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U.S. International Trust Reporting and Planning

By Glenn G. Fox and Paul DePasquale

I. Introduction

This article discusses the various regimes established by Congress and the Department of the Treasury to combat avoidance of U.S. income taxation through the use of foreign trusts and offshore accounts. The circumstances are outlined under which a foreign trust, be it outbound or inbound, is deemed a grantor or nongrantor trust for U.S. tax purposes, and the U.S. income tax implications with regard to each are described. An overview is also provided of the so-called "throwback rules," which prevent U.S. persons from using foreign nongrantor trusts to accumulate income without current income tax.

In addition, the U.S. reporting requirements regarding distributions to a U.S. person from a foreign trust and gifts to a U.S. person from a foreign person, and the rules governing the nature and imposition of penalties for failure to comply with the U.S. reporting requirements, are outlined. U.S. reporting requirements with regard to foreign accounts in which a U.S. person has a financial interest or signature authority, and a foreign trust in which a U.S. person has an interest, are also delineated, and the rules governing the nature and imposition of penalties for failure to comply with these U.S. reporting requirements are outlined. Finally, the reporting and withholding rules under FATCA as they relate to foreign trusts are discussed.

II. U.S. Income Taxation of Foreign Trusts and Their U.S. Beneficiaries

A trust will be considered a U.S. person if a court within the U.S. is able to exercise primary supervision over the administration of the trust (the "court test") *and* one or more U.S. persons have the authority to control all substantial decisions of the trust (the "control test").[1] Any trust which is not a U.S. person (i.e., a trust that does not meet both the court test and the control test) is considered a foreign trust for U.S. tax purposes.[2]

"The first rule is that if any person has the discretion to make a distribution from the trust to any person, the trust will be treated as having a beneficiary who is a U.S. person, unless the trust terms identify the class of persons to whom distributions may be made, and none of those persons is a U.S. person."

The manner in which the income of a foreign trust is taxed for U.S. tax purposes depends upon whether the trust is a grantor trust or a nongrantor trust. Following is a discussion of these two types of trusts.

A. Foreign Grantor Trusts with U.S. Owners

If a trust is a grantor trust, a particular person is treated as the owner of the trust, and the income, deductions, and credits against tax of the trust will be attributed to that person and, therefore, included in computing that person's taxable income and credits.[3] There are a number of sections of the tax law that result in a trust being considered a grantor trust as to a U.S. person. One such section is Code § 679. Under Code § 679, a U.S. person[4] generally is treated as the owner of a foreign trust, and such a trust is therefore considered a foreign grantor trust, if (i) the U.S. person transfers property to the foreign trust, and (ii) the trust could benefit a U.S. person.[5] (Note that it is immaterial for purposes of Code § 679 whether the trust is created for the benefit of the owner or for the benefit of a third party, as long as some U.S. person may be benefited.)

"In essence, this provision says that even if the taxpayer complies with all of the other requirements of Code § 679, the IRS can still require that further information be submitted before it is determined that the trust does not have any U.S. beneficiaries."

If a nonresident alien of the U.S. ("NRA") has a residency starting date within five years after directly or indirectly transferring property to a foreign trust, such person is treated as if he or she transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by him or her to such trust in such transfer.[6] Therefore, the trust will be treated as a grantor trust as to such individual once he or she immigrates to the U.S., thereby preventing him or her from sheltering assets from the income tax by transferring them to a foreign trust prior to his or her arrival in the U.S.

All foreign trusts are presumed by the IRS to benefit a U.S. person unless the transferor can establish that (i) under the terms of the trust, 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* (ii) no part of the income or corpus of such trust could be paid to or for the benefit of a U.S. person if the trust were to terminate at any time during the taxable year.[7] Pursuant

to flush language added to Code § 679(c)(1) by the Foreign Account Tax Compliance Act ("FATCA"), which was enacted on 18 March 2010 as part of the Hiring Incentives to Restore Employment ("HIRE") Act, trust income is deemed to be accumulated during the taxable year to or for the benefit of a U.S. person, even if the U.S. person's interest in the trust is merely contingent on a future event.

