In depth

Foreign nongrantor trusts for US beneficiaries: dos and don'ts

Carlyn S. McCaffrey*, Shudan Zhou†, and William G. Cavanagh‡

Abstract

The throwback tax is the US tax law's main tool for discouraging tax-free accumulation of income by foreign non-grantor trusts for US beneficiaries. Its complex rules are a dangerous minefield that should be avoided. This article reviews the operation of the throwback tax rules, and assesses the effectiveness of this trust anti-deferral regime in various fact patterns. It also discusses how the trust anti-deferral regime interacts with the US law's foreign corporation anti-deferral regime, another minefield.

Overview

The US tax law is known for an ambitious foundational concept—worldwide taxation. But even the United States is sometimes constrained by jurisdictional limitations. The United States generally lacks the jurisdiction to reach foreign entities except to the extent that they have US source income.[1] The creative use by US taxpayers of foreign entities, including foreign trusts, can create an opportunity for US taxpayers to accumulate income free of current US taxation.

With foreign trusts that are not tax transparent, the US tax law's solution is to wait. It waits until a US beneficiary receives distributions of accumulated income from those foreign trusts, and then punitively taxes the US beneficiaries. With foreign corporations, the US tax law either waits and then taxes the US shareholders punitively, or "looks through" the foreign corporations and taxes the US shareholders currently and often punitively.

The overarching goal of the US tax law is to deter tax-free accumulation of income by US taxpayers outside the US tax net. This goal is embodied in the trust anti-deferral regime (in the form of the throwback tax rules) and the foreign corporation anti-deferral regime (in the form of CFCs, PFICs and their related taxation methods).[2] The trust anti-deferral regime and the foreign corporation anti-deferral regime can sometimes result in double taxation of the same beneficiaries.

This article discusses the application of the various anti-deferral regimes under the US tax law to typical cross-border private wealth structures.

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1. A foreign corporation treated as a US corporation for US tax purposes under the corporate inversion rules may be one prominent exception. See Section 7874 of the Internal Revenue Code of 1986, as amended (the "**Code**"). Unless otherwise specified, all the references to "Section" or "Sections" in this article are to sections of the Code.

2. "**CFC**" stands for controlled foreign corporation. "**PFIC**" stands for passive foreign income company. The anti-deferral regimes applicable to these types of corporations are discussed later in this article.

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Trust anti-deferral regime—throwback tax

Overview

A grantor trust strategy is the typical starting point for planning for non-US persons[3] with US families. When the wealth creator in the family is not a US person but his or her beneficiaries are or include US beneficiaries,[4] the wealth creator would be properly advised to settle a trust that is treated as a grantor trust[5] for US income tax purposes. This type of trust is often loosely referred to as a foreign grantor trust.

A foreign grantor trust solves US income tax problems during the grantor's lifetime and US transfer tax[6] problems for the US beneficiaries. The question is what should be the US income tax "exit strategy" when the grantor passes way.

A grantor trust, US or foreign, is treated as transparent for US income tax purposes during the grantor's lifetime. The income or gain that arises within the trust is treated as the grantor's income. If the grantor is a non-US person, the grantor is not subject to US income tax with respect to the trust's non-US source income or US-source capital gains and certain interest income.[7] Accordingly, during the grantor's lifetime, neither the trust nor any of its beneficiaries would be subject to US income tax when the trust disposes of appreciated assets unless the trust generates US-source business income or other US taxable income (in which case the foreign grantor would be subject to US income tax on such taxable income).[8] In addition, the US beneficiaries would not be subject to US income tax on any distributions received from the trust. If the grantor lives in a low-tax jurisdiction or a jurisdiction that does not tax overseas income that arises within a trust, a foreign grantor trust represents a powerful tax saving strategy for the family during the grantor's lifetime.

The foreign grantor trust generally does not shield the US-situs assets held by the trust from US transfer taxes at the death of the grantor.[9] But the use of a trust during the grantor's lifetime as opposed to outright ownership facilitates passing assets to trusts for US beneficiaries rather than outright. If foreign individuals pass wealth (in the form of non-US situs assets) at their deaths to their US beneficiaries through trust, the US tax law does not place any limit on how much wealth can pass from one generation to the next without being subject to US transfer taxes. The foreign wealth creator has an opportunity to eliminate all US transfer tax problems for the US beneficiaries for all future generations no matter the size of the wealth. In contrast, if the US beneficiaries inherit the assets outright, the assets will become includable in their US estates creating a US transfer tax problem for them when they pass the wealth to their heirs.[10]

A grantor trust, foreign or domestic,[11] generally becomes a nongrantor trust upon the grantor's death. While the US transfer tax benefits discussed above remain the same before and after the grantor dies, the grantor's death is a milestone event in the trust's US

3. In this article, a "**US person**" is a US citizen or resident, a US corporation, a US partnership, a US trust or a US estate. See Section 7701(a).

