COMING TO AMERICA: THE "THROWBACK TAX'S" UGLY HEAD – THE NON-RESIDENT ALIEN CUM RESIDENT AS BENEFICIARY OF ACCUMULATED INCOME

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In 1996, the "throwback tax" was a new concept created by the Small Business Job Protection Act of 1996.[1] It was academic then, but now as time has passed, there are many foreign trusts which have accumulated income for beneficiaries who have now become U.S. resident aliens. Many more foreign persons who are beneficiaries will eventually become U.S. resident aliens, obtain their U.S. citizenship or lawful permanent residency. If the trustee distributes this income (or the beneficiary has the right to receive it) when the beneficiary is a resident alien of the U.S.[2] the U.S. income tax consequences can be draconian.

This problem is not uncommon and is often encountered because of the world migration patterns into the United States. Migration is happening at an ever-rapid pace and the U.S. income tax consequences from it are many – including the "throwback tax" on accumulated foreign trust income.

The Economist (*Emigration from Latin America - Making the Most of an Exodus*) reported that starting in the latter part of the 1990s through the beginning of the 2nd millennium, residents of virtually all Latin American countries have been rapidly moving to the U.S. and Western Europe.[3] Brazil and Chile are (or at least were) the only Latin American countries bucking this trend, whereas the U.S. had an estimated 7.5 million Mexicans and 15 million people born in Latin America living on its soil by the year 2002.[4] In 2000 there were an estimated 900,000 Cubans, 700,000 Dominicans, 411,000 Jamaicans and 385,000 Haitians living in the United States; just to name a few of the Caribbean countries with the most significant populations living in the United States.[5]

Migration from Europe and Asia is also common throughout the United States with an ever increasing trend of worldwide entrepreneurs who do business with and in various countries and accumulate the wealth and income from these businesses in at least more than one jurisdiction at the same time.

In 2000, more than 33 million nonimmigrant individuals entered the United States, including some 30 million visitors for business and pleasure.[6] Six hundred and seventy six thousand were students while 634,788 were trainees and students. Almost 850 thousand immigrant individuals (meaning on some type of permanent basis) came to the United States, and nearly 600 thousand of those were family based or sponsored. Only 107 thousand were employment-based immigrants.[7] Immigration (both legal and illegal) is currently one of the most important U.S. national political topics of debate as two different proposed versions of an immigration law has been working its way through the House and Senate.[8]

At the same time, only approximately two hundred thousand persons are apparently emigrating and leaving the United States annually on some type of permanent basis.[9]

I. THE PROBLEM OF ACCUMULATED INCOME IN A FOREIGN TRUST

What does all of the fuss about immigrating to the U.S. have to do with trusts and accumulated income? What happens when one or more of these non-residents (some 850 thousand or so per year) decide to move to the U.S. and eventually receives a distribution of accumulated income from a foreign trust?

The U.S. federal tax cost associated with it can be twofold. First, the "throwback" tax,[10] can apply to distributions of

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1 *P.L. 104-188, §1904(c)(1), 104th Cong., 2d Sess. (1996). See IRC Section 668 regarding the interest charge on accumulation distributions from foreign trusts.*

2 *See IRC Section 7701(b)(1)(A).*

3 *See, The Economist (Emigration from Latin America - Making the Most of an Exodus) , February 23rd through March 1st 2002, page 41.*

4 *See Supra, footnote 3.*

5 *See, Widgren and Martin, International Migration: Facing the Challenge, Vol. 57 No. 1, March 2002, Population Bulletin.*

6 *See footnote 5 and Immigration and Naturalization Service, Legal Immigration: Fiscal Year 2000 (2002).*

7 *See footnote 6. Curiously, an estimated 8.5 million foreign persons live illegally in the United States and this amount is apparently increasing by approximately 700,000 persons annually. See footnote 6 and J. Passel, Estimates of Undocumented Immigrants, (Urban Institute 2001).7*

8 *See, House Leaders Intensify Debate on Immigration , Los Angeles Times, July 13, 2006 (Gaouette)..*

9 *See footnote 6.*

10 *See* Section 667.

accumulated income. Second, an accompanying compounded interest charge is imposed upon the amount.[11] Additionally, various States (such as California) may have their own tax calculation which will not necessarily conform to the federal rules.

This article will explain how and when the federal throwback tax and the compounded interest charge will apply to persons who might receive distributions from a foreign trust.

A. HYPOTHETICAL EXAMPLE

To help demonstrate the U.S. tax problems that can arise from rights to accumulated income, the following hypothetical example will help demonstrate the application of the law in more detail. As is so often the case, the family member establishes trust assets for the benefit of family members without detailed consideration of the possible U.S. international tax consequences. This is only normal, of course, since a family residing overseas which has virtually no connection to the U.S., will not necessarily be able to foresee the future tax consequences arising from a family member beneficiary deciding to move to the U.S. Few foreign families contemplate the possibility that some day one or more of the family members will ever move or live in the U.S. (e.g., go to college in the U.S., marry a U.S. resident, find a job here, etc.).

Let's assume that on April 3, 1990, Mr. Juan Smith a Mexican citizen and resident ("Father" or "Settlor") formed a foreign trust the "Foreign Trust" (the "Trust") and transferred various assets to the Trust for the benefit of his family members. Of course, Father thought he was doing a big favor for the benefit of his children when he funded a trust with cash and investments for their benefit. Let's assume he died about ten years later at age 85 on January 1, 2000 after a big Millennium New Years Party. While Father was alive, he was the present beneficiary of the Trust with a right to revoke all assets from it, and his wife and children were named the remainder beneficiaries, all of whom were Mexican citizens and residents of Mexico and two of the children then resided in Spain and Argentina, respectively. The child who resided in Spain (Liliana) also obtained citizenship from Spain and the home country of her spouse, Switzerland. None of the family then lived in the U.S. and none were then U.S. resident aliens.

