Fundamentals of United States Taxation of Foreign Trusts, Grantors and Beneficiaries

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The Panel

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Overview

1. What is a trust?
2. Trust terminology
3. What does a typical structure look like?
4. Trust income tax concepts
5. Classifying trusts for income tax purposes
6. Tax treatment of grantors, trusts and beneficiaries

Other issues:
- CFCs and PFICs
- U.S. transfer tax issues
- When to consider a foreign trust structure
- What to do when you encounter a foreign trust
- Trust transformations
- Impact of FATCA on foreign trusts
- U.S. reporting/compliance obligations
1. WHAT IS A TRUST?
Trusts in Common Law Jurisdictions

- A trust is a device under which a settlor (known in the U.S. as the “trustor”) provides assets to trustees for the benefit of named beneficiaries or a named class of beneficiaries.

- Originated in England in the Middle Ages to protect Crusaders who conveyed their land to friends or relatives so that it could be managed in their absence.

- Found in common law jurisdictions:
  - U.K. and individual U.S. states
  - Ireland, Canada, Australia, New Zealand, South Africa
  - Other countries influenced by English law, e.g., Israel
  - Many offshore jurisdictions (Channel Islands, Isle of Man, Caribbean, Pacific and others)
Trusts in Civil Law Jurisdictions

- Civil law does not recognize trusts
- Civil law analogs: Bare property/usufruct; Mexican fideicomiso, foundations and establishments
- Due to their proximity to common law jurisdictions, some civil law jurisdictions, e.g., Louisiana, Scotland, Québec, effectively recognize trusts,
- Some countries, e.g., Panama, Liechtenstein, have adopted trust laws modeled on English concepts
- Other jurisdictions have developed rules or informal approaches to deal with trusts; a handful are party to the “Hague Convention on the Law Applicable to Trusts and on their Recognition”
Trusts for U.S. Tax Purposes

- Trust is an arrangement created by will or by inter vivos declaration where trustees take title to property for the purpose of protecting or conserving it for beneficiaries under the ordinary rules applied in chancery or probate courts. Treas. Reg. §§ 301.7701-4(a) and 301.7701-2(a)

- Since U.S. does not separately recognize civil law analogs, case by case determination must be made
  - Liechtenstein Stiftung generally classified as a trust rather than a business entity, but determination should be made based on facts and circumstances in each case. See Swan v. Commissioner, 24 T.C. 829 (1955); IRS Generic Legal Advice AM 2009-012 for discussion of Stiftung and Anstalt
  - Usufruct generally treated as equivalent to life estate. See Boggs v. Boggs, 520 U.S. 833 (1997); IRC sections 1022(c)(5)(B) and 2056(b)(7)(B)(ii); Rev. Rul. 64-249; 1964-2 C.B. 332. Bare property treated as equivalent to remainder,
Trusts and Economic Substance

Tax Court considers following factors in deciding whether trust lacks economic substance:

- Whether the taxpayer's relationship to the property differed materially before and after the trust's formation
- Whether the trust had an independent trustee
- Whether an economic interest passed to other trust beneficiaries
- Whether the taxpayer felt bound by any restrictions imposed by the trust itself or by the law of trusts

2. WHAT DOES A TYPICAL STRUCTURE LOOK LIKE?
Trust with Wholly Owned Company

Settlor → Trust

$ → Company

Beneficiary → $ → Beneficiary
Parallel Trusts for U.S. and Non-U.S. Beneficiaries

Settlor → Private Trust Company

Domestic Trust → U.S. Beneficiary

Foreign Trust → NRA Beneficiary
3. TRUST TERMINOLOGY
Foreign Trust Terminology – 1

- Trust instrument has many designations:
  - (Deed of) Settlement
  - Trust Deed
  - Trust Agreement
  - Declaration of Trust (where settlor is not named)

- The person who creates the trust is known as the settlor; in the U.S., “trustor” or “grantor” is often used.

