

INTERNATIONAL PLANNING

JUST OFF THE BOAT, TRUST FUND IN HAND

A beneficiary of a foreign trust moves to the states and wants to know: Will he be taxed on distributions of income accumulated by the foreign trust before he became a U.S. tax resident?

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(Reprinted with permission of Trusts & Estates, December, 2005 edition)

Many wealthy people today spend substantial amounts of time in various countries and many may eventually find themselves becoming tax residents of the United States. So U.S. trusts and estates practitioners shouldn't be surprised if a client presents them with this interesting question: How will the U.S. tax distributions of income accumulated before such beneficiary became a tax resident of the United States?

How will you answer?

Let's say your client, Ben Tex Aver, is a non-U.S. citizen from Bermuda, a country with which the United States has no comprehensive income tax treaty in effect.¹ He recently obtained permanent lawful U.S. residence status (his Green Card)² and has moved to the United States. He explains that he is a beneficiary of a foreign trust settled by his now-deceased, non-U.S. grandmother. He is due a large distribution from the trust

¹ If the client were instead from a country with which the United States does have a comprehensive income tax treaty (such as France or Spain), the conclusions could be different, as the client could potentially rely on a "treaty tie-breaker" provision to determine his residency; as opposed to having automatic U.S. residency, in the absence of a treaty, by virtue of obtaining his Green Card, as discussed in note 2.

² A non-US citizen who is a lawful permanent resident of the U.S. at any time during a calendar year will generally be considered a U.S. resident for income tax purposes during that year.

later this year, in addition to continuous lifetime payments, in accordance with the terms of the trust.³

You contact the trustee of the trust and determine that:

- the trust is a foreign, non-grantor trust for U.S. income tax purposes;
- the value of the trust's assets should not be includible in the estate of the beneficiary for U.S. estate tax purposes;⁴
- the settlor of the trust died more than 20 years ago;
- since the settlor's death, the trust has only made nominal distributions, well below the trust's annual realized income and gains, and thus, the trust contains a substantial amount of accumulated income, and
- all of that accumulated income was derived from non-business income from foreign sources.

Ben previously has not been subject to U.S. income tax on trust distributions, and now wants to know if he'll be subject to U.S. income tax on both the large distribution he'll receive later this year, and on the forthcoming lifetime distributions. Distributions of income could be subject to U.S. income tax at a maximum rate of 35 percent and in addition, the income tax on distributions of accumulated income from a foreign trust could be subject to a compounded interest charge for the period the income is deemed to have accumulated.

THE LAW

You have a good understanding of Subchapter J of the Internal Revenue Code⁵ and the manner in which U.S. beneficiaries of foreign, non-grantor trusts are taxed on their receipt of distributions from these trusts. In particular, you know that the same general rules that apply to distribution from simple and complex domestic trusts also apply to distributions from foreign trusts. But, unlike beneficiaries of most domestic trusts,

³ Specifically, the trust provides that the beneficiary will receive a certain percentage of the trust corpus before year-end, and that the trustee is required to make further distributions of income and principal to him throughout his lifetime.

⁴ Although any of the trust's assets, once distributed to the beneficiary, could eventually be subject to U.S. estate tax.

⁵ For ease of reference, unless otherwise provided, all Section references herein shall refer to the Internal Revenue Code of 1986, as amended (the "Code" or "IRC"), or the regulations issued thereunder.

beneficiaries of foreign, non-grantor trusts are subject to the “throwback tax” on “accumulation distributions,”⁶ and to a substantial interest charge on such tax.⁷ You also know that the distributable net income (DNI) of a foreign trust includes realized capital gains, regardless of whether or not they are distributed and, if accumulated, the undistributed DNI (including realized capital gains) becomes undistributed net income (UNI).⁸ Therefore, at least in some respects, the character of income in a foreign trust is lost when it passes to a U.S. beneficiary.

The trust in question has accumulated substantial amounts of income in the years before Ben became a U.S. beneficiary. And as a result, the trust has a substantial amount of UNI. For purposes of analyzing how UNI will be taxed to the newly arrived U.S. beneficiary, let’s assume that during the current year and any future year in which the trust makes a distribution, the trust will have realized only enough income or gains to satisfy its current expenses, so that its DNI will be zero.

