



# Internal Revenue Service

DEPARTMENT OF THE TREASURY

## LB&I Process Unit

<b>Unit Name</b>	Taxation of Beneficiary of a Foreign Non-Grantor Trust	
<b>Primary UIL Code</b>	9434	Pass Thru Entities

<b>Library Level</b>	<b>Title</b>
<b>Knowledge Base</b>	International
<b>Shelf</b>	Individual Outbound
<b>Book</b>	Pass Thru Entities
<b>Chapter</b>	Individuals with an Interest in a Foreign Non-Grantor Trust

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# Table of Contents

*(View this PowerPoint in “Presentation View” to click on the links below)*

## [Process Overview](#)

## [Summary of Process Steps](#)

- [Step 1](#) – Determine if Distribution of Income is to a Beneficiary
- [Step 2](#) – Determine if Default Calculation is Required
- [Step 3](#) – Determine the Type of Foreign Non-grantor Trust
- [Step 4](#) – Determine Beneficiary’s Share of DNI
- [Step 5](#) – Determine Accumulated Income, Tax, and Interest

# Table of Contents (cont'd)

*(View this PowerPoint in "Presentation View" to click on the links below)*

[Examples of the Process](#)

[Other Considerations / Impact to Audit](#)

[Index of Referenced Resources](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Practice Units](#)

# Process Overview

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

A trust classified as a foreign trust will be treated as either a “foreign grantor trust” or a “foreign non-grantor trust” for United States (U.S.) tax purposes. This distinction is important because it affects who is taxed on the trust income and when they are taxed. The rules administering foreign trust income taxation encompass both the domestic trust income taxation rules and the nonresident alien individual’s income taxation rules. If a foreign trust is characterized as a grantor trust under Internal Revenue Code (IRC) 671–679, the grantor or another person is treated as the owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes under the grantor trust rules, then generally a distribution to a beneficiary is a non-taxable transaction to the beneficiary. Any foreign trust not determined to be a grantor trust under IRC 671-679 will be treated as a foreign non-grantor trust for U.S. tax purposes.

A beneficiary of a foreign non-grantor trust may be liable for U.S. tax on distributions of income (current and accumulated) from the trust. Foreign non-grantor trust corpus distributions are not taxable to a beneficiary. Therefore, the examiner must determine whether the beneficiary’s distribution is income or principal (corpus). Further, the examiner must determine whether the trust is a simple trust or a complex trust in order to determine the extent and type of income distribution. This determination helps the examiner generate the beneficiary’s income distribution calculation for U.S. income tax purposes which will provide the amount and type of income taxable to the beneficiary. Finally, the U.S. income tax consequences of an income distribution to the beneficiaries of a foreign non-grantor trust depend upon whether the distribution represents current income, Distributable Net Income (DNI) or accumulated income, Undistributed Net Income (UNI); whether the beneficiary is a U.S. person or a foreign person; and whether the trust’s income is U.S. source or foreign source.

This process unit will provide an overview of the steps needed to determine how to tax a beneficiary of a foreign non-grantor trust on distributions received from the trust. Examples of circumstances under which this process applies include:

- A U.S. beneficiary receives a distribution of income from a foreign non-grantor trust. The U.S. beneficiary will generally be taxed on his or her share of DNI of the trust. The U.S. beneficiary receiving distributions from the foreign non-grantor trust is taxed similarly to a U.S. beneficiary receiving distributions from a domestic non-grantor trust, although the calculation of DNI is slightly different for a foreign trust.
- A foreign beneficiary receives a distribution of income from a foreign non-grantor trust. The foreign beneficiary may be subject to U.S. tax on trust income from U.S. sources. The tax is based on the beneficiary’s share of U.S. source DNI.

# Process Overview (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

Prior to using this Practice Unit, the examiner should refer to the Practice Unit “Defining the Entity - Foreign Trusts” to determine that a foreign trust exists. Then determine whether a foreign trust is treated as a foreign grantor trust for U.S. tax purposes by referring to Practice Unit “Foreign Trust Determination - Part I - Section 679”. Even if the foreign trust is not a foreign grantor trust for U.S. income tax purposes under IRC 679, in rare circumstances, the foreign trust may still be treated as a foreign grantor trust under IRC 673-678 as discussed in the Practice Unit “Foreign Grantor Trust Determination - Part II - Sections 671-678”. Once these Practice Units have been reviewed and a determination is made that a foreign non-grantor trust exists, use this Practice Unit to determine the taxation of beneficiaries of a foreign non-grantor trust.

# Summary of Process Steps

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Process Steps

Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the trust income and when they are taxed. Any foreign trust not determined to be a grantor trust under IRC 671-679 will be treated as a foreign non-grantor trust for U.S. tax purposes. If a trust is a foreign non-grantor trust, the trust itself is a taxable entity, and a U.S. or foreign beneficiary may be liable for U.S. tax on a distribution from the trust. The process to determine taxable income of a beneficiary of a foreign non-grantor trust is captured in the steps below.

<a href="#">Step 1</a>	Determine if Distribution of Income is to a Beneficiary
<a href="#">Step 2</a>	Determine if Default Calculation is Required
<a href="#">Step 3</a>	Determine the Type of Foreign Non-grantor Trust
<a href="#">Step 4</a>	Determine Beneficiary's Share of DNI
<a href="#">Step 5</a>	Determine Accumulated Income, Tax, and Interest

# Step 1: Determine Distribution of Income to a Beneficiary

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Step 1

Determine if a foreign non-grantor trust made a distribution of trust income to a beneficiary.

