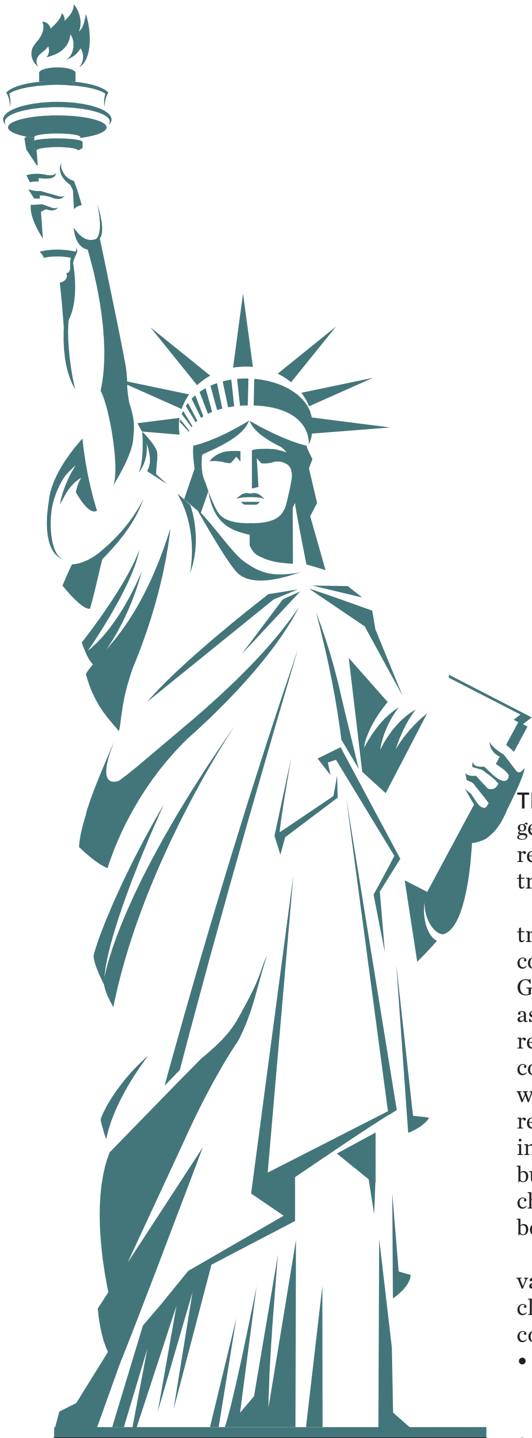

The American *way*

LUCY S LEE AND **PAULA CHARPENTIER** OUTLINE THE US FEDERAL INCOME TAX REPORTING REQUIREMENTS FOR FOREIGN TRUSTS

KEY POINTS

WHAT IS THE ISSUE?
Foreign trustees and beneficiaries are faced with complex US tax and reporting obligations, including Forms 3520, 3520-A, W-8BEN-E, W-8IMY and 8938, and the Report of Foreign Bank and Financial Accounts.

WHAT DOES IT MEAN FOR ME?
All STEP members are increasingly concerned by their duties under the US *Foreign Account Tax Compliance Act* and OECD Common Reporting Standard, and their know-your-client obligations.

WHAT CAN I TAKE AWAY?
A better understanding of the US tax rules behind foreign trust reporting.

THE US *INTERNAL REVENUE CODE* (IRC) generally imposes an income tax filing and reporting requirement on certain foreign trusts with US owners or another US nexus.[1]

Before discussing the taxation of foreign trusts, it is necessary to understand what is considered to be a trust for US tax purposes. Generally, an arrangement will be treated as a trust if its purpose 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, thus, are not associates in a joint enterprise for the conduct of a business for profit.[2] In the absence of such characteristics, an arrangement should not be treated as a trust for US tax purposes.

The US tax and reporting requirements vary depending on the residence and classification of a trust. A trust is generally considered domestic if the following apply:

- **a US court can exercise primary supervision over trust administration, and**
- **US persons control all substantial trust decisions.**[3]

All other trusts are considered foreign.[4]

WHAT MAKES A GRANTOR TRUST?