The accumulation distribution rules are contained in IRC Sections 665 through 668. So you begin your analysis by looking at IRC Section 665, which provides definitional terms for use in the accumulation distribution area. You determine that the large distribution in the current year, and any subsequent distributions in future years, will likely constitute accumulation distributions, as the trust will have little or no DNI in these years. You then look at IRC Section 666, which provides for the allocation of an accumulation distribution to a prescribed number of preceding taxable years, commencing with the earliest of the years the trust had UNI (which remains undistributed) and moving forward on a first-in first-out basis until the amount of the accumulation distribution, or the total of the UNI in such years, has been exhausted by the accumulation distribution. The amount allocated to any particular preceding year is then considered to have been distributed at the end of each such year.

Once the accumulation distribution is allocated to prior years under IRC Section 666, Section 667 determines how such amount will be treated when distributed to a

⁶ IRC Section 665 generally defines an “accumulation distribution” as a distribution of income or gains accumulated in preceding taxable years, when the current year’s distribution is in excess of the trust’s distributable net income (DNI) for the year. It should be noted that, IRC Section 665(c) was added to the Code in 1997, with the effect of exempting most distributions from domestic trusts from the application of the throwback rules.

⁷ IRC Section 668.

⁸ IRC Section 643(a)(6)(C).

beneficiary and potentially imposes the throwback tax on such distributions. The first sentence of IRC Section 667(a) states the general rule that “the total of the amounts which are treated under IRC Section 666 as having been distributed by a trust in a preceding taxable year shall be included in the income of a beneficiary of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary under IRC Section 662(a)(2) (and, with respect to any tax exempt interest to which IRC Section 103 applies, under IRC Section 662(b)), if such total had been paid to such beneficiary on the last day of such preceding taxable year.” In other words, for purposes of calculating the throwback tax, IRC Section 667(a) seems to direct you to look at the income tax consequences of a distribution to a beneficiary, not at the time when the beneficiary actually receives such distribution, but when such distribution was deemed made to the beneficiary under IRC Section 666. In essence, this sentence states that the beneficiary is subject to the throwback tax with respect to an accumulation distribution only if he would have had to include such distribution in his income had he received the accumulated income in the year in which it was earned by the trust.⁹

You are happy with your conclusion, as a literal reading of IRC Section 667(a) seems to result in no throwback tax to a now-U.S. beneficiary who receives a distribution from a foreign, non-grantor trust of income accumulated while this beneficiary was not a U.S. person—particularly when this income comes from foreign sources. In Ben’s case, that result should apply to both the current year’s distribution of accumulated income as well as to any subsequent year’s distribution, as long as the accumulated income is attributable to a period when he was foreign.

A DEEPER LOOK

⁹ Gross income of a foreign individual generally includes only U.S. source income and income effectively connected with the conduct of a U.S. trade or business. IRC Section 872. Because the beneficiary was foreign during all prior years and the income earned by the trust was non-business income from foreign sources, the beneficiary should not have had to include any such distributions in his income had he received them in prior years. If, on the other hand, the undistributed net income (UNI) had included income from U.S. sources, the beneficiary would have had to include such income in prior years, so IRC Section 667 could result in such amounts subject to the throwback tax when distributed currently. However, because the U.S. source income would have likely been subject to U.S. income tax when earned by the trust, the beneficiary should be entitled to a credit for such tax under the accumulation distribution rules. See IRC Sections 666(b), 666(c) and 667(b).

But is this conclusion correct? Certain other related Code sections lead you to doubt that it is. First, while reading IRC Section 667(a), you noted a reference to IRC Section 662(a)(2). By this reference, IRC Section 667(a) seems to allow the character of an accumulation distribution to pass through to a beneficiary only with respect to tax-exempt interest. You wonder whether this apparent denial of the application of the conduit rules of trust taxation with respect to accumulation distributions may alter your initial conclusion. You also look at IRC Section 667(e), which states that in the case of a distribution from a trust to a foreign person, the first sentence of IRC Section 667(a) shall be applied as if the reference to the determination of character under IRC Section 662(b) applied to all amounts, instead of just to tax-exempt interest. Thus, IRC Section 667(e) allows an accumulation distribution to a foreign person to retain its character in full, notwithstanding the general rule under IRC Section 667(a), which provides only for the pass-through of character in the case of tax-exempt interest. You become concerned that the absence of a similar character pass-through rule for a U.S. person (which Ben now is) may be at odds with your initial conclusion.¹⁰

