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INTERNATIONAL LAW

Foreign Trusts: An Answer To the Capital Loss Debate

A foreign non-grantor trust's distributable net income should be computed with a net capital loss carryover

By Jack Brister, partner, Montrose Accounting Company, LLC, New York, N.Y.

The enactment of the Small Business Job Protection Act of 1996 expanded the differences in grantor trust rules for foreign and domestic trusts. At the same time, it narrowed the distributable net income (DNI) computation rules for foreign trusts. These changes leave little room for interpretation—with one major exception. Professionals are still debating if a foreign trust can carry over a net capital loss for the current year.

My view is that taxpayers should be able to compute a foreign non-grantor trust's DNI with the benefit of a net capital loss carryover.

Clearly, with the 1996 Small Business Act, Congress intended to treat foreign and domestic non-grantor trusts differently. But the distinctions codified in the act do not make clear whether a foreign non-grantor trust can utilize a net capital loss carryover against future capital gains. Instead, the answer can be found by analyzing the rules governing DNI, taxable income and other areas of the 1996 Small Business Act.

DNI

Under Internal Revenue Code Section 643(a), DNI is the starting point in computing the taxable income of a domestic trust. The components of DNI are the taxable income (as computed for an individual),¹ less distributions (to the extent taxable to the beneficiaries), an exemption, tax-exempt interest and capital gains²—provided the gains are allocated to the corpus. Gain from small business stock³ is ignored. Net capital losses for the current year up to \$3,000, are added back.⁴ (There are some other modifications that relate specifically to simple trusts, but are not applicable here.)

IRC Section 641(b) states that the taxable income of a trust is computed in the same manner as an individual's, but with certain modifications as prescribed by Section 643. It also states in the last sentence that a foreign trust or estate is taxed as a non-resident alien who is not present in the United States at any time. Some would argue that this last sentence—in conjunction with Section 871(a),⁵ which exempts most capital gains from the definition of U.S.-sourced income—precludes the use of a net capital loss carryover.

That is because the trust itself is a non-resident alien, therefore its DNI includes only U.S.-sourced income; and as capital gains are excluded from U.S.-sourced income, net capital losses also must be excluded. This reasoning seems logical, except that Section 643(a)(6) specifically states that foreign-sourced income and capital gains are a component of a foreign trust's DNI.⁶

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Before 1997 there was no statutory rule requiring a foreign trust or estate to be treated as a non-resident individual not present in the United States at any time. Because foreign trusts or estates were not automatically treated as if they were never present in the United States under the pre-1997 rules, their capital gains from U.S. sources other than an effectively connected trade or business were taxable if the trust or estate had been present in the United States for 183 days or more. The 1997 change merely solidified Congress' intent not to tax non-resident aliens on their U.S.-sourced capital gains other than those derived from operating a U.S. trade or business.⁷

Section 643(a)(6)(C) states that its subparagraph (a)(3), relating to the treatment of capital gains and losses as a component of DNI, is not applicable to a foreign trust. It also says that capital gains will be "reduced by capital losses to the extent such losses do not exceed gains." The IRC's specific language reflects Congress' intent to disallow a current year deduction with regard to foreign trusts. Still, this alone does not prove that the legislative intent is to disallow the utilization of net capital loss carryover.

Treasury department regulations related to

IRC Section 643 provide no more guidance than the code itself. One would think there'd be a ruling or an opinion by an authoritative body on the subject. But there is little on the treatment of capital gains and losses as it relates to computing the DNI of a domestic non-grantor trust. And there appears to be nothing specifically related to computing the DNI of a foreign trust that would help in making a comparative analysis and determining a reason for the different tax treatment.⁹

Instead, we are left to figure out for ourselves what the changes mean, and how they apply to a foreign non-grantor trust.

The Revenue Act of 1962 was when Section 643(a)(6)(C) was first enacted. Before then, a foreign trust was treated identically to a domestic trust with respect to capital gains and losses. All subsequent changes reflect Congress's intent to disallow any deduction for net capital losses.

In addition to Section 643, the trust rules in Section 642(h) allow a beneficiary to take excess deductions and unused capital loss carryovers pursuant to Section 1212(b) when a trust terminates. Nothing in the IRC or related Treasury department regulations states that the

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DOMESTIC VS. FOREIGN TRUST

What differentiates a domestic trust from a foreign trust?

The Small Business Job Protection Act of 1996 significantly changed the distinction between foreign and domestic grantor trusts. The legislation includes a more objective test, which is both stricter and easier to apply than prior law.¹ The new test states that a trust is treated as foreign unless a U.S. court can exercise primary supervision over the administration of the trust and one or more U.S. persons have the power to control all substantial decisions of the trust.