- A self-settled trust is a trust created by the settlor for his or her own benefit

- Purpose trust

- Secret trust
Foreign Trust Terminology – 2

- Many trusts are “discretionary trusts”, meaning the trustees choose which beneficiaries receive distributions, when and how much
  - U.S. term is “sprinkling trust”, but this phrase is not used in other jurisdictions

- Trustees, especially corporate trustees, may be guided by non-binding “letter of wishes” from the settlor or person nominated by the settlor

- Common to have “protector” (often a friend or committee) with various powers:
  - Add, remove, replace trustee
  - Move trust to different jurisdiction (“flight clause”)
  - Veto rights
  - Protector does not automatically owe fiduciary duty
Foreign Trust Terminology – 3

- Protective (known in U.S. as spendthrift) provisions
  - Beneficiary cannot alienate interest or distribution rights
  - Trustee can decline requests/instructions if it believes there is duress

- Decanting and domestication
  - Sometimes it is desirable to move a trust from one jurisdiction to another
  - Many ways to do this, with potentially differing tax (and non-tax) consequences
  - Loosely known as "decanting", a word that has multiple meanings
  - Often referred to as domestication when trust is moved to the United States
Types of Trustees

- Independent trust company
  - Often associated with a law firm or an accounting firm
- Trust division or subsidiary of a bank or other financial institution
- Single- or multi-family private trust company
- One or more individuals
- A combination of the above
4. CLASSIFYING TRUSTS FOR INCOME TAX PURPOSES
Basic Classifications

Every trust has to be analyzed based on three interacting classifications:

- Domestic or foreign
- Grantor or nongrantor
- Simple or complex
Domestic or Foreign

A trust is domestic if:

- A court within U.S. is able to exercise primary supervision over the administration of the trust (court test). Safe Harbor:
  - Trust instrument does not direct that trust be administered outside U.S.
  - Trust exclusively administered in U.S.; and
  - Trust not subject to automatic migration clause ("flight" clause)
- One or more United States persons have the authority to control all substantial decisions of the trust (control test)
  - Reversing unintended loss of U.S. status – Regs. allow trust 12 months from date of cessation as domestic trust to make changes to give control over all substantial decisions to U.S. persons

A trust is foreign if it is not domestic
Grantor Trust

For U.S. tax purposes, the grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust. Treas. Reg. § 1.671-2(e)(1)

Grantor does not include:

◆ Person who creates a trust but makes no gratuitous transfers to the trust

◆ Person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and makes no other gratuitous transfers to the trust

Special rule where nominal grantor is corporation or partnership. Treas. Reg. § 1.671-2(e)(4)
Types of Grantor Trusts

How may a trust be a grantor trust?

- Section 673 – grantor has a revisionary interest
- Section 674 – grantor has certain powers to control beneficial enjoyment
- Section 675 – grantor has an administrative power
- Section 676 – grantor has power to revoke
- Section 677 – grantor or spouse can benefit from income
- Section 678 – person other than grantor can vest trust property or income in himself

Unless section 678 applies, ceases to be grantor trust on death of grantor

Powers held by non-adverse parties including trustees are often attributed to the grantor
Grantor Trust Under Section 679

- A foreign trust is a section 679 grantor trust if
  - The grantor is alive
  - The grantor is a U.S. person or became a U.S. person within five years of funding the trust
  - Any part of the income or corpus of the trust could be paid to a U.S. beneficiary

- Trust can be a grantor trust under section 679 even if no other grantor trust provision applies

- Note trap for newly resident grantors
  - Grantor treated as if he made the transfer on residency starting date, thereby triggering gain
  - If NRA grantor married to U.S. person under community property regime, then ½ of transferred assets may be deemed contributed by U.S. spouse, making U.S. spouse partial grantor (triggers Form 3520 filing requirements)
Section 672(f) Grantor and Non-Grantor Trust

