



Surprise! You have a Foreign Trust

Annual Meeting of the California Tax Bar & California Tax Policy Conference

November 2, 2007

Patrick W. Martin, Esq.

Enrique Hernández Pulido, Esq.

Jon P. Schimmer, Esq.

Contact Details

**Procopio, Cory, Hargreaves &
Savitch, LLP**

530 B Street, Suite 2100

San Diego, CA 92101

T. (619) 238-1900

F. (619) 235-0398

www.procopio.com

Circular 230 Notice: In accordance with Treasury Regulations which became applicable to all tax practitioners as of June 20, 2005, please note that any tax advice given herein is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax penalties or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.



Overview of Topics:

- Definition of Trust
- Domestic Trust vs. Foreign Trust
- Grantor vs. Non-Grantor Trust
- Information Reporting Requirements
- Penalty Provisions



Definition of Trust:

- *“an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.”* Treas. Reg. § 301.7701-4(a)



Foreign Trusts vs. Domestic Trusts

- Foreign Trusts
 - The classification and tax rules applicable to foreign trusts significantly changed with the enactment of the Small Business Job Protection Tax Act of 1996 (the “Act”)
 - Prior to the Act, there were no “bright-line” tests for determining when a trust would be deemed a domestic trust or a foreign trust
 - Under the Act, however, a trust will be a domestic trust only if the trust satisfies both the (i) “control” test, and (ii) “court” test. See IRC §§ 7701(a)(30)(E) and (31)(B) and Treas. Reg. § 301.7701-7. All other trusts that do not satisfy both of these tests are necessarily foreign trusts.



Domestic Trust if:

- *Court Test* - IRC § 7701(a)(30)(E)(i) **AND**
- *Control Test* - Treas. Reg. § 301.7701-7(c)(1)



Foreign Trust or Domestic Trust

- “Court” Test –
 - Satisfied if a U.S. court is able to exercise primary supervision over the administration of the trust.
- “Control” Test –
 - Satisfied if the power to make all “Substantial Decisions” is held by a U.S. person. These powers, which include investment decisions and the power to litigate or arbitrate claims (and the power to name successor trustees), are all “substantial decisions” as defined by IRC § 7701(a)(30)(E)(ii) and Treas. Reg. § 301.7701-7(d)(1)(ii).



Foreign Trusts with U.S. Beneficiaries

- Grantor Trust Rules (Pre- and Post-1996 Act)
 - IRC Sections 671-679
 - Post Act - Limited Applicability to Foreign Trusts with U.S. Persons
 - Pre-Act - IRC Sections 671-679 were Applicable -
 - Under the old law, the U.S. beneficiaries of a foreign grantor trust were generally not subject to U.S. taxation on any distributions from the foreign trust. See Rev. Rul. 69-70.



Foreign Trusts with U.S. Beneficiaries

- Under the Act, a foreign trust (with U.S. beneficiaries) is a **grantor** trust after January 1, 1996, only if the trust instrument or applicable law provides that:
 - the grantor has the sole power to revoke the assets held in trust without the approval or consent of any other person. IRC § 672(f)(2)(A)(i);
 - the only amounts distributable from such portion of the trust during the grantor's lifetime are distributable to the grantor or the grantor's spouse. IRC § 672(f)(2)(A)(ii); or
 - any portion of the trust's distributions from which are taxable as compensation for services actually rendered. IRC § 672(f)(2)(B).



Foreign Trusts – Taxation of U.S. Beneficiaries

- Prior to the Act, U.S. beneficiaries of foreign grantor trusts were generally not subject to U.S. taxation on any distributions from the foreign trust. Rev. Rul. 69-70.
- Prior to the Act, U.S. beneficiaries of foreign nongrantor trusts were always subject to U.S. taxation (albeit at a fairly favorable rate).
 - The U.S. taxation of U.S. beneficiaries was at the U.S. beneficiaries' average marginal tax rate (for the prior five years - plus fixed simple interest at 6 percent) on distributions of previously accumulated distributable net income.
- Under the Act, the U.S. taxation of U.S. beneficiaries is based on a compounded interest calculation that is charged against accumulated income that is distributed (known as an accumulation distribution).
- The Act changed the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the same manner as interest imposed on underpayments of tax under Section 6621(a)(2).



Foreign Accumulation Trusts – Throwback Tax

- If U.S. beneficiary receives distribution in excess of beneficiary's share of trust's "distributable net income" ("DNI"), the excess is characterized as an "accumulation distribution" to the extent of such beneficiary's respective share of the trust's "undistributed net income" ("UNI"). IRC §§ 665 – 668.
- DNI for a particular tax year equals the trust's worldwide income, including foreign-source income, income exempt under treaties, and capital gains net of capital losses. IRC §§ 643(a), 643(a)(6). UNI is the amount by which the trust's DNI for a given year exceeds the sum of the trust's distributions for that year and the U.S. taxes imposed on the trust's DNI for that year (if any). IRC § 665(a).
- Accumulation distributions are "allocated to preceding years" (the so-called "throwback" rule) according to IRC § 666 and taxed as if made in such prior years. They are also ordinary income regardless of whether the original income was capital gain to the trust.
- Once throwback tax is calculated, interest charged against the tax based on the floating rate imposed on underpayment of tax under IRC § 6621(a)(2), with compounding.
- If adequate records of the trust are not available to determine the proper application of the accumulation distribution rules to any distribution, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust. IRC § 666(d).



