HELP – MY EXCLUSIVELY FOREIGN TRUST NOW HAS A U.S. BENEFICIARY! WHAT ARE THE ISSUES A TRUSTEE WILL NOW FACE IN 2020?

Author
Nina Krauthamer

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Many foreign grantors establish foreign trusts to benefit themselves and their foreign beneficiaries. It is not uncommon, however, for a foreign beneficiary to relocate to the United States. This article addresses the U.S. tax consequences to a foreign trust and a beneficiary of a foreign trust who is or becomes a U.S. citizen or resident alien. It is assumed that the grantor is and always will be a foreign person. Recent tax law changes have made planning more difficult in these situations.

For U.S. tax purposes, a foreign trust can be only one of two types – either a "foreign grantor trust" or a "foreign nongrantor trust."

U.S. TAXATION OF FOREIGN TRUSTS

Foreign Grantor Trust

A trust will be characterized as a foreign grantor trust ("F.G.T.") only under two conditions: either, the grantor reserves the right to revoke the trust solely or with the consent of a related or subordinate party (and revest the title assets to himself), or the amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor. Under these circumstances, the income of the trust is taxed to the grantor (*i.e.*, the person who made a gratuitous transfer of assets to the trust). U.S. tax is limited generally to U.S. sourced investment income and income effectively connected with a U.S. trade or business will be subject to U.S. income or withholding tax. A foreign grantor trust will generally become a foreign nongrantor trust upon the death of the grantor. However, U.S. situs assets (which would include U.S. real and tangible property, and stocks and securities of U.S. issuers, other than debt instruments that qualify as "portfolio interest" indebtedness) held by the F.G.T. upon the death of the grantor would be subject to U.S. estate tax.

Foreign Nongrantor Trust

Any trust that does not meet the definition of a foreign grantor trust is a foreign nongrantor trust ("F.N.G.T."), taxed as if it were a nonresident, noncitizen individual who is not present in the U.S. at any time. U.S. tax is generally limited to U.S. sourced investment income and income effectively connected with a U.S. trade or business.

TAXATION OF DISTRIBUTIONS TO U.S. BENEFICIARIES

Foreign Grantor Trust

Distributions to a U.S. beneficiary by an F.G.T. will generally be treated as non-taxable gifts but may be subject to U.S. tax reporting requirements.

Foreign Nongrantor Trust

A U.S. beneficiary will be subject to tax on distributions to the beneficiary of "distributable net income" ("D.N.I.") from the F.N.G.T. The character of such D.N.I. distributions will reflect the character of the income as received by the F.N.G.T. If a F.N.G.T. accumulates its income and distributes the accumulation in later years in excess of D.N.I., the U.S. beneficiary will be subject to the "throwback rules," which generally seek to treat a beneficiary as having received the income in the year in which it was earned by the trust, using a relatively complex formula. The beneficiary may be required to pay a "throwback tax" (a "catch up" tax) and an interest charge on the deferral. Furthermore, such throwback distributions will be taxed at ordinary income tax rates. The throwback rules will not apply to amounts accumulated when the trust was an F.G.T.

REPORTING OBLIGATIONS

Reporting obligations will arise when a foreign trust makes a distribution to a U.S. beneficiary. A U.S. person who receives a distribution from a foreign trust must include Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) with his or her tax return. Generally, the Trustee should furnish to the U.S. beneficiary a "Foreign Nongrantor Trust Beneficiary Statement," which will be attached to the Form 3520. (While there is a "Foreign Grantor Trust Beneficiary Statement," that Beneficiary Statement contemplates a U.S. grantor, who will report the Trust's income on his or her U.S. income tax return, and therefore may not suitable for an F.G.T. with a foreign grantor.) For a F.N.G.T., the Beneficiary Statement includes the distributable net income for the year, the years to which an accumulation distribution is attributed, and the amounts allocable to each year. Steep penalties may apply for failing to report fully all required information and for failing to report on a timely basis.

OTHER TAX CONSEQUENCES

Special Taxing Regimes

If the foreign trust has investments in foreign corporations, the presence of a U.S. beneficiary may have the unfortunate effect of subjecting the U.S. beneficiary to two special U.S. taxing regimes: those applicable to "controlled foreign corporations" ("C.F.C.'s") and those applicable to "passive foreign investment companies" ("P.F.I.C.'s"). The C.F.C. rules (which generally preempt the P.F.I.C. rules) subject certain types of income allocable to a "U.S. Shareholder" (as specially defined) to immediate U.S. taxation, whether or not distributed, and characterize certain gains upon disposition of the stock as ordinary income. Unless certain exceptions apply, the P.F.I.C. rules are designed to penalize U.S. taxpayers on "excess distributions"

from a P.F.I.C. or upon a disposition of P.F.I.C. stock, imposing the highest ordinary income rates and an interest charge.