4. In this article, the term "**US beneficiaries**" generally refers to individuals who are US citizens or residents for income tax purposes. US residents for income tax purposes are individuals who are green card holders or meet the "substantial presence test" under Section 7701(b), without qualifying for an exception under the Code or a tiebreaker position under an applicable bilateral income tax treaty.

5. When a non-US person settles a trust, the trust will be treated as a grantor trust during the settlor's lifetime only if the trust is revocable by the settlor (sometimes referred to as revocable foreign grantor trust) or, during the settlor's lifetime, only the settlor or the settlor's spouse may receive payments from the trust if the trust is irrevocable. See Section 672(f)(2)(A). If the trust is revocable by the foreign grantor, the trust will be a foreign trust. If the trust is a grantor trust because of the restrictions on payments during the grantor's life, the trust could be a domestic trust. See footnote 12.

6. The term "**US transfer taxes**" refers to the US estate, gift and generation skipping-transfer taxes, governed by Chapters 11 through 15 of the Code.

7. See Section 871.

8. *Id.*

9. See Sections 2104 and 2105 for the tests for determining US-situs and non-US situs assets for US estate tax purposes. Typically, a foreign grantor trust would hold US-situs assets through a foreign corporation to prevent the imposition of US estate tax upon the foreign settlor's death, which is loosely referred to as an "estate tax blocker".

10. If the foreign patriarch or matriarch's wealth passes outright to US beneficiaries, it would enter their US estates. The US beneficiaries' estates will be subject to US estate tax to the extent of the value in excess of the exclusion amount. The exclusion amount is currently $12.06 million per US citizen or domiciliary, but is scheduled to be cut in half by the end of 2025 absent legislative action to change the scheduled reduction. See Section 2010.

11. A trust is a US trust (or domestic trust) if (i) a court within the United States is able to exercise primary supervision over the administration of the trust (the "**court test**"), and (ii) one or more US persons have the authority to control all substantial decisions of the trust (the "**control test**"). See Section 7701(a)(30)(E). A foreign trust is a trust that is not a US trust. A trust can be a foreign trust even if it is governed by the laws of a state within the United States and subject to the jurisdiction of that state's courts, if at least one substantial decision of the trust (*e.g.*, the power to replace trustees) is not controlled by US persons.

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income tax planning. If the trust becomes (or remains) a foreign trust when the grantor dies, the trust anti-deferral regime (otherwise known as the throwback tax regime) under the US tax law may be activated, and the trust's US beneficiaries may be taxed punitively when they receive distributions from the trust of income earned in years prior to the years of distribution.

The classic solution to avoid the throwback tax is to allow the trust to become a US nongrantor trust when the grantor dies.[12] The cost of this solution is the imposition of US income tax on the trust's future worldwide income, likely for the duration of its existence.[13] This is no small cost, and can be aggravated drastically if the surtax proposed in the Build Back Better Act becomes law.[14] The potential benefit of domestication is to avoid activating the trust anti-deferral regime which, in the worst-case scenario, could result in all the trust distributions to its US beneficiaries being consumed by US tax and an interest charge. This is why the throwback tax is often thought of as being confiscatory.

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Some commentators, however, have questioned whether domestication is always desirable.[15] We share those commentators' perspective. With the right set of facts, a foreign nongrantor trust may be a viable tax strategy for US beneficiaries. In this article, we will discuss the mechanics of the throwback tax and certain foreign nongrantor trust techniques for reducing its impact.

Throwback tax in general

The throwback tax is the US tax law's primary tool for discouraging tax-free accumulation of income in foreign trusts for US beneficiaries.[16]

A foreign nongrantor trust escapes US income tax for the most part[17] for as long as the trust retains and reinvests its earned income without making distributions to its US beneficiaries. If the US beneficiaries of a foreign nongrantor trust that accumulated its income were taxed on distributions only as if they were distributions of current income then they would enjoy the economic advantage of an accumulation of income free of current US taxation.

The throwback tax regime significantly reduces the tax benefits of this deferral opportunity in two different ways: (i) the taxation of capital gains as ordinary income, and (ii) a daily compounded interest charge.