Whether foreign or domestic, if a trust is treated as a grantor trust, its income and gains are generally taxed to the grantor.[5] The grantor is a person (natural or non-natural) who either creates a trust or directly or indirectly makes a 'gratuitous transfer' of property to a trust.[6] If a person creates or funds a trust on behalf of another person, both are treated as grantors, but only the person making gratuitous transfers may be treated as the owner of the trust.

A trust will be considered a grantor trust if, *inter alia*, the grantor or another non-adverse party retains certain interests or powers over the trust. A foreign trust established by a US person that has, or may have, US beneficiaries will also be considered a grantor trust, even if the grantor has retained no interests in or powers over the trust.[7] In addition, a foreign trust established by a non-US person who becomes a US person within five years of transferring property to the trust, directly or indirectly, will be a grantor trust if, at the grantor's residency starting date, the trust has a US beneficiary.

By contrast, a trust with a non-US grantor is generally treated as a grantor trust only if the following apply:

- **the grantor is a foreign corporation treated as a domestic corporation for US tax purposes;**
- **the grantor can revest the assets of the trust to themselves;**
- **the only amounts distributable from the trust are to the grantor or the grantor's spouse during the grantor's lifetime; or**
- **the trust is a compensatory trust.**[8]

FOREIGN NON-GRANTOR TRUSTS

A non-grantor trust is treated as its own taxpayer, separate from the grantor or settlor. It is taxed as if it were a foreign individual[9] on income from sources within the US, capital gains on sales of US real property interests and other income or gain that is considered to be effectively connected income (ECI) with regards to a US trade or business.[10] A foreign trust can have ECI as a result of investments in partnerships that engage in a US trade or business, in which case the partnership is generally required to withhold on income allocable to the foreign partner.[11] As well as ECI, a 30 per cent withholding tax is imposed on several types of US-source non-business income (e.g. interest, dividends, rents and royalties).[12]

'The throwback rule can leave little net economic benefit when historic UNI is distributed to US beneficiaries'

In determining the taxable income of a non-grantor trust, it is important to understand the concept of distributable net income (DNI) as it applies to trusts. DNI is generally defined to mean taxable income with certain modifications.[13] Distributions to beneficiaries are considered first to carry out the DNI of the current year (pro rata as to each item of income or gain) and will be taxed to the recipient beneficiaries based on the character of the underlying income.[14]

A major distinction between taxation of a foreign trust and a US trust is the inclusion of annual net capital gains and losses in DNI.[15] Accordingly, capital transactions that may be considered on account of capital in the foreign jurisdiction become part of DNI for US tax purposes. This may have a significant impact on the computation of undistributed net income (UNI).

To the extent that all DNI is not distributed to a beneficiary in any US tax year, the undistributed amount is added to the trust's UNI. This has serious implications for future distributions in a number of ways. First, to the extent that the trust has income that would be subject to favourable US tax rates (i.e. the 20 per cent long-term capital gain rate on assets held longer than one year and the 20 per cent rate on 'qualified dividends'), the benefit of the favourable rates is lost. All UNI is treated as ordinary income when it is distributed to a US beneficiary. Second, there is the application of the 'throwback rules' to distributions of UNI accumulated in the trust to US beneficiaries.[16]

The combined impact of these two distinctions results in the following:

- **the foreign trustees will accumulate income in the trust each year that they do not pass out the combined income and capital gains; and**
- **a US-resident beneficiary of a foreign non-grantor trust who receives a distribution of what constitutes accumulated income under US tax rules may be faced with onerous taxation in the year of distribution.**

Because of the punitive consequences of the throwback rule, which can leave little net economic benefit after tax and interest charges when historic UNI is distributed to US beneficiaries, foreign trusts that have, or could have, US beneficiaries often choose to distribute all of their income on a current basis to avoid accumulation of income. Practitioners can also consider using the '65-day election' under s663(b) to calculate the annual DNI of the foreign trust during the first 65 days of the succeeding tax year and ensure that an amount equal to or greater than the DNI (including capital gains) has been passed out to the trust beneficiaries during that period. It may also be possible to 'bail out' historic UNI under the default method.[17]

