Distribution and throwback

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SUMMARISES STRATEGIES TO ADDRESS THE US THROWBACK RULES

KEY POINTS

WHAT IS THE ISSUE?
Different strategies designed to address a set of complex rules that apply when a non-US trust has US beneficiaries.

WHAT DOES IT MEAN FOR ME?
Practitioners must consider not only how these strategies differ in addressing the income tax issues, but also their suitability across a number of dimensions, including transfer taxes, cost and practical considerations that affect international families.

WHAT CAN I TAKE AWAY?
Although there are several viable options to address the US throwback rules, life insurance and annuity contracts deserve special attention, as they provide simple and powerful solutions when used either alone or as a complement to other strategies.

PART ONE OF this article focuses on distribution techniques and the use of underlying foreign entities. Part two, to be published in an upcoming edition, will focus on domestication and private placement variable contracts.

Among practitioners advising US beneficiaries of foreign (non-US) trusts, few topics elicit a more visceral reaction than the throwback tax and the related accumulation distribution rules under ss665–669 of the *Internal Revenue Code* (the throwback rules).

Today, the throwback rules apply mainly to foreign non-grantor trusts, which, roughly speaking, are trusts whose income is taxed to the trust itself or, insofar as it is distributed, to its beneficiaries. In contrast, income of a grantor trust is generally taxed to the grantor.

Under the throwback rules, when a foreign non-grantor trust earns distributable net income (DNI), but fails to distribute it in the year it was earned, the following special provisions apply when previously undistributed net income (UNI) is distributed to its US beneficiaries in later years:

- The distributed UNI loses any capital gains or qualified dividend character it may have had when earned.
- A throwback tax and interest penalties apply via a mechanism that attempts to treat (and tax) the UNI portion of the distribution as if it had been distributed in the years in which it was earned.

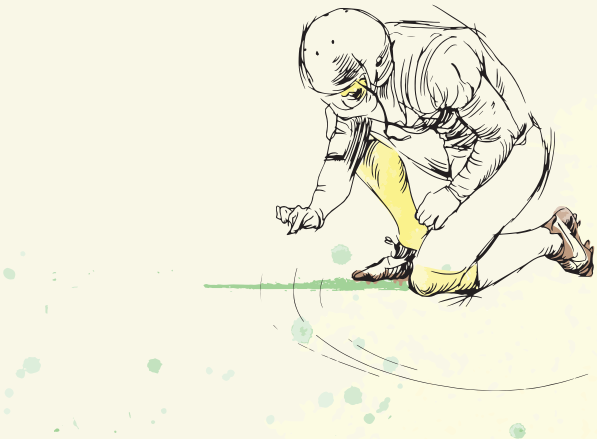
Consistent with the rules' aim to prevent tax deferral, the longer UNI accumulates, the more severe their effect, which can even result in the entire distribution being eroded by the tax and the interest penalty.

Usually, the ideal time to implement a plan to mitigate the effect of the throwback rules is when a foreign trust acquires non-grantor trust status – for example, upon the death of a settlor who had been treated as the owner of the trust assets.

DISTRIBUTION TECHNIQUES

Strategies consisting of the current distribution of DNI by the trust to its beneficiaries, either outright or in trust, can be a straightforward and effective method to mitigate the throwback rules by stopping UNI from accruing to the trust or from flowing to US beneficiaries. However, although such strategies are generally effective even in their simplest form, more complex structuring is required if the trustee wishes to limit the beneficiaries' access to the funds and transfer tax exposure, or if the beneficiaries reside in multiple countries.

Perhaps the simplest way to manage the throwback rules is for the trustee to distribute each year all the trust's DNI outright to its beneficiaries. This way,



'It may be inappropriate for the trustee to make yearly distributions to the beneficiaries'

no UNI accumulates, and future distributions fall outside the scope of the throwback rules. This technique's simplicity translates into relatively low administrative cost, compared to strategies involving additional structures, although it still requires the trustee to calculate the trust's DNI each year.

The yearly DNI distributions would be taxed currently in the hands of the beneficiaries, although any long-term capital gain and qualified dividends would retain their character and may benefit from preferential rates.

ASSET ATTRIBUTION ISSUES

Importantly, however, this strategy fails to address the rules that govern ownership attribution of entities that would qualify as controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs) in the hands of US taxpayers. Under these rules, ownership of certain non-US companies underlying the trust may be attributed to the trust's US beneficiaries, which can cause adverse tax consequences and onerous reporting requirements for the trust's US beneficiaries.

