

TAX 101: TAXATION OF FOREIGN TRUSTS

Authors

Nina Krauthamer
Galia Antebi
Kenneth Lobo

Tags

Foreign Trusts

INTRODUCTION: WHAT IS A FOREIGN TRUST?

In General

A trust is a relationship (generally a written agreement) created at the direction of an individual (the settlor), in which one or more persons (the trustees) hold the individual's property, subject to certain duties, to use and protect it for the benefit of others (the beneficiaries). In general, the term “trust” as used in the Internal Revenue Code (the “Code”) refers to an arrangement created either by a will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.⁵⁰

Trusts can be characterized as grantor trusts or ordinary trusts. Ordinary trusts can be characterized as simple trusts or complex trusts; U.S. tax laws have special definitions for these concepts. A simple trust is a trust that is required to distribute all of its annual income to the beneficiaries. Beneficiaries cannot be charitable. A complex trust is an ordinary trust which is not a simple trust, *i.e.*, a trust that may accumulate income, distribute corpus, or have charitable beneficiaries.⁵¹ Ordinary trusts are “hybrid” entities, serving as a conduit for distributions of distributable net income (“D.N.I.”), a concept defined in the Code,⁵² to beneficiaries and receiving a deduction for D.N.I. distributions, while being taxed on other income (*e.g.*, accumulated income, income allocated to corpus).

A trust can be domestic or foreign. This article will focus on the U.S. tax consequences with respect to “foreign grantor trusts” (“F.G.T.”) and “foreign nongrantor trusts” (“F.N.G.T.”).

Foreign Trusts

A trust other than a domestic trust is considered a foreign trust.⁵³

⁵⁰ Treas. Reg. §301.7701-4(a).

⁵¹ Simple trusts are governed by Code §651 and §652. Complex trusts are governed by §661 and §662.

⁵² Code §643.

⁵³ Code §7701(a)(31)(B).

A trust will be considered domestic if:⁵⁴

- A U.S. court can exercise primary supervision over trust administration (the “court test”); and
- One or more U.S. persons have the authority to control all substantial trust decisions (the “control test”).⁵⁵

U.S. TAXATION OF FOREIGN TRUSTS

Once a determination has been made that a trust is foreign, an analysis must be made as to whether the trust is a grantor trust or a nongrantor trust.

Foreign Grantor Trust

A trust established by a nonresident alien person will be characterized as a grantor trust only if:⁵⁶

- The trust is revocable so that the power to be revested absolutely in the title to the trust property is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor; or
- The amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor.

If a nonresident alien that is treated as a grantor of an F.G.T. subsequently ceases to be so treated (e.g., by amending the trust instrument removing the grantor’s right to revest in himself title to the property transferred and/or by allowing beneficiaries other than the grantor and spouse to enjoy trust income), the grantor is treated as having made the original transfer to the foreign trust immediately before the trust ceases to be treated as owned by him.⁵⁷

Note that if a foreign grantor trust has a U.S. beneficiary, the U.S. beneficiary will be treated as a grantor of a portion of the trust to the extent such beneficiary has made (directly or indirectly) transfers of property to the foreign grantor other than in a sale for full and adequate consideration.⁵⁸

“A foreign grantor trust will generally become a foreign nongrantor trust upon the death of the grantor.”

⁵⁴ Code §7701(a)(30)(E).

⁵⁵ See examples of circumstances meeting the control test in Treas. Reg. §301.7701-7(d)(1)(v).

⁵⁶ Code §672(f)(2).

⁵⁷ Treas. Reg. §1.679-5(a)(1).

⁵⁸ Code §672(f)(5). Any gift shall not be taken into account to the extent the gift would be excluded from tax under Code §2503(b).

A foreign grantor trust will generally become a foreign nongrantor trust upon the death of the grantor.⁵⁹

When a trust is treated as an F.G.T., the property owned by the trust will be treated as owned by its foreign grantor. This will result in the income of the trust being taxed to the foreign grantor (*i.e.*, the person who made a gratuitous transfer of assets to the trust). The grantor will not be taxed by the U.S. on foreign sourced income, but certain U.S. sourced investment income will be subject to withholding tax and income effectively connected with a U.S. trade or business will be subject to U.S. income tax. Distributions to U.S. beneficiaries (other than the grantor) by an F.G.T. will generally be treated as nontaxable gifts but may be subject to U.S. tax reporting as explained below.

Special Rules with Respect to Foreign Trusts

- U.S. Grantor – Foreign Trust

If a U.S. person transfers property directly or indirectly to a foreign trust and the trust has a U.S. beneficiary, the trust will generally be treated as a grantor trust.⁶⁰

If a foreign trust first has a U.S. beneficiary after it has been in existence for some time (*e.g.*, because an alien beneficiary becomes a U.S. resident), any U.S. person who transferred property to the trust will be treated as the owner of a portion of the trust attributable to such property for any year in which there is a U.S. beneficiary. As a result, such U.S. person will be taxed on (i) the income attributable to the transferred property for that year and (ii) the undistributed net income (“U.N.I.”) at the close of the preceding taxable year that is attributable to the transferred property, if the only reason such U.S. person was not taxed on such income in the preceding taxable year was that there was no U.S. beneficiary at that time.⁶¹

- Foreign Grantor Becoming a U.S. Person

If a nonresident alien becomes a U.S. resident within five years after directly or indirectly transferring property to a foreign trust, the transfer will be treated as if it occurred on the residency starting date.⁶² The property deemed transferred to the foreign trust on the residency date includes the U.N.I. attributable to the property deemed transferred. The U.N.I. for

⁵⁹ If the trust was an irrevocable trust that allowed for distributions to be made only to the grantor or spouse during their lifetime, the trust would become a nongrantor upon the death of the grantor. However, if the trust deed allowed the spouse, upon death of the grantor, to appoint the trust assets to any person, including the spouse, the trust will still be treated as a foreign grantor trust, only the grantor will now be the spouse.