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12. In order to be treated as a domestic trust, the trust will be required to meet both the "court test" and the "control test." If the plan is for a foreign grantor trust to become a US non-grantor trust upon the grantor's death, some advisors would have the trust "pre-qualify" for the "court test" and the "control test" as much as possible, during the grantor's lifetime, by (i) subjecting the trust to the laws and jurisdiction of a state of the United States and (ii) having US persons control all the key decisions of the trust (except the settlor's power to revoke the trust in the case of a revocable foreign grantor trust). If a trust is set up this way, the trust would automatically become a US nongrantor trust upon the grantor's death. Otherwise, the governing law/jurisdiction and persons who control key decisions of the trust would need to be changed at the grantor's death for the "court test" and the "control test" to be met. Death is certain for everyone but the timing is not, whereas the required changes will take time. That is why some practitioners would pre-qualify the trust for the two tests so the desirable trust classification will occur simultaneously with the death of the foreign grantor.

13. In theory, a US nongrantor trust can "expatriate" (*i.e.*, become a foreign trust), but will be forced to pay US income tax on all the built-in gain immediately upon the expatriation. See Section 684.

14. The Build Back Better Act (H.R. 5376) (the "**BBB Act**") is a bill pending before the 117th Congress of the United States. Section 138203 of the BBB Act (as released by the Rules Committee on November 3, 2021) would impose a 5% surcharge on an individual's adjusted gross income in excess of $10 million or on a US nongrantor trust's adjusted gross income in excess of $200,000, and another 3% surcharge on an individual on his or her adjusted gross income in excess of $25 million or a US nongrantor trust on its adjusted gross income in excess of $500,000. For the same amount of income that is above $500,000 but under $10 million, a US nongrantor trust's tax rate is at least 8 percentage points higher than an individual's, all else being equal.

15. *See* Shelly Meerovitch, John McLaughlin, and Shea McCabe, *It's About Time—When Offshore Trusts for U.S. Beneficiaries Make Sense*, 43 Tax Mgmt. Est., Gifts & Tr. J. No. 4 (January 7, 2021). *See also* Ellen K. Harrison, Elyse G. Kirschner & Carlyn S. McCaffrey, *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*, SJ027 ALI-ABA 137 (2003).

16. See Section 665(c).

17. A foreign nongrantor trust is taxed as a non-US individual. See Section 641(b). The trust is subject to US income tax only on its US-source business income or other taxable US investment income. It is not subject to US income tax on its non-US source income, US-source capital gains or certain interest income. See Section 871.

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In a particular year, if a foreign nongrantor trust's distribution to a US beneficiary constitutes an "**accumulation distribution,**"[18] the accumulation distribution would be "thrown back" to applicable "**preceding taxable years**"[19] to the extent of each of the applicable year's "**undistributed net income**" ("**UNI**").[20] An amount, roughly averaged, would be "thrown back" and added to the US beneficiary's taxable income for the applicable three relevant prior tax years.[21] Once the taxable income to be recaptured has been identified, the ordinary tax rate will apply in computing the US beneficiary's additional tax liability.[22]

The harshest punishment comes in the form of an interest charge. Under current law, interest will be charged on the throwback tax at the applicable underpayment rates under Section 6621.[23] The interest will be compounded daily over a period of time that can be longer than the income accumulation time.[24] In the worst-case scenario, the entire distribution to a US beneficiary can equal the tax and interest charge combined.[25]

The potential confiscatory nature of the throwback tax and its interest charge makes "domesticating" a foreign grantor trust when the grantor dies an appealing, safe solution. Either the domesticated trust or the US beneficiaries will pay US income tax normally on the trust's worldwide income going forward; there is no more opportunity for tax-free accumulation of income but there is no harsh interest penalty and the trust's capital gain income will continue to enjoy the favorable tax rates applicable to capital gains.

For those who would like to prolong the advantages of the accumulation of income free of US income tax after the death of the foreign grantor, the techniques discussed below will help reduce the likelihood of the application of the throwback tax.

Potential strategies

Distributions from a foreign nongrantor trust constitute an "accumulation distribution" only if they exceed the trust's income and DNI for that year.[26] This creates the opportunity to patiently grow the assets of the trust by allowing the tax-free accumulation of income over an extended period of time, and to slowly drain the trust later, keeping distributions to US beneficiaries below the triggering amount so as to not result in accumulation distributions.

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Consider the fact pattern in Example 1 below.