The Treasury Department issued additional clarification with regulations, finalized on Feb. 2, 1999,² defining "United States" as the 50 states and the District of Columbia; the other U.S. territories are not included. A safe harbor is provided if the trust is administered exclusively in the United States, no trust provision directs administration outside the United States, and the trust has no automatic change of situs clause—except in the event of foreign invasion or widespread confiscation of assets in the United States due to foreign invasion. If a person other than a trustee has substantial authority over trust

decisions, that person will be treated as the fiduciary for purposes of the control test. Such authority includes the power to terminate or revoke the trust; power of appointment over trust property and income; power over distributions; power to select beneficiaries; power over investment decisions; power to allocate receipts between income or principal; power to negotiate or arbitrate for the trust; power to defend and sue on the trust's behalf; and the power to add, change or name a successor trustee.

If a U.S. trustee suddenly resigns or dies, causing control to be shifted outside the jurisdiction of the United States, the trust has a 12-month grace period to reestablish U.S. control, either by changing fiduciaries or changing the residence of the fiduciaries. If no such changes are made within the grace period, the trust will be treated as a foreign trust.

—Jack Brister

Endnotes

1. IRC Section 7701(a)(30)(E) and subparagraph (31)(B).

2. Treasury reg. 301.7701-7.

TAXED DIFFERENTLY

What are the differences in the treatment of a foreign and domestic trust?

The non-resident alien settlor of a foreign grantor trust is taxed on its U.S.-sourced income, while the settlor of a domestic grantor trust is taxed on the trust's worldwide income. A foreign non-grantor trust includes capital gains as a component of its distributable net income, unlike a domestic non-grantor trust. Moreover, the foreign non-grantor trust cannot, without penalty, accumulate and later distribute its undistributed net income.

GRANTOR TRUSTS

If a trust is treated as foreign, it must be determined if the trust is a grantor trust or a non-grantor trust. Under Internal Revenue Code Section 672(f), a foreign trust, unlike a domestic trust, is deemed to be a grantor trust if it is revocable or if its distributions (income or corpus) are made only to the grantor or the grantor's spouse during their lifetimes.¹

If a trust is a foreign grantor trust, the non-resident alien settlor is subject to a flat 30 percent withholding tax² on any U.S.-sourced income. Tax treaties between the United States and other countries can alter these rates. Non-resident alien settlors of foreign grantor trusts, like U.S. persons, also are subject to income tax at the same graduated rates on U.S. trade or business income.³

U.S.-sourced income includes dividends from U.S. corporations, rent or gains from U.S. real property and real property holding companies, compensation for services performed in the United States, royalties and interest from U.S. debtors—but not the gains from U.S. corporate stocks.⁴ Interest on publicly traded bonds⁵ and bank interest, including time deposits and certificates of deposit, generally constitute "portfolio interest," which is exempt from the withholding tax.⁶

On the other hand, a domestic grantor trust is a U.S. person.⁷ The settlor is treated as the owner of the trust property⁸, and is taxed on the trust's worldwide income.⁹

NON-GRANTOR TRUSTS

If a foreign trust does not meet the standards of Section 672(f), it's taxed as a non-grantor trust, and the U.S. beneficiaries are treated as the grantors for income tax purposes.¹⁰

Under U.S. tax law, any distribution from a discretionary trust to beneficiaries carries with it distributable net income (DNI) to the extent of the trust's fiduciary accounting income.¹¹ Each beneficiary is treated as

receiving a proportionate share of the trust's DNI for that year, and any distributions in excess of DNI are used to reduce accumulated income. Distributions in excess of any accumulated income are treated as distributions of corpus and not subject to tax.

When a foreign non-grantor trust distributes less than the current DNI, which includes capital gains, the beneficiaries are taxed to the extent of the distributions which retain their character in proportion to the DNI, and the difference becomes undistributed net income (UNI).¹²

UNI, when distributed, carries with it negative consequences¹³ such as an accumulated distributions tax¹⁴ and an interest charge.¹⁵ Simply put, these rules are a mechanism to tax U.S. beneficiaries at their applicable ordinary income rate on the distributed UNI in the period it was earned. If UNI contains capital gains, these gains lose their character and will be taxed as ordinary income when distributed.

A foreign non-grantor trust's DNI includes net capital gains and foreign source income.¹⁶ Capital losses are allowed only to the extent of the capital gains,¹⁷ unlike a domestic trust, which is allowed a maximum current year deduction of \$3,000 when incurring a net capital loss.¹⁸

—Jack Brister

Endnotes

1. IRC Section 672(f)(2)(A)(i) and subparagraph (ii).
2. IRC Section 871(a)(1).
3. IRC Sections 871(b)(1) and 1 or 55.
4. IRC Section 871(a)(1)(A) through (D).
5. Only publicly traded bonds issued after July 18, 1984 are treated as portfolio interest.
6. IRC Section 871(h).
7. IRC Section 7701(a)(30).
8. IRC Section 671 treats the settlor as owner of the trust property for income tax purposes.
9. IRC Section 61(a).
10. Joint Committee Report, JCX-12-96.
11. IRC Section 643(b)..
12. IRC Section 665(a).
13. IRC Section 665-667 (commonly referred to as the "throw-back rules").
14. IRC Sections 665(b) and 667(b).
15. IRC Sections 668.
16. IRC Sections 643(a)(6)(A) and (C).
17. IRC Section 643(a)(6)(C).
18. IRC Section 1211(b) and 641(b).

beneficiary of a foreign trust is to be treated differently, nor does the history of changes to Section 642(h) suggest a different treatment.