DISTRIBUTIONS TO OTHER TRUSTS

Besides the US income tax considerations, two additional issues arise from making yearly outright DNI distributions. First, from a transfer tax perspective, this strategy may pull significant amounts into the beneficiaries' gross estate for estate tax purposes. Second, whether because of the beneficiaries' young age, creditor claims or other life circumstances, it may be inappropriate for the trustee to make yearly distributions to the beneficiaries. Either issue can be resolved by making the yearly DNI distributions in trust, rather than outright to each beneficiary, providing a way to better regulate the beneficiaries' access to wealth and greater transfer tax protection.

However, the establishment of one or more trusts to receive the yearly DNI increases complexity and administrative cost. If the new trusts are US trusts, practical and logistical issues may arise not only for non-US beneficiaries, but also for non-US trustees and investment advisors who may be reluctant, or unable, to perform their duties for a trust in a US jurisdiction.

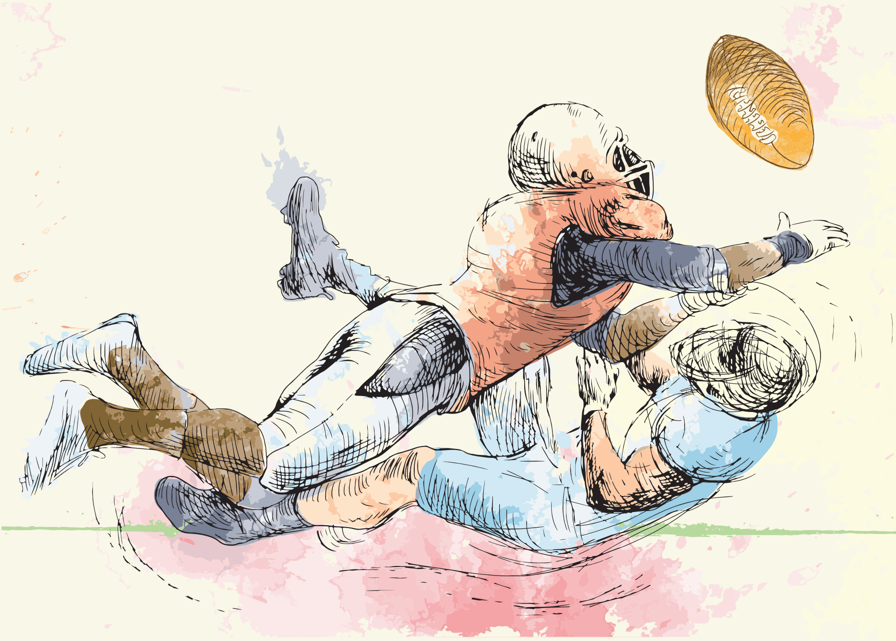
If the new trust is a foreign non-grantor trust, the DNI would accumulate and become UNI in the new trust, passing on the onus of the throwback rules to the newly settled foreign trust, rather than addressing them. Still, a foreign trust could work where there are both US and non-US beneficiaries if the funds in the new 'tainted' trust are used to benefit exclusively non-US beneficiaries, while the funds in the original trust, now devoid of UNI, benefit US beneficiaries.

Regardless of whether the current DNI distributions are outright or in trust, the funds' overall earning potential and the variety of investment options may gradually decrease, as the trust fund and its earnings are no longer pooled. Further, the trustee must ensure that implementing a distribution strategy of any kind is permissible under the terms of the trust and the governing law.

UNDERLYING ENTITIES

Strategies involving underlying foreign entities can be effective to mitigate the throwback rules; however, though they may appear simple, they can trigger onerous reporting and adverse income tax consequences beyond the throwback rules. These strategies are generally most attractive either as remedial or exceptional measures, or where the application of the CFC and PFIC rules does not impair the overall strategy.

Although the administrative cost of forming and maintaining a corporation is similar to the cost involved in the partnership context, strategies to address the throwback rules vary significantly depending on the type of underlying entity.