- Anti-avoidance exception to grantor trust rules
- Section 672(f)(1): Foreign trust is only grantor trust if result is ownership of income by U.S. persons
- Section 672(f)(2) exception:
  - Foreign grantor is alive
  - Grantor is a nonresident for U.S. tax purposes
  - The trust is any one or more of the following
    - Revocable
    - For the sole benefit of the grantor or the grantor’s spouse
    - Compensatory
  - Extended exception for trusts in existence on 9/19/95
- Query – what about foreign trust with foreign grantor and no U.S. beneficiaries?
Foreign Ordinary (or Non-Grantor) Trust

- Foreign trust is an “ordinary trust” (also known as “non-grantor trust”) if the trust is not a grantor trust.
- If grantor is deceased, a foreign trust must be an ordinary trust.
- Section 672(f)(2) treatment apparently not available to allow person other than grantor to be treated as owner of trust.
5. TAX TREATMENT OF GRANTORS, TRUSTS AND BENEFICIARIES
Subchapter J Overview

- **Foreign grantor trust – sections 673-679**
  - Grantor is the owner of (and taxpayer with respect to) all trust assets and income
  - Trust is not taxable
  - Distributions to beneficiary (other than the grantor) treated as gift by grantor

- **Foreign ordinary/non-grantor trust**
  - Simple trust – sections 651 and 652
    - Trustee effectively not taxed
    - Beneficiaries taxed on their share of trust income
  - Complex trust - sections 661-668
    - Trust is taxpayer to the extent of undistributed income
    - Beneficiary taxed on receipt of distributions, including interest on distributions of accumulated income
Classification and Taxation of Trusts

If foreign grantor, grantor trust treatment only if trust revocable or grantor and beneficiary are husband and wife.

Grantor is taxpayer

Domestic

Simple

Beneficiary is taxpayer

Complex

Trust is taxpayer

Ordinary

Simple

Immediate

Deferred

Interest charge on deferred distributions

5/12/2011

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Tax Treatment of Foreign Grantor Trust

- **Grantor** is treated as owner of all trust income
- If grantor is U.S. person, grantor is taxed on all trust income from all sources
- If grantor is nonresident alien or foreign corporation:
  - U.S. source investment income (but not capital gains, except real estate) taxed at flat 30%
  - Income effectively connected with a U.S. trade or business at regular U.S. rates up to 35%
  - Treaty relief available based on grantor’s residence
    - Limitation on benefits provision may apply if grantor not taxed on trust income in home jurisdiction
  - See Rev. Rul. 69-70; 1969-1 C.B. 182
Tax Treatment of Foreign Non-Grantor Trust

- Distribution to non-grantor beneficiary may be treated as gift, taxable if U.S.-situs property
- *Grantor* is not taxed
- *Trust* is taxable like nonresident alien
- Therefore, foreign trust taxed on:
  - U.S. source investment income (but not capital gains, except real estate) at flat 30%
  - Income effectively connected with a U.S. trade or business at regular U.S. rates up to 35%
  - Treaty relief may be available based on residence of trust or beneficiaries (beyond scope of this presentation)
Tax Treatment of Foreign Non-Grantor Trust

- Foreign trust not taxed on any other income, e.g., capital gains, portfolio interest, most foreign income

- Trust may deduct any amount distribution up to distributable net income, as explained below
Taxation of Beneficiaries – Non-Grantor Trust

- Key concepts: DNI and UNI

- Distributable net income (DNI) is the income of the trust for the year from all sources computed under U.S. income tax principles.
  - DNI includes all capital gains
  - DNI includes income exempt under treaty
  - All deductions allowed, including deductions disallowed by section 265 (expenses relating to tax-exempt income)

- Undistributed net income (UNI) is DNI not distributed in or for the year the DNI was earned
Taxation of Beneficiaries – Non-Grantor Trust (cont’d)

- Beneficiaries taxed on trust distributions made out of DNI. Distributions treated as made:
  - First, from DNI of current year (taxable if U.S. beneficiary)
    - Current distributions can be ordinary income or capital gain
  - Then, from the earliest year for which there remains DNI (taxable if U.S. beneficiary - plus interest charge)
  - Finally, from trust corpus (nontaxable)

