Foreign Trusts & the Throwback Tax

AMERICAN BAR ASSOCIATION – SECTION OF TAXATION
2020 MIDYEAR MEETING

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Discussion Topics

I. Background Issues
   A. Foreign Trusts
   B. Trust Income Taxation

II. Throwback Tax Regime
    A. Application
    B. Accumulation Distributions
    C. Undistributed Net Income
    D. Allocation
    E. Taxes Deemed Distributed
    F. Beneficiary Taxation

III. Special Topics and Exceptions

IV. Planning Considerations
FOREIGN TRUSTS

DEFINITIONS

“Administration” is the performance of duties imposed by the terms of the trust and applicable law, e.g., maintaining records, filing tax returns, managing and investing trust assets, defending the trust from claims of creditors, and determining the amount and timing of distributions from the trust. See Treas. Reg. § 301.7701-7(c)(3)(v).

“Control” means the power to make all substantial decisions of a trust and that no foreign person has the authority to make or veto any substantial decision of the trust. See Treas. Reg. § 301.7701-7(d)(1)(iii).

“Court” is defined as any federal, state, or local court. See Treas. Reg. § 301.7701-7(c)(3)(i).

A court “is able to exercise” primary supervision if the court has the authority under applicable law to issue orders or judgments regarding trust administration. See Treas. Reg. § 301.7701-7(c)(3)(iii).
FOREIGN TRUSTS

DEFINITIONS CONTINUED

“Primary supervision” is the authority to determine substantially all issues regarding the trust’s administration. See Treas. Reg. § 301.7701-7(c)(3)(iv).

A “substantial decision” is a decision that a person is authorized or required to make under the trust instrument and applicable law and is not ministerial in nature. Substantial decisions include: (1) making and timing of distributions of income/principal; (2) amounts of distributions; (3) determination of beneficiaries; (4) allocation of receipts to income/principal; (5) termination of trust; (6) suing or defending suit on behalf of the trust and settling claims; (7) removal or replacement of trustees and appointment of successor trustees; and (8) investment decisions. See Treas. Reg. § 301.7701-7(d)(1)(ii).

A “U.S. person” is an individual citizen or resident of the U.S., a U.S. partnership or corporation, or a U.S. estate or trust. See I.R.C. § 7701(a)(30)(E).
FOREIGN TRUSTS
TWO PART TEST

A Foreign Trust is any trust other than a U.S. Trust...

To be considered a U.S. Trust, a trust must meet two tests:

1) The “Court Test”

2) The “Control Test”

See Treas. Reg. § 301.7701-7(a)(1).
FOREIGN TRUSTS

COURT TEST

To meet the Court Test, a court within the U.S. must be able to exercise primary supervision over the trust’s administration. See I.R.C. § 7701(a)(30)(E)(i).

A safe harbor exists if (i) the trust instrument does not direct that the trust be administered outside the U.S., (ii) the trust is in fact administered exclusively in the U.S., and (iii) the trust is not subject to an automatic migration provision. See Treas. Reg. § 301.7701-7(c)(1).
FOREIGN TRUSTS

CONTROL TEST

To meet the Control Test, one or more U.S. persons must have the authority to control all substantial decisions of a trust. See I.R.C. § 7701(a)(30)(E)(ii).

Grace Period for Change in Trustee Structure:

Generally, if there is a change in the Trustee structure of a U.S. trust that is inadvertent which would make such trust a foreign trust, there is a twelve month period to make changes to the Trustee structure for such trust to retain its status as a U.S. trust. See Treas. Reg. § 301.7701-7(d)(2)(i).
TRUST INCOME TAXATION

BASIC CONCEPTS


2. Fiduciary Accounting Income (FAI)

3. Distributable Net Income (DNI) – I.R.C. § 643(a)


5. Character of Distributions – I.R.C. § 652(b) and § 662(b)
THROWBACK TAX

HISTORY

1) Pre-1954 Attacks on Accumulations
2) Internal Revenue Code of 1954
3) Tax Reform Act of 1969
4) Tax Reform Act of 1976
5) Tax Reform Act of 1986
6) Small Business Job Protection Act of 1996
7) Taxpayer Relief Act of 1997
THROWBACK TAX

APPLICATION

For Taxable Years beginning after August 5, 1997:

1. A Foreign Trust;

2. A Domestic Trust that at any time was a Foreign Trust (except as provided in the regulations); and

3. A Domestic Trust created before March 1, 1984 unless it is established that such trust would not be subject to the § 643(f) multiple trust rule if that section applied to the trust.