Considerations	Resources
<p>Income not distributed by a foreign non-grantor trust is taxed to the trust while income distributed to the beneficiary is taxed to the beneficiary. A foreign non-grantor trust may distribute the following income and non-income items to its beneficiary(s):</p> <ul style="list-style-type: none"><li>▪ Trust income, which includes:<ul style="list-style-type: none"><li>- Foreign sourced income,</li><li>- U.S. or foreign source income effectively connected with the conduct of a U.S. trade or business (ECI),</li><li>- Other U.S. sourced income,</li><li>- Gains from sale of U.S. real property.</li></ul></li><li>▪ Gift or bequest not paid from trust income, which includes:<ul style="list-style-type: none"><li>- Specific sum of money,</li><li>- Specific property.</li></ul></li><li>▪ Trust corpus<ul style="list-style-type: none"><li>- Corpus is defined as the principal sum or capital of a trust.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ IRC 661-663</li> <li>▪ IRC 663(a)</li>  <li>▪ IRC 872(a)</li><li>▪ IRC 651(b)</li><li>▪ IRC 661(a)</li></ul>

# Step 1: Determine Distribution of Income to a Beneficiary (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 1](#)


Considerations	Resources
<ul style="list-style-type: none"> <li>▪ A U.S. beneficiary's share of the trust's DNI must be included in the beneficiary's income for U.S. tax purposes in the year of a distribution from the trust. In addition, if the U.S. beneficiary receives a distribution of a portion of the trust's UNI, it is taxable to the beneficiary in the year of receipt, accounting for the accumulation under the throwback tax regime.</li> <li>▪ A foreign beneficiary receiving an income distribution must include the beneficiary's share of the trust's U.S. sourced DNI.</li> <li>▪ Generally, distributions of trust corpus and gifts or bequests of specific property as specified in the trust instrument are generally not taxable to a beneficiary. However, when a foreign non-grantor trust distributes trust income, the distribution may be taxable to the beneficiary. U.S. source income and ECI not distributed by a foreign non-grantor trust is taxed to the trust.</li> </ul> <p>Items to review and request to aid in determining if a distribution was made from trust income include:</p> <ul style="list-style-type: none"> <li>▪ Form 3520: A U.S. person is required to file a Form 3520 if the person receives a distribution from a foreign trust. A distribution includes cash, non-cash property, certain loans, or the uncompensated use of trust assets credited for the beneficiary's benefit.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 667(a)</li> <li>▪ IRM 3.13.2-7 - Definition of Entities</li> <li>▪ IRM 21.7.13.5.8.1 - Definition: Trusts</li> <li>▪ IRC 662(a)</li> <li>▪ Treas. Reg. 1.679-2(a)(4)(i)</li> <li>▪ IRC 6048(c)</li> </ul>



# Step 1: Determine Distribution of Income to a Beneficiary (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 1](#)

Considerations	Resources
<p>Net losses and capital losses of a trust cannot be distributed to a beneficiary unless it is in the termination year of a trust and even then, only certain types of unused carryover losses can be distributed according to IRC 642(h).</p> <p> <b>CAUTION:</b> Disallow losses to a beneficiary from a foreign non-grantor trust from Schedule K-1 in a non-termination year.</p>	<ul style="list-style-type: none"><li>▪ IRC 643(a)</li><li>▪ Treas. Reg. 1.643(a)-3</li><li>▪ IRC 642(h)</li></ul>

# Step 1: Determine Distribution of Income to a Beneficiary (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

[Step 1](#)

Considerations	Resources
<div style="background-color: black; width: 100%; height: 100%; min-height: 300px;"></div> <div style="position: absolute; top: 5px; left: 5px; color: red; font-weight: bold;">#</div> <div style="position: absolute; bottom: 5px; right: 5px; color: red; font-weight: bold;">#</div>	<ul style="list-style-type: none"> <li style="margin-top: 150px;">▪ Notice 97-34</li> </ul>

# Step 1: Determine Distribution of Income to a Beneficiary (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 1](#)


Considerations	Resources
# [Redacted]	
[Redacted]	
[Redacted] #	

# Step 2: Determine if Default Calculation is Required

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Step 2

Determine if a beneficiary must use the default calculation for trust distributions.

Considerations	Resources
<p>Trust distributions to a beneficiary can be comprised of current income and accumulated income. This information is needed to determine how the beneficiary will be taxed.</p> <p>A beneficiary is allowed to complete Form 3520, Part III, Schedule B, Actual Calculation of Trust Distributions, when the beneficiary has sufficient information to complete the Schedule or they can still choose to use Schedule A, Default Calculation of Trust Distributions. If completing Schedule B, the beneficiary should have marked “yes” to Form 3520, Part III, line 30 and attached a Foreign Non-grantor Trust Beneficiary Statement to the Form 3520. Many beneficiaries do not have sufficient information to complete Schedule B.</p> <p>Beneficiaries that do not receive a Foreign Non-grantor Trust Beneficiary Statement from the foreign trust with respect to a distribution or that do not have sufficient information to complete Form 3520, Part III, Schedule B, about the trust’s income and distributions, must use the default calculation of trust distributions to determine their ordinary and accumulation distribution income from the foreign non-grantor trust. The default calculation of trust distributions is reported on Form 3520, Part III, Schedule A.</p> <p> <b>CAUTION:</b> Generally, once the beneficiary uses the default calculation, they should continue to use it for all future years, with an exception in a trust termination year.</p>	<ul style="list-style-type: none"><li>▪ IRC 665-668</li> <li>▪ Form 3520</li><li>▪ Form 3520 Instructions</li></ul>

# Step 2: Determine if Default Calculation is Required (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 2](#)

Considerations	Resources
<p>The purpose of Schedule A is to provide a calculation of the current income and accumulation distribution in the event a beneficiary lacks complete information to generate an accurate income and accumulation distribution tax figure.</p> <p>If the beneficiary receives a Foreign Non-grantor Trust Beneficiary Statement from the trust, then the beneficiary may complete Form 3520, Schedule B, but only if they have not previously used the default calculation of trust distributions on Schedule A or it is the year of termination of the trust. If the beneficiary has completed Schedule B and you determine that the beneficiary is allowed to complete Schedule B, then skip the remainder of Step 2 and proceed to Step 3.</p> <p>A Foreign Non-grantor Trust Beneficiary Statement is not a formal Internal Revenue Service document. Items that the Beneficiary Statement must contain are listed in the Form 3520 Instructions and include:</p> <ul style="list-style-type: none"><li>▪ The trust's basic identifying information and the first and last day of the tax year to which the statement applies,</li><li>▪ A description and fair market value of property distributed,</li><li>▪ A statement regarding whether the trust appointed a U.S. agent.<ul style="list-style-type: none"><li>- If the trust did not appoint a U.S. agent, there must be a statement that the trust will permit either the IRS or the U.S. beneficiary to inspect and copy the trust's books and records to determine the U.S. tax treatment of any distribution or deemed distribution.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ Form 3520 Instructions</li><li>▪ Notice 97-34</li></ul>