A foreign trust also should have in place the appropriate withholding forms. The rules for filing the proper withholding forms became more complex with the new Form W-8BEN-E.[18] Previously, to the extent that the non-grantor trust distributed income to beneficiaries, the trust could provide the US payor with a Form W-8IMY, and attach to the W-8IMY the appropriate Form W-8BEN (for foreign beneficiaries) and Form W-9 (for US beneficiaries). Under the new rules, if the trust is a taxpayer on its own, the trust should file a Form W-8BEN-E.

Trustees should not file a Form W-8BEN-E for simple trusts or grantor trusts unless such trusts are hybrid entities claiming a reduced rate of withholding under a tax treaty. For entities that are fiscally transparent in both jurisdictions, Form W-8IMY should be used rather than W-8BEN-E.

In contrast, W-8BEN-E is required for foreign complex trusts, and also requires the foreign complex trust to identify its chapter 4 status – i.e. its classification for purposes of the US *Foreign Account Tax Compliance Act*. This will vary from one jurisdiction to another depending on whether the jurisdiction where the trust is located has an intergovernmental agreement (IGA), and the type of IGA in place. Trustees of foreign complex trusts will probably need to take professional advice to correctly complete Form W-8BEN-E.

FOREIGN GRANTOR TRUST

Because a grantor trust is fiscally transparent for the purposes of US taxes, to the extent that a foreign grantor trust has ECI or US-source fixed, determinable, annual or periodical (FDAP) income that was not withheld fully at source, the grantor has the obligation to file a US tax return and to pay any resulting taxes.

Note that, because the withholding rules generally differentiate fiscally transparent trusts based on the ultimate recipient of the income, the foreign trust must have in place the appropriate withholding form to ensure that the proper beneficial owner may be identified in the event that a lower rate may be applied. Form W-8BEN-E instructions stress that the beneficial owners of foreign simple trusts and foreign grantor trusts are not the trusts but the ultimate beneficiaries. A foreign grantor trust providing documentation for purposes of s1446 should provide a Form W-8IMY accompanied by the proper documentation, and Forms W-8BEN or W-9 for the ultimate beneficiaries of the trust.

US INFORMATION REPORTING FOR FOREIGN TRUSTS

As well as the rules above, the US generally places information-reporting requirements on US persons that engage in certain transactions with foreign trusts. Reporting is generally required on Form 3520 and/or Form 3520-A. There may be additional reporting on Financial Crimes Enforcement Network Form 114 ('Report of Foreign Bank and Financial Accounts' (FBAR)) and Form 8938, and further reporting on interests held directly or indirectly in certain foreign corporations and partnerships.

1 Unless otherwise noted, all section and chapter references herein are to the *Internal Revenue Code of 1986*, as amended, and Treasury regulations thereunder. This article is an excerpt from a more comprehensive article, 'US Tax Compliance and Reporting of Foreign Trusts', by the authors
2 *Treasury Regulations* §301.7701-4(a)
3 IRC §7701(a)(30)(E)
4 IRC §7701(a)(31)(B)
5 IRC §671
6 *Treasury Regulations* §1.671-2(e)
7 IRC §679
8 *Treasury Regulations* §1.672(f)-1
9 IRC §641(b)
10 IRC §872(a)
11 IRC §1446(a)
12 IRC §§871(a) and 881(a)
13 IRC §643(a)
14 IRC §662(a), (b)
15 IRC §643(a)(6)
16 IRC §666 and 667
17 See Form 3520 and its instructions
18 Chapter 3 (§§1441 through 1464) was formerly the only part of the IRC governing withholding tax obligations on payments made to foreign trusts. That changed when Congress passed the *Hiring Incentives to Restore Employment Act*, which added chapter 4 to the IRC


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