See I.R.C. § 665(c)(2).
THROWBACK TAX

APPLICATION

If a Trust is subject to the Throwback regime, Throwback is required when:

1. A Trust makes an **Accumulation Distribution** during any taxable year; and

2. The Trust had **Undistributed Net Income (UNI)** in one or more of its preceding taxable years.
THROWBACK TAX

ACCUMULATION DISTRIBUTIONS

Accumulation Distribution – for any taxable year of a trust, the amount by which I.R.C. § 661(a)(2) distributions (distributions other than income required to be distributed currently) exceed the trust’s DNI (reduced (but not below zero) by I.R.C. § 661(a)(1) distributions (required current income distributions)). See I.R.C. § 665(b).

See I.R.C. § 665(b) (flush language): If the amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year.

Note: Only I.R.C. § 661(a)(2) distributions can be part of an Accumulation Distribution. I.R.C. § 661(a)(1) distributions, even if they exceed DNI, cannot be part of or increase an Accumulation Distribution.
THROWBACK TAX

ACCUMULATION DISTRIBUTIONS

**Example:** Trust has $100,000 of interest income. Trustee is required to distribute 75% of Trust’s income to Beneficiary A. Trustee also makes a $40,000 discretionary distribution to Beneficiary B.

- I.R.C. § 661(a)(2) “Other Amounts” $40,000
- Less: DNI ($100,000)
- Reduced by I.R.C. § 661(a)(1)
- Required Distributions $75,000 ($25,000)
- Accumulation Distribution $15,000


THROWBACK TAX

UNDISTRIBUTED NET INCOME

Undistributed Net Income – for any taxable year, the amount by which the DNI of a trust for such taxable year exceeds the sum of the I.R.C. § 661(a) distributions (both required income and other distributions) and the taxes imposed on the trust attributable to the excess DNI of the trust. See I.R.C. § 665(a).

Note: For the Throwback regime to apply, a trust must have a UNI for a “preceding taxable year.” For foreign trusts created by a U.S. person, taxable years that began before 1954 or ended before August 17, 1954 are not “preceding taxable years.” See Treas. Reg. § 1.665(e)-1A(a)(2).
THROWBACK TAX

UNDISTRIBUTED NET INCOME

Example: In 2019, Foreign Trust has $100,000 of interest income and $10,000 of deductions. Trustee makes $40,000 of distributions to Beneficiary.

DNI $90,000

Less: Distributions ($40,000)

Plus: Tax on Undistributed DNI ($16,821) ($56,821)

UNI $33,179
THROWBACK TAX

UNDISTRICTED NET INCOME

Tax attributable to Undistributed DNI from prior example:

Interest Income $100,000
Less: Expenses ($10,000)
Less: Distributions ($40,000)
Less: Personal Exemption ($100)
Taxable Income $49,900
Tax $16,821
THROWBACK TAX

ALLOCATION

If a trust makes an Accumulation Distribution and has UNI from one or more preceding years, the distribution must be allocated to those preceding years. This allocation begins in the earliest year with UNI and moves forward until the Accumulation Distribution or total UNI is exhausted.  See I.R.C. 666(a).
THROWBACK TAX

ALLOCATION

Example: Foreign Nongrantor Trust had UNIs of $10,000 from each of tax years 2015, 2016, and 2017 and made a $22,000 Accumulation Distribution in 2018.

The $22,000 Accumulation Distribution will be allocated $10,000 to each of 2015 and 2016 and $2,000 to 2017. An $8,000 UNI from 2017 will remain.

Had the Accumulation Distribution been $32,000, $10,000 would have been allocated to each of 2015, 2016, and 2017, and the remaining $2,000 would be a payment of corpus and pass tax free to the beneficiaries.
THROWBACK TAX

TAXES DEEMED DISTRIBUTED

In general, if an Accumulation Distribution creates a deemed distribution of a UNI from a prior year, the taxes imposed on the trust relating to the undistributed amount is also deemed distributed. See I.R.C. § 666(b) & (c).

Example: In 2019, Trust has $100,000 of interest income and $10,000 of deductions. Trustee makes $40,000 of distributions to Beneficiary. The 2019 UNI is $33,179 and the tax on the undistributed DNI is $16,821. If in a subsequent year, an Accumulation Distribution of $33,179 is made, the total deemed distribution will be $50,000 ($33,179 of UNI and $16,821 of attributable taxes).
THROWBACK TAX

BENEFICIARY TAXATION

The total of the amounts which are treated as having been distributed in a preceding taxable year are included in the income of the Beneficiary as if such distributions were made on the last day of such taxable year. See I.R.C. § 667(a).

However, the tax on the amounts included is calculated separate from the Beneficiary’s regular tax for the year.