# Step 2: Determine if Default Calculation is Required (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 2](#)

Considerations	Resources
<ul style="list-style-type: none"><li>▪ An explanation or sufficient information regarding the appropriate U.S. tax treatment of any distribution or deemed distribution, and</li><li>▪ A statement identifying whether any grantor of the trust is a partnership or a foreign corporation.</li></ul> <p>If the beneficiary used or was required to use the default calculation for trust distributions, Form 3520, Part III, Schedule A:</p> <ul style="list-style-type: none"><li>▪ Ensure the beneficiary's income tax return reported the amount on Schedule A, line 36 of the Form 3520 as income, as an example, on Form 1040 the income would be reported on Schedule E, Part III, Income or Loss from Estates and Trusts,</li><li>▪ Skip Steps 3 and 4 of this Practice Unit, and</li><li>▪ Move to Step 5 to calculate the accumulation distribution tax and interest charge if Form 3520, Schedule A, line 37 is more than zero or the total distributions received during the current tax year are more than the amount treated as ordinary income earned in the current year.</li></ul>	<ul style="list-style-type: none"><li>▪ Form 3520</li><li>▪ Form 3520 Instructions</li></ul>

# Step 3: Determine Type of Foreign Non-grantor Trust

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Step 3

Determine the type of foreign non-grantor trust (simple or complex) if the beneficiary did not use the default calculation for trust distributions, Form 3520, Part III, Schedule A.

Considerations	Resources
<p>Once it has been determined that a foreign non-grantor trust made an income distribution to a beneficiary and the beneficiary did not use the default calculation for the distribution as described in Step 2, determine whether the trust is a simple trust or a complex trust.</p> <p><u>Simple or Complex Foreign Non-Grantor Trusts</u></p> <ul style="list-style-type: none"> <li>▪ A Simple Trust receives a distribution deduction for current year income, limited by DNI, and that income is taxed to the beneficiary.               <ul style="list-style-type: none"> <li>– A trust is a simple trust under IRC 651 if under the trust terms it:                   <ul style="list-style-type: none"> <li>▪ Is required to distribute all income in the year in which it's earned, whether or not the income is in fact distributed,</li> <li>▪ Makes no distributions other than current income, and</li> <li>▪ No amounts can be paid or set aside for charitable, or other purposes.</li> </ul> </li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 651</li> <li>▪ Treas. Reg. 1.651(a)-1</li> <li>▪ IRM 21.7.13.5.8.1 - Definition: Trusts</li> <li>▪ IRC 652</li> <li>▪ IRC 661</li> <li>▪ Treas. Reg. 1.661(a)-1</li> <li>▪ IRC 642(c)</li> <li>▪ IRC 662</li> <li>▪ IRC 666-668</li> </ul>

# Step 3: Determine Type of Foreign Non-grantor Trust (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 3](#)

Considerations	Resources
<p data-bbox="87 504 872 536"><u>Simple or Complex Foreign Non-Grantor Trusts (cont'd)</u></p> <ul data-bbox="87 575 1404 1032" style="list-style-type: none"><li data-bbox="87 575 1404 718">▪ A Complex Trust receives a distribution deduction of the current income required to be distributed plus any other amounts properly paid, credited, or required to be distributed for the tax year limited by the trust's DNI. This amount is included in the gross income of the beneficiary.<ul data-bbox="111 736 1404 1032" style="list-style-type: none"><li data-bbox="111 736 1404 1032">– A trust is a complex trust if it does not qualify as a simple trust for a tax year, including:<ul data-bbox="157 772 1404 1032" style="list-style-type: none"><li data-bbox="157 772 1404 953">▪ Having the power to accumulate, or accumulating income instead of distributing it yearly to its beneficiaries,<ul data-bbox="182 851 1404 953" style="list-style-type: none"><li data-bbox="182 851 1404 953">– Accumulated income is designated as an accumulation distribution upon distribution and additional taxes may be required under IRC 666-668, see Step 5 of this Practice Unit.</li></ul></li><li data-bbox="157 965 1404 996">▪ Having the power to make or making a charitable contribution, or</li><li data-bbox="157 1001 1404 1032">▪ Distributing principal to its beneficiaries.</li></ul></li></ul></li></ul>	<ul data-bbox="1423 711 1607 789" style="list-style-type: none"><li data-bbox="1423 711 1607 742">▪ IRC 667(a)</li><li data-bbox="1423 753 1607 789">▪ IRC 667(e)</li></ul>



**CAUTION:** A trust may be a simple trust for one year and a complex trust in another year.



# Step 3: Determine Type of Foreign Non-grantor Trust (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 3](#)

Considerations	Resources
<p><u>Simple or Complex Foreign Non-Grantor Trusts (cont'd)</u></p> <ul style="list-style-type: none"><li>▪ Whether a trust is a simple or a complex trust affects the beneficiary's taxable income from a trust distribution and calculation of the trust's distribution deduction.</li><li>▪ The trust's DNI limits the amount included in the gross income of the beneficiary and the corresponding deduction of the trust for a simple or complex trust.<ul style="list-style-type: none"><li>– All the income of a simple trust will be taxed to the beneficiaries receiving distributions, and the trust will receive a deduction for its current income whether or not that income is actually distributed.</li><li>– A beneficiary of a complex trust includes all the income that the trust is required to distribute to the beneficiary pursuant to the governing instrument and any other amounts distributed to the beneficiary.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ IRC 643(h)</li><li>▪ Treas. Reg. 1.643(h)-1</li></ul>

