longer wish to be the beneficiary of a foreign trust for a number of reasons. Given the increasing stigma and populist outrage at individuals with foreign trusts and offshore holding companies fanned by information leaks such as the Panama Papers and the Paradise Papers, the beneficiary may be worried about the social and professional consequences of being identified as a beneficiary of a foreign trust. The beneficiary may not wish to comply with the reporting obligations of receiving distributions from a foreign trust, or may no longer wish to have the trust's investment options affected by its foreign taxpayer status. Finally, a beneficiary and trustee may prefer not to have to be concerned with managing distributions to deal with the throwback tax.

B. *Termination Through Distributions to Other Trusts*

1. Decanting is the name given to the process when a trustee transfers all or a substantial portion of the principal of a trust to another trust. As a general matter of English trust law, a trustee who has the power to distribute trust assets "for the benefit" of a beneficiary may distribute trust assets to the trustee of another trust for the same beneficiaries or in some instances to a trust with different beneficiaries, such as charities, if that would be for the "benefit" of the beneficiaries of the first trust. *E.g*., *Re Clore* [1966] 1 WLR 955; *Re Pauling* [1964] Ch. 303; *Pilkington v. IRC* [1964] AC 612; *Re Ropner* [1956] 1 WLR 902; *Re Halsted* [1937] 2 AER 570; *Roper-Curzon v. Roper-Curzon* (1871) 11 Eq. 452). In addition, many trust instruments will give a trustee or other fiduciary the power to appoint or distribute property in further trust separate from the trustee's power to make distributions of income and principal to beneficiaries.

2. There are a number of reasons why a trustee of a foreign trust may decide to distribute property to another trust. If the instrument creating the foreign trust does not provide for a change of situs or governing law, the act of decanting to a trust in a different jurisdiction may be the only way to make such a change without applying to one or more courts. In addition, a decanting may be used to effectively change certain administrative (and possibly even dispositive) provisions of a trust by decanting assets into a trust with the preferred provisions.

3. The provisions of Subchapter J and Treasury Regulations under Subchapter J do not have any explicit provisions related to the fiduciary income tax effects of dividing or decanting trusts other than Treas. Reg. § 1.1001-1(h), which provides that a severance of a trust that results in a non-pro rata distribution is not an exchange (i.e. a disposition) of property for federal income tax purposes if applicable law or the governing instrument permits the severance and permits the allocation of trust assets among the divided trusts on a non pro-rata basis.

4. The IRS, however, is thinking (slowly) about how, if at all, it should treat decanting distributions for federal income, gift, estate, and generation-skipping tax consequences. *See* IRS Notice 2011-101, 2011-52 I.R.B. 932 (requesting comments on the tax consequences of decanting). Although numerous industry groups provided comments including ACTEC, the ABA, and AICPA, the IRS has yet to release any guidance.

5. Absent specific guidance from the IRS, practitioners should rely on general principles of Subchapter J and existing authorities to evaluate the income tax effects of a decanting distribution involving the trustee of a foreign trust. Those rules, however, are unclear.

   a. As a general matter, if a nongrantor trust makes a distribution to another trust with different terms, the distribution will carry out the DNI and UNI of the distributing trust to the recipient trust in the usual manner. *See Lynchburg Trust & Savings Bank v. Commissioner*, 68 F.2d 356, 361 (4^{th} Cir. 1984) (considering the tax effect of distributions from trust holding a decedent's residuary estate to separate trusts for beneficiaries). Similarly, a distribution from one trust to another trust can be an accumulation distribution. Treas. Reg. § 1.665(b)-1A(b)(1).

   b. On the other hand, if the dispositive provisions of the recipient trust are the same as the dispositive provisions of the distributing trust, the IRS may treat the recipient trust as a continuation of the distributing trust. *See, e.g*., PLR 200736002 (modified trust is treated as a continuation of existing trust); PLR 200607015 (division of one trust into four trusts is not a distribution from the divided trust); PLR 200527007 (division and merger of trusts do not constitute trust distributions for purposes of IRC § 661).

   c. Taken together, these court decisions and rulings indicate that a decanting distribution from one trust to a trust with different dispositive provisions will likely be treated as a distribution for Subchapter J purposes. On the other hand, a decanting distribution that is simply a division of one trust into identical trusts for different beneficiaries, or a distribution of one trust to a trust with identical dispositive provisions, is not a distribution but a continuation of the original trust.