Example 1:
A foreign nongrantor trust is funded with $100 million. The trust's US beneficiaries do not need to receive distributions

18. The accumulation distribution of a trust for a particular year is equal to the amounts properly paid, credited, or required to be distributed by the trust in that year in excess of the trust's DNI (defined below) unless those amounts do not exceed the trust's fiduciary accounting income See Section 665(b). DNI stands for "distributable net income," a key concept in the US taxation of trusts, estates, and beneficiaries. It is defined in Section 643(a), and in the accompanying Treasury Regulations. For a foreign trust, DNI is roughly equal to its taxable income before reduction for the amount of distributions to beneficiaries.

19. See Section 665(e) for the definition of "preceding taxable year." Certain prior tax years of a simple trust are not treated as "preceding taxable years" for purposes of the throwback tax. See Treas. Reg. 1.665(e)-1A(b).

20. See Section 665(a) for the definition of "undistributed net income".

21. See Sections 666 and 667 in general as to how the accumulation distribution is "thrown back" to applicable prior taxable years. See Ellen K. Harrison, Elyse G. Kirschner & Carlyn S. McCaffrey, *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*, SJ027 ALI-ABA 137 (2003) for a more detailed description of the mechanics.

22. Sections 666 and 667.

23. See Sections 668.

24. *Id.*

25. See Ellen K. Harrison, Elyse G. Kirschner & Carlyn S. McCaffrey, *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*, SJ027 ALI-ABA 137 (2003).

26. See Section 665(b) and Section 643(b).

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from this trust for an extended period of time because they have access to other income or assets. The trust generates and realizes 10% investment returns every year for 15 years. This income would have been taxed at a 23.8% capital gains rate if the trust was a US nongrantor trust.[27] *During this period, the trust does not make any distributions to the beneficiaries and does not have the obligation to pay US income tax on the trust income. At the end of the 15-year period, this foreign nongrantor trust's assets will have grown free of US tax to approximately $417 million. If the trust had been domesticated at the beginning of Year 1 and paid US income tax on its investment return every year, at the end of the same period, the US trust's assets would be worth only $304 million.*

The trust assets have grown. The question is how to access the trust assets without activating the throwback tax regime.

The most straightforward access method is to make yearly distributions from the trust not in excess of its DNI for the year of distribution. Example 2 shows how this would work.

Example 2:
The facts are the same as those in Example 1. Further, the $417 million trust continues to grow at the same pace as the previous 15 years. In Year 16, the trust's DNI is $40 million. The trust distributes all the $40 million to the US beneficiaries.

In Example 2, the US beneficiaries would pay US income tax on the $40 million distributions but would not be subject to the throwback tax. The items of income included in the trust DNI retain their original characters.[28] For instance, capital gains would be taxed at the 23.8% capital gains rate and ordinary income at the 40.8% rate applicable to ordinary income. If the trust had been domesticated at the beginning of Year 1, using the same assumptions, in Year 16, the domesticated trust's income would be only $30 million. Everything else being equal, the US beneficiaries of the foreign nongrantor trust each year will be $10 million (before tax) ahead of the US beneficiaries of the domesticated trust.

Examples 3 and 4 suggest two ways of preserving access to the original trust corpus.

Example 3:
The facts are the same as those in Example 1, except that the trust makes annual distributions starting in Year 1 equal to its DNI to a second foreign trust or a series of foreign trusts. Annual distributions of DNI will prevent the trust from ever having UNI. The original trust will be able to make distributions to US beneficiaries, free of the throwback tax including distributions of the original principal. The recipient trusts will be able to make distributions to US beneficiaries equal to their annual DNI free of the throwback tax.

For this technique to work, care must be taken to avoid the multiple trust rule of Section 643(f). Under this rule, two or more trusts will be treated as the same trust if they have substantially the same grantors and substantially the same beneficiaries and a principal purpose of the trusts is to avoid income taxes. For this purpose spouses are treated as the same person. This rule should be avoided if the recipient trusts have as their primary beneficiaries less than all of the primary beneficiaries of the distributing trust.

Example 4:
The facts are the same as those in Example 1, except that the trust instrument, upon settlement, contains a provision requiring a distribution of $100 million in 15 years to two domestic trusts, one for each of two beneficiaries of the distributing trust.

Section 663(a)(1) provides that "any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or

27. In all the examples in this article, we use simplistic assumptions about growth rates, rate of realization, expenses, tax rates etc. and focus on illustrating the directional impact of certain practices.

28. Capital gains are included in a foreign trust's DNI. See Section 643(a)(6). By contrast, capital gains are generally excluded from a domestic trust's DNI, unless an exception applies. See Section 643(a)(3) and Treas. Reg. § 1.643(a)-3.