# Step 3: Determine Type of Foreign Non-grantor Trust (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 3](#)

Considerations	Resources
<p><u>Simple or Complex Foreign Non-Grantor Trusts (cont'd)</u></p> <ul style="list-style-type: none"> <li>▪ Generally, distributions include indirect distributions from a foreign trust to U.S. persons by persons who have received property from a foreign trust.</li> <li>▪ IRC 643(i) specifies that a loan from a foreign trust (in cash or marketable securities) directly or indirectly to a U.S. beneficiary or someone related to a U.S. beneficiary is treated as a distribution.</li> <li>▪ A loan is treated as a distribution unless it is considered a “qualified obligation.”</li> <li>▪ IRC 643(i) also provides that the uncompensated or undercompensated use of a foreign non-grantor trust’s property by a U.S. beneficiary is treated as an indirect distribution to the U.S. beneficiary, to the extent of the fair market value of the use, limited by the trust’s DNI and UNI.</li> </ul> <p>The issue of whether a foreign non-grantor trust is simple or complex directly relates to the calculation of trust distributions figured on the Form 3520, Part III, Schedule B, Lines 40a – 46 and reported on the beneficiary’s income tax return.</p> <p>If the trust is a simple trust and had only one beneficiary an examiner could expect the amount the beneficiary treated as income as calculated on Form 3520, Part III, line 40 to equal the trust’s current year income before its distribution deduction if the trust’s DNI did not limit the distribution.</p>	<ul style="list-style-type: none"> <li>▪ IRC 643(i)</li> <li>▪ Notice 97-34</li> <li>▪ Form 3520</li> </ul>

# Step 3: Determine Type of Foreign Non-grantor Trust (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 3](#)

Considerations	Resources
<p data-bbox="84 504 872 536"><u>Simple or Complex Foreign Non-Grantor Trusts (cont'd)</u></p> <ul data-bbox="84 572 1396 682" style="list-style-type: none"><li data-bbox="84 572 1396 682">▪ If the trust is a complex trust an examiner should determine if the income amounts reported on Form 3520, Part III, line 40 include the amounts the trust was required to distribute and any other amounts distributed, limited by the trust's DNI.</li></ul> <p data-bbox="84 725 1406 908">For example, if the examiner determines that the beneficiary incorrectly treated the trust as a complex trust when the trust was a simple trust, the examiner's determination and resulting change to the Form 3520, Part III, will affect one or more of the Lines 40a – 46 and the income reported on the beneficiary's income tax return depending upon the facts and circumstances.</p> <p data-bbox="84 951 1386 993"># [REDACTED]</p> <p data-bbox="84 1036 866 1079">[REDACTED]</p> <p data-bbox="84 1122 1253 1165">[REDACTED]</p> <p data-bbox="84 1208 1253 1250">[REDACTED] #</p>	

# Step 3: Determine Type of Foreign Non-grantor Trust (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 3](#)

Considerations	Resources
# [REDACTED]	

# Step 4: Determine Beneficiary's Share of DNI

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Step 4

Determine a beneficiary's share of the foreign non-grantor trust's DNI to determine whether there is a limitation on inclusion of the distribution in the beneficiary's gross income.

Considerations	Resources
<p>Taxable distributions of a foreign non-grantor trust are limited by the trust's income. A distribution from a foreign non-grantor is comprised of, in order: (1) DNI to extent of DNI, then (2) UNI to the extent of UNI, and then (3) trust principal. Distributions of DNI are reflected directly in the U.S. beneficiary's Form 1040 as items of income, and distributions of UNI are considered separately to arrive at an accumulation distribution tax amount. A foreign trust's DNI includes both U.S. and foreign-source income. DNI for a foreign trust is the taxable income of the trust with the following modifications:</p> <ul style="list-style-type: none"><li>▪ No distribution deduction is taken.</li><li>▪ No personal exemption is taken.</li><li>▪ Capital gains are included, reduced by losses from sales or exchanges of capital assets, to the extent such losses do not exceed gains.</li><li>▪ For simple trusts, which by definition do not distribute any amounts other than current income, extraordinary dividends or taxable stock dividends are not included, unless the dividends are allocable to corpus.</li><li>▪ Tax-exempt interest is included, reduced by any amounts which would be deductible if not disallowed.</li><li>▪ Plus or minus any adjustment needed related to abusive transactions.</li></ul>	<ul style="list-style-type: none"><li>▪ IRC 643(a)</li><li>▪ Treas. Reg. 1.643(a)-1 to Treas. Reg. 1.643(a)-7</li> <li>▪ IRC 265</li></ul>

# Step 4: Determine Beneficiary's Share of DNI (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 4](#)

Considerations	Resources
<p>A foreign trust specifically includes U.S. source income determined without regard to IRC 894, relating to income exempt under treaty. Therefore, income excluded from tax due to a tax treaty is included as income for purposes of calculating DNI.</p> <p>Many foreign non-grantor trusts have non-U.S. source income which means an examiner must be aware of and inquire about this income.</p> <p>Once an examiner has determined the beneficiary's share of the trust's DNI, it should be compared with the beneficiary's taxable income inclusion reflected directly on Form 1040 to determine if the income inclusion was limited by DNI. This step directly relates to Form 3520, Part III, lines 40a to 46 of Schedule B. If the examiner determines that the beneficiary calculated DNI incorrectly, this error could directly affect one or more of the lines 40a to 46 and the income required to be reported on the beneficiary's income tax return.</p> <p>If there was a distribution to the beneficiary in excess of the beneficiary's share of income or DNI move to Step 5 to determine if there was an accumulated income (UNI) distribution.</p>	<ul style="list-style-type: none"> <li>▪ IRC 643(a)(6)(B)</li> <li>▪ IRC 894</li> <li>▪ Treas. Reg. 1.894-1</li>   <li>▪ Form 3520</li> </ul>

# Step 5: Determine Accumulated Income, Tax, and Interest

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Step 5

Determine whether any distribution in excess of a beneficiary's share of income or DNI is a distribution of accumulated income and if so, the related income tax and interest that applies.

