Vanderbilt Journal of Transnational Law

Volume 10
Issue 1 *Winter 1977*

Article 6

1977

Foreign Accumulation Trusts and the Tax Reform Act of 1976

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Recommended Citation
David H. Simmons, Foreign Accumulation Trusts and the Tax Reform Act of 1976, 10 *Vanderbilt Law Review* 123 (2021)
Available at: https://scholarship.law.vanderbilt.edu/vjtl/vol10/iss1/6

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NOTES

FOREIGN ACCUMULATION TRUSTS AND THE TAX REFORM ACT OF 1976

I. INTRODUCTION

Congress has again "reformed" the law of income taxation of domestic and foreign accumulation trusts. A need for reform was felt to exist because some of the computations in the old law were too burdensome for fiduciaries of foreign and domestic accumulation trusts. Further, a growing body of literature[1] encouraging tax attorneys to advise their clients to create foreign accumulation trusts in order to achieve a tax savings over comparable domestic trusts evidenced the inequitable tax avoidance possibilities of the foreign trust. The result of this need for reform is the Tax Reform Act of 1976 (TRA '76).[2]

The TRA '76, which became law on October 4, 1976, changes the law of income taxation of trusts, particularly accumulation trusts; but the basic principles remain the same. In order to understand the changes made by the TRA '76 concerning foreign accumulation

1. *See, e.g.*, Bush, *The Foreign Trust Sets the New Tax Pattern*, MIAMI U. 5TH INST. ON EST. PLAN. 12-1 (1971); Kanter, *The Foreign Trust—A "One World" Concept of Tax Planning*, 1970 SO. CALIF. TAX INST. 467; Kroll, *Foreign Trusts: Advantages and Problems*, 112 TRUSTS & EST. 618 (1973); Pine, *How to Use Foreign Trusts in Estate Planning*, 1 SUCCESSFUL EST. PLAN. IDEAS & METHODS (P-H) ¶ 2018 (1973); Tovey, *Structure and Tax Advantages of Foreign Situs Trusts*, 49 GEO. L.J. 697 (1961); Zimmerman, *Foreign Trusts: Their Present and Future Estate Planning Potential*, 31 J. TAX. 258 (1969); Comment, *Foreign Situs Trusts: The Option of Utilizing a High Taxation Jurisdiction*, 52 TEX. L. REV. 949 (1974) [hereinafter cited as *Foreign Situs Trusts*].

2. Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 701, 1013-1015, 90 Stat. 1520 (codified in scattered sections of I.R.C. (1976)) [hereinafter cited as TRA '76].

> The Tax Reform Act of 1975 [sic] is designed to serve four major purposes. First, it contains tax reforms that improve the equity of our tax system and reduce undesirable effects on the allocation of resources. Second, the bill contains a number of provisions designed to simplify the tax law and make it easier for taxpayers to file their tax returns. Third, the bill includes an extension of the individual and business tax reductions that were enacted in the Tax Reduction Act of 1975, tax cuts that are an important ingredient in the economy's recovery from the worst recession since the 1930's. Fourth, the bill improves the administration of the tax laws and strengthens the rights of taxpayers.

H.R. REP. No. 658, 94th Cong., 2d Sess. 7 (1976).

trusts, the term "foreign trust" (for income tax purposes) must be defined. Also, the basic unchanged principles of the income taxation of domestic and foreign accumulation trusts, the income taxation of accumulation trusts under the Tax Reform Act of 1969,[3] and the changes brought about by the TRA '76 must be analyzed.[4]

II. THE FOREIGN TRUST—WHAT IS IT?

In an unilluminating section, the Internal Revenue Code defines a foreign trust for taxation purposes as "[a] trust . . . the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includable in gross income under Subtitle A."[5] This statute is of no help in determining if the trust is a foreign trust; it only describes the tax consequences once the trust is found to be a foreign trust. The court decisions and commentators have construed this section to mean that the foreign trust is taxed as a nonresident alien individual under sections 871-874.[6] Because of the lack of clarity of the statute, reference must be made outside of the Code in determining whether a trust is a foreign trust, *e.g.*, one must look to the treasury regulations, court

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3. Pub. L. No. 91-172, 83 Stat. 487 (1969) [hereinafter cited as TRA '69].

4. This article is limited to a comparison of domestic and foreign trusts that attempt to obtain tax benefits by accumulating income. The tax avoidance possibilities of an accumulation trust depend upon the identities of the grantor and the beneficiary and the foreign or domestic nature of the trust. The possible variations are as follows:

(1) Foreign Trusts:
(a) U.S. grantor . . . foreign trusts . . . U.S. beneficiary
(b) U.S. grantor . . . foreign trusts . . . non-U.S. beneficiary
(c) Non-U.S. grantor . . . foreign trusts . . . U.S. beneficiary
(d) Non-U.S. grantor . . . foreign trusts . . . non-U.S. beneficiary
(2) Domestic Trusts:
(a) U.S. grantor . . . domestic trusts . . . U.S. beneficiary
(b) U.S. grantor . . . domestic trusts . . . non-U.S. beneficiary
(c) Non-U.S. grantor . . . domestic trusts . . . U.S. beneficiary
(d) Non-U.S. grantor . . . domestic trusts . . . non-U.S. beneficiary

5. I.R.C. § 7701(a)(3). *See* J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT, AND ESTATE TAXATION § 54.08; 1 R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 2.22(2) (1976); S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NON-RESIDENT ALIENS, ¶ II/5 C (1971).