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credited all at once or in not more than 3 installments" shall not be included as amounts falling within Section 662(a). Section 662(a) governs the amounts included in a US beneficiary's gross income. Here, because the trust instrument, as drafted from Day 1, requires a payment of a specific sum ($100 million) all at once, this $100 million is not included in the US beneficiaries' gross income for purposes of determining their US gross income. The US beneficiaries receive this amount free of US income tax. The net result is the US beneficiaries of the foreign nongrantor trust will have access to the original principal without triggering the throwback tax.

Finally, there is at least one method for a US beneficiary to, in effect, access the UNI of a foreign trust without being subject to the throwback tax. Recognizing that in many cases the US beneficiaries of foreign trusts will lack sufficient information to accurately characterize the distributions they receive from foreign trusts, the IRS created a default method of reporting foreign trust distributions.[29] The method is described in Form 3520 and may be elected by US beneficiaries whether or not they possess adequate information. There are at least two drawbacks to the method. An election to use the default method by a beneficiary cannot be reversed until the last year of the trust and all distributions are treated as ordinary income.

When a US beneficiary is using the default method, a distribution from the trust will be treated as an accumulation distribution only to the extent that the distribution exceeds 125% of the average of the distributions the beneficiary received from the trust in the preceding three years. Using this method, it should be possible to construct a pattern of distributions that will permit the beneficiary to receive the entire corpus of the trust without triggering the throwback tax. Consider the following example.

Example 5:
One of the recipient trusts described in Example 3 had assets worth $150,000,000 at the end of Year 15. After Year 15, all of these assets would be treated as UNI. The trust continued to earn income at an annual rate of 10%. In each of Years 16 through 18 the trustee distributed $15,000,000 to its US beneficiary. These distributions were not accumulation distributions because they did not exceed the trust's DNI. Starting in Year 19, the trustee began a pattern of distributions to the US beneficiary that were equal to 125% of the average of the prior three years' distributions. These distributions were treated as ordinary income but were not accumulation distributions. If this pattern of distributions is continued and if the trust continues to earn income at a rate of 10%, annually, the trust fund will be exhausted in Year 27.

Interaction between trust anti-deferral regime and foreign corporation anti-deferral regime

If a trustee administers a foreign nongrantor trust the beneficiaries of which are all US persons, the trustee will have the foreign corporation anti-deferral regime to worry about as well as the throwback tax. The bad news is that, when the trust anti-deferral regime meets the foreign corporation anti-deferral regime, there are sometimes no clear answers as to the correct tax results.

Foreign corporation anti-deferral regime in general

A corporation is a separate taxpayer. When a US person owns equity interests in a foreign corporation and when that foreign corporation earns income, the United States faces a challenge similar to the one it faces when foreign trusts with US beneficiaries accumulate income.

The foreign corporation anti-deferral regime is similar to the trust anti-deferral regime. It imposes a punitive tax on the US shareholders of certain types of foreign corporations to prevent the tax-free accumulation of income in those corporations.

The US tax law divides all foreign corporations in which a US person has any equity interest (or voting rights in some instances) into three categories: (i) controlled foreign corporations ("**CFCs**"), (ii) passive foreign income companies ("**PFICs**"), and (iii) foreign corporations that are not CFCs or PFICs.

29. There is no direct statutory authority supporting the default reporting method. Presumably the IRS based its decision to provide this method on Section 6048(c).

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The CFC analysis starts with entity classification, to be followed by the identification of the types of income the CFC regime reaches. A CFC is a foreign corporation in which "**US Shareholders**" collectively own more than 50% of the value or voting rights of the corporation on any day of a tax year.[30] For CFC purposes, a "**US Shareholder**" is a US person[31] who owns at least 10% of the value or voting rights of a foreign corporation.[32] For the purpose of determining who is a "US Shareholder"[33] and whether a foreign corporation is a CFC[34], "ownership" includes direct and indirect ownership,[35] as well as constructive ownership.[36] Once a CFC is identified, the next step is to determine whether the CFC has Subpart F income or GILTI (or "global intangible low-tax income") income.[37]

Direct or indirect US Shareholders[38] who are individuals or trusts are generally subject to current US federal income tax at ordinary income tax rates on the CFC's Subpart F income or GILTI income, regardless of whether the income is distributed to them in the form of a dividend.[39] While Subpart F income could be avoided, GILTI income (added to the Code under the Tax Cuts and Jobs Act of 2017) functions as a minimum tax on CFC earnings.