- Accumulation distributions from foreign trust ("throwback rules")
  - Ordinary income – even if paid out of capital gains
  - Subject to interest on deferred tax at tax late payment rate
  - Carry credits for U.S. and foreign taxes paid by the trust
Taxation of Beneficiaries – Non-Grantor Trust (cont’d)

- Good recordkeeping is vital – IRS Form 3520
- Distributed DNI taxed to the beneficiaries retains character, e.g., source, ordinary or capital gain
- Credit for foreign taxes and U.S. withholding tax
- UNI taxed as ordinary with interest charge under the throwback rules. Sections 665-668
- No accumulation distribution in year that distributions are less than fiduciary accounting income. Section 665(b)
- If no beneficiary statement from trustee, distribution taxed under default method, with assumption that entirely paid from UNI
Tax Attributes of Distributions

- If trust only distributes a percentage of the DNI of particular year tax attributes are divided proportionately according to that percentage
  - Capital gain or ordinary income, foreign or U.S. source
  - Associated credits for foreign or U.S. taxes paid by trust
- Similarly, if distributed to several beneficiaries, tax attributes divided proportionately
- Some room to maneuver using “separate shares”.
- Example:
  - Trust has current year DNI 100 (60 capital gain, 40 ordinary income); trust distributes 80
  - Result, 60% x 80 = $48 capital gain; 40% x 80 = $32 ordinary income; undistributed $20 will be UNI
Constructive Distributions

- Indirect distributions – section 643(h)
- Loans by foreign trust to U.S. grantor, beneficiary or related person treated as distribution – section 643(i)
  - Previously applied only to cash and marketable securities
  - Loan repayment ignored
  - Exception for “qualified obligations”
    - Documented
    - U.S. dollar-denominated
    - Interest rate 100 to 130% of applicable Federal rate
    - Maximum five year term
    - Form 3520 reporting and statute waiver if loan not repaid
  - Rule extended in 2010 to fair use value of other trust assets (e.g., home, yacht, artwork) – see FATCA slides
6. Impact of CFC and PFIC Rules

- Both the Passive Foreign Investment Company (PFIC) and Controlled Foreign Corporation (CFC) rules can apply when a foreign trust has an underlying foreign corporation.

- Stock owned by a foreign trust shall be considered owned proportionately by its beneficiaries. Sections 958(a)(2) and 1298(a)(3).

- Inclusions of Subpart F income, under Section 956, PFIC or QEF rules are not included in trust’s DNI and do not become UNI.

- TAM 162267-05 (Aug 2007)
- Prop. Reg. § 1.1291-1(b)(8)(iii)(C)
7. U.S. Transfer Tax Issues

- The grantor trust rules do not apply to estate, gift and generation skipping taxes ("transfer taxes")
- Instead, analogous rules apply that do not precisely overlap with the grantor trust rules
  - A transfer of property may be treated as incomplete, so that no gift has occurred
  - Property transferred with respect to which the grantor retains certain powers may be included in the grantor’s estate
  - Property over which the grantor or someone else has a power of appointment may be treated as part of the estate of the holder of the power
Estate Tax

- U.S. citizen/domiciliary grantor
  - Transfers of property where grantor retains control or enjoyment of the property will be includable in grantor’s estate
    - Sections 2035-2041
    - Irrespective of situs of property
    - Release of these powers within 3 years of death also causes inclusion
    - Right to revoke or amend, right to income, right to control beneficial enjoyment, power to remove and appoint a related or subordinate party, general power of appointment

- NRA grantor
  - Same rules apply if trust assets are situated in U.S. at time of transfer or death. Section 2104(b)
  - But in some cases basis step up may not be available for non-U.S. property. Section 1014(b)(9)
Gift/Generation Skipping Taxes

- NRA transferor: No U.S. gift or GST tax on transfers of non-U.S. situs assets to foreign trust; taxed only on transfers of U.S. situs assets (i.e., U.S. real property and U.S. situs tangible personal property)