6. *See Foreign Situs Trusts, supra* note 1. *See also*, Revenue Act of 1962, Pub. L. No. 87-834, § 7(a)(2), 76 Stat. 985 (current version of I.R.C. § 667) (describing a foreign trust as a trust whose fiduciary is a foreign corporation or non-resident alien individual, but applicable only to production of records in Tax Court).

decisions, and congressional reports.[7]

Several criteria can be used in establishing whether a trust is a foreign trust.[8] The legislative history of the TRA '76 states these criteria:

> The Internal Revenue Code does not specify what characteristics must exist before a trust is treated as being comparable to a non-resident individual. However, Internal Revenue Service Rulings and court cases indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries. If an examination of these factors indicates that the trust has sufficient foreign contacts, it is deemed comparable to a non-resident alien individual and thus is a foreign trust.[9]

This premise that the present test is a "sufficient foreign contacts" test, analogous to a conflict of laws determination, reflects the views already taken by some commentators.[10] Unfortunately, the

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7. The determination of a trust's status as a foreign trust under substantive rules is a different determination than its classification as a foreign trust for tax purposes. References made in this article to a "foreign trust" refer to its tax classification.

8. The foreign status of a trust could be determined solely on the basis of the law under which the trust was created, disregarding all other factors. Such an analysis, however, produces irreconcilable difficulties since an artificial foreign citizenship could be created in the United States. This foreign citizen (trust) would be taxed as a non-resident alien merely because the grantor so contracted. *See* Kanter, *supra* note 1. *Cf.* I.T. 1885, II-2 C. B. 164 (1923); Rev. Rul. 245, 1957-1 C.B. 286; Rev. Rul. 181, 1960-1 C.B. 257.

Citizenship or residence of the beneficiaries might be used as the determinative factor in deciding the citizenship of the trust. This method, however, is subject to criticism because of the possibility of dual citizenship or the existence of multiple beneficiaries in different countries. Kanter, *supra* note 1, at 475-76.

A third alternative is to define a foreign trust as one not created under the laws of the United States (or the District of Columbia or any state) and principally administered outside of the United States. This, however, requires looking into various factors on a case by case basis to determine which trusts are principally administered outside of the United States. *Id.* at 476.

A fourth alternative would involve an analysis of all pertinent facts and circumstances. *Id.* at 477.

The fifth alternative is to rely on the location of the trustee as determinative. This, Kanter asserts, is the most accepted view. *Id.*

9. S. REP. No. 938 (Part I), 94th Cong., 2d Sess. 215-216 (1976).

10. *See* ROBERTS & WARREN, *supra* note 5, at ¶ II/5 ("the current position of the Internal Revenue Service . . . is that residence of a trust or estate is determined by weighing all relevant connecting factors"). *But see,* Kanter, *supra* note 1, at 483 (the residence of the beneficiaries and of the grantor is irrelevant).

proper weight to be given these criteria is uncertain,[11] except that residence of the trustee and place of administration of the trust seem to be the crucial factors. Following these criteria, a grantor must establish the trust in a foreign jurisdiction under foreign law; the trustees should be non-resident aliens or foreign corporations without branches in the United States; and all trust administrations should take place outside the United States. Commentators generally feel that such a trust will be categorized as a foreign trust.[12]

III. BASIC UNCHANGED PRINCIPLES OF INCOME TAXATION OF ACCUMULATION TRUSTS

A. *Tax Imposed upon the Trust During Accumulation*

While it is accumulating income, a trust is treated, for income tax purposes, as an entity rather than as a conduit;[13] *i.e.*, the trust is treated as a taxable entity with regard to any income that is not distributed or distributable to the beneficiaries. But to the extent income is distributed or distributable to the beneficiaries, the Code treats the trust as a conduit "through which the income flows to the beneficiaries without any change in character."[14] This is done by permitting the trust to *deduct* from its income the amounts of income that actually are or are supposed to be distributed to the beneficiary, and then taxing the beneficiary on the amounts deducted by the trust. Generally, then, the foreign trust, while accumulating income, will be taxed as a non-resident alien would be taxed on his income received from the United States;[15] and the domestic trust, while accumulating income, will be taxed as an individual citizen of the United States would be taxed on his income from the United States.[16]

B. *Tax Imposed upon the Beneficiary of the Trust upon Distribution*

The taxation of income upon its distribution to the beneficiary

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11. *See* RHOADES, *supra* note 5, at § 2.22(2).
12. *See, e.g., Foreign Situs Trusts, supra* note 1.
13. A. MICHAELSON, INCOME TAXATION OF ESTATES AND TRUSTS 3 (1974).
14. *Id. See* I.R.C. §§ 661(b), 662(b), 667(a).
15. The TRA '76 has changed this concept for foreign trusts created by U.S. grantors for U.S. beneficiaries. The U.S. grantor is treated as the owner of the trust and is taxed on its income to the extent he contributed property to the trust. I.R.C. § 679. *See* text at note 62 *infra.*
16. *See* I.R.C. § 641.

of an accumulation trust has been an area of increasing confusion, all as a result of congressional efforts to prevent these trusts from receiving a tax advantage over trusts that distribute income in the year it is earned. As previously stated, when the trust distributes income, it receives a deduction for the amount distributed, and the beneficiary includes this amount in his income. An understanding of this conduit principle is a key to understanding the taxation of distributions of accumulated income by the trust.