A foreign corporation is a PFIC (i) if at least 75% of the gross income in a particular year is passive income[40], or (ii) at least 50% of the assets produce or are held for the production of passive income in a particular year.[41] A foreign corporation's PFIC status is tested on a year-to-year basis but if the test is met during the US person's ownership period in one year, the corporation will generally continue to be PFIC. A foreign corporation can be a PFIC even if it generates no income at all in a particular year. Once a PFIC is identified, the punitive PFIC tax regimes are activated.[42]

A direct or indirect US shareholder of a PFIC can be taxed under one of the three regimes: (i) the excess distribution regime[43], (ii) the qualified electing funds ("**QEF**") regime[44], and (iii) the "mark to market" regime[45].

For a particular US person, if a foreign corporation can be classified as either a CFC or a PFIC, then the CFC regime will control.

CFC and PFIC attribution through trusts

A domestic trust is a US person. If it owns equity interests or voting right in a foreign corporation, its CFC and PFIC analysis is similar to an individual US person's.

A foreign grantor trust is tax transparent. The foreign grantor is the taxpayer. As a result, the CFC and PFIC analysis is irrelevant to the trust's US beneficiaries.[46]

30. Section 957(a).
31. Here, the "US person" is the definition of "US Person" under Section 7701(a)(30) as modified by Section 957(c).
32. Section 951(b).
33. *Id.*
34. Section 957(a).
35. Section 958(a).
36. Section 958(b).
37. See Section 952 and Section 951A.
38. For CFCs, only direct or indirect US Shareholders may have actual adverse tax consequences. Constructive US Shareholders are not subject to the punitive tax treatment.
39. Individuals and trusts may elect to be taxed as corporations under Section 962 (a "**Section 962 election**"). With a Section 962 election, an individual or a trust will be taxed at the corporate tax rate (currently at 21%) and will be eligible for a deduction (currently at 50%) under Section 250, resulting in an effective GILTI tax rate of 10.5%. However, there are downsides to a Section 962 election, including unfavorable tax rates upon the subsequent actual distribution of dividends in some instances. Financial and tax modeling is usually conducted for deciding whether a Section 962 election should be made.
40. "Passive income" is specially defined under the PFIC regime. See Section 1297(b).
41. Section 1297(a).
42. See Blanchard, 6300 T.M., *PFICs*, for an excellent, comprehensive discussion about the PFIC taxation regime.
43. Generally, the excess distribution regime imposes an interest charge on gain from any disposition of PFIC shares as well as certain distributions made by a PFIC. The purpose is to approximate the US income tax that would have been imposed if the PFIC's income had been distributed currently. See Section 1291.
44. If a PFIC is willing to provide certain annual financial information to a US shareholder, the US shareholder may make a QEF election on his or her US income tax return to be treated as receiving an annual distribution of his or her pro rata share of the PFIC's ordinary earnings and net capital gain. See Sections 1293 through 1295.
45. If a PFIC is regularly traded on a qualified stock exchange, a US shareholder may make a mark-to-market election to treat his or her PFIC stock as if it were sold at the end of each year and pay US income tax at ordinary tax rates. See Section 1296.
46. But see Textron Inc. v. Comm'r, 117 T.C. 67 (2001), holding that the US grantor of a domestic grantor trust would not be treated as owning the shares of a CFC held by the trust. In that case, the determination of non-owner status did not protect the grantor from the application of Section 951. The Section 951 tax was imposed on the grantor because the trust was subject to Section 951 and, under Section 671, the grantor was subject to tax on all of the trust's income. See a discussion of this case

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When a foreign nongrantor trust with US beneficiaries owns equity interests or voting rights in a foreign corporation, it is effectively layering one tax deferral opportunity on top of another. The foreign corporation's direct shareholder is another foreign person (*i.e.*, a foreign nongrantor trust), so the CFC and PFIC analysis does not apply directly to the shareholder itself. Because the foreign shareholder holds the corporate equity interests for the benefit of US persons, the CFC and PFIC analysis focuses on attributing the corporate equity interests to the trust's US beneficiaries in order to determine whether the foreign corporation punitive taxation regime should be activated.

CFC attribution

The CFC regime divides a CFC's US Shareholders into (i) direct US Shareholders, (ii) indirect US Shareholders, and (iii) constructive US Shareholders.[47] Only direct or indirect US shareholders will suffer actual punitive tax consequences in the form of Subpart F and GILTI tax.[48]

The rules governing the attribution of **indirect** CFC ownership through a foreign nongrantor trust to its US beneficiaries are not sufficient to determine ownership in many cases.

