Foreign Trusts With U.S. Beneficiaries: Best Practices for Administration

By: Kathryn von Matthiessen

May 3, 2013
Foreign Trust Basics
Definition of Foreign Trust

- Under U.S. law, a trust is a foreign trust unless both of the following conditions are satisfied:

  (1) a court within the U.S. exercises primary supervision over the administration of the trust; and

  (2) one or more U.S. persons have the authority to control all substantial decisions of the trust.

- These are called the “Court Test” and the “Control Test”.

Definition of Foreign Grantor Trusts and Foreign Non-Grantor Trust

- A foreign trust is a grantor trust (which means income is taxable to the grantor) only if:
  
  (1) the grantor retains the right, exercisable either alone or with the consent of another person who is a related or subordinate party who is subservient to the grantor, to revoke the trust; or
  
  (2) the only amounts which may be distributed from the trust during the grantor’s life are amounts distributable to the grantor or his spouse.

- A foreign non-grantor trust is any foreign trust that is not a foreign grantor trust.
The Small Business Jobs Protection Act of 1996 ("SBJPA") significantly changed the rules regarding foreign trusts and foreign grantor trusts.

Generally, the grantor trust rules in the Code dictate when the income of a trust will be taxed to the grantor of a trust (or some other person), regardless of who in fact receives the income.

These rules are based upon whether the grantor has retained any of an enumerated series of economic interests in the trust or administrative powers over the trust.
Before the SBJPA, because the grantor trust rules operated regardless of whether or not the grantor was subject to U.S. income taxation, trust income could be distributed to a U.S. citizen or resident tax-free, and no beneficiary would ever pay U.S. income taxes on these distributions.

Even if the grantor was outside of the United States’ taxing jurisdiction, the grantor would not pay any tax, either. Such distributions were, in effect, tax-free gifts for U.S. purposes.

The SBJPA significantly narrowed this loophole.
There are a number of reasons why foreign grantor trust status is desirable.

- Accumulation distributions to U.S. beneficiaries from foreign non-grantor trust are subject to “throwback” rules – U.S. income tax and interest charge, accumulated gain loses character.
Best Practices: Avoiding Common Mistakes Made in Administration
• Blowing grandfathered status – key date: September 19, 1995
• Funding of Trust
  o Transfer of U.S. situs property
    o Gift tax exposure – U.S. tangible or real property
    o Wire transfer
  o Transfer of foreign situs property
• Failure to recognize and plan for CFC or PFIC issues
  
  o Controlled Foreign Corporation (“CFC”)
    • More than 50% of vote or value owned by United States residents
    • Applies only to 10% shareholders - a U.S. person who owns 10% or more of the total combined voting power
  
  o Passive Foreign Investment Company (“PFIC”)
    • 75% or more of gross income is passive income or average percentage of assets which produce or are held for production of passive income is at least 50%
    • No minimum threshold of ownership
• Failure to maintain companies properly

• Transfer from account owned by foreign corporation or foreign partnership to beneficiary
• Remember revocation and gift option
  
  o If a foreign grantor trust, minimize filing for U.S. beneficiary if grantor revokes trust and makes a gift to a beneficiary, rather than the trust making a distribution. In the former scenario, a 3520 will only be required if all gifts to beneficiary from the foreign individual exceed $100,000. In the latter scenario, a 3520 will be required with much more detailed information concerning the trust distribution.
• Failure to treat certain loans or property use as distributions

• Failure to take into consideration U.S. accounting standards
• Failure to file U.S. reporting requirements on a timely basis
Important Forms

- U.S. Treasury Department Form TD F 90-22.1 (June 30)
- IRS Form 3520
- IRS Form 3520-A (March 15)
- Foreign Grantor/Nongrantor Trust Beneficiary Statement
- IRS Form 5471
- IRS Form 8261
- IRS Form 8938
Contact Information

• Kathryn von Matthiessen
  Cantor & Webb P.A.
  1001 Brickell Bay Drive
  Suite 3112, Miami, FL 33131

• Phone: (305) 374-3886

• Email: kathryn@cantorwebb.com

• Website: www.cantorwebb.com