Another Code section that seems to conflict with your conclusion is 668(a), which deals with computing the interest charge on an accumulation distribution, and contains the interest charge exclusion (ICE) that applies to years in which the beneficiary receiving the distribution was a foreign person. You wonder about the necessity for the ICE, essentially forgiving the interest charge on tax on accumulation distributions attributable to years in which a beneficiary was foreign, based on your conclusions.¹¹ You realize that many of these rules focus on character, as opposed to source, and that you are actually mainly interested in the retention of the prior source of the accumulated income upon its subsequent distribution to the beneficiary. However, it's generally

¹⁰ Note that IRC Section 667(e) appears to only apply to accumulation distributions when paid, credited or required to be paid and not when deemed paid under IRC Section 666(a).

¹¹ It is conceivable that, even under the above interpretation of IRC Section 667, a U.S. beneficiary who was previously foreign would be subject to the throwback tax with respect to UNI attributable to U.S. source income earned when the beneficiary was foreign. It makes sense that the interest charge exclusion (ICE) forgives the interest charge on a period when the beneficiary was foreign, as presumably, accumulation of income during such period was not intended to avoid U.S. income tax. What troubles you, however, is why the ICE is an essential provision if, based on the above conclusions, the beneficiary would only be subject to the throwback tax on U.S. source income, much of which would be credited by any tax already paid by the trust. The ICE thus, seems to have an extremely limited application.

understood that character includes source, at least for purposes of applying the general trust (that is to say, non-accumulation) distribution rules.¹²

Because you are still not completely convinced of your conclusion based on a literal reading of the Code, you review the history of the legislative changes made to Subchapter J of the IRC in 1976 and 1978. The 1976 changes in this area generally:

- caused all foreign trusts to include capital gains in DNI¹³;
- repealed the former throwback tax applicable to capital gains;¹⁴
- and repealed the character flow-through rules with respect to accumulation distributions, except in the case of tax-exempt interest.¹⁵

You then discover that in 1978 Congress made a “technical change” to IRC Section 667, adding IRC Section 667(e), purportedly to clarify how IRC Section 667(a) would apply to distributions to foreign persons.¹⁶ IRC Section 667(e) is the rule that results in character flow-through to foreign persons when applying IRC Section 667(a) to accumulation distributions. In this manner, the taxation of U.S. source income or income effectively connected with the conduct of a U.S. trade or business earned by a foreign or domestic trust is preserved when ultimately distributed to a foreign beneficiary. Although the legislative history does not explain exactly what the result would have been absent clarification, it refers to difficulty in the determination of the amount of withholding, if any, that would have applied to such distribution in the absence of a change.¹⁷ It is possible that in the absence of a statutory conduit rule applying to an accumulation distribution, the source and character of the payment would be determined by looking at the payor of the income (that is to say, the trust) without regard to character of the income earned in the hands of the trust.¹⁸ In such a case, accumulation distributions from a

¹² See for example, *Isidro Martin-Montis Trust v. Comm’r*, 75 T.C. 381 (1980), acq. 1981-2 CB 2; Rev. Rul. 81-244, 1981-2CB 151. See also Section 667(e).

¹³ IRC Section 643(a)(6)(c).

¹⁴ Pre-1976 IRC Section 669.

¹⁵ IRC Section 667(a), formerly 668(a). The 1976 legislative history says that this third change was made “in keeping with changes made applicable to domestic trusts.” *Senate Committee Report 6681.15*. (1976 Tax Reform Act, P.L. 94-455).

¹⁶ IRC 667(e), added by Section 701(r)(1) of the Revenue Act of 1978, P.L. No. 95-600.

¹⁷ S. Rep. No. 745, 95th Cong., 2d Sess. 35 (1978); Staff of the Joint Committee on Taxation, “General Explanation of the Revenue Act of 1978,” 95th Cong., 2d Sess. 365 (1978) (Committee Print).