If a foreign nongrantor trust has a **mandatory** distribution standard, the trust's equity interests in a foreign corporation will be treated as indirectly owned by the beneficiaries in proportion to their interests.[49] Once each beneficiary's ownership percentage has been determined, each of the US beneficiaries whose interest is at least 10% of the corporation will be aggregated (each, a "**10% US beneficiary**"). If the total exceeds 50%, then the foreign corporation will be treated as a CFC to those 10% US beneficiaries. They are treated as indirect CFC shareholders, and will be taxed on the corporation's Subpart F and GILTI income currently whether or not the income is distributed to them.

However, there is no clear guidance on how the CFC indirect attribution rules should apply in a much more common fact pattern: a foreign nongrantor trust that has a **discretionary** distribution standard and **a mix of US and non-US beneficiaries**. [50]

The rules on attributing **constructive** CFC ownership through a foreign nongrantor trust are equally inadequate. There is no clear guidance on how to apply the constructive ownership attribution rules when a trust is a discretionary foreign nongrantor trust with a mix of US and non-US beneficiaries.[51]

in Monte A. Jackel, *More on Grantor Trusts: Tax Attribution or Asset Ownership*, Tax Notes, January 24, 2022. Treas. Reg. §1.1291-1(b)(8)(iii)(D), however, provides that, for PFIC purposes, the grantor of a grantor trust is treated as owning the stock held by the trust. See also proposed PFIC regulations (REG-118250-20 "Guidance on Passive Foreign Investment Companies and Controlled Foreign Corporations Held by Domestic Partnerships and S Corporations and Related Person Insurance Income") published on Federal Register on January 25, 2022.

47. Section 958.

48. Section 951(a) and Section 951A(e)(1).

49. Section 958(a)(2) provides that a foreign corporation's stock owned, directly or indirectly, by or for a foreign trust, is considered as being owned proportionately by beneficiaries. Treas. Reg. § 1.958-1(d) provides one example: "Example 3. Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E, and F is considered to own 30 percent (1/3 of the 90 percent) of the stock in S Corporation."

50. In FSA 199952014 (September 13, 1999), the IRS National Office concluded that the actuarial values of a trust's beneficiaries' interests were not relevant facts and circumstances for purposes of applying the indirect ownership rules under Section 958(a)(2), leaving us with even less guidance on how to potentially measure the indirect ownership.

51. For purposes of determining "constructive ownership", inter alia, Section 958(b) provides that Section 318(a) should apply in determining whether a foreign corporation's stock owned, directly or indirectly, by or for a trust is considered as owned by its beneficiaries. Under Section 958(b)(1), the constructive ownership rules do not apply to treat a U.S. Person as the constructive owner of shares owned by a nonresident alien individual. Section 318(a)(2)(B)(i) provides that a foreign corporation's stock owned, directly or indirectly, by or for a foreign trust is considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust. Treas. Reg. § 1.318-3(b) provides that, for purposes of applying Section 318(a)(2)(B), the factors and methods prescribed in Treas. Reg. § 20.2031-7 should be used in determining a beneficiary's actuarial interest in a trust. Treas. Reg. § 20.2031-7(d)(1) provides that for purposes of determining actuarial valuation on or after May 1, 2009, Section 7520 factors should be used. Treas. Reg. § 20.7520-3(b)(1)(ii) provides that –

- a standard Section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest,
- a restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances, and
- when a standard Section 7520 factor does not apply, a special Section 7520 factor may be used under some circumstances pursuant to the methods illustrated by certain Examples (discussed below).

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PFIC attribution

The PFIC regime divides a PFIC's US shareholders into (i) direct US shareholders, and (ii) indirect US shareholders. Both are subject to one of the three PFIC taxation regimes discussed above.

In January 2021, the Treasury Department published final PFIC regulations.[52] Unfortunately, the final regulations fail to provide clear guidance on how to attribute PFIC ownership to US beneficiaries through foreign nongrantor trusts.

Section 1298(a)(3) and Treas. Reg. § 1.1291-1(b)(8)(iii)(C) provide that PFIC stock owned by a trust will be considered as being owned "proportionately" by its beneficiaries. Treas. Reg. § 1.1291-1(b)(8)(i) provides that in applying this proportionate ownership test all facts and circumstances should be taken into account.

The preamble to the PFIC final regulations states, in a pertinent part, that:

> "The Treasury Department and the IRS remain aware of the need for guidance regarding both the ownership attribution rules and the interaction of the rules in subchapter J with the PFIC rules. The Treasury Department and the IRS are also aware that in some cases, the application of the PFIC attribution rules may impose tax on U.S. beneficiaries of foreign trusts that never receive the related distributions. The Treasury Department and the IRS believe that further guidance with respect to the identification of indirect shareholders in such circumstances requires coordination of the PFIC rules with the rules of subchapter J, which is beyond the scope of this regulation project. Pending the issuance of further guidance, taxpayers should continue to apply these rules in a reasonable manner as expressed in the preamble to the 2013 temporary and final regulations." (emphasis added)

The preamble tells US beneficiaries of a foreign nongrantor trust that, under the PFIC rules, they may have to pay US tax on income that they may never receive unless the trust refrains from owning any interest in a foreign corporation that can be classified as a PFIC.

