January 2021

US Taxation of Foreign Trusts

ANDERSEN

In this document we provide an overview of the US tax rules for foreign trusts, including some of the tax risks and opportunities for US persons who are grantors/settlors or beneficiaries of such trusts, whether in name or substance.

A 'US person' for this purpose means a US citizen, green card holder or a person who is a US resident by virtue of meeting a threshold of day's presence in the US.

What is a foreign trust?

The first step is to determine whether the entity in question is in fact a trust. This may seem obvious in most cases, but there are exceptions. In order for an entity to be a trust,

- there must be an arrangement, written or oral;
- the arrangement must be created by means of a will or an intervivos declaration;
- the arrangement must entitle trustees take title to property, which is protected and conserved for the beneficiaries;
- the beneficiaries cannot share in the discharge of the trustees' responsibility.

Having established that an entity is a 'trust' the next step is to determine whether it is 'foreign'. A foreign trust is any trust which does not meet **both** the '*Court*' and the '*Control*' tests, described below.

Court Test

The Court Test is satisfied if a US court is able to exercise primary supervision over the 'administration' of the trust. This means exclusive authority to resolve issues around the trust's administration; with administration being defined as 'carrying out of the duties imposed by the terms of the trust instrument and applicable law.'

The regulations specify four bright line situations where a trust will satisfy the Court Test:

1. A trust that is registered with a US court;
2. Testamentary trusts, where all fiduciaries of the trust have been qualified as trustees by a US Court;
3. Intervivos trusts, where the fiduciaries and/or beneficiaries take steps with a US court to cause the administration of the trust to be subject to the primary supervision of the court;
4. Where both a United States court AND a foreign court are able to exercise primary supervision over the administration of the trust.

The regulations provide that a US court will not have primary supervision over the administration of a trust where there is a provision in the trust instrument stating that a US court's attempt to assert jurisdiction would cause the trust to migrate from the US. This is known as an 'automatic migration' clause.

Under a Safe Harbour rule, a trust will satisfy the Court Test if (i) there is no provision in the trust's instrument allowing for its administration outside the U.S; (ii) the administration of the trust is exclusively in the US, and; (iii) there is no 'automatic migration' provision.

Control Test

The 'Control Test' is met if the following conditions are satisfied: (i) one or more US persons (ii) have the authority (iii) to control all 'substantial decisions' of the trust.

'Control' means the power to make all substantial decisions regarding the trust, without being limited by any other person having the ability to veto any substantial decision.

A 'substantial decision' is a decision that persons are authorised and/or required to make under the trust instrument. The regulations also include a non-exhaustive list of 'substantial decisions'.

Note that even a trust which appears to be domestic may be a foreign trust e.g. if there is a foreign person (such as a protector) who has the power to veto trust decisions. Where a US trust becomes a foreign trust due to one of the trustees ceasing to be a US person, there is generally a 12-month grace period during which the situation can be rectified in order to prevent potential adverse consequences.

It is also possible to structure a trust which is managed in the US and subject to the jurisdiction of a US court, but fails the control test (e.g. because there is a foreign protector) and is therefore 'foreign' for US tax purposes. This may be beneficial if there are no current US beneficiaries but there may be a need to 'domesticate' the trust if the trust acquires US beneficiaries in future.

Types of Foreign Trust

There are two basic types of foreign trust, foreign grantor trusts and foreign non-grantor trusts.

For the purpose of these rules, the 'grantor' of a trust is the person who provided funding to the trust, whether directly or indirectly. If the trust becomes a 'grantor trust' with respect to that person, then all of the income of the trust is deemed, for US purposes, to belong to the grantor. However just because someone is the 'grantor' of a trust, that does not necessarily make the trust a 'grantor trust'. Indeed, many US trusts are deliberately structured as non-grantor trusts.

Foreign grantor trust with US grantor

Generally, a trust established by a US person will be a 'grantor trust' if the US grantor retains one or more 'grantor trust powers', such as powers over the beneficial enjoyment of the trust property, or the power to distribute income for the benefit of the grantor or their spouse. Powers held by a 'non-adverse party' (i.e. non-beneficiaries) are attributed to the grantor for the purpose of these rules i.e. a grantor can be deemed to have a power actually held by a trustee or protector, resulting in grantor trust status.

If the grantor retains no 'grantor trust powers' but the trust is 'foreign' then it will automatically be a grantor trust if income or principle could be distributed in the future to US persons. This additional rule is designed to prevent US persons from setting up foreign trusts to shield income from US taxation. If the grantor is not initially caught by this rule when the trust is funded, but the trust acquires a US beneficiary within five years, the grantor is immediately taxed on all undistributed income of the preceding years.

