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Calculating Foreign Trust DNI and UNI: Avoiding Throwback Tax on Undistributed Net Income

WEDNESDAY, OCTOBER 31, 2018, 1:00-2:50 pm Eastern

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Calculating Foreign Trust DNI and UNI

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Calculating Foreign Trust DNI and UNI

Dianne C. Mehany

Is The Trust Foreign?

- Trust easily "triggers" foreign classification. It is only domestic if:
  - A US court has the ability to supervise administration; <u>and</u>,
  - A US person has the ability to control all substantial decisions of the trust
  - (Control and Court Test applies post-1996)
- One year grace period to correct inadvertent residency change due to change in control
- Can you have a foreign US trust?

Are Your Beneficiaries Foreign?

Focusing on U.S. Beneficiaries.

- U.S. citizen – consider citizenship of parents as well to properly determine whether U.S. citizen.
- Greencard holders – does not matter whether "reside" in the United States or whether expired.
- Substantial Presence test (IRC 7701(b)(3))
  - changes from year to year and may impact distribution decisions to avoid UNI
  - Remember treaty tie-breaker may be useful

Taxation of NonGrantor Trust Distributions

- "Default" Regime, or
- DNI (distributable net income) and UNI calculated
  - It functions as an accounting methodology by which worldwide income and gains are carried out to U.S. beneficiaries.
  - (DNI not completely taxable to foreign beneficiaries. One must look through to the character and source of income to determine taxability for foreign beneficiaries.)
  - DNI not distributed out to a trust's beneficiaries becomes UNI (Undistributed Net Income).

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When does Default Regime Apply?

- Default Regime (Schedule A) applies automatically if U.S. beneficiary does not receive a Foreign Nongrantor Trust Beneficiary Statement ("FNGTBS").
- A beneficiary might choose to apply the default regime in certain instances.
- Once default regime used, its application is irrevocable, unless
  - It is the foreign trust termination year, <u>and</u>
  - The beneficiary can attach a FNGTBS to the timely filed Form 3520.

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Default Regime Calculation

- Entire distribution is treated as taxable, regardless of whether paid form the trust's corpus.
- Amount of distribution is compared to the average of the past three years' distributions to determine the portion that is subject to the throwback tax and interest charge
  - The amount equal to 1.25 times the average of the past three years' distributions to the U.S. beneficiary is treated as ordinary income
  - The excess current distribution amount, if any, is taxed as an accumulation distribution paid out of UNI. (the applicable number of years for the interest charge is the number of years the trust has been in existence, divided by 2.)

Distributable Net Income

- DNI (distributable net income): a unique income tax concept.
  - It is <u>essentially</u> fiduciary accounting income that is distributable to beneficiaries, net of trust expenses and deductions.
    - Foreign trust may only receive deductions to the extent they serve to offset ECI. May also receive a distribution deduction for beneficiary distributions (but only to the extent the distribution consists of DNI).
    - Foreign trust DNI <u>includes</u> capital gains and losses

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Distributable Net Income

- Fiduciary Accounting Income (Section 643(b)) is the amount of income of the trust under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing income and applicable local law shall not be considered income.

Distributable Net Income

- To calculate DNI
  - First identify items of gross income (by type)
  - Apply deductions to specific gross income items
  - Allocate DNI between beneficiaries
    - Division depends on whether trust is simple or complex
      - Simple = attribute ratably amongst beneficiary distributions, regardless of whether foreign or domestic
      - Complex = allocate according to the terms of the trust document

Distributable Net Income – Complex Trusts

- Tier System
  - Permits separate classes of beneficiaries
    - Some receive mandatory distributions (typically all consisting of DNI)
    - Some are discretionary beneficiaries
  - If the amount of distribution required for Tier 1 beneficiaries *exceeds* DNI, then all DNI is allocated to the Tier 1 beneficiaries.
  - If, however, there remains DNI after Tier 1 beneficiaries receive their full distributions, the remaining DNI is allocated proportionately among the Tier 2 beneficiaries, based upon the amount of trust property received by each

Undistributed Net Income

- If a foreign non-grantor trust does not distribute all of its DNI in the current year, the undistributed DNI, reduced by any taxes imposed on the trust's DNI, will become "undistributed net income" (UNI).
- Any distribution to a U.S. beneficiary that exceeds DNI must first exhaust UNI in order to reach the trust's corpus.
- This distribution of UNI to a U.S. beneficiary is known as an accumulation distribution.
- UNI distributed on a first-in-first-out basis.
- U.S. beneficiary is subject to the "throwback tax" on accumulation distributions.

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Taxation of Accumulation Distribution

- "Throwback rule" seeks to approximate the tax the beneficiary would have paid if UNI carried out by the accumulation distribution was distributed in the year it was earned by the trust, and to impose underpayment interest on each year's amounts.
- Assumes that beneficiary has sufficient information and documentation to know the actual breakdown of the trust distribution for the relevant year.
- The throwback tax is a function of the number of years to which the distribution relates and the beneficiary's average tax rate for the five years (with the highest and lowest years removed) immediately preceding the distribution year.
  - Note, any amount of capital gains accumulated by a foreign trust loses its character and is treated as ordinary income when later distributed.
  - Many times, the highest individual marginal rate ends up applying to the accumulation distribution.