Considerations	Resources
<p>A complex trust may accumulate income from one year to the next instead of distributing it. When income accumulated from prior years is distributed, a U.S. beneficiary of a foreign non-grantor trust may be required to calculate additional taxes under IRC 665-668, referred to as an accumulation distribution tax. The accumulation distribution tax ensures income not distributed currently would be imposed with a tax and interest charge, therefore approximating the tax imposed on current income distributions as though the distributions were made in a prior year. Note that these rules apply only to distributions from a foreign trust received by a U.S. beneficiary.</p> <p>Form 3520, Part III, Schedules A, B, and C assist U.S. beneficiaries with applying the accumulation distribution rules in IRC 665-668 and calculating the accumulation distribution tax amount due.</p> <ul style="list-style-type: none"><li>▪ Schedule A, Default Calculation of Trust Distributions, provides a calculation for beneficiaries using the default calculation method as discussed in Step 2 of this Practice Unit. The total current year foreign trust distributions received by the beneficiary less an average distribution calculation yields the amount treated as an accumulation distribution.<ul style="list-style-type: none"><li>- Note: A beneficiary may have no accumulation distribution but be subject to the accumulation distribution tax because the beneficiary does not have sufficient information to substantiate that it is not subject to the accumulation distribution tax.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ IRC 665-668</li>          <li>▪ Form 3520</li></ul>

# Step 5: Determine Accumulated Income, Tax, and Interest (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 5](#)

Considerations	Resources
<ul style="list-style-type: none"> <li>- When a beneficiary does not receive a Foreign Non-grantor Beneficiary Statement, it is required to complete Schedule A, Part III of Form 3520 which can generate an accumulation distribution tax regardless of whether or not the beneficiary received an accumulation distribution and regardless of whether or not the foreign trust had undistributed net income.</li> <li>▪ Schedule B, Actual Calculation of Trust Distributions, is used to calculate trust distributions for beneficiaries not using the default calculation method. The amount treated as an accumulation distribution and undistributed net income, UNI, is calculated separately by the beneficiary and entered on Form 3520, Part III, Schedule B, line 41a and line 45, respectively.</li> <li>▪ Schedule C, Calculation of Interest Charge, in combination with Form 4970, Tax on Accumulation Distribution of Trusts, are used to calculate the accumulated distribution tax and interest which should be included in the beneficiary's income.</li> </ul> <p>Determine if the beneficiary correctly calculated any accumulation distribution and UNI, and properly reported it on Part III of Form 3520.</p> <p>If the beneficiary is using Schedule B instead of the default calculation in Schedule A, they must calculate the accumulation distribution tax if they have an accumulation distribution.</p>	<ul style="list-style-type: none"> <li>▪ Form 4970</li>            <li>▪ Form 3520</li> </ul>



# Step 5: Determine Accumulated Income, Tax, and Interest (cont'd)

2

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 5](#)

Considerations	Resources
<p>The beneficiary's accumulation distribution calculation that supports the amount entered on Form 3520, Part III, Schedule B, line 41a, Amount treated as accumulation distribution, and Schedule C, line 48, Accumulation distribution, is calculated as follows:</p> <ul style="list-style-type: none"><li>▪ Accumulated distribution calculation<ul style="list-style-type: none"><li>– Total distributions to a beneficiary in the current tax year<ul style="list-style-type: none"><li>▪ Less:<ul style="list-style-type: none"><li>– Current year income distributions required to be distributed</li><li>– Gifts included in the total distribution</li><li>– Bequests included in the total distribution</li><li>– Charitable contributions included in the total distribution</li></ul></li></ul></li><li>– Equals: Total Other Distributions<ul style="list-style-type: none"><li>▪ Less:<ul style="list-style-type: none"><li>– DNI of the trust less the income required to be distributed currently (but not below zero)</li></ul></li></ul></li><li>– Equals: Accumulation Distribution</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ IRC 665(b)</li><li>▪ Treas. Reg. 1.665(b)-1A</li> <li>▪ IRC 661(a)</li></ul>

# Step 5: Determine Accumulated Income, Tax, and Interest (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Step 5

Considerations	Resources
<ul style="list-style-type: none"> <li>▪ Example: A trust's DNI is \$10,000. The current income required to be distributed currently is 60% of DNI. Total distributions other than gifts, bequests, and charitable contributions were \$15,000.               <ul style="list-style-type: none"> <li>– Total distribution: \$15,000                   <ul style="list-style-type: none"> <li>▪ Less: Income required to be distributed currently: \$6,000 (<math>\\$10,000 \times 60\%</math>)</li> <li>▪ Less: Gifts, bequests, and charitable contributions distributed currently: \$0</li> </ul> </li> <li>– Equals: Total other distributions: \$9,000 (<math>\\$15,000 - \\$6,000</math>)                   <ul style="list-style-type: none"> <li>▪ Less: \$4,000 (DNI of \$10,000 less income required to be distributed currently of \$6,000)</li> </ul> </li> <li>– Equals: Accumulation Distribution of \$5,000 (Total other distributions of \$9,000 less \$4,000 of DNI subtracted by income required to be distributed currently)</li> </ul> </li> </ul> <p>When using Form 3520, Schedule B, the beneficiary must also calculate the foreign trust's aggregate and weighted average UNI in respect of the distribution to the beneficiary. UNI is defined and calculated as follows:</p> <ul style="list-style-type: none"> <li>▪ UNI is the amount by which a trust's DNI for the taxable year exceeds the sum of amounts distributed under IRC 661(a)(1) &amp; (2) (amount of current income required to distributed currently and other amounts properly paid or credited or required to be distributed for such taxable year) and the amount of taxes imposed on the trust attributable to DNI.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 665(b)</li> </ul>