FATCA added three more new rules that make it more likely that a foreign trust will be deemed to have a beneficiary who is a U.S. person, therefore causing a U.S. person who transferred property to that trust to be considered the owner of the trust income under Code § 679(a).

"A beneficiary shall not be treated as a U.S. person for the purpose of the above rules with respect to any transfer of property to a foreign trust, if such beneficiary first became a U.S. person more than five years after the date of such transfer."

The first rule is that if any person has the discretion to make a distribution from the trust to any person, the trust will be treated as having a beneficiary who is a U.S. person, unless the trust terms identify the class of persons to whom distributions may be made, and none of those persons is a U.S. person.[8]

The second new rule enacted by FATCA is that if the U.S. person who transferred property to a foreign trust is directly or indirectly involved in any agreement (written or oral) that may result in trust assets being paid to or accumulated for the benefit of a U.S. person, such agreement will be treated as a term of the trust, making the trust a grantor trust as to the transferor under Code § 679(a).[9]

Finally, FATCA provides that if a U.S. person transfers property to a foreign trust, the trust may be treated as having a U.S. beneficiary unless the U.S. person submits information to the IRS as the IRS requires *and* demonstrates that under the terms of the trust, 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 no part of the income or corpus of such trust could be paid to or for the benefit of a U.S. person if the trust were to terminate at any time during the taxable year.[10] In essence, this provision says that even if the taxpayer complies with all of the other requirements of Code § 679, the IRS can still require that further information be submitted before it is determined that the trust does not have any U.S. beneficiaries.

A beneficiary shall not be treated as a U.S. person for the purpose of the above rules with respect to any transfer of property to a foreign trust, if such beneficiary first became a U.S. person more than five years after the date of such transfer.[11]

B. Grantor Trusts with Non-U.S. Owners

In the case of trusts having a foreign grantor—so-called "inbound grantor trusts with foreign grantors"—Code § 672(f) applies special rules that make it difficult for a foreign person to be treated as the owner of a trust for income tax purposes under the grantor trust rules. This, in many instances, prevents a foreign person from creating a foreign trust for U.S. beneficiaries and taking the position that he or she is the owner of the trust for income tax purposes.

A trust, be it foreign or domestic, is treated as a grantor trust with respect to transfers after 19 August 1996, only if the person deemed to own the trust is a U.S. person or a domestic corporation.[12] This rule applies whether the trust income would be imputed to the foreign person either "directly or through 1 or more entities."[13] Prior to the enactment of Code § 672(f), a foreign grantor could use a foreign trust to convert into a tax-free distribution a gift to U.S. beneficiaries of assets—say, foreign securities—producing taxable income. This is because, if such income were taxable only to the grantor, and the grantor were a foreign grantor receiving foreign-source income, then no person would wind up being taxed in the United States on the trust's income.[14]

"If the first or last taxable year of the trust (including the year of the grantor's death) is less than 183 days, the grantor is treated as having a power to revest if the grantor has such power for each day of such first or last taxable year."

There are some important exceptions to the above rule that prohibits grantor trust status unless the person deemed to own the trust is a U.S. person or domestic corporation. The first exception is when an NRA funds the trust and "the power to revest absolutely in the grantor title to the trust property to which such portion is attributable 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."[15] In such a case the NRA grantor will be deemed the owner of the trust income and the trust will be treated as a grantor trust for U.S. income tax purposes. A related or subordinate party is presumed to be subservient to the grantor unless the presumption "is rebutted by a preponderance of the evidence."[16]

trust is required to distribute, and all income actually distributed to the beneficiaries pursuant to the governing instrument.[30] If and to the extent that a complex non-grantor trust does not distribute (and is not required to distribute) DNI, such DNI is taxable to the trust.