Interest on Accumulation Distribution

- Interest accumulates for the period beginning on the date that is the applicable number of years prior to the applicable date and ending on the applicable date.
  - The "applicable date" is the date mid-year through the tax year for which the reporting is made. In the case of an individual (calendar year taxpayer), the applicable date would be June 30 of the distribution year.
  - The "applicable number of years" is the number of years for which the interest runs. It is derived by first calculating the "weighted UNI" for all years in which the trust had UNI, and then dividing such amount by the total amount of UNI of the trust as of the distribution year. Weighted UNI is calculated by multiplying the UNI from each of the trust's years by the number of years since that year, and then adding each year's result.
- Use the Table of Combined Interest Rate Imposed on the Total Accumulation Distribution to determine applicable interest rate (pg. 11 on instructions to Form 3520).

Thank You

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Calculating Foreign Trust DNI and UNI

Christiana M. Lazo

Planning for Foreign NonGrantor Trusts with US Beneficiaries

- Flush DNI
- Opportunistic DNI Distributions
- Deemed Distribution Rules
- Default Method Planning
- FAI Strategy
- Various Other Techniques

Flush DNI

A trust has UNI only if it accumulates DNI.

Distribute the DNI each year, and no UNI accumulation.

Sounds simple, but…..

Flush DNI

Advantages	Disadvantages
Prevents accumulation of UNI – future distributions in excess of DNI are free from throwback tax	Requires commitment to annual accounting and administrative rigor
	Economics may not align with planning goals
	May be too little, too late!

Flush DNI

“Requires commitment to annual accounting and administrative rigor”

At least two possible pitfalls:

(1) DNI not appropriately identified

(2) Missed timing

Flush DNI

Techniques to avoid the pitfalls:

- Strong accounting team familiar with US fiduciary income tax rules
- 65-Day rule
  - Don’t forget to file the election!
- Other possible solutions

Flush DNI

"Economics may not align with planning goals"

- Distribution to an individual foreign beneficiary may eliminate potential for UNI, but US beneficiary loses potential for economic access
  - Anti-avoidance intermediary rules apply (unless 'intermediary' is grantor) (IRC § 643(h))
- Distribution to a foreign trust will only shift, and not solve, the problem
  - DNI eventually becomes UNI in the hands of the recipient trust
  - Recipient trust as separate trust (not extension of distributing trust)
- Distribution to a US beneficiary (individual, trust, entity) avoids the throwback tax but accelerates US income tax exposure

Flush DNI

“May be too little, too late!”

Clients often arrive with ‘mature’ trusts, with significant accumulated UNI.

Adds additional pressure to the question of appropriate economics.

Flush DNI

"May be too little, too late!"

Avoid pitfalls if you try to "flush" a mature trust of UNI:

- May call for additional care to ensure recipient trust is not viewed as an extension of distributing trust
- Only distributions in following tax year will be "clean"
  - Remember consequences of any 65 day election!
- Take care around distributions to charities and interplay with distribution deduction rules
- Planning for the future

Opportunistic DNI Distributions

- Even if flushing DNI each year does not work for a client, don’t forget to consider opportunistic DNI distributions
  - Years of significant “preferential rate” income (capital gains and qualified dividends)
  - In anticipation of increasing tax rates

Deemed Distributions (IRC § 643(i))

- Deemed distribution if US person beneficiary (or someone related):
  - – Receives a loan from foreign trust
    - *Unless* loan is a qualified obligation
      - – No regulations to define. Notice 97-34.
  - – Uses trust property (real or tangible personal property, wherever located)
    - *Unless* pays fair market value for use

Deemed Distribution Rules

- Deemed distributions may attract a throwback tax if they cause an accumulation distribution to the US beneficiary.

Deemed Distribution Rules

- Planning solutions:
  - Ensure loans to US beneficiaries (or related persons) are ‘qualified obligations’
  - Consider holding real estate and tangible personal property in ‘dry trusts’, if possible
  - US beneficiaries pay fair market value for use of real estate and tangible personal property

Deemed Distribution Rules

- Qualified Obligation Requirements:
  - In writing
  - Term does not exceed 5 years (considering last possible date it could be outstanding)
  - Payments denominated in US dollars
  - Yield to maturity not < 100% AFR and not > 130% AFR
  - US person extends statute of limitations (Form 3520)

Default Method Planning

- US beneficiaries may elect “default method”
  - *Even where* adequate records are available to determine the treatment of a distribution
  - Made on Form 3520
- Default method:
  - 125% of 3-year average distributions is ordinary income
  - Only excess is UNI

Default Method Planning

Planning option:

- Elect default method and systematically increase distributions over many years to access an increasing principal amount without attracting throwback tax

Potential pitfall: Default method must be used for all future years of trust (except year of trust termination) once elected

FAI Strategy

- Distributions that do not exceed fiduciary accounting income (“FAI”) are not accumulation distributions
- Planning option:
  – If FAI exceeds DNI, distributions above DNI that do not exceed FAI will not attract throwback tax
  – Partnership distributions timed in years of desired trust distributions may create sufficient FAI to avoid an accumulation distribution

Various Other Techniques

- Combined attacks
  - For example, FAI Strategy plus Default Method Election: FAI distributions included in 125% 3-year average calculation!
- Specific gifts included in dispositive terms of trust instrument (IRC § 663(a)(1))
- "In-Kind" distributions of appreciated property

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Planning Opportunities to Stop Growth of UNI & Distribute at Discount

October 31, 2018

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FORWARD THINKING.