- U.S. citizen/domiciliary transferor: Taxable
8. When to Consider Foreign Trust Structure

- NRA without U.S. issue or substantial U.S. connections
- NRA coming to the U.S. on a temporary basis
- Pre-immigration planning
- U.S. citizens and long-term residents
9. Top 10 Questions When You Encounter a Foreign Trust

1. Who are the settlor, trustee, and beneficiary/ies?
2. Are any such persons U.S. citizens or residents?
3. Is the settlor dead or alive?
4. What are the trust's main terms? Revocable/irrevocable/section 678 power/power of appointment
5. What/where is the trust property?
6. Is there an underlying company?
7. Is it a grantor trust; if not, simple or complex?
8. If non-grantor, has income been accumulating?
9. Who set up the structure and gave US tax advice?
10. What U.S. tax and information reporting has been done?
What to Do If You Encounter a Foreign Trust

Foreign trust with U.S. beneficiary

- How to bring it home?
- May require long-term plan to maximize benefits (decades not years)
- Must consider trust’s assets (stocks/bonds/allocation) and check if trust holds offshore funds or other interests in foreign corporations
- Very long-term trusts – threat of throwback rules and interest charge could almost erode all trust assets
  - Distributions of current year income (DNI) subjects U.S. beneficiaries to normal U.S. income tax treatment and may accomplish shifting much of the trust’s assets over time
  - For estate tax purposes, trustee should avoid making outright transfers of assets not needed by the beneficiary and leave in trust
What to Do If You Encounter a Foreign Trust

- Look at trust records – absence of records for long term trusts mandate use of “default method” of calculating tax consequences
- This method may result in quicker shifting of assets from trust
- Consider distribution planning where beneficiaries include both U.S. and foreign beneficiaries
10. Trust Transformations

- Grantor trust becomes non-grantor trust
  - Grantor dies
  - Grantor becomes nonresident alien – section 672(f)
  - Section 679 trust ceases to have U.S. grantor or beneficiaries

- Non-grantor trust becomes grantor trust
  - Foreign grantor moves to the U.S.

- Trust moves from or to the U.S.
  - Domestication of a foreign trust should not be a taxable distribution
  - Mechanics of domestication matter
  - Post-domestication distributions of pre-domestication DNI attract interest charge. Rev. Rul. 91-6, 1991-1 C.B. 89
11. IMPACT OF FATCA ON FOREIGN TRUSTS
In General

- Foreign Account Tax Compliance Act ("FATCA") included in the Hiring Incentives to Restore Employment Act of 2010 ("HIRE Act")

- Key Provisions effective March 18, 2010
  - Presumption that beneficiary is U.S. person
  - Uncompensated (or undercompensated) use of trust property and unqualified loans are treated as distributions

- Main FATCA provisions imposing withholding on foreign financial institutions and non-financial foreign entities effective January 1, 2013
FATCA – Presumption of U.S. Beneficiary

Section 679(d): For purposes of applying grantor trust treatment to foreign trust, conclusive determination that a foreign trust has a U.S. beneficiary if a U.S. person transfers property directly or indirectly to a foreign trust, unless the transferor demonstrates that no part of the income or trust may be paid to or accumulated for the benefit of a U.S. person.

Amounts treated as accumulated for the benefit of a U.S. person even if that person’s interest in the trust is contingent on a future event. Section 679(c)(1)

What if the contingency is ceasing to be U.S. person (see next slide)?
FATCA – Presumption of U.S. Beneficiary

- If any person has discretion to make a distribution from a foreign trust to or for the benefit of any person (U.S. or otherwise), the trust will be treated as having a beneficiary who is a U.S. person, unless the trust specifically identifies the class of persons to whom such distributions may be made and none of those persons are U.S. persons during the tax year. Section 679(c)(4)

- If any U.S. person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding that may result in trust income or corpus being paid to or accumulated for the benefit of a U.S. person, that agreement or understanding will be treated as a term of the trust.
FATCA – Presumption of U.S. Beneficiary