6. In the case of a foreign trust decanting to a domestic trust, the most important issue is whether such an action triggers an accumulation distribution to the recipient domestic trust, or if no accumulation distribution is made and the UNI remains preserved within the domestic trust. Generally, a distribution from one trust to another trust constitutes an accumulation distribution that could trigger the throwback tax. Treas. Reg. § 1.665(b)-1A(b)(1). A U.S. resident trust is included in the definition of a U.S. person that is required to file a Form 3520 in that form's instructions. This would seem to apply to a partial decanting where only a portion of the first trust's assets are distributed to the second trust. However, similarly to the comments in response to Notice 2011-101, it seems reasonable that a complete decanting to a domestic trust with identical or at least substantially similar terms could be deemed a continuation of the original trust which would not trigger an accumulation distribution. In either case, the lack of firm guidance makes the decision to make such a distribution overly risky, as opposed to the treatment of a domestication.

7. There is even less guidance available to determine the consequences of a decanting distribution from one foreign trust to another foreign trust. The primary question in this case is whether any accumulation distribution preserves the UNI of the first trust in the second trust, or if the act of decanting manages to strip the UNI. The logical and likely correct answer is that the UNI should be preserved in the hands of the new foreign trust. *See* Rev. Rul. 91-6, 1991-1 C.B. 89 (change in residency of a foreign trust to a domestic trust preserves UNI). Otherwise, such a decanting distribution to cleanse UNI would be an easy fix for UNI-laden foreign trusts. With the ability to make a preliminary decanting to a new foreign trust to strip out UNI prior to the new trust making a distribution to a U.S. beneficiary, it would be unlikely that a throwback tax would never be paid again.

8. Sometimes in a trust reorganization that involves beneficiaries receiving beneficial interests in a new trust that are significantly different than their interests in the old trust, the beneficiaries may recognize a capital gain. *See Cottage Savings Assn v. Commisioner*, 499 U.S. 554 (1991). If, however, a trustee exercises its discretion to make a decanting distribution pursuant to a trust's governing instrument or applicable law, a beneficiary should not be deemed to have disposed of his or her interest in a way that generates a capital gain. *See, e.g.*, Treas. Reg. § 1.1001-1(h)(trust severance pursuant to governing law or governing instrument that allows non pro rata distributions among beneficiaries is not a taxable event); PLR 200736002 (decanting distribution does not cause beneficiaries to recognize gain because their beneficial interests were substantially the same before and after the decanting). The reason why *Cottage Savings* should not apply in a decanting situation is that the beneficiary's interest in the old trust was always subject to the trustee's discretion and the beneficiary would not be involved in the change in his or her interest. If the beneficiary affirmatively consents to the decanting distribution, however, it may result in the beneficiary being deemed to have disposed of his or her interest in the old trust in exchange for the new trust, so ideally the trustee would act on its own.

C. *Domestication of Foreign Trusts*

1. *Introduction: Why Domesticate?*

a. One way to avoid many of the headaches of foreign nongrantor trusts is for a foreign trust to become a domestic trust. If a foreign nongrantor trust is a domestic trust, the trustee will file annual income tax returns that result in K-1s for the beneficiaries. In this way the beneficiary will have a much easier time preparing his or her income tax return and will not need to file an IRS Form 3520 reporting the receipt of the distribution. Similarly, a beneficiary can use the property of a domestic trust on a rent-free basis without being deemed to have received a distribution.

b. In a "domestication," a foreign trust changes residency such that it becomes a U.S. domestic nongrantor trust for U.S. purposes. Ordinarily this will involve a change of trustee from a non-U.S. trustee to a U.S.-resident trustee, but it may also involve other non-U.S. persons giving up powers they have to remove and replace trustees and otherwise make substantial decisions with respect to the trust. As discussed above, in order for a trust to be a domestic trust for federal income tax purposes, all substantial decisions related to the trust must be made by U.S. persons. Therefore, a domestication may require substantial changes in fiduciary and nonfiduciary personnel related to the trust.