When an ordinary trust distributes income to its beneficiary, the deduction permitted the trust and the inclusion of the amount deducted in the income of the beneficiary is gauged by a two-tier system. First, the trust may deduct and the beneficiary must include the amounts of income, measured in the trust accounting sense, that are "required to be distributed currently."[17] In general, these amounts are the amounts of income that the trustee cannot within his discretion accumulate. These amounts are commonly called "first tier" distribution. Second, the trust may deduct and the beneficiary must include other amounts properly paid, credited, or distributed to the beneficiary.[18] In general, these amounts are amounts of income that the trustee has discretion to accumulate. These amounts are commonly called "second tier" distributions. But the amounts deductible by the trust and includable in the income of the beneficiary of both first tier and second tier distributions are limited to "distributable net income" (DNI).[19]

17. *See* I.R.C. §§ 661, 662.

18. I.R.C. §§ 661(a)(2), 662(a).

19. I.R.C. § 643 defines DNI, with respect to any taxable year, as the taxable income of the trust computed with certain modifications. These modifications are: (1) no deductions shall be taken under sections 642(b), 651, or 661; (2) gains from the sale or exchange of capital assets by a domestic trust shall be excluded to the extent that such gains are allocated to corpus and are not (a) paid, credited, or required to be distributed to any beneficiary during the year, or (b) paid, permanently set aside, or designated for the purposes specified in I.R.C. § 642 (c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction under section 1202 shall not be taken into account; (3) for purposes of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of governing instrument and applicable local law; (4) there shall be included any tax exempt interest to which I.R.C. § 103 applies, reduced by any amount which would be deductible with respect to disbursements

Conceptually, then, DNI and the tier system are measuring sticks for determining the amounts deductible by the trust and taxable to the beneficiary.[20]

First tier distributions are taxed fully before any second tier distributions are taxed. Assuming the existence of only first tier distributions:

> (1) if DNI is greater than first tier distributions, then the beneficiary is taxed only to the extent of first tier distributions;
> (2) if DNI is less than first tier distributions, then the beneficiary is taxed only to the extent of DNI.

Assuming the existence of both first tier and second tier distributions:

> (1) if DNI is greater than first tier distributions but is less than both first and second tier distributions, then the beneficiary is taxed on second tier distributions to the extent of DNI

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allocable to such interests but for the provisions of section 265. In the case of a foreign trust:

> (A) There shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(1). . .
> (B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).
> (C) . . . (i) there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and (ii) the deduction under section 1202 . . . shall not be taken into account.

I.R.C. § 643(a)(6).

The ramifications of the change in definition of DNI with respect to foreign trusts will be discussed *infra.*

20. *See* MICHAELSON, *supra* note 13, at 12-13. All distributions, except narrowly defined distributions out of principal, are deemed included in the beneficiary's income to the extent of the lesser of (1) the amount of the distribution or (2) DNI.

DNI and the tier system are also measuring sticks for determining when an accumulation distribution has been made. The TRA '76 introduced another measuring stick, "trust income", for determining when an accumulation distribution has been made. *See* note 68 *infra.*

In addition to its "measuring stick" function, DNI also serves to establish the character of the income pool from which distributions are deemed to take place. I.R.C. §§ 652(b), 662(b), 667.

(reduced by first tier distributions).[21]

(2) if DNI is greater than first and second tier distributions, then the beneficiary is taxed fully on both first and second tier distributions.[22]

Because the beneficiary's income liability on trust distributions is limited by DNI,[23] the trustee could, by accumulating income and lumping it into distributions in later years, shelter the beneficiary from taxes—the beneficiary's income tax would be limited to the amount of the trust's income for that year. For example, if the trust earned $100,000 a year for three years, but did not distribute any income until the third year, the beneficiary would be taxed only on the $100,000 earned by the trust in the third year and distributed to him. The $200,000 accumulated income that was distributed to him would escape taxation because DNI for the third year was $100,000.[24] This tax advantage prompted the creation of the "throw back rules," which attempt to tax the beneficiary as if the distribution of accumulated income had been distributed in the year it was earned.[25]

The throw back rule states that if a trust makes an "accumulation distribution,"[26] this accumulation distribution will be thrown back to the last day of the earliest preceeding taxable year in which the trust had "undistributed net income" (UNI).[27] If the accumulation distribution, once carried back to the earliest

21. An excess of second tier distributions over DNI (reduced by first tier distributions) means that an accumulation distribution has been made. *See* note 26 *infra,* and accompanying text.

22. If the trust has more than one beneficiary, then the tier system, operating alone, could produce gross inequities in taxation of the beneficiaries. If, for example, a trust with beneficiaries, A and B, accumulates income for A and distributes income to B, B would bear more than his proportionate share of taxes unless the beneficiaries' shares were treated as separate trusts. The Code remedies this problem by creating a separate share rule. I.R.C. § 663(c).

23. *See* note 19 *supra,* and accompanying text.

24. For purposes of simplicity, this example assumes DNI to be equal to trust income in the accounting sense. *See* I.R.C. § 666(b); Treas. Reg. § 1.666(b)-1A (1972).