¹⁸ The 1954 Internal Revenue Code codified a general conduit theory of trust taxation (for example, IRC Sections 652 and 662) that has been a basic concept of trust taxation since the early revenue acts. It is unclear what rules should apply in the absence of a statutory conduit rule. One area of law that provides

foreign trust could be seen as foreign source in their entirety. This argument would be helpful to a now-U.S. beneficiary of a foreign trust who lacks a specific statutory conduit rule in his favor. You believe, however, that if Congress had analyzed a fact pattern similar to Ben's case, taking into account the policy behind the throwback tax, the lawmakers would have likely determined that the absence of a clear character rule would leave his situation dubious, and should be corrected in the same way that IRC Section 667(e) was added as a technical correction to the IRC. Absent administrative or congressional clarification and because 667(e) does not limit its application to actual distributions, it could also be argued that this section should additionally be applied to distributions deemed made in prior years under IRC Section 666, during such time while the now U.S. beneficiary was a foreign person.¹⁹ This argument would allow the application of the conduit rules to accumulation distributions that Ben will receive, at least those allocated to prior years while he was a foreign person, notwithstanding the fact that IRC Section 667(e), standing alone, may not apply to a U.S. person.

To further confirm that your analysis is correct, you examine secondary sources, but fail to find anything directly on point. There is one comment by well known commentators in this area who agree with your initial conclusion, based on a literal reading of IRC Section 667(a),²⁰ but without making reference to a statutory mechanism confirming that the prior character, and more importantly in your client's case, the prior source, will be retained in the hands of a now U.S. beneficiary receiving an accumulation distribution from a foreign, non-grantor trust. This seems to be the proper result, but you are still not convinced that the statutes clearly give you a way to apply conduit principles in Ben's situation.

some guidance is that pertaining to pension plans. In the pension plan context, the general conduit principles of Subchapter J are inapplicable. The compensation component of pension distributions is sourced under IRC Section 72(f), which provides, in essence, a statutory conduit rule. By contrast, the growth component of pension distributions is sourced by the location of the pension plan, regardless of the source from which such income was derived by the plan itself. See Rev. Rul. 55-61, 1955-1 C.B. 40, Rev. Rul. 72-99, 1972-1 C.B. 115, Rev. Rul. 79-388, 1979-2 C.B. 270.

¹⁹ This argument is also supported by Rev. Rul. 91-6, 1991-4 I.R.B. 4, which holds that a beneficiary must apply the accumulation distribution rules (IRC Sections 665-668) as of the time when the distribution was deemed to have been made.

²⁰ See Norman H. Lane and Howard M. Zaritsky, *Federal Income Taxation of Estates and Trusts* (1993), Section 6.06(6)(b).

You do find one case that may have some relevance. *Furstenberg v. Commissioner*,²¹ dealt with a U.S. beneficiary of a domestic accumulation trust when the accumulation distribution rules still applied to all domestic trusts and before the 1976 elimination of the conduit rules. This beneficiary received distributions of accumulated income in the same calendar year in which, but before, she expatriated from the United States. All of the income was accumulated while she was a U.S. person. However, the beneficiary argued that any distribution received by her during her year of expatriation should be taxed to her at the rates applicable to a foreign person, because she was a foreign person at the end of the trust's taxable year. Essentially, she was arguing that the court should not look back to the time when the income was accumulated or actually paid. That beneficiary lost. The *Furstenberg* court held that the distributions were taxable as accumulation distributions at the time that they were paid, and subject to tax at the rate that applied to U.S. citizens. In reaching this conclusion, the court stated that the accumulation distribution rules "indicate that consideration of the beneficiary's status both at the time of distribution and during the years of income accumulation is relevant in determining the tax consequences of an accumulation distribution to a status changing taxpayer."²² The court declined to comment on what the result would have been had the beneficiary received any such distribution after expatriation.²³

One could argue under *Furstenberg* that the character and source of the distribution should have flowed through to the beneficiary the day after expatriation as well, considering the beneficiary's status at both the time when she received the distribution and the time during which the income had been accumulated; an argument that would bolster Ben's position (in a situation that is the reverse of *Furstenberg*), that character and source of income accumulated while he was a foreign person should flow through after he has become a U.S. person.

POLICY

Finally, you look at the policy behind the throwback tax. These rules were first enacted in 1954 with the intention of capturing income tax that had been avoided by the

²¹ 83 T.C. 755 (1984).

²² *Ibid.* at p. 789.