c. The domestication of a foreign nongrantor trust, however, does not eliminate the potential for an accumulation distribution from the foreign trust. When Congress repealed the throwback tax in 1997, it provided that the tax does not apply to an accumulation distribution from a "qualified trust" in tax years starting after August 5, 1997. IRC § 665(c)(1). A "qualified trust" is any trust other than a "foreign trust (or, except as provided in regulations, a domestic trust which at any time was a foreign trust)" or "a trust created before March 1, 1984, unless it is established that the trust would not be aggregated with other trusts under section 643(f) if such section applied to such trust." IRC § 665(c)(2). This means that accumulation distributions from a domestic trust that was once a foreign trust remain subject to the throwback tax. The Instructions to IRS Form 1041, Schedule J, and IRS Form 4970 confirm this point.

d. Accordingly, the significant tax benefits of a domestication of a foreign trust is the regularization of the trust's accounting for U.S. purposes, the current payment of U.S. tax on the trust's income and realized gains, the elimination of reporting headaches for the beneficiary, and the ability for the beneficiary to use trust property on a rent-free basis. There may also be nontax benefits of administering the trust in the United States as well.

2. *Is a Domestication an Accumulation Distribution?*

a. If a foreign trust has UNI, it raises the question of whether the domestication of the trust is a taxable event that crystallizes the UNI into an accumulation distribution subject to the throwback tax. Fortunately, a domestication should not have this effect, though as discussed below it does not mean that the UNI disappears.

b. By way of background, an accumulation distribution occurs when a trust "pays" or "credits" an amount to a beneficiary. For an amount to be paid or credited, the amount must pass from the control of the trustee to the control of the beneficiary. *See, e.g.*, *Commissioner v. Stearns*, 65 F.2d 371 (2d Cir. 1993), *cert. denied*, 290 U.S. 670 (1933). If a trust makes a distribution to another trust, that is a distribution that could trigger the throwback tax. Treas. Reg. § 1.665(b)-1(A)(b). However, when a trustee retires and a successor trustee takes office, there is no payment of assets to a beneficiary. Because no amounts are paid or credited within the meaning of IRC § 661(a)(2), no accumulation distribution should result under IRC § 665(b).

c. When a new trustee takes over from a retired trustee, however, there is a transfer of assets from the retiring trustee to the new trustee. Such a transfer should also not give rise an accumulation distribution. Under IRC § 665(b), an "accumulation distribution" for a complex trust is the amount by which "the amounts specified in [IRC § 661(a)(2)] for such taxable year" exceed the trust's DNI for the taxable year. The operative language of IRC § 665(b) tracks the language of IRC § 661(a)(2), which suggests on its face that unless a transfer of assets from one trust to another trust is an amount "paid or credited" with the meaning of IRC § 661(a)(2), the transfer is not an accumulation distribution. *See also* Treas. Reg. § 1.665(g)-2A(d)(2)(the termination of a separate share of a trust with the result that the property constituting the share continues to be held as part of the same trust does not result in an accumulation distribution).

d. The regulations, however, without obvious statutory authority, expand the definition of an accumulation distribution by providing that an accumulation distribution includes an amount to which IRC § 661(a)(2) does not apply but that was otherwise paid or credited during the taxable year:

> An accumulation distribution also includes, for a taxable year of the trust, any amount to which section 661(a)(2) and the preceding paragraph are inapplicable and which is paid, credited, or required to be distributed during the taxable year

of the trust by reason of the exercise of a power to appoint, distribute, consume, or withdraw corpus of the trust or income of the trust accumulated in a preceding taxable year.

Treas. Reg. § 1.665(b)-1A(a)(2).

e. The meaning of this regulation is not entirely clear, but it appears that the purpose of the rule is to cause exercises of beneficiary-held powers, such as powers of withdrawal, to be accumulation distributions. *See* Treas. Reg. § 1.665(b)-1A(d), Example 4 (beneficiary's exercise of right to withdraw $5,000 is an accumulation distribution). *See also* Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries, § 7.2.3 at 7:8 (2d ed. 1993). Because this rule should apply to the exercise of a beneficiary-held power, it should not be the basis on which the government could impose a throwback tax on a change of trustee.

