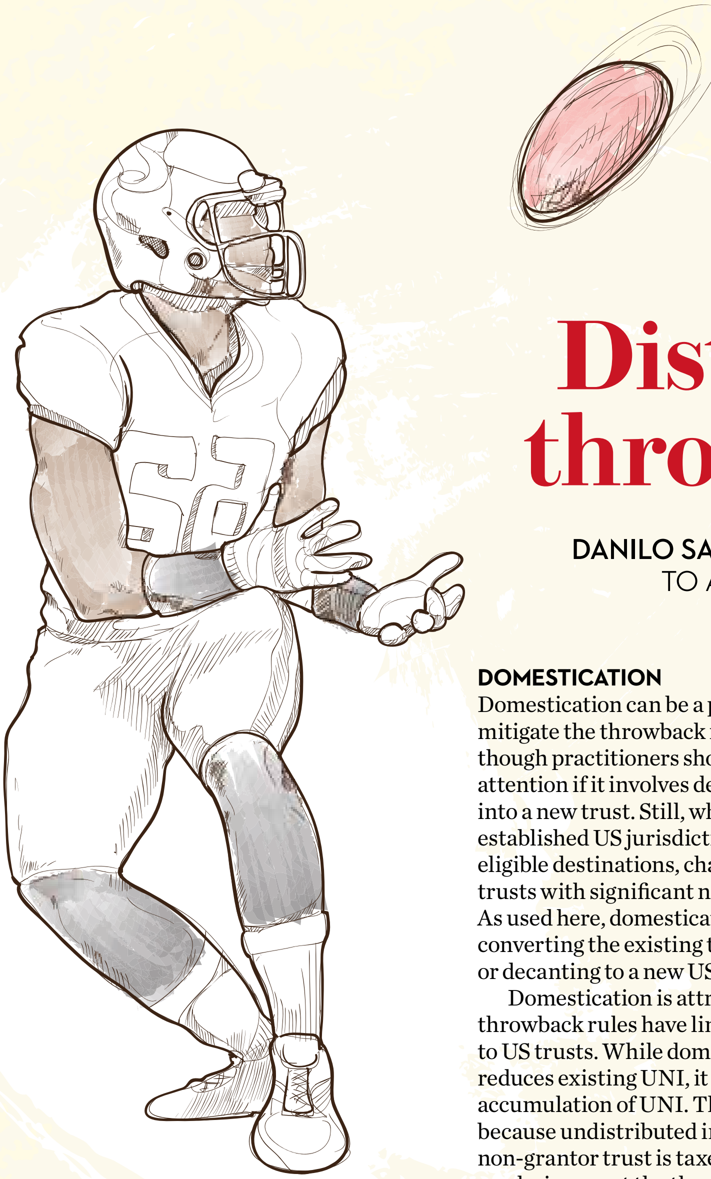


# Distribution and throwback, part 2

**DANILO SANTUCCI** SUMMARISES FURTHER STRATEGIES TO ADDRESS THE US THROWBACK RULES

**PART ONE OF** this article, published in the November 2017 issue of the *STEP Journal*,[1] summarised the throwback tax and the accumulation distribution rules that apply to foreign non-grantor trusts (the throwback rules) and discussed mitigating techniques involving distribution strategies and underlying entity structures.

This second part summarises two other strategies to manage the throwback rules: domestication and the use of variable contracts.

As a reminder, the throwback rules are special rules under the US *Internal Revenue Code* that can result in adverse tax consequences when a foreign non-grantor trust earns distributable net income (DNI), which accumulates and becomes undistributed net income (UNI), before being distributed to US beneficiaries in later years.

## DOMESTICATION

Domestication can be a powerful method to mitigate the throwback rules prospectively, though practitioners should pay special attention if it involves decanting property into a new trust. Still, while several well-established US jurisdictions can serve as eligible destinations, challenges remain for trusts with significant non-US connections. As used here, domestication means either converting the existing trust into a US trust, or decanting to a new US non-grantor trust.

Domestication is attractive because the throwback rules have limited application to US trusts. While domestication rarely reduces existing UNI, it prevents further accumulation of UNI. This makes sense, because undistributed income of a US non-grantor trust is taxed currently, rendering moot the throwback rules' anti-deferral purpose. Still, without additional planning tools, such as a life insurance or annuity contract, domestication generally subjects 'domesticated' income to current US taxation, regardless of the income's source or whether or not it is distributed. Foreign investments within the now-domesticated US trust could also raise controlled foreign corporation and passive foreign investment company considerations, making such investments less attractive and indirectly restricting the trust's investment universe.

Domestication can also preserve estate tax protection for the beneficiaries, although practitioners should ensure that the new trust receives the intended generation-skipping transfer tax treatment.

Domestication can vary in both cost and complexity. Usually, converting the existing trust is simpler and less costly than decanting into a new trust, although it may not be viable if the circumstances require significant additional changes to the deed unrelated to the domestication. However, the decanting method presents unique challenges and uncertainties which can affect the tax consequences of the domestication itself, including whether or not the decanting was a mere change in form or a split transaction, and whether or not it should be treated as a sale of decanted assets.

Over time, many US states have become attractive jurisdictions for trusts, whether because of the local tax environment or the flexibility afforded to resident trusts. But domestication can still raise regulatory and compliance hurdles for foreign trustees and investment advisors, who may be unable or unwilling to continue their involvement with the trust. Similarly, the domesticated trust's US status may increase the administrative burden of establishing and maintaining banking relationships outside the US. Lastly, non-US beneficiaries may not always find domestication the ideal solution if they would otherwise have little or no US ties.