Implications

If a trustee is administering a foreign nongrantor trust for the benefit of US beneficiaries, even if the throwback tax may be avoided, the trustee should make sure that the CFC and PFIC attribution rules will not cause punitive taxation to the trust's US beneficiaries.

If a trustee is administering a foreign nongrantor trust for the benefit of US beneficiaries, even if the throwback tax may be avoided, the trustee should make sure that the CFC and PFIC attribution rules will not cause punitive taxation to the trust's US beneficiaries.

Given that there is no clear guidance and that the potential US tax consequences are severe, the trustee of a foreign nongrantor trust that has a reasonable amount of US beneficiaries may want to avoid holding equity interests in any foreign corporation that could be treated as a CFC or a PFIC.

Further, in illustrating Section 7520 factors' applicability in view of provisions of governing instrument, Treas. Reg. § 20.7520-3(b)(2)(ii)(B) provides that a standard Section 7520 factor may not be used to value an income interest or similar interest in property for a term of years, or for one or more measuring lives, if –

- the trust, will or other governing instrument requires or permits the beneficiary's income or other enjoyment to be withheld, diverted, or accumulated for another person's benefit without the consent of the income beneficiary, or

- the governing instrument requires or permits trust corpus to be withdrawn from the trust for another person's benefit without the consent of the income beneficiary during the income beneficiary's term of enjoyment and without accountability to the income beneficiary for such diversion.

Example 4 of Treas. Reg. § 20.7520-3(b)(2)(v) and Example 1 of Treas. Reg. § 20.7520-3(b)(4) describe two scenarios where a special Section 7520 factor is applied, in conjunction of other factors and considerations. In both Examples, the interest is ascertainable, quantifiable and predictable. In reality, most of the trusts (including foreign nongrantor trusts), the distribution standards are discretionary, so the US beneficiaries' interests would not be ascertainable, quantifiable or predictable, making it unreasonable to apply the above authorities directly.

Treas. Reg. § 20.7520-3(b)(1)(iii) provides that, when Section 7520 factors do not apply, the actual fair market value of the interest is based on all the facts and circumstances. It is not clear what other facts and circumstances would be relevant. Again, when most of the foreign nongrantor trusts are discretionary, they are left with a "facts and circumstances" test. To say that the rules are not clear is an understatement.

52. The PFIC regime was added to the Code in 1986. The PFIC final regulations (T.D. 9936) were published in the Federal Register (86. FR 4516) in 2021.

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Practically, that means the trust can still invest in single stocks in the foreign capital market, but the trust should avoid unnecessarily pooling overseas investments into a foreign holding company unless a "check the box" election[53] is made to treat it as tax transparent for US tax purposes.

If a "check the box" election is not possible and if the risk of CFC attribution remains more than remote, analysis must be conducted to quantify the potential Subpart F or GILTI tax consequences to the US beneficiaries which will inform a potential trust restructuring decision.

The trust should also avoid investing in foreign mutual funds, alternative investments and other investment products or entities that can be treated as PFICs. The current PFIC attribution rules tend to result in exceptionally harsh US tax consequences to the trust's US beneficiaries. Until there is sufficient legislative and regulatory clarity on this issue, a foreign nongrantor trust with US beneficiaries should avoid PFICs.

Conclusion

Cross-border private wealth structures can be very complex. When US beneficiaries are involved, with the right set of facts, it is possible to utilize a foreign nongrantor trust to achieve the family's goals, while avoiding US adverse tax consequences under the trust and foreign corporation anti-deferral regimes.

* * *

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53. A foreign corporation that is not a "per se corporation" may elect to be treated as a partnership (if it has two or more shareholders) or a disregarded entity (if it has only one shareholder) for US tax law purposes. See Treas. Reg. § 301.7701-3. This elective regime is often called the "check the box" election. A "per se corporation" is an entity type from a certain foreign jurisdiction specified under Treas. Reg. § 301.7701-(b)(8). A foreign eligible corporation that elects to be treated as a partnership or disregarded entity under the "check the box" election regime is deemed to be liquidated for US tax law purposes immediately before the effective date of the election. See Treas. Reg. § 301.7701-3(g).

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