f. I have not found any court decision, public ruling, or private ruling that squarely addresses the issue of whether the change of a trustee from a foreign trustee to a domestic trustee is or is not an accumulation distribution. Commentators often cite Revenue Ruling 91-6, 1991-1 C.B. 89, for the proposition that a domestication of a foreign trust is not an accumulation distribution. This is not entirely accurate. In the ruling, the IRS addressed whether an accumulation distribution from a domestic trust that had been a foreign trust and that had UNI would be treated as a distribution from a foreign trust for purposes of the throwback tax. The distinction was important because the throwback tax rules were then different if a foreign trust, rather than a domestic trust, made an accumulation distribution. In the ruling the IRS assumed that the domestication of the trust did not cause a termination of the trust or another event that gave rise to an accumulation distribution that triggered the throwback tax. Because the IRS did not address the effect of the domestication, the ruling appears to leave open the question of whether a change in trustee that results in a change of residency is a distribution or termination of the trust.

g. It is important, however, to remember that in 1991, a multi-factor test applied to determine whether a trust was foreign or domestic. The IRS did not specify how the trust changed from a foreign trust to a domestic trust; it could have happened in any number of ways. One of those ways, but not the only way, would be through a change in trustee. Therefore, we should not read too much into the IRS's implicit assumption that the change in residency was not a termination or distribution. The ruling is helpful to the extent that the IRS could have taken the position that the domestication was a taxable event but did not do so. But because it assumed away the issue, the ruling is not particularly helpful on the positive side.

h. Much more important to this analysis is the IRS's position that it has taken in several post-1991 private letter rulings that a change in trustee of a domestic trust, usually accompanied by a trust severance or division, is not an event that results in the payment or crediting of amounts from a trust to a beneficiary. *See, e.g.*, PLRs 201109004; 200736002; 200723014; 200607015. Of additional comfort is the IRS's position taken in Treas. Reg. § 1.641(b)-3(b) that a termination of a trust occurs when the trustee distributes trust assets to persons entitled to the trust assets. Because the change in trustee is not a termination of the trust, it should not rise to the level of a distribution from the trust. *See also* Treas. Reg. § 1.665(g)-2A(d)(2)(termination of a separate share of a trust with the result that property that was part of the separate share is added back to the same trust is not an accumulation distribution). It is worth noting that in Revenue Ruling 91-6, the IRS, in addressing a situation involving the change of a trustee, did not take the position that that action was a distribution. Instead, the IRS simply ruled that any UNI in the trust retained its character. Implicit in this conclusion is the notion that the change in trustee was not a distribution.

3. *Is a Domestication a Reportable Event under IRC § 6048?*

a. Generally, a U.S. person who receives a distribution, directly or indirectly, from a foreign trust after August 20, 1996 is required to report on IRS Form 3520 the name of the trust, the aggregate amount of distributions received from the trust during the taxable year, and such other information as the Secretary may prescribe. *See* Notice 97-34, 1997-1 C.B. 422; IRC § 6048(c). A U.S. beneficiary who fails to report a distribution received after August 20, 1996, will be subject to a 35 % penalty on the gross amount of the distribution. IRC § 6677(a).

b. While there is no direct authority, it seems unlikely that a newly domesticated trust would be required to report the domestication as a distribution on Form 3520, although some practitioners do advise that a protective Form 3520 be filed nonetheless. However, available authority indicates that a Form 3520 is probably not required. For instance, in PLR 7917037 the IRS ruled that with respect to domestication of a pair of foreign trusts, the change of the fiduciary to a U.S. resident trustee would not result in imposition of any transfer tax of any kind, and "the domestication would not constitute a sale, exchange, or distribution to a beneficiary or other event of recognition." The IRS further ruled in PLR 7917037 that the pair of trusts would, for the taxable year of domestication and all subsequent taxable years for which the trusts were treated as residents of the U.S., be required to file returns on IRS Form 1041 but made no mention of a requirement to file Form 3520. Because Form 3520 is used, in relevant part, to report "Distributions to a U.S. Person from a Foreign Trust During the Current Tax Year," and if a domestication is not deemed to be a distribution, then it stands to reason that a domestication would not be reportable on Form 3520. *See* Part III, IRS Form 3520.