## PRIVATE PLACEMENT VARIABLE CONTRACTS

Strategies involving private placement variable contracts[2] can mitigate the effect of the throwback rules and streamline tax reporting without sacrificing the trust's investment options. Special tax rules make variable life insurance a uniquely powerful tool, although biometric risk and related constraints can limit its availability. Variable annuities are simpler to implement and more accessible, although they do not share in all the tax features of life insurance. When considering a variable contract, the trustee must carefully weigh the fees against the potential benefits and select an established carrier with experience dealing with foreign trusts and multinational clients.

This section discusses two types of variable contracts: variable life insurance policies (VLs) and deferred variable annuity contracts (VAs).

### BASIC FEATURES

In a VL, the trustee pays the premium, which is invested in assets supporting the policy value by an investment manager appointed by the insurer. The policyholder may access the cash value of the policy during the life of the contract via withdrawals or loans, and a death benefit is paid out upon the death of the insured person. The death benefit generally equals the cash value of the underlying assets plus a 'net amount at risk' or 'life cover', representing the risk assumed (or reinsured) by the insurer.

A VA works similarly, with two notable distinctions. First, a VA provides for annuity payments beginning on the date on which a natural person designated in the contract (the annuitant) reaches a set age, usually between 85 and 95 (if the holder is not an individual, the annuitant's death also triggers payment). Second, a VA need not provide a life cover. Consequently, payments under the contract usually reflect only the value of the underlying assets.

### KEY TAX CONSIDERATIONS

To provide tax benefits, a variable contract must meet certain common-law and statutory requirements. An especially important requirement is that the contract's design and administration respect the US investor control doctrine, which, broadly speaking, prohibits the policyholder from influencing the specific composition of the assets underlying the contract. Therefore, the policyholder (here, the trustee) is generally limited to the selection of a broad investment strategy or programme among those offered by the issuer.

The first tax benefit is that a variable contract allows the trustee to manage the application of the throwback rules, as income within the contract is not DNI to the trust. In other words, the trust receives no DNI unless it receives a payout from the contract. Therefore, the trustee can largely limit the flow of DNI to the years in which it wishes to make distributions to the beneficiaries, while preventing UNI accumulation in years when no distributions are planned. If a payout from the contract generates DNI, the trustee can distribute it in the current year to avoid UNI accumulation. Upon receipt of DNI deriving from the contract, a US beneficiary is taxed at ordinary income rates and, depending on the contract, an early withdrawal tax penalty may apply.

In some circumstances, however, access to the value of a variable contract does not result in the receipt of DNI by the trust – e.g. with certain VLs, or where the contract's underlying assets have not appreciated. In these cases, the trustee may receive a payment from the contract without having to distribute part of it to the trust beneficiaries in the same year to avoid accumulating UNI.

The second benefit concerns VLs, which not only prevent the trust from receiving DNI during the life of the policy, but also allow the trust to receive the entire death benefit without generating DNI.[3] In contrast, when a trust-held VA pays out upon the annuitant's death, any amount over the premium will generate DNI in the year of death.

Third, the insurer, rather than the trust, is the owner of the contract's underlying assets. Therefore, a variable contract often raises the trust to benefit from indirect exposure to a wide variety of investments, without necessarily triggering the adverse tax consequences and reporting obligations that arise when US beneficiaries are attributed ownership of certain foreign assets held by the trust, such as passive foreign investment companies.

### SIMPLICITY

Another notable feature of variable contracts is their simplicity. On the one hand, acquiring a variable contract often raises structuring considerations – e.g. to ensure that a trust holding a VA does so 'as an agent for a natural person'.[4] On the other hand, the trustee need not remove funds from the trust, but need execute only one contract, which rarely requires extensive ongoing maintenance. Similarly, although it is often advisable to combine variable contracts with other strategies (e.g. domestication) to provide additional tax advantages, implementing a variable contract solution itself rarely requires the establishment of additional entities or trusts. Still, there are costs associated with variable contracts, consisting primarily of upfront taxes, as well as carrier and broker fees, both of which can be upfront and ongoing. Further, contracts that include a life cover are usually more expensive, because the fees include insurance costs.

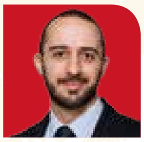
### CHOICE OF CARRIER

Lastly, in choosing a suitable carrier, the trustee must weigh several factors, such as the carrier's reputation and financial stability. The carrier's experience in international wealth planning and structuring is also important, especially where it may be necessary to design the variable contract to comply with the laws of an additional jurisdiction in order to benefit non-US beneficiaries or US beneficiaries living abroad. The trustee must also choose carefully between a US and a non-US insurer, considering federal and local taxes, investment options, administrative convenience, and the insurance law of the jurisdiction where the carrier resides.

### CONCLUSION

Together, parts one and two of this article provide an overview of a few strategies that address the throwback rules. It leaves out many other potentially viable strategies, including the settlement of a new foreign grantor trust and techniques involving the distribution of assets in kind. Still, the discussion of the strategies covered should provide a basic framework to assess their suitability in tackling common issues that arise in the administration of foreign non-grantor trusts with US beneficiaries.

**1** *STEP Journal*, November 2017 (Vol 25 Iss 9), page 27 **2** By 'variable contract', this article refers to a private placement contract with value and benefits based on the performance of assets held in one or more accounts that are segregated from the issuer's general accounts **3** *Internal Revenue Code*, s101(a)(1) **4** *Id*, s72(u)



**DANILO SANTUCCI TEP**
IS SENIOR US TAX COUNSEL AND WEALTH PLANNER AT LOMBARD INTERNATIONAL ASSURANCE