25. MICHAELSON, *supra* note 13, at 24-25.

26. An accumulation distribution is the amount by which the second tier distributions exceed DNI after reduction is made for first tier distributions. I.R.C. § 665(b).

27. The undistributed net income for any taxable year is the amount by which the distributable net income of the trust for such year exceeds (1) the trust's distributions for that year and (2) the federal income taxes imposed on the trust that are allocable to the DNI for that year. I.R.C. § 665(a).

year of UNI, exceeds the UNI for that year, then the excess is carried forward to the next year. This excess is then reduced by the UNI for the next year forward. Any further excess is again carried forward, and the process continues up to the year of actual distribution.[28]

Another rule finally accomplishes the goal of treating an accumulation distribution as if it were never accumulated, but was distributed each year when earned. Upon accumulation, a trust incurs taxes it would not have incurred had it distributed its income rather than accumulated it; once an accumulation distribution is thrown back to the earliest preceding taxable year, and the amount is not less than the UNI for that year, then the taxes for that preceding year are also deemed distributed in that year.[29] To prevent double taxation, however, the beneficiary receives credit for those taxes deemed distributed.[30]

The above described rules provide the basis for the income taxation of accumulation trusts, both domestic and foreign. However, a close analysis reveals that beyond this general basis, there was disparate treatment of domestic and some foreign trusts under the TRA '69; there is considerable difference in treatment of domestic and foreign accumulation trusts under the TRA '76.

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28. MICHAELSON, *supra* note 13, at 29. An accumulation distribution of a domestic trust made after December 31, 1973, may not be thrown back to a year earlier than 1969. I.R.C. § 665(e)(1)(B); Treas. Reg. § 1.665(e)-1A(a)(1)(ii) (1972). But the throw back rule extended back to 1954 for foreign trusts created by U.S. persons. I.R.C. § 665(e)(2); Treas. Reg. § 1.665(e)-1A(a)(2) (1972).

29. Treas. Reg. § 1.665(d)—1A(b)(1) (1972) (promulgated by substantive rulemaking power prior to the TRA '76) provides that "taxes imposed on the trust attributable to the UNI" are to be computed as follows (assuming the alternative tax computation under § 1201(b) is not used):

$$\frac{\text{taxes attributable to UNI}}{\text{total taxes for that year}} = \frac{\text{taxable income of the trust, other than capital gain not included in DNI less their share of § 1202 deduction}}{\text{total taxable income}}$$

If the amount thrown back is less than UNI for a preceding year, proration occurs. *See* Treas. Reg. § 1.666(c)-1A (1972).

30. I.R.C. § 667(b)(1); Treas. Reg. § 1.665(a)-OA(b) (1972). The TRA '76 amended the rules concerning credits for taxes paid by the beneficiary. *See* I.R.C. §§ 666(e), 667(b).

IV. INCOME TAXATION OF FOREIGN ACCUMULATION TRUSTS AS COMPARED WITH DOMESTIC ACCUMULATION TRUSTS UNDER THE TRA '69

A. *Tax Imposed upon the Trust During Accumulation*

Under the TRA '69, a foreign trust that avoided the sections 671-678 grantor trust rules could provide considerable tax advantages for a beneficiary who could afford to have the foreign trust accumulate income. Having avoided the grantor trust rules, the foreign or domestic trust would be treated under the "simple" or "complex" trust rules.[31] Because the real tax advantage of the foreign trust was its ability to avoid taxes upon accumulation, only complex (accumulation) trusts[32] were of any special use to the grantor seeking tax advantages through the foreign trust device.[33]

The foreign trust is, for tax purposes, a non-resident alien individual.[34] Investment income of a non-resident alien individual that is not effectively connected with the conduct of a United States trade or business is taxed at a flat 30 percent rate (or a lower treaty rate).[35] (Note that on all income effectively connected with the conduct of a United States trade or business, a non-resident alien is taxed just as his United States citizen counterparts under regular tax rates.)[36] Thus, the treatment of the foreign trust as a non-resident alien during accumulation permitted the foreign trust whose income consisted largely of investment income to enjoy a 30 percent withholding tax (or lower treaty rate) on that income.[37]

Capital gains are treated separately from the non-resident alien individual's other income. If the non-resident alien individual spends a total of at least 183 days[38] in the United States during a

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31. *See* note 67 *infra.*

32. *Id.*

33. *See* note 4 *supra.*

34. *See* I.R.C. §§ 871-874. The TRA '76 did not alter the basic rules of income taxation of non-resident alien individuals.

35. I.R.C. § 871. Several tax treaties provide for lower rates. Treaties now exist with Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, Sweden, Switzerland, Trinidad and Tobago, South Africa, U.S.S.R., and the United Kingdom.

36. RHOADES, *supra* note 5, at § 2.12(1).

37. I.R.C. § 641(a) provides that the tax rates of I.R.C. § 1(d) apply to the taxable income of a domestic trust. Thus a foreign trust composed largely of non-business investment income would, under the TRA '69, have provided an income tax advantage only if taxable income were greater than $10,000.

38. These 183 days need not be consecutive.

tax year, the net capital gains from transactions affected during that year that are not effectively connected with a United States trade or business are taxed at a flat 30 percent rate.[39] If he spends less than 183 days in the United States, the non-resident alien's capital gains that are not investment income escape taxation.[40] (If the non-resident alien's United States-source capital gains are effectively connected with the conduct of a United States business, regular United States capital gains rates apply.)[41] Thus, the appropriately administered foreign trust's capital gains were not subject to tax at all.