The tax calculation can be divided into a nine step process. See I.R.C. § 667(b)(1).
THROWBACK TAX

BENEFICIARY TAXATION

STEP 1: Determine the number of the trust’s preceding taxable years to which an Accumulation Distribution has been allocated.

Example: Foreign Nongrantor Trust had UNIs of $10,000 from each of tax years 2015, 2016, and 2017 and made a $32,000 Accumulation Distribution in 2018. Thus, there are three preceding taxable years to which the Accumulation Distribution is allocated.

STEP 2: Of the aggregate amount deemed distributed in a preceding year, determine what portion would have been taxable to the beneficiary had it actually been distributed during that preceding taxable year (including by subtracting the amount of taxes which had been paid by the trust).
THROWBACK TAX

BENEFICIARY TAXATION

STEP 3: Divide the result of STEP 2 by STEP 1.

STEP 4: Determine the Beneficiary’s taxable income for each of the five years preceding the year of the Accumulation Distribution. Eliminate the year of highest taxable income and lowest taxable income.

STEP 5: Add the average amount determined in STEP 3 to the taxable income of the three remaining years determined in STEP 4.
THROWBACK TAX

BENEFICIARY TAXATION

STEP 6: Determine the Beneficiary’s taxes for the three years determined in STEP 4 as if the Beneficiary’s taxable income from those years had been the amounts determined in STEP 5.

Note: This effectively treats all of the increase as ordinary income.

STEP 7: Subtract from the amount, determined under STEP 6, for each taxable year the actual amount of tax for that year. Average the three differences.
THROWBACK TAX

BENEFICIARY TAXATION

**STEP 8:** Multiply the **STEP 7** average by the number of taxable years determined in **STEP 1**.

**STEP 9:** Determine the excess of the **STEP 8** amount over the total taxes deemed distributed to the Beneficiary. This amount is the tax on the Accumulation Distribution.

**Example:** If the total tax amount determined under **STEP 8** is $15,000, but the tax which is deemed distributed as part of the Accumulation Distribution is $10,000, then the tax on the Accumulation Distribution is $5,000.
THROWBACK TAX

BENEFICIARY TAXATION

For distributions from foreign trusts, the tax relating to an Accumulation Distribution is subject to an interest charge. See I.R.C. § 668. The I.R.C. § 6621 underpayment rate is applied and is compounded daily over a specifically calculated number of years. See I.R.C. § 668(a); I.R.S. Form 3520.

STEP 1: Multiply the UNI for each calendar year by the number of years between each such year and the year of distribution.

STEP 2: Add the amounts calculated under STEP 1 together.

STEP 3: Divide the amount calculated in STEP 2 by the trust’s undistributed income and round to the nearest half-year.
THROWBACK TAX

BENEFICIARY TAXATION

Example: In 2005, Trust makes an Accumulation Distribution to Beneficiary. Trust has the following UNIs: $100 from 2001, $0 from 2002, $300 from 2003, and $100 from 2004. The weighted number of years is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Years</th>
<th>UNI</th>
<th>Weighted UNI</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>4</td>
<td>$100</td>
<td>$400</td>
</tr>
<tr>
<td>2002</td>
<td>3</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2003</td>
<td>2</td>
<td>$300</td>
<td>$600</td>
</tr>
<tr>
<td>2004</td>
<td>1</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$500</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

The weighted number of years is 2.2 which is rounded down to the nearest half-year, or 2. As such, interest is calculated over a 2 year period.
SPECIAL TOPICS AND EXCEPTIONS

1) Distribution of FAI in excess of DNI
2) Distributions in excess of FAI
3) Withdrawal Rights
4) Gifts and Bequests of Specific Sums
5) Separate Shares
6) 65 Day Rule
7) Distribution into further Trust
8) Estates
9) I.R.C. § 645 Election
10) Domestication of Foreign Trust
11) Loans
PLANNING CONSIDERATIONS

1) Distribution of all DNI
2) Distribution of DNI to second Trust
3) 65 Day Distributions
4) Form 3520 Method for Calculating non-Accumulation Distributions
FURTHER RESOURCES


ABOUT THE AUTHOR

Nolan A. Moullé, III is a Senior Vice President and Senior Wealth Advisor with The Northern Trust Company. In this capacity, Nolan provides insight and guidance on wealth planning and tax issues of interest to clients, their businesses, and their advisors. He has a particular affinity for advising clients with closely held business interests. Nolan is Board Certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization. He earned a Bachelor of Science degree in Accounting and Finance from Louisiana State University, a Juris Doctor degree, magna cum laude, from Tulane University Law School, and an LL.M. in Taxation from New York University School of Law.
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