Foreign Accumulation Trusts – Throwback Tax

Very Basic Hypothetical Illustration:

- Assumptions:
 - Trust formed in 2001 and funded with U.S.\$1,000,000
 - Trust generates \$100,000 annually from 2001-2020, and makes no distributions, so on 12/31/2020 trust has \$3,000,000 in assets and \$2,000,000 of UNI
 - On 12/31/2020 trust distributes \$600,000 to U.S. beneficiary, whose average taxable income and marginal rate for 2018-2020 was \$70,000 and 35 percent, respectively.
 - Interest rate imposed on throwback tax based on floating underpayment rate

- Under these assumptions:
 - Throwback tax of approximately \$140,000
 - Interest charge of approximately \$284,000
 - Of \$600,000 distribution, \$424,000 consumed by federal taxes



Foreign Trusts – Basis Considerations

- U.S. rules govern to determine trust's (and later, upon distribution, beneficiary's) tax basis in trust assets. *U.S. v. Goodyear Tire and Rubber Co.*, 493 U.S. 132, 145 (1989).
- Step-up or step-down to fair market value when foreign grantor dies and trust becomes nongrantor trust. IRC §1014.
 - Issues for stock ownership
- For property distributions, amount of distribution is generally lesser of trust's basis in the property or fair market value of the property. IRC § 643(e).
 - Planning opportunities to mitigate throwback tax



§6048(a), (b) – Information With Respect To Certain Foreign Trusts

- Gratuitous transfers by U.S. persons to foreign trusts (e.g., creation of foreign trust) must be reported by transferor on Form 3520
- No reporting required for transfers for value. Notice 97-34.
- If trust is treated as having a U.S. owner, U.S. owner required to annually file Form 3520-A to report trust information; U.S. owner should also appoint a U.S. person to act as trust's limited agent regarding requests by the IRS to examine records



§6048(c) – Information With Respect To Certain Foreign Trusts

- U.S. beneficiaries who receive any direct or indirect (e.g., loan) distributions from a foreign trust during any tax year are required to file Form 3520 so IRS can evaluate whether distribution is taxable (e.g., distribution of income or corpus)
- If Form 3520 not filed, entire distribution is included in beneficiary's income as accumulation distribution subject to throwback rules and compound interest charge
- Beneficiary should obtain from the trust a Foreign Nongrantor Trust Beneficiary Statement (or a Foreign Grantor Trust Beneficiary Statement) and attach to Form 3520 to avoid default treatment as accumulation distribution. Notices 97-34
- Penalty for failure to file Form 3520 is 35% of the distribution (even if distribution was non-taxable), with additional \$10,000 penalties for each 30-day period failure continues after 90-day notice period, not to exceed amount of distribution; reasonable cause exception. §6677
- Statute of limitations does not commence until Form 3520 filed. §6501(c)(8), TAM 200024051



Penalty Provisions - Informational Reporting Requirements

- **Reporting of a Foreign Trust with Foreign Grantor and U.S. Beneficiaries**
 - There are no direct reporting requirements by a foreign grantor of a foreign trust.
 - Reporting obligations fall on the U.S. beneficiary, where she is required to make a return reporting the aggregate amount of the distributions she received during the year, the name of the trust and other information required pursuant to IRC § 6048(c) and 6677.
- The distributions should be reported if actually or constructively received. Notice 97-34. Additionally, a loan made to a U.S. beneficiary from a foreign trust is generally deemed a reportable distribution to the beneficiary.
 - IRS Form 3520 - 35% Penalty for Failure to Report Trust Distributions (Even if Non-Taxable Distributions from Grantor Trust) - IRC § 6677



Penalty Provisions - Informational Reporting Requirements

- **Reporting of a Foreign Trust with Foreign Grantor and U.S. Beneficiaries**
 - This should be distinguished from reporting under IRC § 6039F because § 6039F applies to reporting of U.S. persons who receive foreign “gifts” in excess of US\$ 100,000 (this threshold amount was increased from \$10,000 per the statute to US\$ 100,000 per Notice 97-34), and for U.S. beneficiaries who receive distributions in such amounts by a domestic trust owned by a foreign person.
 - “Foreign gifts” are those transfers treated as gifts or bequests, other than transfers to pay medical or education expenses which qualify for a gift tax exclusion and other that those distributions reported under IRC § 6048(c).
 - Penalty under IRC Section 6039F is 5 percent of the value of the gift per month, not to exceed 25 percent





The End