A corresponding domestic trust was not treated as kindly by the Code. Domestic trusts were required to report accumulated income at the section 1(d) schedule for married individuals filing separate returns.[42] Capital gains of the domestic trusts were subject to taxation, although a 50 percent deduction was permitted on long term capital gains.[43]

Comparison of an appropriately created foreign trust and a domestic trust indicates that during the accumulation of income, the foreign trust was capable of providing a clear tax advantage. This tax advantage was not lost when income was distributed.

B. *Tax Imposed upon the Beneficiary of the Trust upon Distribution*

Working together, Code sections 666 and 669 threw back accumulated income to prevent tax avoidance through accumulation distributions. Generally, when an accumulation distribution[44] was made by either a domestic or foreign trust, the unlimited throw back rule[45] of section 666 applied.[46] If all the undistributed net

39. I.R.C. § 871(a)(2).

40. RHOADES, *supra* note 5, at § 2.11(3)(c).

41. *Id.*

42. *See* I.R.C. § 641(a).

43. *See id.* § 641(b) (generally, a trust may take the same deductions as an individual). *See also* I.R.C. § 1202.

44. *See* note 26 *supra.*

45. *See* note 25 *supra,* and accompanying text.

46. The Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, attempted to equalize the tax treatment of foreign and domestic trusts by abolishing the I.R.C.'s five year throw back limitation and several exceptions that permitted accumulation distributions to avoid all income taxes by foreign accumulation trust distributions. *See* I.R.C., § 665(e)(2); Treas. Reg. § 1.665(e)-1A(a)(2) (1972).

The TRA '69 made trusts other than foreign trusts created by United States persons subject to an unlimited throw back rule, except that accumulation distri-

income was deemed distributed, then the section 669 capital gain throw back rule came into play. The two throw back rules operated as follows:

> An accumulation distribution is deemed to consist of, first, "undistributed net income" . . . of the trust from preceding taxable years, and, after all the undistributed net income for all preceding taxable years has been deemed distributed, "undistributed capital gain"[47] . . . of the trust for all preceding taxable years commencing with the first year such amounts were accumulated. An accumulation distribution of undistributed capital gain is a "capital gain distribution"[48] . . . . To the extent an accumulation distribution exceeds the "undistributed net income" and "undistributed capital gain" so determined, it is deemed to consist of corpus.[49]

Under these throw back rules (sections 666 and 669), the beneficiary's taxes were computed in one of two ways—the "exact method" or the "short cut method."[50] Under the "exact method," the tax on accumulation distributions was the aggregate of the taxes that the distributions would have borne if they had been included by the beneficiary in the respective earlier years of accumulation.[51] An alternative short cut method was provided by Congress to aid the fiduciary in his tax computation and record keeping. Under the short cut method,

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butions made prior to January 1, 1974, were still subject to the five year limitation. I.R.C. § 665(e)(1)(A). In addition, accumulation distributions made after December 31, 1973, could not be thrown back prior to 1969. I.R.C. § 665(e)(1)(B); Treas. Reg. § 1.665(e)-1A (1972). The TRA '69 also provided an ultimate limit upon the throw back of capital gains because, under the '69 Act, a capital gains throw back rule existed. *See* I.R.C. § 665(e)(C).

47. "Undistributed capital gain" meant (for trusts other than foreign trusts created by a United States person): Net capital gain of the trust minus capital gain included in DNI under I.R.C. § 643 minus taxes for such year attributable to UCG minus, for trusts not using the alternative tax (I.R.C. § 1201), deductions to the extent properly allowable and other than I.R.C. § 642(b) or (c) minus DNI. Treas. Reg. § 1.665(f)-1A(a)(1) (1972) (which does not reflect changes made by the TRA '76). Thus it can be seen that the concept of UCG was generally analogous to that of UNI.

48. "For any taxable year of a trust, the term 'capital gain distribution' means, to the extent of the (total) undistributed capital gain of the trust, that portion of an accumulation distribution that exceeds the amount of such accumulation distribution deemed under § 666(a) to be undistributed net income of the trust for all preceding taxable years." Treas. Reg. § 1.665(g)-1A (1972) (which does not reflect the repeal of § 665(g) by the TRA '76).

49. Treas. Reg. § 1.665(a)-OA(a)(2) (1972).

50. Act of Aug. 16, 1954, c. 736, 68A Stat. 225 (current version at I.R.C. § 667).

51. MICHAELSON, *supra* note 13, at 33.

> the accumulation distribution [was] averaged over the number of years in which the income was earned (not counting "de minimus" years in which there was earned less than 25 percent of the average annual amount of the accumulation in question). This average accumulation determine[d] the rate of additional tax on the total—and in that determination another average [was] used: the test [was] the average of the increase in tax if the average accumulation amount [was] added to the beneficiary's gross income for each of his three immediately preceding years.[52]

This set of alternative computation methods, however, created an extreme burden upon the fiduciary. The trustee's fiduciary obligation required him to compute the beneficiary's tax under both methods in order to arrive at the lesser tax; this, of course, defeated the whole purpose of the short cut method.[53]

The capital gains throw back rule of section 669 did not apply to foreign trusts created by United States persons because the definition of DNI of such trusts included net capital gains.[54] Since all net capital gains were included in DNI, such a trust could never have undistributed capital gains.[55] If there were no undistributed capital gains, there could, of course, be no "capital gain distribution" as that term was defined in section 665(g).[56] Any capital gains accumulated by a foreign trust created by a United States person were thus thrown back upon distribution by the section 666 throw back rules instead of section 669 rules. The capital gains thrown back were treated as received proportionally with any ordinary income earned by the trust in the same year.[57]

A trust that was not a foreign trust created by a United States person (*e.g.*, a domestic trust), however, could have had a "capital gain distribution." Thus the beneficiaries of these trusts could, upon an accumulation distribution, benefit from the section 1202

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52. *Id.* at 34.