Section 1212(a) permits a corporation to carry over net capital losses to offset future capital gains in subsequent tax years. Section 1212(b) allows a capital loss carryover for a taxpayer other than a corporation. Before the Revenue Act of 1964, the capital loss carryover rules applied equally to corporations and other taxpayers.¹⁴ There is nothing in the history of this section of the code that would imply a foreign trust is denied similar treatment. It also is logical that a foreign trust is a taxpayer¹⁵ other than a corporation, because this section does not define a corporation differently from the general definitions of the IRC¹⁶.

Additionally, in the enactment of the 1996 Small Business Act and subsequent legislation, Congress has not implied that a foreign trust is exempt from the carryover treatment as accorded a taxpayer other than a corporation. Therefore, it appears that Congress' silence implies that a foreign non-grantor trust is within the definition of a taxpayer other than a corporation, and is allowed the same net capital loss carryover treatment.

Finally, it should be noted that the primary reason for most of the provisional changes made by the 1996 Small Business Act, as noted in the Joint Committee Report JCX-12-96, was to ensure that U.S. persons receiving an economic benefit by way of a distribution from a foreign trust would not escape taxation.¹⁷

Congress has made it very clear throughout the code that domestic non-grantor trusts are taxed some-

There is nothing to imply that Congress intentionally exempted foreign trusts from the carryover treatment accorded to non-corporate taxpayers.

what differently than foreign non-grantor trusts. A principal difference is that foreign non-grantor trusts are not allowed a current year deduction for net capital losses, but rather only allowed to offset capital gains to the extent of net capital losses.

It is also well founded that Congress specifically passed legislation to ensure that U.S. citizens receiving distributions from foreign trusts do not escape U.S. taxation, and the lawmakers have shown no intention to disallow a net capital loss carryover by enactment of any prior or present legislation. There have been no regulations, court rulings or other authoritative rulings suggesting that a foreign non-grantor trust is exempt from the carryover rules of Section 1212(b).

Until legislation is enacted or an authoritative ruling states a contrary position, taxpayers should be able to compute a foreign non-grantor trust's DNI with the benefit of a net capital loss carryover. **I**

Endnotes

1. IRC Section 641(b).
2. IRC Section 643(a)(3).
3. IRC Section 1202.
4. See note 2.
5. IRC Section 871(a)(1)(B).
6. IRC Section 643(a)(6)(C).
7. IRC Section 871(b).
8. IRC Section 643(a)(3).
9. IRC Section 643(a)(6)(C).
10. Revenue Act of 1962 (P.L. 87-834 section 7).
11. Tax Reform Act of 1976 (P.L. 94-455 section 1013(c)(i) and Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239 section 7811(b)(1)).
12. IRC Section 642(h)(1).
13. Tax Reform Act of 1976 [P.L. 94-455 section 1906(b)(13)(A)].
14. Revenue Act of 1964 [P.L. 88-272 section 230(a)].
15. There may be some fact patterns in which a foreign trust would not be a taxpayer as defined in IRC Section 7701(a)(14).
16. IRC Section 7701(a)(3) and Treasury regulation 301.7701-2(b).
17. Joint Committee On Taxation, General Explanation of Tax Legislation Enacted by the 104th Congress (JCS-12-96), Dec. 18, 1996; 4. PART FOUR: REVENUE PROVISIONS OF THE SMALL BUSINESS JOB PROTECTION ACT OF 1996 (H.R. 3348): V.. REVENUE OFFSETS: 20. Modify treatment of foreign trusts (sec. 1901-1907); Reasons for Change; "The Congress was informed that prior law's U.S. grantor trust provision were being used as a vehicle to avoid U.S. tax. Under the grantor rules, only the owner of the trust (and not the trust's beneficiaries) is subject to U.S. tax on the trust's income. Thus, under prior law, if a foreign person created a trust with U.S. beneficiaries that was treated as a grantor trust for U.S. tax purposes and if the foreign person's home country did not tax the income, the income of the trust would not be subject to tax by either jurisdiction. The Congress believed that the income derived through these types of arrangements should be subject to tax by at least one jurisdiction."

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Montrose Accounting Company



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505 Park Avenue, 20th Floor
New York, NY 10022
(212) 888-5959
Fax: (212) 888-4018
www.montroseaccounting.com
E-mail: info@montroseaccounting.com