⁶⁰ Code §679(a)(1).

⁶¹ Code §679(a)(1) and (b).

⁶² Code §679(a)(4). For a definition of the residency starting date for foreign nationals becoming U.S. residents under the different tests see Code §7701(b)(2)(A).

periods before the residency starting date is taken into account only for purposes of determining the amount of property deemed transferred.⁶³

- **Domestic Trusts Becoming Foreign Trusts**

If a U.S. citizen or resident transferred property to a domestic trust that subsequently becomes a foreign trust, the transferor (if then living) is deemed to transfer the portion of the trust that is attributable to the transferred property to a foreign trust.⁶⁴ Transfers to foreign trusts that are not taxed as grantor trusts are taxable transactions on which the transferor recognizes gain but not loss.⁶⁵

Reporting Obligations with Respect to a Foreign Grantor Trust

An F.G.T. that does not make any distributions to U.S. beneficiaries does not have any reporting obligations for that taxable year. For the taxable year of a distribution to a U.S. beneficiary, a trustee of an F.G.T. is obligated to provide the beneficiary with a “Foreign Nongrantor Trust Beneficiary Statement.”⁶⁶ Among other things, the statement provides a description of the property distributed and its fair market value, as well as a statement permitting the I.R.S. or the beneficiary to inspect a copy of the trust’s permanent books of account, records, etc.

A U.S. person who receives a distribution from an F.G.T. must include Form 3520 (*Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*) with his or her tax return if the distribution is in excess of \$100,000.⁶⁷

Foreign Nongrantor Trust

Any foreign trust that does not meet the definition of a grantor trust is a foreign nongrantor trust. An F.N.G.T. is taxed as if it were a nonresident, non-citizen individual who is not present in the U.S. at any time.

The F.N.G.T. will not be taxed on foreign sourced income, but certain U.S. sourced investment income and income effectively connected with a U.S. trade or business will be subject to U.S. withholding tax or income tax. Note that the “net investment income tax” (known as the “Obamacare tax”) does not apply to nonresident non-citizens, and therefore, does not apply to an F.N.G.T. However, certain distributions made to U.S. beneficiaries will be subject to this tax.⁶⁸

⁶³ Code §679(a)(4)(B).

⁶⁴ Code §679(a)(5).

⁶⁵ Code §684. Treas. Reg. §1.684-1(a).

⁶⁶ Although the trust is a grantor trust, it is appropriate for the trustee to provide a Foreign Nongrantor Trust Beneficiary Statement, as the purpose of the statement is to coordinate the U.S. income tax treatment of U.S. grantors and U.S. beneficiaries of grantor trust to ensure that at least one level of tax is paid.

⁶⁷ Code §6048, §6677.

⁶⁸ Treas. Reg. §1.1411-3(b)(1)(viii).

A U.S. beneficiary will be subject to tax on D.N.I. distributions received from the F.N.G.T., the character of which will reflect the character of income as received by the F.N.G.T. A foreign trust is required to include net capital gain income in D.N.I.⁶⁹

If a F.N.G.T. accumulates its income and distributes the accumulation to U.S. beneficiaries in later years, those beneficiaries will be subject to the “throwback rules” if distributions are in excess of the current year D.N.I. The throwback rules generally seek to treat the beneficiary as having received the income in the year it was earned by the trust, using a relatively complex formula. A late payment interest is then applied. Furthermore, such throwback distributions will be taxed as ordinary income regardless of their characterization at the hands of the trust. Note that the throwback rules will not apply to amounts accumulated when the trust was a F.G.T.

Reporting Obligations with Respect to a Foreign Nongrantor Trust

As mentioned above, the trustee is required to provide the beneficiaries with a Foreign Nongrantor Trust Beneficiary Statement. In this case, the statement will also include the D.N.I. for the taxable year, the year(s) to which an accumulation distribution is attributed, and the amounts allocable to each year.

Distributions to a U.S. beneficiary made from an F.N.G.T. are reported on Form 3520 regardless of the amount.

PLANNING SUGGESTIONS

Foreign persons have several planning opportunities:

Assuming all assets are non-U.S. situs assets (for estate tax purposes), establishing a foreign grantor trust (with a power to revoke) for the benefit of grantor’s family members (including U.S. beneficiaries) may be advisable. It is important to domesticate or decant such trust upon the death of the foreign grantor to avoid the application of the throwback rules.

Another planning alternative is to establish a U.S. dynasty trust for the benefit of U.S. beneficiaries and descendants. In this case, the assets transferred to the trust may include U.S. stocks and securities (not subject to U.S. gift tax as intangible property).

Finally, if the grantor plans to immigrate into the U.S., establishing a U.S. (domestic) “drop off” trust prior to immigrating (*i.e.*, prior to establishing a U.S. domicile) may be advisable.⁷⁰

⁶⁹ Code §643(a)(6)(C). This differs from the treatment of a domestic trust’s D.N.I., which does not include capital gains. Capital gains of a domestic trust are generally taxed to the trust.

⁷⁰ Note that under Code §679, the trust will be treated as a grantor trust.