# Step 5: Determine Accumulated Income, Tax, and Interest (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 5](#)

Considerations	Resources
<ul style="list-style-type: none"><li>- Example: A trust's DNI is \$100. The current income required to be distributed is 60% of DNI (<math>\\$100 \times 60\% = \\$60</math>). All other amounts distributed (other than gifts, bequests, and charitable contributions) was \$10. The tax imposed on the trust attributable to DNI is \$9.<ul style="list-style-type: none"><li>▪ DNI \$100<ul style="list-style-type: none"><li>- Less: Income required to be distributed currently: <math>\\$60 (\\$100 \times 60\%)</math></li><li>- Less: Other amounts paid, credited, or required to be distributed: \$10</li><li>- Less: Taxes imposed on trust attributable to DNI: \$9</li></ul></li><li>▪ Equals: UNI \$21 (<math>\\$100 - \\$60 - \\$10 - \\$9</math>)</li></ul></li></ul> <p>The UNI must be calculated for each year since the foreign trust was created and aggregated. This aggregated total must be entered on Form 3520, Part III, Schedule B, line 45, Amount of foreign trust's aggregate undistributed net income.</p> <p>The UNI must also be weighted for the years the foreign trust has accumulated income and entered on Form 3520, Part III, Schedule B, line 46. The Form 3520 Instructions have a detailed example of the calculation. This weighted UNI amount is then divided by the trust's aggregate UNI to arrive at an applicable number of years which is used in the calculation of an interest charge.</p> <p>Determine if the beneficiary correctly calculated the accumulation distribution tax and the accumulation distribution interest charge.</p>	<ul style="list-style-type: none"><li>▪ Form 3520 Instructions</li></ul>

# Step 5: Determine Accumulated Income, Tax, and Interest (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Step 5

Considerations	Resources
<p>The accumulated distribution tax and interest charge are entered on Form 3520, Part III, Schedule C, Calculation of Interest Charge. The accumulated distribution tax is calculated on Form 4970, Tax on Accumulation Distribution of Trusts, if there is an amount treated as an accumulated distribution on Form 3520, Schedule A, line 37, or Schedule B line 41a. Form 4970 is used as a worksheet attachment to the Form 3520.</p> <p>The accumulated distribution is entered on line 48 of Schedule C and line 1 of Form 4970. Lines 1 through 28 of Form 4970 are used to compute the tax on the total accumulation distribution. The tax from line 28 of the Form 4970 is entered on Form 3520, Part III, Schedule C, line 49, which is the tax on the total accumulation distribution.</p> <p>Interest accumulates on the accumulated distribution tax and is added to this tax. This interest accumulates at a 6% rate (without compounding) for tax periods after 1976 but before 1996. For periods after 1995 the interest is compounded daily at the rate imposed on underpayments of tax in IRC 6621(a)(2). The interest rate table in the instructions to Form 3520 for tax years 1996 to 2020 may be used for calendar-year taxpayers using the mid-year ending date for the accumulation period to calculate the interest charge. Interest rates for tax years 2021 and later can be found at <a href="https://www.irs.gov/CombinedInterestRate">IRS.gov/CombinedInterestRate</a>. The interest rate is entered on Form 3520, Part III, Schedule C, line 51 and multiplied by the total accumulation distribution for the interest charge reported on line 52 of the form. This accumulated distribution interest charge is added to this accumulation distribution tax for the total tax attributable to accumulation distributions which is reported on Form 3520, Part III, Schedule C, line 53.</p>	<ul style="list-style-type: none"><li>▪ IRC 665(b)</li><li>▪ IRC 667(b)</li><li>▪ Form 4970</li>          <li>▪ IRC 668(a)</li><li>▪ IRC 6621(a)(2)</li><li>▪ Form 3520 Instructions</li></ul>

# Step 5: Determine Accumulated Income, Tax, and Interest (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### [Step 5](#)

Considerations	Resources
<p>Determine if the beneficiary correctly included the total tax attributable to the accumulation distribution tax on their income tax return.</p> <p>The tax attributable to the accumulation distributions from Form 3520, Part III, Schedule C, line 53 should be added to additional tax on the beneficiary's income tax return for the tax year of the distribution.</p>	<ul style="list-style-type: none"><li>▪ Form 3520 Instructions</li></ul>

# Examples of the Process

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

### Description

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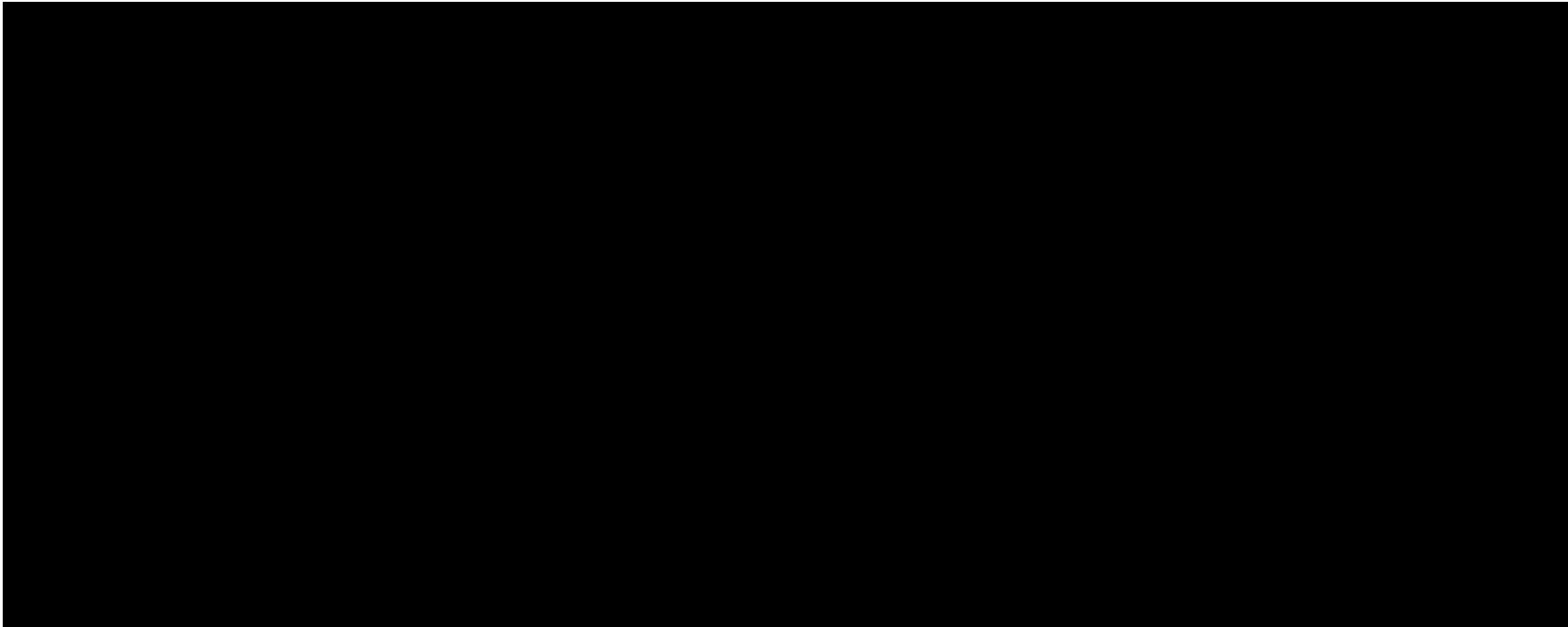
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# Examples of the Process (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