D. *Can Foreign Trusts Terminate by Operation of Law for Federal Income Tax Purposes?*

1. In many instances a foreign trust is a boon for U.S. citizen and resident beneficiaries because the trust can allow for the deferral of tax on income and capital gains and can provide a tax-free investment pool on which to earn income and capital gain.

2. Most trusts, however, will terminate by their terms or by reason of the application of a perpetuities rule, bringing the good times of tax-free growth and deferral of tax on income and capital gains to an end. If at this point the trust has a substantial amount of UNI, terminating distributions to U.S. citizen or resident beneficiaries could result in a substantial throwback tax and interest charge. The risk of such a large tax and the related interest charge puts a premium on determining when a trust actually terminates for federal income tax purposes.

3. In some countries, the termination of a trust and the distribution of trust assets may trigger a capital gains tax. For example, in Australia the distribution of appreciated property from a trust on the termination of the trust may trigger a capital gains tax on the appreciation in the trust on assets acquired after the effective date of the Australian capital gains tax on September 20, 1985. For this reason, the trustee of an Australian trust may seek to prolong the administration of a trust following its termination according to its terms to defer the payment of capital gains tax.

4. If a trustee continues to administer a foreign trust for an unreasonably long period after the trust interests have vested, a U.S. citizen or resident trust beneficiary may be deemed to have received a distribution from the trust before the trustee actually distributes the trust property.

5. As a general matter of U.S. tax law, a trust does not terminate on the occurrence of the event that triggers the vesting of the trust property in the remainder beneficiaries. Instead, and consistent with the general U.S. law of trusts, tax law gives a trustee a reasonable period of time to wrap up the administration of the trust. Treas. Reg. § 1.641(b)-3(b). During this time, the trust remains a nongrantor trust and the allocation of the trust's income and gains between the trust and the beneficiaries is based on general fiduciary income tax principles. If, however, a trustee unduly prolongs the administration of a trust, the trust will be deemed to have terminated for tax law purposes even though the trustee continues to administer the trust property:

> "[I]f under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust

continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust."

Id.

6. This regulation makes it clear that the law governing the administration of the trust does not dictate when a trust will be deemed to have terminated for tax purposes. Instead, when a trust terminates becomes a question of federal tax law. The regulation, which the government promulgated in 1956, is consistent with court decisions that predated the regulation. The regulation also reflects Congress's intention to make the question of when a trust terminates for tax law one of federal law rather than of one of state law. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 340 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A191-2 (1954).

7. If the administration of a trust has been unduly prolonged, the result is that the beneficiaries who are entitled to receive the trust property will be personally taxable on the trust's items of income, gain, and loss from the date of the effective termination of the trust. Treas. Reg. § 1.641(b)-3(d). *See also Marx v. Commissioner*, 47 B.T.A. 204 (1942)(if trust distribution unreasonably delayed, trust beneficiary becomes in substance the owner of the trust property and taxable on the gains derived from the trust property); Ferguson, Freeland & Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries* § 6.5.3 at fn. 120 (2d ed 1992)("if administration is unduly prolonged, so that the entity is considered terminated for tax purposes, the income belongs to the beneficiaries as it arises and is taxable directly to them"). This result is consistent with the analogous situation of when the administration of a decedent's estate is unduly prolonged. In those cases the estate's beneficiaries, rather than the executor or administrator, are the owners of the estate property for federal income tax purposes. *See, e.g.*, Treas. Reg. § 1.641(b)-3(d); *Brown, Jr. v. United States*, 890 F.2d 1329 (5^{th} Cir. 1989); *Estate of Miller v. Commissioner*, 39 T.C. 940 (1963), *aff'd* 333 F.2d 400 (8^{th} Cir. 1964).