Among other assets, let us assume the Trust held stock in three different foreign corporations (none were ever domestic corporations[12]), which in turn owned various assets, including foreign bonds that produce interest income. We will also assume that the Trust has always had European institutions (or at least non-U.S. persons) acting as trustee ("Trustee") and by its terms can never be subject to U.S. law or the jurisdiction of a U.S. court.[13] The Trust also provides that at all times at least one person (who is not a U.S. person) will have the power to determine whether to arbitrate, compromise or abandon claims of the trust.[14] Accordingly, the Trust was, is and always will be a foreign trust since it will at all times "flunk" the "court test" and the "control test" provided for in the statute and regulations.[15]

Upon Father's death, the terms of the Trust required that the Trust assets (20 percent - the "Wife's Share") be further held in a separate trust for the benefit of Father's wife, Mrs. Maria Smith ("Wife"). Current income of the Wife's Share is payable annually to Wife.

The remaining Trust assets, after distribution of the Wife's Share, are to be held in equal shares of 20 percent for Father's two sons and two daughters upon separate trusts for Jose, Edward, Liliana and Véronique (the "Children" or "Beneficiaries"). Let us further assume that by its terms, the Children have no right to income or principal until they reach the age of 45, at which time

". . . income generated from the Children's Share in the year that Child turns 45 years, shall be distributed by the Trustee to that Child on June 30th and December 31st of that year. Every year thereafter, that Child shall receive the income generated from the Children's Share in that year on the same dates hereinbefore mentioned until he or she reaches the age of 65 years. One month after his or her 65th birthday, the Trustee shall distribute to that Child the balance of income and capital of his or her respective Children's Share."

Véronique is about to marry a U.S. citizen and plans to move and live permanently in the United States where she expects to obtain "lawful permanent resident" (i.e., "green card" holder) dividing their time between Miami and La

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11 See Section 668. For years prior to 1996, the interest on the throwback tax is computed at a fixed annual rate of 6 percent, with no compounding. For years beginning on January 1, 1996, the interest rate applicable to the throwback tax is the floating rate imposed on underpayment of tax under §6621(a)(2), with compounding. The compound interest based on the underpayment rate would be imposed not only on throwback tax, but also on the total simple interest for pre-1996 periods.

12 See IRC Section 7701(a)(3), (4) and (5).

13 See IRC Section 7701(a)(30)(E)(i) and (31)(B) and Treas. Reg. Section 301.7701-7(b) which provide the detailed rules of when a trust is a foreign trust or a domestic trust. See also PLR 200243031 for a more detailed discussion of the foreign trust rules under similar scenarios (including when a trust is subject to U.S. law, but still a foreign trust because it "flunks" the "control test."

14 See Treas. Reg. Section 301.7701-7(d)(1)(ii)(F).

15 See footnotes 13 and 14.

Jolla. Because of her current age, Véronique will have to wait approximately ten years before receiving any distributions from the Trust.

Of course, income (as of 2006) has already been accumulating in Trust for her benefit of Véronique (for more than five years) since the death of Father on January 1, 2000.

For purposes of this article, we will assume the following additional facts in our hypothetical example:

- The Trust was a foreign "grantor" trust until Father's death;
- Upon Father's death, the Trust converted into a foreign "non-grantor" trust;
- At no time has the Trust ever been subject to U.S. income tax (i.e., no income effectively connected with a U.S. business, and no U.S.-source taxable income); and
- Véronique will be a U.S. income tax resident at the time the Trust makes distributions (unless she and her husband decide not to move to Miami or to the house in La Jolla after their marriage and reside outside of the U.S.).

For purposes of analyzing more directly the tax consequences, we will pose various initial considerations, provide preliminary answers, and then analyze each in some detail. A word of caution, since some thought and analysis has to be provided to the State income tax consequences (e.g., California and Florida) of the income earned. Although this article does not analyze in great detail the State income tax consequences, it is important to articulate the general rules of trust income taxation for California tax law purposes.[16]

B. INITIAL FEDERAL TAX CONSIDERATIONS

- What preliminary determinations must be made regarding Véronique's U.S. income tax consequences from Trust distributions?
- Is Véronique subject to U.S. income taxes for years prior to when she turns 45 years of age even though she will not receive any Trust distributions during such years? Should the Trust (or the "Children's Share" Trust for Véronique) utilize a dedicated foreign holding corporation to hold its investments?
- What are Véronique's U.S. income tax consequences from distribution(s) when she turns 45 years of age (through the age of 65) and has a right to receive certain trust distributions?
- Would Véronique's U.S. income taxes be reduced if the Trustee invested in a different type of assets?