Each beneficiary must include in his or her gross income an amount equal to that beneficiary's pro-rata share of the trust's DNI.[31] A distribution in excess of the trust's DNI is treated either as a nontaxable distribution of principal or as a distribution of income accumulated from prior years taxable under the so-called "throwback rules."[32]

"The throwback tax is determined by averaging the distributions over a number of years equal to that over which the income was earned, and by including a fraction of the income received from the trust in the beneficiary's income for each of the five preceding years, excluding the years with the highest taxable income and the lowest taxable income."

The purpose of the throwback rules is to prevent U.S. persons from using foreign nongrantor trusts to accumulate income without current tax. Under the throwback rules, if a foreign nongrantor trust accumulates DNI in one year, the accumulation becomes undistributed net income ("UNI") for the following year. Since DNI for a foreign trust includes gains allocable to corpus, UNI will include any accumulated gains. An "accumulation distribution" is a distribution of any amount from the trust, other than income that is required to be distributed from the trust, to the extent that the amount distributed exceeds the trust's DNI for the year, reduced by income that is required to be distributed.[33] The throwback rules apply only to foreign trusts, since distributions from domestic trusts are calculated without regard to UNI.[34]

Under the throwback rules, the U.S. taxes a U.S. beneficiary of a foreign nongrantor trust that makes an accumulation distribution in the same manner that the U.S. would have taxed the beneficiary if the trust had distributed all of its income on a current basis.[35] U.S. beneficiaries who receive distributions of UNI from a foreign nongrantor trust may be subject to onerous U.S. income tax treatment on the distribution in the form of two types of penalties.[36]

First, the distribution of UNI is taxed to the U.S. beneficiary as ordinary income (taxable at marginal rates up to 39.6%), even if the UNI represents gains accumulated in a prior year (long-term capital gains are generally taxable to U.S. persons at a flat 23.8% rate, when accounting for the Medicare tax under Code Section 1411).[37] The throwback tax is determined by averaging the distributions over a number of years equal to that over which the income was earned, and by including a fraction of the income received from the trust in the beneficiary's income for each of the five preceding years, excluding the years with the highest taxable income and the lowest taxable income. The fraction of income included in the five years is based on the number of years the income was accumulated.[38]

Second, the U.S. income tax on the distribution is subject to an interest surcharge, calculated on a compounding basis, that is intended (in a rough manner) to charge the U.S. beneficiary as if he or she had owed the U.S. tax for the prior year in which the UNI was earned in the foreign nongrantor trust. The interest surcharge imposed on the throwback tax is equal to the rate of interest applicable to underpayments of tax (which is the Federal short-term rate as determined monthly, plus three percent).[39]

The combination of the above two penalties can result in a confiscatory tax as large as the distribution itself, because the longer UNI accumulates in a trust, the higher the interest charge.

In order to determine whether a distribution from a foreign nongrantor trust carries out UNI, certain ordering rules apply. To apply the ordering rules, one must understand the definitions of DNI and UNI discussed above and must understand the definition of fiduciary accounting income ("FAI"). FAI is the amount of the trust's income determined under the terms of the governing instrument and applicable local trust law. FAI can be, and often is, different in both timing and amount from DNI. To the extent there is any FAI exceeding DNI, it is not subject to U.S. tax but may be subject to local tax.

When the total distributions from a foreign nongrantor trust during the year at issue do not exceed FAI for the year, the distribution will be deemed to carry out the trust's current-year DNI. Once DNI is exhausted, FAI is carried out and no UNI is carried out, so the throwback rules will not apply.

"With the partnership blocker solution, the foreign trust owns an interest as a ninety-nine percent partner in a partnership."

When the total distributions from a foreign non-grantor trust during the year at issue exceed FAI for the year, the distribution will be deemed to carry out the trust's current-year DNI and once DNI is exhausted, UNI carried forward from prior years is carried out. Once all DNI and UNI have been carried out, the balance of any distributions from the trust is deemed to be trust capital.