8. There have been very few court decisions that have applied Treas. Reg. § 1.641(b)-3(b). The only relatively recent decision is *Dominion Trust Company v. United States*, 786 F. Supp. 1321 (M.D. Tenn. 1991).

   a. This case involved a trust the life beneficiary of which had died in 1987, resulting in the vesting of the remaining trust assets in the taxpayer. The taxpayer, however, was bankrupt at the time, and the trustee did not distribute the trust property to him. The taxpayer had many creditors who had claims against him. In 1991 the trustee, which had retained the trust property since 1987, brought an interpleader action in an attempt to resolve the creditors' competing claims to the trust property.

   b. The court first determined the priority of the various creditors' claims, and the trustee sold shares held in the trust's account in order to satisfy the claims of the creditors. The sales, however, gave rise to a capital gains tax, which raised the issue of whether the trustee or the beneficiary was required to pay the tax. The trustee took the position that the trust had not terminated and that it was required to pay the tax. One of the creditors, however, took the position that the trust administration had been unduly prolonged and that therefore the trust had terminated, with the result that the beneficiary was liable for the capital gains tax. That creditor pointed out that the trust assets vested in the beneficiary in 1987 and also argued that the trustee's filing of the interpleader action effectively terminated the trust.

   c. The court had little difficulty in deciding that the trust had not terminated. The court first determined that filing the interpleader action was not a distribution. The court then found that the creditor had not produced any evidence to suggest that the trust administration had been unduly prolonged. The court pointed out that the matter had been in litigation continuously since 1987 when the life beneficiary died, including a trial and an appeal. Also, because the IRS was not a party to the bankruptcy proceedings, there had been no resolution of the IRS's claims to the trust property until the trustee brought the interpleader action. Under these circumstances, the court concluded that it could "hardly find unreasonable delay" on the part of the trustee and that in fact the trustee was not responsible for the length of time of the court process.

9. Though not exactly the same, it is helpful to look at the factors courts have considered in determining whether the administration of an estate has been unduly prolonged.

a. During the period of estate administration, the executor is considered the owner of the estate property for federal income tax purposes; after the estate has been administered, the estate's beneficiaries are owners of the estate property for tax purposes. The period of administration for an estate is the period actually required by the executor to perform the ordinary duties of administration and cannot be unduly prolonged. Treas. Reg. § 1.641(b)-3(a). The estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. *Id*. The time that is considered to be required for the estate administration (and whether estate administration has been unduly prolonged) is a factual question that will depend on the complexity and nature of the assets in the estate and any problems encountered in the administration process.

b. The issue of when an estate has been terminated for federal tax purposes was addressed by the Tax Court in *Estate of Berger*, T.C. Memo. 1990-554 (1990). In that case, the decedent's will provided that on her death her husband would receive a life estate in the residue of her estate with the remainder going to charity. The will was admitted to probate on December 7, 1976 and letters of office issued to decedent's husband as executor. On August 1, 1978 the court issued an order finding that all assets of the estate had been collected, state and federal estate tax had been paid, no personal property taxes were due, no claims had been filed and all bequests had been paid. Four years later the executor sold a farm making up part of the residue of the estate, and claimed that the estate could deduct for federal income tax purposes part of the gain realized on the sale because of a special tax rule applicable to estates. The Tax Court found that the estate had been terminated for federal income tax purposes sometime before the sale of the farm. All assets had been collected and all taxes, debts and bequests payable by reason of the decedent's death had been paid. The court acknowledged that the residue of the estate had not been formally distributed to the decedent's husband, as trustee, but said that that fact was not sufficient to keep the estate open for federal income tax purposes. *See also Brown, Jr. v. United States*, 890 F.2d 1329 (5th Cir. 1989) (estate administration unduly prolonged when all administrative duties had been completed and no litigation regarding claims to the assets or tax disputes were pending, but legacies remained to be paid).

c. Ongoing litigation embroiling an estate, or litigation and disagreements between the executor and beneficiaries of an estate may prolong the administration period. *See Wylie v. United States*, 281 F. Supp. 180 (N.D. Tex. 1968). But in *Estate of Miller v. Commissioner*, 39 T.C. 940 (1963), *aff'd* 333 F.2d 400 (8th Cir. 1964), the Tax Court found that estate administration had been unduly prolonged when the estate remained open for over 12 years and all controversies and litigation involving the estate's tax liabilities had ended. The Tax Court stated that the record did not show any remaining administrative duties which would have made it reasonable for the executor to prolong the administration of the estate.