C. PRELIMINARY FEDERAL TAX CONSIDERATIONS

- Preliminary determinations would include: (a) determine the tax basis (for U.S. tax purposes as defined below) and fair market value of each asset held by the Trust, (b) the type and amount of Trust income generated since inception of the Trust (as a non-grantor trust as of the date of Father's death), and (c) the type and amount of Trust distributions that have been made by the Trust (if any)..
- Véronique should generally not be subject to U.S. tax until she receives a distribution from the Trust (assuming she is a resident alien as of the date of the distribution). However, a U.S. beneficiary can be subject to U.S. tax, even in the absence of a distribution, if: (a) the Trust, or a segregated trust formed under

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[16] *For California tax purposes, capital gains are taxed at ordinary income rates, which apply to both resident individuals and trusts, and these ordinary income rates are progressive. Cal. Rev. and Tax Code (the "CRTC") § 17041 Also like the federal rules, California will tax a gain recognized by a trust if it is immediately distributed to a California resident beneficiary. CRTC Section 17731 incorporates federal tax law regarding trusts, except as otherwise provided (which incorporates the general "distributable net income" regime of IRC Section 662). In contrast, if gain is not immediately distributed, California will try to tax it under a combination of the federal tax rules and its own rules governing such accumulations. California incorporates federal tax law regarding trusts, except as otherwise provided. Indeed, In McCulloch v. Franchise Tax Board, the California Supreme Court upheld the operation of these statutes as they apply to noncontingent beneficiaries. McCulloch, 61 Cal.2d at 186. In that case, a grandfather established a testamentary trust for the benefit of his grandson and selected three trustees. Two trustees resided in Missouri. The third trustee was the grandson, and he resided in California. Based on these facts, the California Supreme Court held that residence of the grandson alone, as beneficiary, was enough to subject the trust to California tax on its accumulated income. McCulloch, 61 Cal.2d at 198. To justify this holding, it pointed to the statutes discussed above. Id at 192. Furthermore, it reasoned that residence in California provides "the essential 'minimum connection' … necessary for due process of law." . Id at 197. Residence offers certain benefits, such as the "protection of [California's] laws" and "the protection of California's courts." . Id at 196. These protections, among other things, ensure that a beneficiary "may ultimately obtain the benefit of the accumulated income." Id at 192. The reasoning of the California Supreme Court may seem tenuous, at best, but should behoove all future California resident to consider the California tax consequences associated with distributions (or even accumulations) of trust income.*

the Trust for Véronique's benefit, owns stock in one or more foreign corporations that generate passive income (interest, dividends, etc.), and (b) Véronique is treated as indirectly owning greater than 50 percent of such corporation or corporations through the Trust or the segregated trust.

- Véronique may be subject to a substantial "throwback" tax (defined below) with significant interest imposed thereon depending upon what type of assets the Trust maintained and maintains and whether Véronique is a resident alien as of the date of the distribution. Indeed, the throwback tax plus interest may consume greater than one half of all of the distributions from the Trust.
- The Trustee should consider the tax consequences arising from the various type of investments made (how made) by the Trust.

Of course, one of the most simple considerations to avoid any U.S. income taxation is for Véronique to decide not to move to the U.S. and not be a resident alien at the time any distributions from the Trust are made to her. She and her future husband might prefer to reside predominantly outside of the United States (and she of course should not obtain her lawful permanent residency "green card" status"). Her fiancé may not like that option if he wants to live in the U.S. and raise the future children here too.

II. DETAILED ANALYSIS - PRELIMINARY FEDERAL TAX DETERMINATIONS

A. APPLICABLE TAX LAW

Since the Trust is a foreign trust and Véronique is anticipating becoming a U.S. income tax resident (and thus subject to U.S. income tax), an initial question is whether U.S. tax laws will even govern Véronique's U.S. taxation, or whether consideration must also be given to the tax laws of the jurisdiction under which the Trust was formed or her current residence. According to the IRS and U.S. federal courts, "United States tax concepts apply to determine the tax consequences of events [for U.S. Tax purposes] even if those events occur outside of the United States and even if those events result from activities conducted by foreign persons."[17] These U.S. tax principles control over foreign tax principles or characterization absent express congressional intent to the contrary.[18] Indeed, the IRS has taken the position that U.S. tax principles govern notwithstanding the existence of a conflict with foreign tax treatment or policies.[19]

Consequently, Véronique's U.S. income tax consequences from Trust distributions will be governed by U.S. tax laws (if she is a resident of the United States at the time she receives or has a right to receive distributions from the Trust), even though the Trust was formed by Father, a nonresident alien, under foreign law. Of course, she (and most all of her family members) should also be aware of the application of Mexican, Spanish, Argentinean and even Swiss tax law with respect to the Trust income, principal and its activities.

B. TAX BASIS[20] AND FAIR MARKET VALUE OF EACH TRUST ASSET

As discussed more fully at ***Different Investment Strategy to Minimize Adverse Effect of Throwback Tax*** below, one potential means to reduce Véronique's U.S. income taxes would be for the Trustee to distribute appreciated property to Véronique instead of cash. To evaluate the tax consequences of such distribution, a careful analysis is required to determine the tax basis and the fair market value of the Trust asset or assets that would be distributed to her. Additionally, U.S. rules would also govern the calculation of the tax basis and the fair market value of each Trust asset, irrespective of the tax basis of each asset calculated under foreign tax principles.[21] The discussion now turns to the calculation of the tax basis in each Trust asset.

Tax Basis. To begin with, it is assumed that prior to Father's death in 2000, the Trust was a "grantor" trust, which

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17 *See 2002 IRS CCA LEXIS 134, citing, U.S. v. Goodyear Tire and Rubber Co. 493 U.S 132, 145 (1989), reh'g denied, 493 U.S. 1095 (1990); Biddle v. Comm'r, 302 U.S. 573, 578 (1938); Rev. Ruls. 73-254, 64-158. See generally, Mary F. Voce, Basis of Foreign Property Subject to U.S. Taxation, 49 Tax Law. 341 (Winter, 1996).*

18 *See Goodyear Tire and Rubber Co., at 145.*

19 *See 1998 FSA LEXIS 630; 1997 FSA LEXIS 208; 1993 FSA LEXIS 44.*

20 *"Tax basis," as used herein, refers to the U.S. federal income tax adjusted cost basis of property for purposes of determining gain or loss upon disposition, and other U.S. income tax consequences.*

