ED NORTHWOOD AND ASSOCIATES *"A Tax, Estates, and Trusts Boutique"*

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Subject: **SUMMARIES OF U.S. ANTI-DEFERRAL RULES**

FOREIGN TRUST RULES (FROM A U.S. PERSPECTIVE)

A foreign trust generally is taxed as a nonresident of the United States, so a trust is subject to U.S. tax only if it has income from U.S. sources or U.S. business activities. U.S. grantors or beneficiaries of a foreign trust, may, however, be subject to U.S. income tax on the earnings of the trust under certain circumstances. In contrast, the worldwide income of a U.S. domestic trust is subject to U.S. income tax.

The issue of whether the U.S. domestic trust itself, or its grantor (during his or her lifetime) or beneficiaries, is the taxpayer responsible for U.S. income tax on the trust earnings depends initially on the identity of the grantor and the types of powers the grantor has with respect to the trust.

There is a two-part "objective" test for determining whether a trust is foreign or domestic for U.S. income tax purposes. A trust satisfying both parts of the test is a domestic trust; whereas a trust that fails either (or both) parts is a foreign trust.

A trust satisfies the first test, referred to as the "Court Test," if a court within the United States is able to exercise primary supervision over the administration of the trust. A court is "able to exercise primary supervision" over the trust if it has or would have the authority under applicable law to render orders or judgments resolving substantially all issues regarding the administration of the trust. The "administration" of the trust includes those duties imposed upon a fiduciary under both the trust instrument and applicable law. The second test, referred to as the "Control Test," is satisfied if one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. A "fiduciary" includes a trustee and a protector.

A foreign grantor trust ("FGT") funded by someone other than a U.S. person or a beneficiary typically allows U.S. beneficiaries to receive a distribution of current or accumulated income from such trust without subjecting the U.S. beneficiary to U.S. income tax thereon. Most foreign trusts, however, are non-grantor trusts (generally, irrevocable trusts that may benefit persons other than the grantor or the grantor's spouse, such as testamentary trusts.). <u>A U.S. beneficiary of a foreign non-grantor trust ("FNGT") generally is taxed on a distribution from such a trust, and an interest charge is imposed as well if a distribution is an "accumulation distribution"</u> (a distribution that is made from accumulated income, rather than current income). This interest charge is designed to penalize the beneficiary because U.S. income tax was not paid in the year when the income was earned. For these purposes, income includes net realized capital gains, even though such gains are allocations to trust corpus for accounting purposes.

Compound interest is imposed not only on tax amounts with respect to accumulation distributions made since January 1, 1996, but also on total simple interest for pre-1996 periods, if any. The interest rate varies monthly and it is higher than the bank rate because it is based on IRS' rates charged on underpayment of taxes. To compute the interest charge, the accumulation distribution is allocated proportionally to prior trust years in which the trust has income, rather than to the earliest of such years.

The conversion of capital gain income to ordinary income upon distribution as an accumulation distribution (as opposed to a current distribution) remains in the law. Now that the maximum U.S. capital gains tax rate (20%) is about one half of the top ordinary income tax rate (39.6%), this rule carries significant additional costs.

U.S. beneficiaries (recipients) of foreign trust distributions must file information returns to report the name of the trust, the aggregate amount of distributions received, and calculate the interest charges on accumulation distributions. Most loans are considered to be distributions. It will be assumed that the distributions include accumulation distributions unless the beneficiary establishes otherwise, or there is a limited U.S. agent who may demonstrate the proper tax treatment. The penalty for failure to file a timely information return or failure to include all required information is equal to 35% of the reportable amount (even if it is tax-free), with additional penalties that may be imposed.

CONTROLLED FOREIGN CORPORATION" ("CFC")

CFC. A foreign corporation is a "controlled foreign corporation" ("CFC") if "U.S. shareholders" own more than 50% of the total combined voting power or more than 50% of the total value of the stock in the foreign corporation on any day during the corporation 's tax year. For this purpose, "U.S. shareholders" are U.S. persons owning, directly, indirectly or by attribution, 10% or more of the total combined voting power of the foreign corporation.

Indirect ownership occurs, for example, through a U.S. beneficiary's interest in a non-U.S. trust or non-US estate; the foreign trust's or estate's ownership is attributed to its beneficiaries. Where it is a discretionary trust the determination of attribution is more problematic. The most reasonable algorithm is premised on the history of distributions from the trust. Another example of indirect ownership arises through parent companies, the shares of which are owned by a US taxpayer.

Under the CFC regime, any passive income (such as, interest, dividends, rents, where the company does not manage the real property, royalties, capital gains from sales of investments, etc.) is considered "Subpart F" income. Certain U.S. shareholders of a CFC are required to report on a current basis every year their pro rata share of Subpart F income as a deemed ordinary dividend (not eligible for the lower US tax rates), even if the company does not make a distribution of such income. Matching actual dividends, however, would not be taxable in the U.S. (but the Canadian taxes on such dividends are available as foreign tax credits against the U.S. income if incurred in the same year.)

PASSIVE FOREIGN INVESTMENT COMPANY ("PFIC").

A foreign corporation is a PFIC if (1) at least 75% of its gross income for the taxable year is passive income as defined under Internal Revenue Code (the "Code" or "I.R.C.") Section 954(c), or (2) at least 50% of the assets held by the corporation during the taxable year produce passive income. Passive income generally includes dividends, interest, royalties, rents, annuities and gain from the sale or exchange of property giving rise to the forgoing types of income. Foreign mutual funds are classic examples of publicly-traded PFIC's. Privately held companies also could be PFIC's, of course, for any US shareholders (proportionate to their interests.)

Under the PFIC regime, unless they make a special election, U.S. shareholders are not taxed on undistributed income of the foreign company. Instead, when a distribution is made, it is taxed on a more punitive basis than it otherwise would be if it constitutes an "excess distribution." An excess distribution is (1) a distribution exceeding 125% of the average of the prior three years of distributions, or (2) a disposition (including a deemed disposition, such as occurs if the company is converted to an unlimited liability company or when a " QEF" election is made) of PFIC stock.

The CFC foreign trust, foreign estate, and parent/subsidiary ownership attribution rules apply to PFIC's as well. There are some special PFIC (and mostly beneficial) rules that apply to subsidiaries that are more than 25% owned by a parent.

The CFC rules override the PFIC rules. Generally, it is preferable for the company to be a CFC as opposed to a PFIC, but that determination must be made on a case-by-case basis.