²³ The application of IRC Section 667 to former U.S. citizens or residents is similarly unclear.

accumulation of income in trusts (both domestic and foreign). The primary need for such rules was based upon widely differential tax rates between individuals and trusts at the time, which encouraged such accumulation.²⁴ Thus, from a policy perspective, the throwback tax rules should only apply in instances where the use of a trust results in deferral and/or avoidance of U.S. income tax, which otherwise would have been payable by the trust's beneficiaries in the absence of a trust. In the case of income accumulated in a foreign trust during the time a beneficiary was foreign, such tax deferral and avoidance concerns are generally not applicable, as the beneficiary would not otherwise have been subject to U.S. income tax, with respect to foreign source income, or subject to additional U.S. income tax beyond what was paid by the trust, with respect to the U.S. source income.²⁵ Furthermore, even relying a literal reading of IRC Section 667(a), the previously foreign, now-U.S. beneficiary still may be subject to a throwback tax on UNI attributable to U.S. sources,²⁶ notwithstanding the fact that the trust may have in fact, paid tax on such income. Two cases in the foreign personal holding company area, a related (and now extinct) anti-deferral regime, *Marsman v. Comm'r*²⁷ and *Gutierrez v. Comm'r*,²⁸ dealt with similar statutory implications for status-changing taxpayers that Congress likely did not intend. In *Marsman* and *Gutierrez*, taxpayers who had recently become U.S. persons would have been, based on a literal application of the relevant statutes, based on their ownership interests in certain foreign companies and their U.S. residency status on the last day of the taxable year, subject to U.S. income tax on deemed

²⁴ For example, under prior law, a trust in a low tax bracket would have earned income in a given year and paid tax on such income at the trust's marginal tax rate. If such income had been distributed to a beneficiary during the year it was earned, the beneficiary would have paid tax at his higher marginal tax rate and the trust would have received a corresponding deduction. However, before the accumulation distribution rules and absent a distribution to a beneficiary in the year in which the income was earned by the trust, the income would have been converted to principal within the trust at year end. If the trust were to subsequently distribute such income in a later year in which the trust had no DNI, such distribution could have been tax-free upon receipt by the higher tax bracket beneficiary, who would have, in essence, lowered his applicable tax rate by the accumulation of income in the trust. In 1997, Congress realized that changes to the tax rates in 1986 had made the need for the throwback rules less important with respect to domestic trusts. Thus, the Taxpayer Relief Act of 1997 provided generally that the throwback tax rules would no longer apply to most domestic trusts. IRC Section 665(c)(1) added by the Taxpayer Relief Act of 1997, P.L. 105-34, Section 507(a)(1).

²⁵ It is conceivable that with a foreign trust to which an income tax treaty applies, certain deferral opportunities might otherwise arise.

²⁶ Subject to any possible credit available to the beneficiary for taxes previously paid by the trust.

²⁷ 205 F. 2d 335 (4thCir. 1953), reversing in part 18 T.C. 1 (1952).

²⁸ 53 T.C.394 (1969).

distributions of income accumulated in such companies throughout the entire year, notwithstanding that during a portion of the year the taxpayers had foreign status. Rather than applying the statutes strictly, the courts in both cases looked at Congressional intent. That intent was to reach income accumulated in a foreign entity by taxpayers otherwise subject to U.S. income tax. Therefore, the courts allowed the taxpayers to prorate the deemed distribution, so that the foreign personal holding company rules would apply only to income accumulated during the period of U.S. residency. Similar reasoning and a similar result should apply with respect to a previously foreign beneficiary of a foreign trust who has recently become a U.S. person.

CONFIRMATION NEEDED

Based on all of your research and ruminations, you conclude that the proper result for Ben should be that he'll not be subject to the throwback tax (or the interest charge) on his receipt of UNI derived from foreign sources and allocated to years during which he was foreign, as he would not have been required to include such income in his gross income had the trust distributed such income to him at the time that it was earned by the trust.

Still, the Treasury Department should help make this clear. Treasury should issue regulations under IRC Section 667(e) confirming that a distribution from a foreign trust of UNI derived from non-business income from foreign sources attributable to a period in which the beneficiary was foreign should not be subject to the throwback tax. Or maybe Congress should act. The federal lawmakers could amend the Code to exempt from the throwback tax all distributions from a foreign trust of UNI attributable to periods in which the beneficiary was foreign—in other words, extend the ICE's application to the interest charge to the throwback tax itself.