53. S. Rep. No. 938 (Part I), 94th Cong., 2d Sess. 170 (1976).

54. I.R.C. § 643(a)(6)(C) provided that the general rule concerning exclusion of certain capital gains (I.R.C. § 643(a)(3)) would not apply to a foreign trust created by a United States person:

> In the case of such a trust, (i) there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and (ii) the deduction under section 1202 . . . shall not be taken into account.

55. Treas. Reg. § 1.665(f)-1A(b) (1972).

56. *Foreign Situs Trusts, supra* note 1.

57. *Cf.* S. Rep. No. 938 (Part I), 94th Cong., 2d Sess. 216 (1976).

capital gains deduction only after all UNI was depleted. This resulted in beneficiaries of foreign trusts created by United States persons being favored, upon current or accumulated income distributions, over beneficiaries of trusts that were not foreign trusts created by United States persons.[58]

V. INCOME TAXATION OF FOREIGN ACCUMULATION TRUSTS AS COMPARED WITH DOMESTIC ACCUMULATION TRUSTS UNDER THE TRA '76

A. *Tax Imposed upon the Trust During Accumulation*

Generally, the amendments made by the TRA '76 do not change the basic concepts of income taxation of trusts. As before, if the trust is an accumulation trust, during accumulation of income the trust is treated as a taxable entity, and is taxed as an individual.[59] Upon distributions of income (current or accumulated), the conduit concept applies, and the beneficiary is made ultimately liable for the tax.[60] Thus, the underlying accumulation of income advantages that a foreign trust has after the TRA '76 are the same as under the TRA '69[61] except for one provision added by the TRA '76, which seeks to remove this accumulation advantage in the situation where Congress felt the most tax abuse existed.

The new provision states that any United States person[62] directly or indirectly transferring property to a foreign trust that has a United States beneficiary[63] will be treated as the owner of that

58. *See* I.R.C. §§ 661(b), 662(b); TRA '69, *supra* note 3, at Title III, § 331(a), 83 Stat. 594 (current version at I.R.C. § 667).

59. *See id.* §§ 641(a)-(b), 661, 662.

60. *See id.* §§ 661, 662.

61. *See* text accompanying notes 31-43 *supra* (discussing the accumulation advantages of foreign trusts over domestic trusts).

62. I.R.C. § 7701(a)(30) defines a United States person as:

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation, and

(D) any estate or trust (other than a foreign estate or trust, within the meaning of section 7701(a)(31).

63. "For purposes of [I.R.C. § 679], a [foreign] trust shall be treated as having a United States beneficiary for the taxable year unless—

(A) under the terms of the trust no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person (defined in I.R.C. § 7701(a)(30)), and

(B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a United States person."

I.R.C. § 679(c)(1). In addition, I.R.C. § 679(c)(2) provides attribution of owner-

portion of the trust attributable to the property transferred by the United States person.[64] Thus, the new provision makes such a foreign trust a "grantor trust," unless it is a section 404(a)(4) employee trust.

Two types of transfers, however, are excepted from this rule: (1) transfers by reason of death of the United States person,[65] and (2) "sales or exchanges of the property at its fair market value in a transaction in which all the gain is realized at the time of the transfer and is recognized either at such time or is returned as provided in section 453."[66]

TRA '76 does not remove any advantages of the complex trust *during accumulation,* but the foreign trust with United States grantor and United States beneficiary is no longer considered a complex trust.[67] Even though non-grantor or foreign trusts have an advantage over domestic trusts on the accumulation of income, this advantage is lost when the foreign trust makes an accumulation distribution to its beneficiary, because the TRA '76 has made several amendments penalizing the beneficiaries of foreign trusts upon an accumulation distribution.

B. *Tax Imposed upon the Beneficiary of the Trust upon Distribution*

When an accumulation distribution occurs,[68] the unlimited throw back rule, restricted only by the definition of "preceding

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ship rules for determining if amounts paid to or accumulated for foreign partnerships, corporations, estates or trusts may be attributed to a United States person. *See also* I.R.C. § 679(b) (concerning foreign trusts acquiring United States beneficiaries).

64. I.R.C. § 679.

65. *Id.* § 679(a)(2)(A). For example, income for a foreign testamentary trust created by a United States person is not taxed to the estate of the United States person. Also, an inter vivos trust that is treated as owned by a United States person under section 679 is not treated as owned by his estate upon death. S. REP. No. 938 (Part I), 94th Cong., 2d Sess. 218 (1976).

66. I.R.C. § 679(a)(2)(B).

67. It should be noted that a foreign trust, even if it avoids I.R.C. § 679, may still be a grantor trust if it fits the control criteria of I.R.C. §§ 671-677. *See* Kanter, *supra* note 1, at 522.