10. A number of cases involving this question predate Treas. Reg. § 1.641(b)-3(b), but because the regulation effectively adopted the rule laid out in those cases, they are worth considering.

a. The most important of these cases is *Marx v. Commissioner*, mentioned above. In *Marx*, the taxpayer received one-third of the income of a trust and was entitled to receive one-third of the principal when he reached age 30 in 1934. The beneficiary took the position that for tax purposes the trust was still in existence in 1937 and 1938. The trust assets consisted in large part of shares in corporations that owned real estate, and the beneficiary claimed that difficulties in administering the shares and the companies prevented the distribution of the trust property. The beneficiary and his sister, however, were the sole trustees of the trust.

b. The issue the Board of Tax Appeals considered was whether the trustee had delayed the distribution of the trust property to the taxpayer so long that as a result the taxpayer could have compelled the outright transfer of the trust property to himself:

> [I]n this proceeding if the delay in the payment to petitioner of one-third of the corpus was not unreasonable, the trust remained fully effective so far as petitioner's control over the trust as beneficiary was concerned. However, if and when the delay became unreasonable petitioner could have compelled the outright transfer to himself of his share of the corpus and different considerations become important.

47 B.T.A. at 210.

c. The court first observed that as a general principle of tax law, the extent of a taxpayer's power over trust property determines whether the trustee or the taxpayer should be taxed on the income of the trust property. The taxpayer argued that the trust had to first be liquid before it could be distributed to him, and one of the trustees, the taxpayer's sister, claimed that it would be "very poor business and detrimental to divide up" the shares. The taxpayer, however, presented no evidence as to why it would have been difficult to divide shares in the companies or why it would have been "very poor business and detrimental to the beneficiaries" to do so.

d. The court rejected the taxpayer's arguments, pointing out that the taxpayer and his sister, as trustees, controlled the companies in question. *Id*. ("[w]ith such control distribution would have apparently been an easy matter"). The court also did not see any disadvantage to distributing the shares of stock from the taxpayer's name as trustee to his individual name as trustee; the family would have remained in control of the shares. For these reasons, the court held that the distribution of the trust property had been unreasonably delayed and that for 1937 and 1938, the taxpayer should be deemed to be the owner of a proportionate share of the trust's income.

11. A number of other earlier cases addressed the issue of when a trust that had terminated by its terms had terminated for federal tax purposes.

a. In many of these cases the court held that the administration of a trust had not been unduly prolonged, but in all those cases the time between the termination of the trust according to the trust instrument and the time that the government thought the trust had terminated for tax purposes was less than one year. *E.g.*, *Swoboda v. United States*, 258 F.2d 848 (3d Cir. 1958)(two months and 11 days not an unreasonable delay); *Neave v. Commissioner*, 17 T.C. 1237 (1952)(five-month period); *Coachman v. Commissioner*, 16 T.C. 1432 (1951)(roughly nine-month period): *Bryant v. Commissioner*, 14 T.C. 127 (1950)(seven-month period).

b. In *First Trust & Deposit Co. v. Commissioner*, 41 B.T.A. 107 (1940), however, the Board of Tax Appeals determined that a six-year delay in the distribution of the property of an insurance trust from 1929 to 1935 was not was not an undue delay. In that case, however, it took four years to finally determine the federal estate tax on the decedent's estate (which raised issues related to the insurance trust), almost another year to finally determine the New York inheritance tax, and almost another year for the trustees to prepare a final accounting.

12. Taken together, these cases give us a good sense of when a court would determine the administration of an otherwise terminated trust has or has not been unduly delayed. In particular, the courts seem willing to allow a trust to continue for federal tax purposes as long as necessary to allow the trustee to do the following:

a. The filing of tax returns and the resolution of tax audits and other controversies;

b. Participate in litigation involving competing claims to the trust property;

c. The selling of assets in order to generate liquidity to make distributions among multiple beneficiaries where appropriate;

d. Determining whether all the preceding beneficiaries have received what they were entitled to receive before the trust terminated.

13. All of these facts justify the continued administration of a trust following its technical termination according to the governing instrument. If, however, no such impediments to final distribution remain, both the IRS and the courts are likely to determine that a trust has terminated, particularly if the delay is attributable to a beneficiary's failure to call for his or her share of the trust property under those circumstances. A court is particularly likely to find that an unreasonable delay has occurred when there are no impediments to a distribution and the beneficiary, either alone or with others, controls the trustee. In such a situation, it is the beneficiary rather than the trust who is the proper taxpayer:

> [T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid. . . . The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

Corliss v. Bowers, 281 U.S. 376, 378 (1930).