21 *See, e.g., Gutwirth v. Comm'r, 40 T.C. 666, 678 (1963); Reisner v. Comm'r, 34 T.C. 1122 (1960), acq., 1961-2 C.B. 5; PLR 8749008; RR 64-158 (holding that "[i]n determining the effects of a transaction for Federal income tax purposes, the [Internal Revenue] Code governs, whether or not the parties to the transaction are United States taxpayers" and notwithstanding the fact that "the transaction in question could in no event have any immediate [U.S.] tax consequences"); 1993 FSA LEXIS 44 (noting that the IRS must consistently apply U.S. tax principles to determine the basis of assets subject to U.S. tax, even if there is conflicting treatment under foreign law and a double tax benefit is created by applying U.S. principles to establish the basis of such assets).*

meant that Father, and not the Trust, was treated as the owner of all the Trust assets for U.S. tax purposes.[22] Upon Father's death in 2000, the Trust became a foreign "non-grantor" trust,[23] and Father was treated as transferring ownership of the assets to the Trust on the date of his death.

A special rule provides that the tax basis of property acquired from a decedent is generally its fair market value on the decedent's date of death.[24] The statute does not distinguish the application of these basis rules to U.S. decedents versus foreign decedents nor does it preclude its application to assets held by foreign decedents (even if for the benefit of U.S. persons and even if there is no equivalent estate tax in their foreign jurisdiction).[25] Operation of this rule may result in either a stepped-up or stepped-down tax basis depending on whether the property has an inherent gain or loss as of the date of death.[26] Consequently, the Trust's initial tax basis in each asset it received from Father on his death will have equaled the fair market value of each such asset as of the date of death for purposes of determining U.S. tax basis.[27]

For example, assume the following as of the date of Father's death: (a) Trust owned 100 percent of the stock in a single foreign corporation from a low tax jurisdiction (the stock was held by the grantor trust but treated as owned by Father); (b) Father's tax basis in the stock was U.S.$50;[28] (c) the fair market value of the underlying assets held by the corporation equaled U.S.$200, which meant that the stock's fair market value was also U.S.$200 (exclusive of goodwill, if any); and (d) the corporation's tax basis in its assets equaled U.S.$50.

Upon Father's death, the Trust would be treated as acquiring the stock from Father, a decedent, and the Trust would therefore take a stepped-up fair market value tax basis in the stock of U.S.$200. Importantly, the Foreign corporation's tax basis in its assets would remain unchanged at only U.S.$50.

Fair Market Value. For U.S. tax purposes, the fair market value of each asset held by the Trust would equal the price at which the asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[29] Of course, appraisals are often used to establish asset fair market values.

C. TRUST INCOME AND DISTRIBUTIONS (IF ANY)

Of primary importance would be determining the type and amount of income generated by the Trust since its inception, and evaluating the effects of any distributions of Trust income or principal. For instance, has the Foreign corporation(s) distributed dividends to the Trust? Has the Foreign corporation, which is owned by the Trust, generated significant amounts of income and losses; have there been no distributions; has all income been accumulated and/or reinvested?

III. IS VÉRONIQUE SUBJECT TO U.S. INCOME TAXES FOR YEARS PRIOR TO WHEN SHE TURNS 45 YEARS OF AGE EVEN THOUGH SHE WILL RECEIVE NO TRUST DISTRIBUTIONS IN SUCH YEARS?

A. TAXATION OF U.S. BENEFICIARIES ON CURRENT TRUST DISTRIBUTIONS

In this scenario, the Children, including Véronique, have not yet received any distributions from the Trust because no distributions are required nor allowed under the terms of the Trust (as to the "Children' Shares") until Véronique or one of the Children turns 45 years of age.

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[22] *The assumption is that the Trust was a "grantor" trust because until his death in 2000: (a) Father had the power to revest in himself title to the Trust property; or (b) the only amounts distributable during Father's lifetime were amounts distributable to Father or his wife. §672(f)(2)(A). Since the first circumstance existed, the Trust was characterized as a "grantor" trust, and Father was treated as the owner of the Trust assets, up until his death. This means that income accumulated in the Trust prior to Father's death **may** not become subject to U.S. income tax depending upon how those assets were held as of the date of death.*

[23] *Generally speaking, a foreign trust (with U.S. beneficiaries) is a "non-grantor" trust where the grantor (creator) of the trust does not have the power to revoke the trust and revest title to the trust property back in himself. §672(f). Once Father died, he obviously no longer had the power to revoke the Trust (nor any other person), and therefore the Trust became a foreign non-grantor trust. For the remainder of this article, all references to foreign trusts shall mean foreign non-grantor trusts.*

[24] *IRC Section 1014(a).*

[25] *IRC Section 1014(b).*

[26] *IRC Section 1014(a)(1).*

[27] *The special rule under §1014, which permits a step-up in tax basis, does not apply to property that is income in respect of a decedent ("IRD"). §1014(c). IRD property is generally property which carries a fixed right to receive earned but unpaid income in the future, such as installment obligations owed to the decedent and accrued but unpaid interest on bonds owned by the decedent individually. Thus, if the Trust received from Father any IRD property, such property would not be entitled to a step-up in tax basis.*

[28] *Under U.S. principles, Father's tax basis in the stock would equal the "cost" of the stock, which consists of the sum of (a) any cash paid for the stock, (b) the face amount of any liability incurred, assumed, or taken subject to in respect of the stock, and (c) the fair market value of other property transferred in consideration for the stock. §1014.*

[29] *Treas. Reg. §25.2512-1.*

Generally speaking Véronique's U.S. income tax consequences from a distribution of Trust income will depend on whether:

- the distribution represents current Trust income, which is also known as "distributable net income" ("**DNI**");[30]
- the distribution represents accumulated Trust income, which is also known as "undistributed net income" ("**UNI**");[31] or
- the distribution of principal (e.g., appreciated property) that itself is not treated as DNI or UNI.