Since the US grantor of a foreign trust is subject to tax on all of the trust income, distributions can generally be made to US beneficiaries free of tax, provided that they comply with their reporting obligations.

Foreign grantor trust with non-US grantor

Where the grantor of the trust is a non-US person, it will only be a 'grantor trust' in circumstances where either

v. (the trust is revocable by the grantor alone or together with the consent of a related or subordinate non-adverse party; or

vi. all payments of income or capital are made only to the grantor or their spouse during the grantor's life.

The income of the trust is deemed to belong to the non-US grantor. He or she will only be subject to US tax to the extent of any US source income.

A grantor trust with a non-US grantor can be a highly effective tax planning structure since distributions can be made to US beneficiaries free from US tax, provided they comply with their reporting obligations discussed below. This is why the US rules severely restrict the circumstances in which a foreign trust with a non-US grantor will be a non-grantor trust.

Note that where a non-US grantor becomes US resident within five years of transferring property to a foreign trust, the transfer is deemed to have happened on the person's US residency start date. The effect of this rule is to prevent individuals doing pre-immigration planning by setting up non-grantor trusts before moving to the US. Such trusts will generally be grantor trusts from the date the individual becomes US resident, i.e. because of the rule described above under which foreign trusts established by US persons are automatically grantor trusts if the trust is capable of benefiting US persons.

Foreign non-grantor trust (with US or non-US grantor)

A foreign non-grantor trust is taxed in a similar way to a non-US individual. The trust is generally subject to US tax on income from US sources, unless the income is distributed in the year it arises to a beneficiary of the trust.

Distributions to US beneficiaries from a foreign non-grantor trust are subject to a complex set of rules. A beneficiary in receipt of a distribution from such a trust is generally taxable firstly to the extent of his or her share of current year trust 'distributable net income' (DNI) at the same tax rates as would apply if the trust did not exist. If the trust does not distribute all its DNI in the year of receipt (or within 65 days of 31 December, pursuant to a special 65 day election the trustees can make) then it will have undistributed net income ('UNI'). If the value of the distribution to a US beneficiary exceeds the individual's share of DNI for that year, then the individual is likely to be treated as receiving UNI, referred to as an 'accumulation distribution'. An interest charge may be imposed on the tax associated with the accumulation distribution. This is commonly referred to as the 'throwback tax'. Only once all UNI has been exhausted, will the beneficiary be able to access trust capital.

Use of trust property by a US beneficiary

The use of foreign trust property by a US beneficiary is treated as a distribution from the trust, equivalent to the fair rental value of the property used by the beneficiary. Loans are treated as outright cash distributions, with a limited exception for 'qualified obligations' meeting defined restrictive terms. These rules are designed to ensure that a US beneficiary of a non-grantor trust pays tax on benefits received, in accordance with the rules discussed above.

ANDERSEN

Interests in foreign corporations owned by trust

A particular trap arises where a non-grantor trust with US beneficiaries has a direct or indirect interest in one or more foreign corporations which meet the definition of a 'controlled foreign corporation' (CFC) or passive foreign investment company' (PFIC). Broadly, direct and indirect 10% US owners of a CFC are taxed on income of the CFC irrespective of whether or not it is distributed. The PFIC rules apply to most foreign investment funds and tax US owners at punitive rates on distributions and gains.

Stock in CFCs and PFICs directly or indirectly owned by a foreign non-grantor trust may be deemed to be owned proportionately by the beneficiaries of the trust. This may give rise to additional tax and reporting requirements for the beneficiaries even in a year when they do not receive a distribution from the trust.

Similar attribution rules apply to foreign grantor trusts, whereby the grantor is deemed for tax purposes to own CFCs and PFICs belonging directly or indirectly to the trust.

Distributions through intermediaries

The rules described above which tax US beneficiaries on distributions from non-grantor trusts cannot normally be circumvented by having the trust make a distribution to a non-US beneficiary who in turn makes a payment to a US beneficiary, if one of the purposes of the transaction is the avoidance of tax. There is a rebuttable presumption of tax avoidance for related parties where the transfers take place within a 24-month period.

Gain recognition rules for transfers of property to trusts

The funding of a foreign non-grantor trust with appreciated assets by a US person generally triggers a tax charge on the gain by reference to the market value of the assets, with no deduction for losses. This gain recognition rule can also apply

i. where the US grantor of a foreign grantor trust becomes a non-US person;
ii. where a US trust is migrated to a non-US trust; and
iii. on the death of the grantor since the trust will automatically become a non-grantor trust.

Reporting requirements

In addition to having to file a US tax return to report income subject to US tax, the US grantors, beneficiaries and the trustees themselves may be required to file additional information returns.