1. The Partnership Blocker Solution to the Throwback Rules for Foreign Non-Grantor Trusts

Generally speaking, if a U.S. person is a beneficiary of a foreign nongrantor trust, the solution to avoid the throwback rules is to distribute all of the income on an annual basis (either to the U.S. person beneficiary or to another non-U.S. person beneficiary). Another solution is to decant the trust assets to a domestic trust where the income can be accumulated without being subject to the throwback rules.

If annual distributions from the foreign trust or decanting to a domestic trust are not possible or are not appropriate in the given circumstances, another solution that may be useful is the so-called "partnership blocker solution." The partnership blocker solution is intended to take advantage of the ordering rules discussed above for DNI, UNI, and FAI. The partnership blocker solution's objective is to control when the trust receives FAI.

> *"Because the income generated by the underlying investments passes through the partnership directly to the trust for U.S. income tax purposes as DNI, UNI will gradually accumulate in the trust."*

With the partnership blocker solution, the foreign trust owns an interest as a ninety-nine percent partner in a partnership. The other one percent partner can be a corporation, all of the stock of which is owned by the trust. The assets that would have otherwise been held by the trust are held by the partnership. The partnership is transparent for tax purposes and, therefore, the DNI/UNI of the trust will be determined by the income of the partnership and the distributions from the trust. The partnership will nevertheless serve as a *blocker* for purposes of the trust's FAI. FAI will only be provided to the trust when an actual distribution is made by the partnership to the trust.

In most cases when the partnership makes a distribution to the trust, the trust will also have a DNI amount for the current year. Under the above ordering rules, a distribution from the trust will be first treated as taxable DNI to the extent of any current year DNI and, if the distribution does not exceed the current year FAI, the remainder of the distribution should be treated as FAI, which is not subject to taxation.

The partnership blocker allows the trustee to accumulate income in the underlying partnership without triggering the adverse effects of the accumulation distribution rules once a distribution to a U.S. beneficiary is made. Because the income generated by the underlying investments passes through the partnership directly to the trust for U.S. income tax purposes as DNI, UNI will gradually accumulate in the trust. However, the UNI will not be deemed distributed out of the Trust, and thus a U.S. beneficiary will not be taxed on such UNI as long as the trust's total distributions for the year do not exceed its FAI (the distributions will likely not exceed FAI, since the distributions will equal exactly what was distributed to the trust by the partnership).

D. Tax on Contribution of Assets to a Foreign Trust

If a U.S. citizen or U.S. resident transfers property to a foreign trust, the transfer is treated as a sale or exchange of the transferred property for an amount equal to the fair market value of the property, and the transferor recognizes gain on the excess of the fair market value of the property over its adjusted basis.[40] Such a transfer essentially is taxed at the capital gains tax rates (which is currently twenty percent plus a 3.8% Medicare surcharge, as discussed above). The tax on contribution to the foreign trust is not imposed, however, if the foreign trust is treated as a grantor trust for U.S. income tax purposes.[41] There would, however, still be IRS reporting requirements, discussed below.

III. Reporting Requirements for Contributions to and Distributions from a Foreign Trust and Receipts of Foreign Gifts

A. Overview

When a U.S. person makes a contribution to a foreign trust or receives a distribution from a foreign trust, in addition to complying with any required income tax reporting requirements and payments (discussed above), he or she is required to file a report with the IRS for the year of the contribution or distribution reporting the same.[42] Contributions by U.S. persons to foreign trusts and distributions to U.S. persons from foreign trusts must be reported annually on IRS Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. If a U.S. person is an owner of a foreign trust, IRS Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner, also must be filed.

> *"The U.S. person may also be required to report the names of the trustees or other persons in control of the trust and the names of the beneficiaries thereof, and may be required to attach a copy of the trust documents and other agreements and letters of understanding that control the trust relationship."*

It should be noted that "distributions from foreign trusts" also may include distributions that are constructively received, such as the payment of the beneficiary's debts by the trust, payments to the beneficiary in ex-