Véronique, if she becomes a resident alien (as a U.S. beneficiary), must include in her gross income for any particular year she is a resident alien all Trust income that the Trust is required to distribute to her,[32] and all Trust income actually distributed to her, pursuant to the terms of the Trust instrument.[33] However, the taxable amount of the distribution is limited to Véronique's pro rata share of the Trust's DNI for the taxable year in which the distribution occurs.[34] Trust distributions to Véronique that exceed the Trust's DNI for the year of such distributions (e.g., the distributions when Véronique obtains 45 years of age) will be treated either as nontaxable distributions of principal, or distributions of UNI which had been accumulated from prior years. To the extent any distribution to Véronique represents UNI, such distribution will be taxable to her under the harsh "throwback" rule discussed below.

If, as here, the terms of the Trust do not require the Trustee to annually distribute trust income to Véronique, she generally would not be taxed on Trust income until she actually receives a distribution of Trust income. However, she may arguably be subject to U.S. tax if the Trust, or a separate or segregated trust formed under the Trust for Véronique's benefit, owns stock in certain foreign corporations. This situation is addressed next and special care must be taken to avoid the application of these rules especially considering the application of the Service's position set forth in a private letter ruling and revenue ruling.

B. Possible Current Taxation of U.S. Beneficiaries Where Trust Owns Stock in Certain Foreign Corporation(s)

Under certain circumstances, U.S. beneficiaries of a foreign trust will be taxed currently on trust income, even if the terms of the trust do not require the Trustee to distribute income to them, and even if they have not received an actual distribution of trust income. Such taxation on undistributed trust income can occur where a trust with one or more U.S. beneficiaries owns stock in a foreign corporation which is considered a controlled foreign corporation (a "**CFC**"),[35] a foreign personal holding company (a "**FPHC**"),[36] or a passive foreign investment company (a "**PFIC**").[37] Since, the Trust owns stock in at least one foreign corporation, two determinations are required to evaluate whether Véronique is subject to U.S. tax on the corporation's income (regardless of whether the corporation distributes its income to the Trust, and irrespective of whether the Trust distributes such income to Véronique).

First, Véronique's proportionate beneficial interest in the Trust must be determined. In the case of discretionary trusts, each beneficiary's beneficial interest in the Trust is generally based on such beneficiary's actuarial interest in the Trust according to the regulations.[38] Once each beneficiary's beneficial interest in the Trust is calculated, the

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[30] *The DNI of the Trust for any particular year equals the Trust's worldwide taxable income, including foreign-source income net of related deductions, income that is exempt under treaties, and capital gains reduced (but not below zero) by capital losses. §§643(a), 643(a)(6).*

[31] *See note 42 for definition of UNI. The taxation of UNI is discussed below.*

[32] *IRC Sections 661(a)(1) and 662(a)(1).*

[33] *IRC Sections 661(a)(2) and 662(a)(2).*

[34] *IRC Section 662(a). The character of foreign trust distributions received by U.S. beneficiaries, to the extent of the trust's DNI, has the same character in the hands of the beneficiary as in the hands of the trust. §662(c). However, the character of distributions of UNI is ordinary income, even if such income was capital gain in the hands of the trust. §667(a). Also, if the Trust paid foreign income taxes on the trust income, its U.S. beneficiaries who receive distributions of trust income on which such taxes have been paid may elect to take either a credit or a deduction for their share of foreign taxes attributable to their share of the income. §§164, 901, 904.*

[35] *Under §957, a foreign corporation is a CFC if over 50 percent of its stock is owned by U.S. individuals or entities. Stock ownership can be either direct, or indirect if the U.S. individual or entity is a beneficiary of a trust which owns the stock. §958(a)(2).*

[36] *Overlap among various anti-deferral regimes and complexity led to repeal (pursuant to the American Jobs Creation Act of 2004) of the FPHC rules (FPHC was any foreign corporation if (a) at any time during the year more than 50% of the vote or value is owned directly or indirectly by a group of five or fewer U.S. persons, and (b) at least 60% of the corporation's gross income is passive). Stock ownership can be either direct, or indirect if the U.S. individual is a beneficiary of a trust which owns the stock. See prior IRC §554(a)(1).*

[37] *Under §1297, a foreign corporation is a PFIC if either (i) 75 percent or more of its gross income for the taxable year is passive (e.g., dividends, interest, royalties), or (ii) the average percentage of assets held by the corporation for the production of passive income is at least 50 percent.*

[38] *A beneficiary's "actuarial interest" in a trust is essentially the present value of the trust assets that beneficiary is entitled to receive, based on mortality rates and other factors. When the trust is a discretionary trust (i.e., the beneficiaries have no current right to*

second step is to apply complex ownership attribution rules to determine the amount of stock owned by the Trust that is treated as indirectly owned by Véronique (which in turn will dictate whether the foreign corporation is or was a CFC, a FPHC[39], or a PFIC, and whether Véronique is currently taxable on the corporation's income).

For example, assume the Trust owns 100% of a foreign corporation and has five Beneficiaries, as in this case, only one of which, Véronique, is a U.S. resident subject to U.S. tax. Further assume that all beneficiaries have equal beneficial interests (i.e., equal actuarial interests) in the Trust of 20 percent each (currently the Children each have equal beneficial interests). In such case, Véronique would be deemed to indirectly own only 20 percent of the stock (which equals her direct ownership) in the foreign corporation (through the Trust). Thus, the corporation would not be a CFC[40] (or a FPHC or a PFIC) because over 50 percent U.S. ownership is required.