Tax law changes in late 2017 made significant – and unfortunate – changes to planning for investments in foreign corporations. It is not uncommon for an F.G.T. to own U.S. stocks and securities through a foreign corporate "blocker" corporation, usually in a low or no-tax jurisdiction, to avoid the imposition of U.S. estate tax upon the death of the foreign grantor. If the foreign corporation became a C.F.C. upon the death of the grantor, because of the presence of sufficient U.S. beneficiaries, it was often possible to make a check the box election (effective immediately after death) to treat the C.F.C. as a disregarded entity. The election would be treated as a taxable liquidation of the C.F.C. for U.S. tax purposes, resulting in "foreign personal holding company income" that could be subject to an income tax inclusion by a U.S. beneficiary as a form of so-called "Subpart F income." However, under prior law, no such inclusion was required unless the corporation was a C.F.C. for 30 days or more.

"The presence of a U.S. beneficiary may have unexpected tax consequences depending on the nature of the assets held by the foreign trust."

Report of Foreign Bank and Financial Accounts ("F.B.A.R.") Filings

F.B.A.R. filings on Form FinCEN Form 114 are generally required to be made by U.S. persons who have reportable financial interests in or signature authority over a foreign financial account ("F.F.A."). A U.S. person who has more than a 50% present beneficial interest in a trust's income or assets may be deemed to have an F.F.A. interest and may be required to make an F.B.A.R. filing. A trust beneficiary of a foreign nongrantor trust may receive an exemption from F.B.A.R. reporting if a trustee who is a U.S. person makes an F.B.A.R. filing disclosing the trust's F.F.A.'s and provides information as required.

FOREIGN ACCOUNT TAX COMPLIANCE ACT ("F.A.T.C.A.")

F.A.T.C.A. Entity Reporting

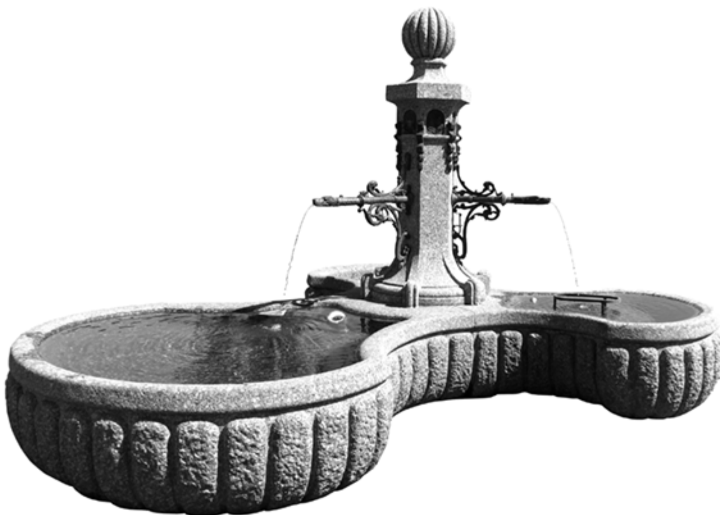
F.A.T.C.A. imposes a 30% withholding tax on payments to "foreign financial institutions" ("F.F.I.'s") that do not comply with certain disclosure requirements about their U.S. account holders. When applied, the withholding tax is imposed on principal as well as income. A foreign trust that invests (directly or indirectly) in securities and other financial interests may, under certain circumstances, be treated as an F.F.I. if the trustee is a trust company or if an entity, such as a bank or other financial institution, is acting as the investment advisor. In that case, the trust may have to register with the I.R.S. and receive a global intermediary identification number.

F.A.T.C.A. Individual Reporting

A U.S. person who holds an interest in a specified foreign financial asset must disclose such interest on Form 8938 if the aggregate value of all such assets exceeds certain threshold amounts (*e.g.*, in the case of an unmarried individual, $50,000 on the last day of the tax year, or $75,000 at any time during the year). A foreign financial asset includes an interest in a foreign trust, although special valuation rules may apply. Typically, assets are reported only when and as a trust makes a distribution to a U.S. beneficiary, the amount of the distribution being the reportable asset. This disclosure requirement is in addition to the F.B.A.R. requirement described above.

Items reported on Form 3520, described above, do not have to be reported on Form 8938, but Part IV of Form 8938 must be completed to indicate the Form 3520 filing.

The presence of a U.S. beneficiary in what had been a purely foreign trust presents tax challenges. In addition to the imposition of additional U.S. taxes and enhanced reporting requirements, the presence of a U.S. beneficiary may have unexpected tax consequences depending on the nature of the assets held by the foreign trust. It is important to identify these issues early in the process, as it may be easier to address and resolve some of these issues before the beneficiary becomes a U.S. taxpayer.



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