Foreign grantor trust with US grantor - the US grantor and US beneficiaries receiving a distribution or benefit must include Form 3520 Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) with their returns, as well as a Foreign Grantor Trust Owner (or Beneficiary) Statement which should be provided to them by the trustees. The trustees are also required to file Form 3520-A (Annual Information Return of Foreign Trust with a US Owner). Note that the 3520-A has a filling deadline of 15 March (instead of the usual 15 April) however this can be extended.

Foreign grantor trust with non-US grantor - US beneficiaries receiving a distribution or benefit must include Form 3520 with their US tax returns, as well as a Foreign Grantor Trust Beneficiary Statement, which should be provided to them by the trustees. Failure by the beneficiary to comply with the correct reporting requirements may result in the beneficiary being subject to US tax on the full amount of the trust distribution.

Foreign non-grantor trust - US beneficiaries receiving a distribution or benefit must include Form 3520 with their US tax returns, as well as a Foreign Non-Grantor Trust Beneficiary Statement, which should be provided to them by the trustees. Failure by the beneficiary to comply with the correct reporting requirements may result in the beneficiary being subject to a higher US tax charge on the trust distribution than would otherwise be the case.

Also applicable to US grantors and beneficiaries are the FinCEN Form 114 (Report of Foreign Bank and Financial Accounts, and 'FBAR') and Form 8938 (Statement of Specified Foreign Financial Assets). There are similarities between the FBAR and 8938, however filing one of these forms does not necessarily eliminate the requirement to file the other.

It can be beneficial for a foreign trust to appoint a US agent, since not doing so can result in the IRS being able (in some circumstances), to unilaterally determine the taxable income for US beneficiaries, in the absence of appropriate reporting information.

Penalties can be imposed where the relevant forms are filed late, incomplete or are inaccurate. Note in particular that where the trustees of a grantor trust have failed to file Form 3520-A, penalties can be imposed on the US grantor.

Planning considerations for foreign trusts with US beneficiaries

There are a number of techniques which, depending on the circumstances, can potentially be used to mitigate the adverse tax consequences for US beneficiaries receiving a distribution from a foreign trust:-

- Establish a new structure which meets the definition of a grantor trust, with the 'grantor' being a non-US person. Migrate the structure to a US trust once the non-US grantor has deceased.
- A foreign non-grantor trust can be drafted in such a way that up to three lump sums can be paid to a US beneficiary without tax.
- Require all trust income to be paid to non-US beneficiaries so that US beneficiaries can only receive discretionary payments of trust capital. Note that this may not be an effective technique for trust capital gains.
- Make 'stripping' distributions of DNI and UNI to non-US beneficiaries (or a separate trust for non-US beneficiaries) and then distribute trust capital to US beneficiaries in the following year.
- If a beneficiary is going to receive UNI then he or she may choose to treat the distribution as DNI based on 125% of the average of distributions from the last three years, with only the excess being treated as UNI. This can enable the trust to distribute actual UNI which is taxed instead as DNI at lower effective rates.
- A distribution which does not exceed 'fiduciary accounting income' (FAI) does not carry out UNI. The amount of DNI for a year may be lower than the FAI due to differences in the definitions of these terms. It can sometimes be possible to make a distribution of current year income which is partially tax-free.
- If the grantor of a foreign non-grantor trust is a non-US person then the trust could make a distribution to the US beneficiary through the grantor. The special rules regarding 'distributions through intermediaries' discussed above may not apply because there is an exception where the grantor is the intermediary.
- If the trust is revocable and the grantor dies, then it may be possible to make a special election (a Section 645 election) for the trust to be disregarded and treated as part of the grantor's estate for US purposes, which may enable trust distributions to be made to US beneficiaries free of US income tax, generally for up to two years after the date of death.
- In certain situations where the tax consequences are extreme, US individuals could consider becoming a non-US person e.g. by giving up their US citizenship. Note however that a US citizen or 'long term resident' (meaning a green card holder for eight of the last fifteen years) may also be subject to an exit tax and other adverse consequences.

Conclusion

Trustees, settlors and beneficiaries should understand and take pre-emptive action to understand and plan for the consequences of the foreign trust having a US connection, whether by virtue of the settlor or beneficiaries becoming US resident, or the trust acquiring US investments.

Further information

For further information please contact:

Julian Nelberg
Head of Private Clients
M: +44(0) 78 0350 2555
T: +44(0) 20 7242 5000
E: julian.nelberg@uk.andersen.com

Paul Lloyds
Partner
M: +44(0) 75 1881 0993
T: +44(0) 20 7242 5000
E: paul.lloyds@uk.andersen.com