On the other hand, this may be an issue for Véronique if separate or segregated trusts for the benefit of each Beneficiary are formed under the Trust (thus meaning that each Beneficiary has 100 percent beneficial interest in their respective segregated trust). In such case, if the separate trust for the benefit of Véronique owns greater than 50 percent of a foreign corporation, then such corporation would arguable be a CFC, since Véronique would indirectly own greater than 50 percent of the corporation (through her trust). As a result, she may be subject to U.S. tax on the corporation's income.

It should be pointed out, however, that neither the statute (Section 958(a)) nor the regulations thereunder (Regulation Section 1.958-1 and 1.958-2) expressly deal with indirect stock ownership by a beneficiary of a trust, like this hypothetical Trust, with respect to which the beneficiary cannot receive any current distributions (discretionary or otherwise) and has absolutely no control over the trust. Plus, there is scant judicial authority concerning this issue.

On one hand, Regulation Section 1.958-2 provides that stock is treated as owned by a beneficiary according to that beneficiary's "actuarial" interest in the trust. Under the actuarial approach, Véronique would be treated as the sole owner of Véronique's Trust. Accordingly, the IRS would likely rely on Regulation Section 1.958-2 to treat Véronique as the owner of the stock held by Véronique's Trust. However, Regulation Section 1.958-2 is an "interpretive" regulation, since its promulgation by the IRS was not authorized by Congress when Congress drafted Section 958. Of course, Congress will often draft into the statute a provision expressly authorizing the IRS to promulgate regulations thereunder, and such regulations generally have the force of the statute.

Section 958(a), which is the law, does not refer to ownership attribution based on an"actuarial" interest. In addition, Regulation Section 1.958-1(c)(2) provides, in part, that for purposes of Section 958(a), the determination of a beneficiary's proportionate interest in a foreign trust <u>will be made on the basis of all the facts and circumstances</u>. In other words, one might logically conclude that a beneficiary has no proportionate interest in a trust (for purposes of Section 958), and thus will not be attributed with ownership of the trust property, unless such beneficiary has fixed or discretionary income rights, or other control over the trust property (e.g., the effective power to obligate the foreign beneficiary to make trust distributions). Bolstering this conclusion is Regulation Section 1.958-1(d), Ex. (3), which is the only regulation under Section 958(a) that provides a factually similar example of how to determine a beneficiary's interest in a foreign trust for purposes of Section 958(a).

That example in the regulations (which in is not particularly illuminating) describes a foreign trust, the income of which is to be divided into three equal shares for three U.S. beneficiaries. Each beneficiary's share of income may be accumulated for him <u>or distributed to him</u> in the discretion of the trustee. Upon termination of the trust, each beneficiary is to receive one-third of the corpus and the accumulated income applicable to his share. The trust owns ninety percent (90%) of the stock of a foreign corporation. Under these circumstances, the example states that each beneficiary is treated as owning thirty percent (30%) of the stock of the corporation owned by the trust. While the example does not state that the discretionary right to income is the reason the beneficiaries are treated as owning the stock, that would seem to be the case, given the rule in Regulation Section 1.958-1(c)(2) that for purposes of Section 958(a), a beneficiary's interest in the foreign trust, and ownership of the trust's assets, is based on all the facts and circumstances (i.e., the possibility that the beneficiary will receive trust income).

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distributions of trust assets), the beneficiaries have no fixed interests in the trust that can be easily calculated. In the CFC context, there are two approaches for determining a beneficiary's proportionate interest in a discretionary trust. The first approach is to determine the beneficiary's interest based on all the facts and circumstances. Reg. §1.958-2(c)(2). The second approach is to determine the beneficiary's interest based on actuarial valuations. Reg. §1.958-2(c)(1)(ii)(a). Similarly, in the FPHC context, the IRS position is that a beneficiary's interest is determined by the beneficiary's actuarial interest in the trust. Rev. Rul. 62-155; <u>See also</u>, Reg. §§1.554-1, -3. In PLR 9024076, the IRS provided some guidance by describing several relevant facts and circumstances to be considered in determining the actuarial interest of a beneficiary in a discretionary trust. These facts include (a) the pattern of past distributions, (b) appropriate mortality assumptions, (c) the trustee's fiduciary duties, and (d) the relationship among the trustee(s) and the beneficiaries.

[39] Although the FPHC rules have been repealed, they still would be relevant for purposes of determining the income attributable to a U.S. beneficiary of a foreign trust for those periods prior to the repeal of the FPHC regime.

[40] If U.S. beneficiaries of a foreign trust indirectly own greater than 50 percent of the foreign corporation (through the trust) thus making the foreign corporation a CFC, the beneficiaries must also annually file Form 5471. §6038.

Consequently, in light of Regulation Section 1.958-1(c)(2) and the example cited above, it may be reasonable to interpret Section 958(a) as requiring a beneficiary to have a present income interest (at least a present discretionary income interest) in the trust in order for ownership of the trust's property to be attributed to the beneficiary. Under this interpretation, it may be a sustainable position that Véronique is not the owner of the Foreign corporation's stock owned by Véronique's Trust given the fact that Véronique has no present income interest in Véronique's Trust (whether discretionary or otherwise). In such case, the foreign corporation would not be a CFC, and Véronique wold not be required to recognize its Subpart F income or file Form 5471. On balance, this interpretation seems reasonable and seems supported by the statute and the regulations, such that Véronique would therefore not be treated as the owner of the foreign corporation stock. As a result, she should not be required to currently recognize the Subpart F income of the foreign corporation (assuming it has such income), and she should not be required to file Form 5471 in respect of the foreign corporation. This conclusion, however, seems that it could contradict the positions the Service has articulated in IRS FSA 199952014 and PLR 8748043 where the U.S. beneficiaries were deemed to constructively own the shares of the foreign corporations owned by foreign trusts.