Description

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# Examples of the Process (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

Description

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# Examples of the Process (cont'd) 2

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

Description

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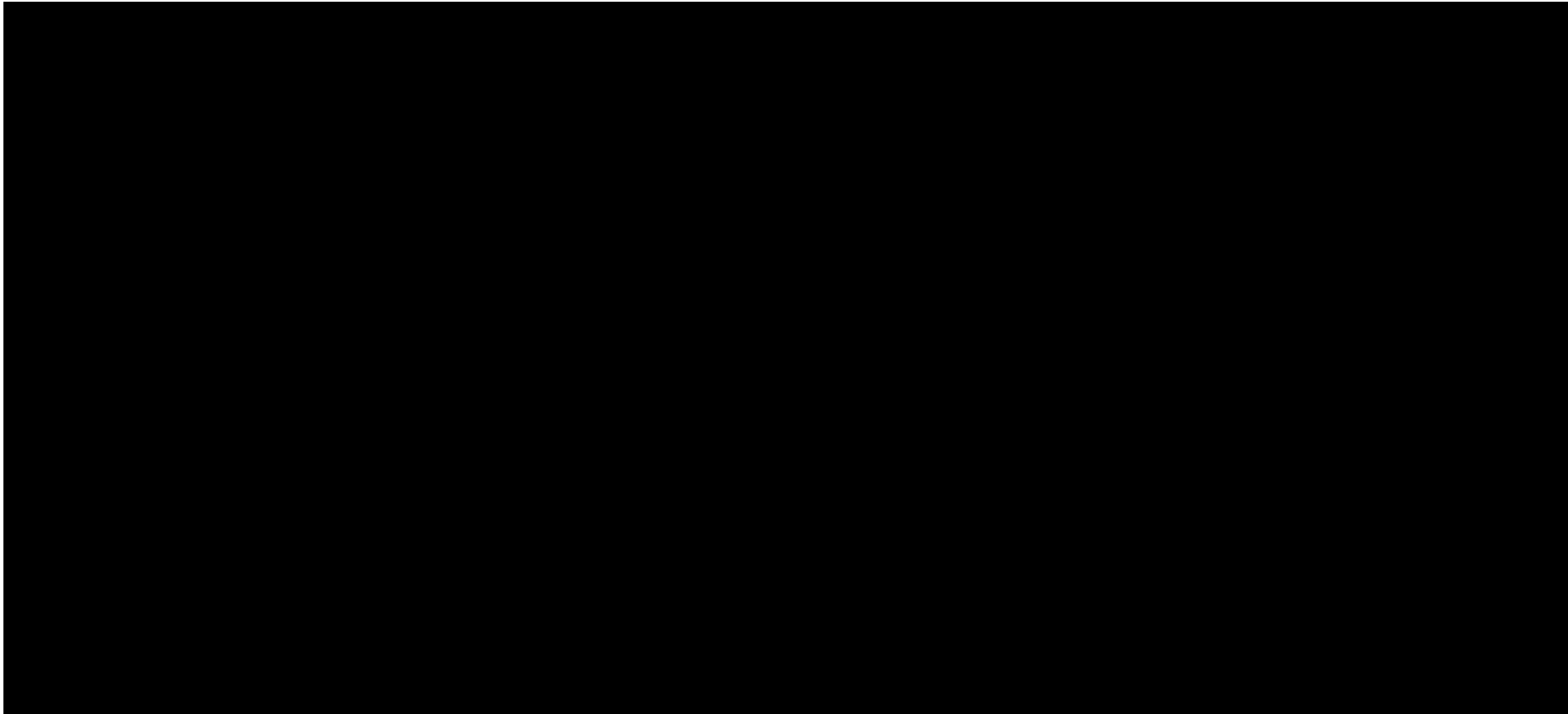
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# Examples of the Process (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

Description

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# Examples of the Process (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

Description

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# Examples of the Process (cont'd)

Taxation of Beneficiary of a Foreign Non-Grantor Trust	
Description	
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# Examples of the Process (cont'd)

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

Description

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# Other Considerations / Impact to Audit