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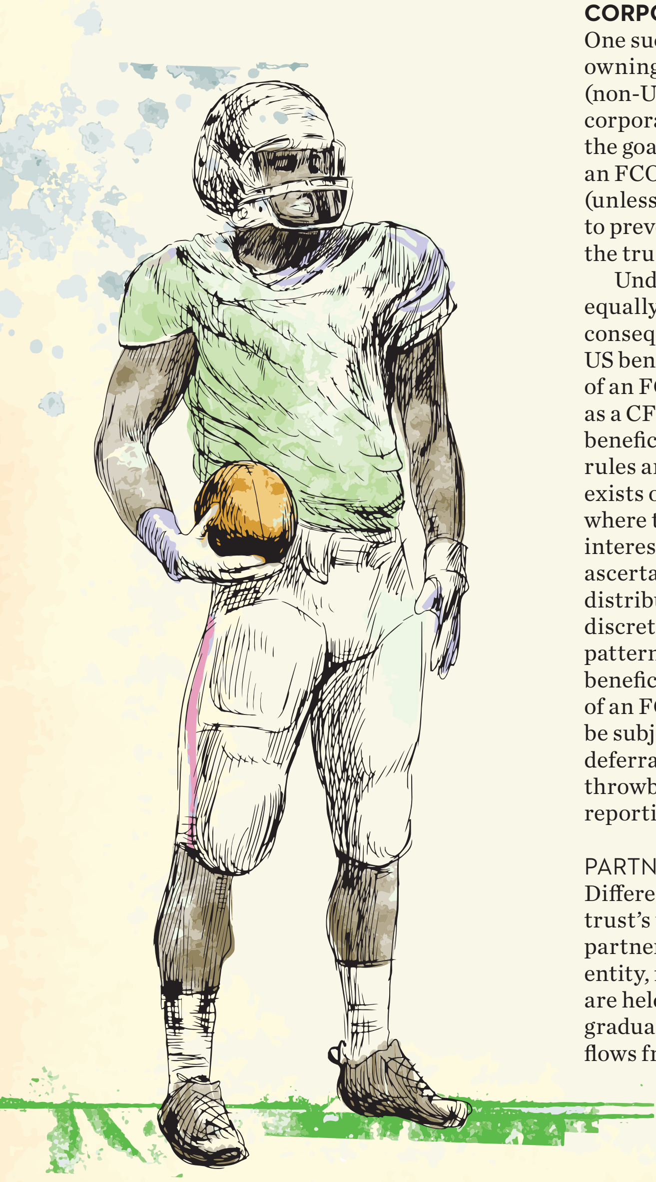

CORPORATIONS

One such strategy involves the trust owning its assets through a foreign (non-US) company (FCO) taxed as a corporation for US tax purposes, with the goal to block DNI from flowing from an FCO's underlying assets to the trust (unless distributed from an FCO) and to prevent UNI from accumulating in the trust.

Under this strategy, different but equally adverse tax and reporting consequences may still arise if the trust's US beneficiaries are attributed ownership of an FCO, and if that FCO would qualify as a CFC or a PFIC in the hands of the US beneficiaries. The ownership attribution rules are unclear, and little guidance exists on their interpretation, especially where the beneficiaries' respective interests in the trust are not readily ascertainable – for example, where distributions are at the trustee's full discretion, and there is no discernible pattern of distributions. But if the US beneficiaries are attributed ownership of an FCO, the US beneficiaries could be subject to the CFC or PFIC anti-deferral regimes (separate from the throwback rules) and additional reporting obligations.

PARTNERSHIPS

Different tax considerations apply if the trust's underlying company is a foreign partnership (FP), i.e. a flow-through entity, for US tax purposes. If the assets are held by a partnership, UNI would gradually accumulate in the trust, as DNI flows from an FP regardless of whether it makes any distribution. However, the trust would receive 'accounting income' only upon receiving a distribution from an FP.

The distinction between the trust's accounting income and DNI explains why, despite an FP's inefficacy in preventing UNI accumulation, an FP may nevertheless prevent trust distributions from being subject to the throwback tax.

To illustrate the mechanism, say the trustee intends to make a distribution to a US beneficiary over the trust's yearly DNI. Ordinarily, such a distribution would trigger the throwback tax and, possibly, interest penalties. However, under the accumulation distribution rules, if a trust distribution does not exceed the trust's accounting income, the distribution does not carry out UNI, and thus is not subject to throwback tax. Therefore, the trust could time distributions to US beneficiaries to coincide with years when the trust receives distributions from an FP that generates sufficient trust accounting income. Under this strategy, although the trust would gradually accumulate UNI over time, which would be subject to throwback tax eventually, the trust may still occasionally make distributions to its US beneficiaries over current-year DNI when it receives a distribution from an FP that covers the trust distribution.

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