- The agreement or understanding may be written, oral or otherwise. Any discretion held by a trustee or protector to make a distribution to or accumulate income for a U.S. person will be deemed to have been exercised. Section 679(c)(5)

- Any loan of cash or marketable securities (or the use of any other trust property directly or indirectly to or by any U.S. Person will be treated as paid or accumulated for the benefit of such U.S. person
  - N/A to the extent that the U.S. person repays the loan at market rate of interest or pays FMV for the use of property within a reasonable period of time. Section 679(c)(6)

- Subsequent return of the property to the trust is disregarded for tax purposes.
FATCA – Uncompensated Use of Trust Property

Law already provided that loan of cash or marketable securities was to be treated as a distribution by the trust.

FATCA extended this rule in the case of all other trust property other than cash or marketable securities.


- Therefore, fair market value of use of trust property, net of rent or license fee paid to trust, treated as deemed distribution.
FATCA – Uncompensated Use of Trust Property

- First from DNI, then from UNI??
- U.S. beneficiary files Form 3520
  - Penalty for failure to file is greater of $10,000 or 35% of deemed distribution
  - Is there withholding on deemed payments to foreign trust? – problem if no cash received by beneficiary
  - How is FMV determined? By whom?
  - Applicable to use of furnishings in the property, etc?
  - Multiple users – prorate?
  - Use by guests who are not beneficiaries?
- Enter into lease and pay rent
FATCA – New Reporting Requirements

FATCA imposes a 30% withholding obligation on “withholdable” payments to:

- FFIs (foreign financial institutions); and
- NFFEs (non-financial foreign entities) unless it certifies that it has no “substantial U.S. owners” or identifies such owners with name, address and TIN.
  - If U.S. owner does not provide info, he/she receives no credit for the withholdable amount.
- Effective for payments made after 12-31-12
FATCA – New Reporting Requirements (cont.)

A “substantial U.S. owner” of a trust is one who:
- Is treated as the owner under the grantor trust rules; and
- Holds directly or indirectly more than 10% beneficial interest in the trust

Notice 2010-60 implies that a trust is an FFI under Section 1471(d)(5)(C). If a trust is an FFI, the 10% threshold for a substantial U.S. owner is irrelevant

ACTEC comments on Jan. 6, 2011 – a trust should be neither an FFI nor an NFFE.
FATCA – New Reporting Requirements (cont.)

- FFIs can avoid the withholding requirement if they enter into an agreement with the IRS – a participating FFI – PFFI
- NFFEs can avoid the withholding requirement by providing information on their “substantial U.S. owners” or certifying they have none
- ACTEC recommends foreign trust companies be treated as FFIs but foreign trusts be treated as NFFEs. Recommends avoiding duplicative reporting for foreign trusts and beneficiaries. Recommends *de minimis* standard of $50,000, etc.
## 12. U.S. Reporting/Compliance Obligations

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<th>Form</th>
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<tr>
<td>Form 3520-A</td>
<td>Annual Information Return of Foreign Trust with a U.S. Owner</td>
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<tr>
<td>Form 3520</td>
<td>Annual Return to Report Transactions with Foreign Trusts and Receipts of Certain Foreign Gifts</td>
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<tr>
<td>Forms 4970 and Form 1041 Schedule J</td>
<td>Tax on Accumulation Distribution of Trusts (only applies directly to domestic trust; may be used as worksheet attached to Form 3520)</td>
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<tr>
<td>Form 5471</td>
<td>Information Return of U.S. Persons with Respect to Certain Foreign Corporations</td>
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<tr>
<td>Form 8621</td>
<td>Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund (for years beginning 3/18/2010, required annually even if no income)</td>
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<tr>
<td>TDF 90.22-1</td>
<td>Report of Foreign Bank and Financial Accounts</td>
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<tr>
<td>Form 8938</td>
<td>Statement of Foreign Financial Assets (under new Section 6038D – draft form only at this point)</td>
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<tr>
<td>FATCA</td>
<td>See preceding slides</td>
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- And many more . . .
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