Nonetheless, because of Regulation Section 1.958-2, the law being extremely gray and ambiguous, and the likelihood that the IRS would (despite the above analysis) treat Véronique as the owner of any stock owned by the Trust, it would be ill-advised for the Trust to hold stock in any closely held foreign corporations (particularly non-operating corporations that generate passive income).[41] Instead, it would be preferable for the Trust to hold the investment assets directly in order to avoid the possible application of the CFC and other anti-deferral rules. As explained further in this article, the trustee might wish to consider that the investment assets held by Trust not consist of large portions of income-producing assets because of the throwback rules; but rather the trustee could consider the investing and holding of capital assets that appreciate over time.

In sum, Véronique should not be subject to U.S. tax on Trust income prior to when she turns 45 years of age provided that she does not receive any distributions until then. That said, however, she may be subject to current U.S. tax if the Trust, or a segregated trust formed under the Trust for the benefit of Véronique, owns stock in one or more foreign corporations (CFC, FPHC or PFIC) that generate specified types of passive income.

IV. WHAT ARE VÉRONIQUE'S U.S. INCOME TAX CONSEQUENCES FROM DISTRIBUTION(S) WHEN SHE OBTAINS 45 YEARS OF AGE?

A. DISTRIBUTIONS OF UNI ACCUMULATED IN PRIOR YEARS - "THROWBACK RULE"

This is where the ugly head is raised! In our example, the Trustee of the Trust is required, under the terms of the Trust, to make distributions to Véronique in the year when she obtains 45 years of age. The distributions will consist of income generated only for the year that Véronique reaches the age of 45. Every year thereafter (until she obtains 65 years) distributions will consist of income generated from the Children's Share in that year, respectively.

The portion of Véronique's distribution(s) when she turns 45 years of age from the Trust that exceeds her share of the Trust's DNI will be characterized as "accumulation distributions,"[42] up to the extent of Véronique's share of the Trust's UNI. Based upon the Trust language, it appears that Véronique will not have UNI when she reaches 45 (but rather when she reaches 65 years of age when all accumulated income and principal are distributed). If the Trustee distributed income in any particular year that exceeds the DNI, then the throwback tax would apply in any such year that UNI is distributed.

Regardless of when Véronique received UNI, accumulation distributions are subject to a special tax, referred to as the "throwback" tax,[43] as well as an accompanying compounded interest charge thereon.[44] The tax and interest charge were designed by Congress to approximate the U.S. tax burden Véronique would have borne had the Trust

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[41] It is possible for Véronique's Trust to hold some stock in a foreign corporation without triggering the CFC rules, so long as the stock held in trust does not constitute more than fifty percent (50%) of the vote or value of the foreign corporation. If, however, stock in the corporation is also held by Véronique's relatives (either directly, or through their trusts), Véronique will be imputed with such ownership under the family constructive ownership rules, which may trigger the CFC rules. §958(a)(2); §958(b).

[42] IRC Section 665(b). A foreign trust makes an accumulation distribution in any year in which the trust distributes more than its current year's DNI, provided that the trust has UNI from prior years. Id. UNI is the amount by which the trust's DNI for a given year exceeds the sum of the trust's distributions for that year and the federal taxes imposed on the trust's DNI for that year (if any). §665(a). Accumulation distributions are "allocated to preceding years" according to §666 and taxed approximately as if made in such prior years. If adequate records of the trust are not available to determine the proper application of the accumulation distribution rules to any trust distribution, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust. §666(d).

[43] IRC Section 667.

[44] IRC Section 668. For years prior to 1996, the interest on the throwback tax is computed at a fixed annual rate of 6 percent, with no compounding. For years beginning on January 1, 1996, the interest rate applicable to the throwback tax is the floating rate imposed on underpayment of tax under §6621(a)(2), with compounding. The current interest rate is 5 percent. The compound interest based on the underpayment rate would be imposed not only on throwback tax, but also on the total simple interest for pre-1996 periods.

distributed all its income in the year in which such income was earned, instead of accumulating it and distributing it in a later year.

The amount of the throwback tax is taxed as ordinary income at Véronique's marginal U.S. tax rates, and then the interest charge is calculated thereon. Since, in this example, the Trust has not distributed any of its income, the application of the throwback tax and interest charge gives rise to potentially draconian U.S. tax consequences for Véronique, particularly since the Trust has been in existence and has been accumulating income (free from U.S. tax) since 2000.

For example, to give you an idea of the severity of the throwback tax and interest charge, assume the following hypothetical facts, which all go into a series of complex calculations to determine the amount of the throwback tax and interest charge: (1) the Trust was formed in 2001 and funded with U.S.$1,000,000 cash; (2) the Trust generated income of U.S.$100,000 each year from 2001 through 2020 (20 years), meaning that, as of December 31, 2020, it had U.S. $3,000,000 in assets, and U.S.$600,000 (1/5) was distributed to Véronique; (3) Véronique's average U.S. taxable income for 2018 through 2020 was U.S.$70,000, and she was subject to a marginal tax rate of 35 percent; and (4) the applicable interest rate on underpayment of tax was 6 percent.[45]

Based on these hypothetical facts, on the U.S.$600,000 distribution to Véronique when she turns 45 years of age, she would be subject to a throwback tax of approximately U.S.$140,000, together with an interest charge thereon of approximately U.S.$284,000, for a total U.S. tax bill of approximately U.S.$420,000. That means, without even considering possible California State income taxes, she would net approximately only U.S.$176,000 on her total distribution of U.S.$600,000.