14. The result of the application of Treas. Reg. § 1.641(b)-3(b) – that the beneficiary is the owner of the trust property for tax purposes – is related to the pervasive federal income tax doctrine of constructive receipt.

a. Under that doctrine, a taxpayer is deemed to have received income if he or she has the unqualified right to receive the immediate payment of the income:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions

Treas. Reg. § 1.451-2(a). *See also Lynchburg Trust & Savings Bank v. Commissioner*, 68 F.2d 356, 359 (4th Cir. 1984)("Taxpayers generally are charged with income not reduced to possession, but only if it may be said that the income is received constructively, and has become so far subject to the taxpayer's demand that its nonreceipt is a matter of his own choice."). Although Treas. Reg. § 1.451-2(a) and most of the cases on constructive receipt address whether a taxpayer is taxable on a particular item of income, the principle also applies to whether a trust distribution has in fact been made. *See Furstenburg v. Commissioner*, 83 T.C. 755 (1984)(holding that a beneficiary did not constructively receive a distribution).

b. The doctrine of constructive receipt is in fact the basis for the rule in Treas. Reg. § 1.641(b)-3 that deems a beneficiary to be the owner of the income of an estate or trust the administration of which has been unduly prolonged. In *McCauley v. United States*, 193 F. Supp. 938 (D. Ark. 1961), a decedent's widow who was both the executor and sole residuary legatee of a decedent's estate and kept the estate open for several years to participate in a tax refund claim controversy with the IRS. The IRS initially took the position that the administration of the estate had been unduly prolonged, but lost on that issue. The IRS argued in the alternative that because the widow was both the executor and the sole residuary legatee, she had constructively received the income. The court held that apart from the rule related to the undue delay in the administration of estates, the doctrine of constructive receipt did not apply with respect to Subchapter J:

> In sections 641, 661, and 662 of the Internal Revenue Code and in Regulations § 1.641(b)-3, the Congress and the Treasury have dealt specifically and fully with the taxation of the income of estates of decedents. When those sections of the Code and the cited regulation are read together, it is clear that the income of the estate of a decedent is taxable to the estate as a separate entity, unless: (1) the administration is unduly prolonged, or (2) the income is in fact distributed during the tax year involved, or (3) such income, although not actually distributed, is "required to be distributed" during such year. No reason is shown and none suggests itself why the Court should go outside the statute and regulations in determining the incidence of the taxes here involved. *To the extent that the doctrine of constructive receipt has play in connection with the taxation of the income of decedents' estates it is encompassed in the concept of an administration being "unduly prolonged," as that term is defined in the regulations, and in the statutory requirement that the beneficiary shall report as his individual income that which is "required to be distributed" to him out of the estate during the tax year in question*. Here, the jury has found that the administration was not "unduly prolonged," and the income of the Fulbright estate was not "required to be distributed" while the estate was in administration.

Id. at 945.

c. Constructive receipt is the other side of the same coin as Treas. Reg. § 1.641(b)-3(b). If the facts of a case indicate that the taxpayer has constructively received a trust distribution, the same facts will likely support a determination that the administration of the trust has been unduly prolonged. As noted above, constructive receipt will not apply if there are substantial limitations on a taxpayer's ability to reduce an item of income or property to his possession. Similarly, the administration of a trust is not likely to be deemed to have been unduly prolonged if there are impediments to the beneficiary claiming the trust property, such as ongoing litigation or a tax dispute. Under both the doctrine of constructive receipt and Treas. Reg. § 1.641(b)-3, however, if there are no impediments to a taxpayer calling for property or income to which he or she is entitled, he or she will be deemed to have received the property or income at the time when those impediments cease to exist. *See, e.g., Marx, supra* (involving a trust distribution); *Roberts v. Commissioner*, T.C. Memo. 2002-281 (2002)(being incarcerated was not a sufficient limitation on a taxpayer's ability to cash a check issued by a pension plan); *Seligson v. Commissioner*, T.C. Memo. 1992-320 (1992)(involving income required to be distributed to a taxpayer from a trust that did not wish to receive but which the trustee was ready to distribute to him).