Taxation of Beneficiary of a Foreign Non-Grantor Trust	
Considerations	Resources
<p>Domestic trusts report their income on Form 1041. A foreign non-grantor trust reports U.S. income on a Form 1040NR using the instructions for Form 1041 and Form 1040NR. Foreign non-grantor trust income can also show up on a U.S. beneficiary's Form 1040 when a U.S. beneficiary of a foreign non-grantor trust reports a distribution it received as income. The U.S. beneficiary should file a Form 3520 if they receive a distribution from a foreign trust. The amounts reported on the Form 3520 should reconcile to the income reported on the beneficiary's Form 1040.</p> <p>The three most common situations in which foreign non-grantor trusts intersect with the U.S. Tax Code are: (1) trusts created by nonresident alien individuals for the benefit of one or more U.S. beneficiaries (or some combination of U.S. and foreign beneficiaries); (2) trusts created by nonresident alien individuals who own U.S. assets and may or may not have U.S. beneficiaries; and (3) trusts created by nonresident alien individuals who subsequently become U.S. residents.</p>	<ul style="list-style-type: none"> <li>▪ Form 1040NR</li> <li>▪ Form 1041</li> </ul>
<p><u>Foreign Tax Credit</u></p> <p>A foreign non-grantor trust may credit any foreign taxes imposed on its foreign source income against its U.S. income tax liability. Additionally, a beneficiary may also credit against his or her U.S. tax liability a proportionate share of the taxes the trust paid to a foreign country. However, the applicable regulations do not provide a method for allocating the credit between a trust and a beneficiary.</p>	<ul style="list-style-type: none"> <li>▪ IRC 642(a)</li> <li>▪ IRC 667(d)(1)</li> <li>▪ IRC 901(b)(5)</li> </ul>

# Other Considerations / Impact to Audit (cont'd)

Taxation of Beneficiary of a Foreign Non-Grantor Trust	
Considerations	Resources
<p><u>Timing of Distributions</u></p> <p>The fiduciary of a trust may elect to treat distributions made in the first 65 days of a taxable year as having been made on the last day of the prior tax year.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.663(b)-1</li> </ul>
<p><u>Change of Trust Status to Grantor Trust</u></p> <p>A foreign non-grantor trust that subsequently acquires a U.S. beneficiary may become a grantor trust under IRC 679. Once the non-grantor trust becomes a grantor trust, any accumulated trust income is treated as an immediate accumulation distribution to the person treated as the owner.</p> <p>A foreign trust shall be treated as having a U.S. beneficiary unless (1) 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 U.S. person, and (2) if the trust were terminated, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person. In addition, an amount shall be treated as paid or accumulated to or for the benefit of a U.S. person if such amount is paid to or accumulated for a controlled foreign corporation, foreign partnership if a U.S. person is a partner, or foreign trust or estate which has a U.S. beneficiary. Note that as of 2010, IRC 679(d) provides a rebuttable presumption that a foreign trust to which a U.S. person directly or indirectly transferred property may be treated as having a U.S. beneficiary.</p> <p>If a non-resident alien individual has a residency start date within 5 years after directly or indirectly transferring property to a foreign trust, the individual is treated as having transferred to the foreign trust on the residency starting date an amount equal to the portion of the trust attributable to the original transfer.</p>	<ul style="list-style-type: none"> <li>▪ IRC 679(b)</li> <li>▪ Treas. Reg. 1.679-2(c)(3)</li>   <li>▪ IRC 679(c), (d)</li>   <li>▪ IRC 679(a)(4)</li> <li>▪ Treas. Reg. 1.679-5(a)</li> </ul>

# Other Considerations / Impact to Audit (cont'd)

Taxation of Beneficiary of a Foreign Non-Grantor Trust	
Considerations	Resources
<p><u>Loans to Beneficiaries or Uncompensated Use of Trust Property by Beneficiaries</u></p> <p>Loans of cash or marketable securities (or uncompensated use of trust property) made directly or indirectly from a foreign non-grantor trust to a U.S. beneficiary, or any other U.S. person related to the U.S. beneficiary are treated as trust distributions to the beneficiary. The trust cannot be treated as a simple trust in the year of the loan, and any subsequent transactions between the trust and the original borrower regarding the loan balance are disregarded for income tax purposes for the trust and beneficiary.</p>	<ul style="list-style-type: none"><li>▪ IRC 643(i)</li></ul>



# Index of Referenced Resources

## Taxation of Beneficiary of a Foreign Non-Grantor Trust

IRC 265

IRC 642

IRC 643

IRC 651

IRC 652

IRC 661

IRC 662

IRC 663

IRC 665

IRC 666

IRC 667

IRC 668

IRC 679

IRC 872(a)

IRC 894

IRC 901(b)(5)

IRC 6048(c)

# Index of Referenced Resources (cont'd)

<b>Taxation of Beneficiary of a Foreign Non-Grantor Trust</b>
IRC 6621(a)(2)
Treas. Reg. 1.643
Treas. Reg. 1.651(a)-1
Treas. Reg. 1.661(a)-1
Treas. Reg. 1.663
Treas. Reg. 1.665(b)-1A
Treas. Reg. 1.679
Treas. Reg. 1.894-1
IRM 3.13.2-7
IRM 21.7.13.5.8.1
Form 1040 NR
Form 1041
Form 3520
Form 3520 Instructions
Form 4970
Notice 97-34

# Training and Additional Resources

Taxation of Beneficiary of a Foreign Non-Grantor Trust	
Type of Resource	Description(s)
Saba Meeting Sessions	<i>Defining the Entity - Trusts - 2014 Saba Meeting</i> <i>Failure to File Forms 3520 &amp; 3520A - 2014 Saba Meeting</i> <i>Foreign Grantor Trusts - Part I - 2014 Saba Meeting</i> <i>Foreign Grantor Trusts PT 2 - 2014 Saba Meeting</i>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
AMT	Alternative Minimum Tax
DNI	Distributable Net Income
ECI	Effectively Connected Income
IRC	Internal Revenue Code
Treas. Reg.	Treasury Regulation
UNI	Undistributed Net Income
U.S.	United States

# Index of Related Practice Units

<b>Associated UIL(s)</b>	<b>Related Practice Unit</b>
9434	<i>Defining the Entity - Foreign Trust</i>
9434	<i>Foreign Grantor Trust Determination - Part I - IRC Section 679</i>
9434	<i>Foreign Grantor Trust Determination - Part II - IRC Sections 671-678</i>
9434	<i>Failure to File the Form 3520 and 3520-A Penalties</i>