The above example is intended to be an illustration of the severity of the throwback tax. The throwback tax and accompanying interest charge would be substantially higher. Indeed, it is possible that most if not all of the income distribution(s) to Véronique could be consumed by taxes and interest.[46]

B. DIFFERENT INVESTMENT STRATEGY TO MINIMIZE ADVERSE EFFECT OF THROWBACK TAX

Because the throwback tax is based on UNI accumulated by the Trust, the Trustee should consider investing in capital assets that appreciate over time (e.g., real property) and assets that do not otherwise generate taxable income (although might generate positive cash flow). This follows because interest-bearing bonds, dividend-paying stocks, and other assets that regularly generate income serve to increase UNI, which will ultimately be taxed to Véronique under the throwback rule.

On the other hand, capital assets that appreciate over time may be the more attractive investment from Véronique's U.S. tax perspective, provided such property is not sold by the Trust but rather is distributed to Véronique and the other Beneficiaries when Véronique obtains 45 years of age.[47] When property other than cash is distributed by the Trust to the Beneficiaries, the amount of the taxable distribution is limited to the lesser of the Trust's tax basis in the property[48] or the fair market value of the property,[49] and the Trust's tax basis in the property carries over to the Beneficiary receiving such property.[50] Because the amount of the taxable distribution is less than what it would have been for an equivalent value of cash distribution, the potential throwback tax is reduced accordingly.

For example, assume that among other assets the Trust holds appreciated capital property with a tax basis of U.S.$50 and a fair market value of U.S.$100, and that Véronique is entitled to a distribution of U.S.$100 when Véronique obtains 45 years of age. Further assume that Véronique's share of Trust DNI for the year of distribution is U.S.$60 and that Véronique's share of Trust UNI is U.S.$40. If U.S.$100 worth of cash was distributed to Véronique, she would be subject to regular tax on U.S.$60 (up to her share of DNI), and she would also have an accumulation distribution of

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[45] *For ease of illustration and calculation, a steady interest rate of 6 percent was used. However, the rate was as high as 9 percent during periods in 1996, 1998, and 2000, which, of course, would mean the interest charge would be much higher.*

[46] *See, Carlyn McCaffrey and Elyse Kirschner, Learning to Live with the New Foreign Nongrantor Trust Rules, 32 Vand. J. Transnat'l L. 613, at p. 657 (May 1999) (observing that, if the interest rate on underpayments is 9 percent and the U.S. beneficiary's tax rate is 40 percent, the entire amount of the distribution from a trust that has been in existence for twenty or more years will be consumed by tax and interest). It should also be pointed out that U.S. beneficiaries are required to file an information return (IRS Form 3520) along with their U.S. tax returns reporting the distribution from the foreign trust. Failure to file such form would subject them to a penalty equal to 35 percent of the distribution.*

[47] *Sales by the Trust of capital assets would be included in the Trust's DNI, and would become UNI to the extent not distributed currently and hence not taxed at more favorable capital gains rates. See note 30.*

[48] *See the discussion of "tax basis." Essentially, the Trust's tax basis in any particular property, under U.S. principles, would equal the Trust's ."cost" of such property, which consists of the sum of (a) any cash paid for the property, (b) the face amount of any liability incurred, assumed, or taken subject to in respect of the property, and (c) the fair market value of other property transferred in consideration for the subject property. §1014.*

[49] *IRC Section 643(e)(2).*

[50] *IRC Section 643(e)(1).*

U.S.$40, which is subject to the unfavorable throwback tax and interest charge just explained.

In contrast, if the capital property was distributed to Véronique, she would be subject to regular tax on U.S.$50 (taxable distribution limited to the Trust's tax basis in the property), and she would not have an accumulation distribution. She would also take a tax basis in the property of U.S.$50, so if she turned around and sold the property, she would be subject to the favorable long term capital gains tax on U.S.$50 at the 15 percent rate (U.S.$100 fair market value less U.S.$50 tax basis). Even though she would be subject to a capital gain tax, the U.S. income tax outcome for her is much better in light of the favorable capital gains rate and because she avoided the throwback tax and interest charge.

V. CONCLUSION

The throwback tax on UNI can have significant tax consequences for foreign persons who move to the U.S. (or just U.S. persons who might become a beneficiary of a foreign trust) and are beneficiaries of a foreign trust. The throwback tax and the compounded interest charge can be truly draconian as the illustrations explain.

In the example used in this article, when the Trustee of the Trust does distribute the assets of the Trust to the Beneficiaries (with accumulated income) when Véronique turns 45 years of age (and for each year until age 65), she will be subject to a severe throwback tax and interest charge that may consume a significant portion of her income distribution. The throwback tax can be mitigated significantly if the Trustee begins investing in assets that appreciate (as opposed to assets that generate income), and if such assets are distributed to Véronique in lieu of a cash distribution. Additionally, other investment strategies can be structured so that the Trust is not generating any income, and significant U.S. tax benefits can be obtained arising from a range of investment assets, which satisfies various requirements of U.S. tax law.

Finally, Véronique might simply consider that the U.S. income tax consequences associated with distributions of UNI are simply too costly and might prefer to live outside of the United States so as to be a non-resident alien at the time the distributions are made.[51]

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[51] *See IRC Section 7701(b)(1)(B)*