68. The TRA '76 has amended the time for determining when an accumulation distribution is made. I.R.C. § 665(b) states in relevant part that "[i]f the amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year." For an explanation of the reason for this amendment *see* S. REP. No. 938 (Part I), 94th Cong., 2d Sess. 172 (1976).

year" in section 665(e), applies as under the TRA '69.[69] The TRA '76 preserves the same limit on throw backs by "foreign trusts created by United States persons" that existed under the TRA '69—accumulation distributions cannot be thrown back prior to 1954.[70] Further, it preserves the same limit on the throw backs by trusts that are not foreign trusts created by United States persons—accumulation distributions of these trusts cannot be thrown back prior to 1969.

Although resulting in no discrimination against the foreign trusts, the computation of the beneficiary's tax under the throw back rules has been changed by the TRA '76. There is now a single method of computation that is similar to the old "short cut method" of the TRA '69. The new computation applies both to domestic and foreign trusts (regardless of who created the trusts). Tax credits or refunds on accumulation distributions to the beneficiary or the trust have also been abolished to some extent. The beneficiary in computing the partial tax under section 667 still receives credit for the amount of taxes paid by the trust because of accumulation.[71] But to the extent that the partial tax on the accumulation distribution is less than the amount of taxes deemed distributed, the beneficiary cannot use the excess to offset his tax liability on other sources of income, and he cannot receive a refund.[72] This restriction would seem to apply equally to foreign and domestic trusts, but one looseleaf tax service has asserted that it does not.[73]

Changes by the TRA '76 in the throw back of capital gains have put foreign trusts at a distinct disadvantage to domestic trusts. The new Act repealed the capital gains throw back rules of section 669, which applied only to trusts that were not "foreign trusts created by United States persons." Thus, for domestic trusts, there is no throw back of distributions of capital gains that have been accumulated by the trusts, and they will not be taxed to the beneficiary upon distribution.[74]

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69. *See* note 46 *supra* and accompanying text.

70. *See* note 46 *supra*. The TRA '76, however, repeals the definition of "foreign trusts created by a United States person" that existed under the Revenue Act of 1962, Pub. L. No. 87-834, § 7(a)(2), 76 Stat. 985.

71. I.R.C. § 667(b)(1).

72. *Id.* §§ 666(e), 667(b)(1).

73. [1976] 62 FED. TAXES (P-H) §§ 168-171.

74. Although the *beneficiary* is not taxed, the trust may be taxed under I.R.C. § 644. *See* note 80 *infra* and accompanying text.

While repealing the capital gains throw back on domestic trusts, the new Act causes the regular (section 666) throw back rules to apply to capital gains accumulation distributions of *all* foreign trusts. This was accomplished by modifying the definition of DNI. Under the TRA '69 the DNI of foreign trusts created by United States persons included net capital gains. Under the TRA '76, this rule has been extended to cover all foreign trusts—*i.e.*, in computing DNI of any foreign trust, net capital gains are included in DNI.[75] Thus, when any foreign trust makes an "accumulation distribution," capital gains will be thrown back to the preceding taxable years when there was UNI, just as was true for foreign trusts created by United States persons under the TRA '69. This inclusion of capital gains in DNI of the foreign trusts (resulting in their inclusion along with ordinary income in an accumulation distribution) results in their being taxed to the beneficiary while a similarly situated domestic trust's capital gains distribution might not be taxed at all.

After placing foreign trusts at a disadvantage by throwing back accumulation distributions of capital gain, Congress further handicapped them by amending the character rules. Under the TRA '76, current distributions of first tier and second tier income, to the extent of DNI, still retain their character.[76] But when the trust makes an accumulation distribution (which is thrown back to preceding years when there was UNI), the amount thrown back loses its character, except for interest that is tax exempt under section 103.[77] For example, capital gains that have been accumulated by a foreign trust lose their character as capital gains and become ordinary income, and when distributed to the beneficiary, he will not receive the benefit of the section 1202 deduction for capital gains.[78] The loss of character of income in the hands of the beneficiary upon an accumulation distribution applies to both domestic and foreign trusts, but because capital gains allocated to corpus are not included in the DNI of a domestic trust, they will not be affected by a loss of capital gains character.[79]

This advantage created in favor of a domestic trust when it makes a capital gain distribution is not tempered by the enact-

75. I.R.C. § 643(a)(6)(C).
76. *Id.* §§ 661(b), 662(b).
77. *Id.* §§ 667, 103.
78. S. REP. No. 938 (Part I), 94th Cong., 2d Sess. 222 (1976).
79. Non-resident alien beneficiaries apparently will suffer from the loss of character rules of I.R.C. § 667 when an accumulation distribution is made.

ment of section 644, which apparently applies to both foreign and domestic trusts. This new section creates the concept of "includable gain" in order to prevent the more blatant tax avoidance possibilities of income splitting between the grantor and the trust which were available after the repeal of the capital gains throw back rules.[80]

In addition to the advantage given domestic trusts by not subjecting them to capital gains throw back rules and a resulting loss of chracter as capital gains, the new Act also exempts these trusts from the ordinary throw back rule when the income was accumulated during the beneficiary's minority or before his birth. Section 665(b)(2) provides that "for purposes of section 667 . . ., the amounts specified in paragraph (2) of section 661(a) shall not include amounts properly paid, credited, or required to be distributed to a beneficiary from a trust (other than a foreign trust) as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21." Thus, accumulation distributions by foreign trusts cannot take advantage of this exemption.