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Freeze Growth of UNI with purchase of permanent life insurance

Compliant, properly structured and financed, the internal growth of a life insurance policy's cash surrender value (CSV) does not produce taxable income from an United States perspective

With no taxable income, no DNI is created

No new DNI, so internal CSV growth does not create UNI when not distributed out of the foreign trust

Note: There is general agreement among practitioners that contributing UNI to a life insurance policy does not make the UNI go away. Rather, the life insurance policy holds and eventually disburses the UNI (even when paying the policy's death benefit).

Types of Permanent Life Insurance

First, mention is required that all life insurance is term, only permanent life insurance has a built into the policy investment element

Whole Life (WL), Universal Life (UL), Variable Life (VL), Variable Universal Life (VUL)

Traditional i.e. off the shelf and private placement life insurance (PPLI)

For PPLI, choice between §7702(a) compliant (either modified endowment contract (MEC) or not) and §7702(g) labeled "noncompliant" but it is a misnomer for a frozen cash value (FCV) policy

Provided by domestic and foreign life insurance carriers

Note, premium finance is not a different type of life insurance policy but simply how the premiums are paid and domestically usually involve a UL-type policy

Some Ways to Access UNI but at Lower Throwback Cost

Split-dollar Life Insurance

Preferred Freeze Partnership

Premium Finance

Combination of the above

Split-Dollar as an UNI Solution
(Especially when the Alternative Calculation rolling average approach is thought to take too long)

There appeared to be more clarity before and certainly after Estate of Morrissette, 146 TC 171 (2016) as to ability to rely upon Treasury regulation §1.61-22 directing how to apply on a domestic level split-dollar and any remaining questions seemed to go away on the foreign level

The idea was to own the life insurance in a new domestic trust, pay the premiums from the existing Accumulation Trust and down the road distribute the collateral assignment interest carrying out UNI but a greatly discounted valuation using a zero coupon bond pricing approach

Much to all the clarity seemed to dry up with Estate of Cahill (TC Memo 2018-84) along with the published settlement) which may be just very bad facts for the taxpayer and then Estate of Morrissette – a/k/a Morrissette II (US Tax Court Docket 4415-14; Order dated June 21, 2018)

Still, the concerns including § 2036, §2038 and §2703, as well as more globally Estate of Powell,148 TC 18 (2017) on the domestic level might not be relevant to a foreign trust's split-dollar agreement

Even if the cases are relevant to a foreign trust, further exploration is required regarding movement from the Economic Benefit to the Loan Regime (but be aware of Treasury regulation §1.7872-15 rules)

Preferred freeze partnership

Foreign trust containing accumulation obtains preferred interest and new domestic trust obtains common interest with hope investment gains will not create DNI and then UNI

Thought is the accumulated UNI allows investments with above market returns on investment to help domesticate a portion of otherwise foreign income

Query whether Chapter 14 will apply to foreign trust, and if not, will preferred interest require a premium in terms of rate of return before common share?

One thought has been to fund the preferred freeze partnership with private placement life insurance so even the preferred interest is not DNI generating

Premium finance life insurance

Premium finance usually involves Universal Life (but some feel safer with some or all Whole Life) but in any case traditional life insurance policies and borrowing from “relationship” or “transactional” lenders

With some private banks, they allow access to offshore lending capacity where loan rates are significantly lower than in the United States

Some European banks have started to offer premium financing on private placement life insurance policies – experientially American and other banks have refused since the segregated accounts of a private placement life insurance policy are deemed to obviate the lender’s ability to attain proper collateral to protect the loan

At the end of the day, planners have considered premium finance a way to use the Accumulation to help finance a solution most easily available with a new life insurance trust and inter—generational split dollar (but see the earlier slide as to Estate of Morrissette concerns)

Note: Qualified Obligation rules

A couple concepts to remember with Throwback Rules

Since foreign estates, unlike foreign trusts are not subject to throwback rules, often making a §645 Election can be helpful when foreign revocable trusts are involved

Throwback is often easiest understood by practitioners outside the International Trusts & Estates subspecialty and even some sophisticated clients as related to Subpart F Inclusion for Controlled Foreign Corporations (CFCs) and Passive Foreign Investment Companies (PFICs) – and now comes the Repatriation Tax and other aspects of the 2017 Tax Reform Act

Thank You

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