As if the exemptions from the throw back rules provided to domestic trusts were not enough to dissuade the use of foreign accumulation trusts, Congress created a non-deductible interest charge in addition to the other taxes paid by the beneficiary if the foreign trust accumulates income.[81] The Senate Reports to the TRA '76 provide an example of how this interest charge is computed:

> [I]f amounts distributed in year 8 were earned in years 2, 3, and 4, the number of years for which interest is charged is determined first by calculating the number of years of accumulation for each year in which amounts distributed were originally earned (in this case 8 — 2 or 6 years for amounts earned in years 2, 8 — 3 or 5 years for amounts earned in year 4, and 8 — 4, or 4 years for amounts earned in year 4). The total of these number of years of accumulation (here 6 + 5 + 4 or 15 years) is then divided by the number of different years from which the amounts distributed were earned (three different years). The result (5 years) is the average number of years of accumulation and is multiplied by the 6 percent interest rate to produce the total percentage of interest (30%) which is applied against the amount of the tax.[82]

Once computed, this interest charge is merely added on to the

80. S. REP. No. 938 (Part I), 94th Cong., 2d Sess. 172 (1976).

81. *See* I.R.C. §§ 668, 667(a)(3).

82. S. REP. No. 938 (Part I), 94th Cong., 2d Sess. 221, n.14 (1976).

other taxes computed under the partial tax rules of section 667(a)(1)-(3).

These new rules discriminating against foreign accumulation trusts upon distribution remove any accumulation advantage that the foreign trust obtained over its domestic counterpart during accumulation. The desirability of this result is debatable.

VI. CONCLUSION

A good tax system contains three essential ingredients. First, it serves the revenue needs of the government. Second, it provides for administrative feasibility. Third, it provides for equity among taxpayers. Assuming that the new trust provisions serve the revenue needs of the government,[83] are the latter two criteria satisfied?

The TRA '69 created several provisions that were too difficult for fiduciaries to cope with, particularly the section 669 capital gains throw back rules, the alternative computation of the tax on amounts thrown back, and the throw back on minors. Realizing this problem, Congress set out to remedy this defect by repealing the section 669 capital gains throw back rule, creating a single method of computation for the tax on amounts thrown back, and exempting the accumulation distributions of domestic trusts during a beneficiary's minority or prior to his birth from the throw back rules. Thus, each of these amendments by the new Act will facilitate the administration of the income taxation of accumulation trusts.

Under the TRA '69, inequity among taxpayers clearly existed.[84] Those taxpayers who were informed of the tax avoidance possibilities of the foreign accumulation trust had a distinct advantage over similarly situated grantors who created domestic accumulation trusts. The TRA '76 attempts to (and surely does) remove any tax advantages that the foreign accumulation trust had over a domestic trust.

In the situation most susceptible of abuse prior to the TRA '76 (a foreign trust with United States grantor and United States beneficiaries), the new Act deems the trust to be a grantor trust.[85] As a rule of general applicability, this seems sensible, because one

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83. For a description of the anticipated revenue effects of the TRA '76, *see generally* H.R. REP. No. 658, 94th Cong., 2d Sess. 17 (1976).

84. This was true even though both the Revenue Act of 1962 and the TRA '69 sought to produce equitable treatment of similarly situated domestic and foreign accumulation trusts.

85. *See* text accompanying note 64 *supra*.

would think that few United States persons need to create a foreign accumulation trust for United States beneficiaries; domestic trusts usually will suffice. Unfortunately, however, where either the grantor or the beneficiary or both are United States persons[86] living abroad, a domestic trust may not be a feasible alternative,[87] and, depending on the number of persons falling within this category, the treatment of such a foreign trust as a grantor trust may create an unjustifiable inequity.

If the foreign trust is not a grantor trust under the Grantor Trust Provisions (sections 671-679), then the new Act creates several new disparities in the tax treatment between it and a corresponding domestic accumulation trust. Domestic accumulation trusts are no longer subjected to a capital gains throw back, while capital gains of foreign trusts are included in DNI, subject to throw back, and then taxed as ordinary income to the beneficiary because of the abolition of the character rules upon accumulation distribution. Foreign trusts are subjected to throw back of accumulation distributions even though the accumulation was during the beneficiary's minority or prior to his birth; domestic trusts are excepted from such throw back. Finally, foreign accumulation trusts are affirmatively penalized by the six percent interest charge on accumulation. Thus, in its fervor to end the tax avoidance possibilities of foreign accumulation trusts, Congress may have over-reacted, producing an unjustifiable inequity against those persons who, for non-tax reasons, need a foreign trust in their estate plan.

The result, then, of the TRA '76 seems to be an improvement in the administration of the income taxation of domestic trusts and, to a lesser extent, foreign trusts. Further, the clear accumulation advantage of the foreign trust has been removed, and the tables have now turned so as to possibly produce an inequitable favoring of domestic trusts. If such an inequity actually results from the new Act, the congressional solution has just become a new problem.

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86. I.R.C. § 7701(a)(30) defines the term "United States person." *See* note 62 *supra*.

87. For example, where the grantor is living abroad and desires to create an accumulation trust for his children, the creation of a foreign trust may result in substantial tax disadvantages.