

U.S. Taxation and information reporting for foreign trusts and their U.S. owners and U.S. beneficiaries



United States (U.S.) owners and beneficiaries of foreign trusts (i.e., non-U.S. trusts) have complex U.S. reporting requirements, which are different from the reporting requirements imposed on U.S. domestic trusts. The U.S. taxation of the income and distributions from a foreign trust depends on the type of foreign trust and the status of the trust’s beneficiaries at the time of distribution. This publication will provide an overview of the questions that must be addressed by foreign trustees, U.S. owners of foreign trusts, and U.S. beneficiaries of foreign trusts under current U.S. law.

Please note that all references to “U.S. owners” and “U.S. beneficiaries” refer to persons who are considered U.S. residents for income tax purposes; i.e., either a U.S. citizen, a green card holder, or someone who meets the “substantial presence test” in any tax year.

I. Tax residence of the trust: Foreign or domestic?

The status of a trust as foreign or domestic will affect the U.S. taxation and reporting requirements of the trust and its beneficiaries. All trusts that do not meet both the “court test” and “control test” are considered foreign trusts.

A. Court test: Any federal, state, or local court within the United States is able to exercise primary authority over substantially all of the administration of the trust (the authority under local law to render orders or judgments).

There are also four so-called “bright-lines rules” for meeting the U.S. court test.

1. A trust will automatically meet the court test if the trust is registered with a U.S. court.
2. In the case of a testamentary trust created pursuant to a will probated within the U.S. (other than ancillary probate), the trust will meet the court test if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the U.S.
3. For inter vivos trusts, if the fiduciaries and/or beneficiaries take steps with a court within the U.S. that cause the administration of the trust to be subject to the primary supervision of such U.S. court, the trust will meet the court test.
4. If a trust document specifies that a foreign country’s law will govern the trust, this does not necessarily mean that the trust will fail the court test. If the trust specifies that the law of a foreign country governs, but gives a court within the U.S. the authority to exercise primary supervision over enforcing that law, the court test will be met.

In addition to the bright-line rules there is also a safe harbor rule, which provides that a trust will be a U.S. trust where the trust instrument does not direct the trust to be administered outside the U.S., the trust is administered exclusively in the U.S., and the trust is not subject to an automatic migration provision, as discussed below.

B. Control test: One or more U.S. persons must have the authority, by vote or otherwise, to make all “substantial decisions” of the trust with no other person having veto power (except for the grantor or beneficiary acting in a fiduciary capacity).

Substantial decisions mean all decisions, other than ministerial decisions, that any person is authorized to make under the terms of the trust instrument or applicable law, including but not limited to::

- Whether and when to distribute income or corpus;
- The amount of any distributions;
- The selection of a beneficiary;
- Whether to allocate receipts to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate or abandon claims of the trust;
- Whether to sue on behalf of the trust or to defend suits against the trust;
- Whether to remove, add or replace a trustee; and
- Investment decisions.

C. Automatic migration: A trust will automatically fail the court test if the trust document provides that a U.S. court’s attempt to assert jurisdiction or otherwise supervise the trust directly or indirectly would cause the trust to migrate from the United States.

A trust will automatically fail the control test if the trust instrument provides that an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by U.S. persons.

II. Types of foreign trusts

The U.S. income taxation of a foreign trust depends on whether the trust is a grantor or nongrantor trust. Income from a foreign grantor trust is generally taxed to the trust's grantor, rather than to the trust itself or to the trust's beneficiaries. In contrast, income from a foreign nongrantor trust is generally taxed when distributed to U.S. beneficiaries, except to the extent U.S. source or effectively connected income is earned and retained by the trust, in which case the nongrantor trust would pay U.S. income tax for the year such income is earned.

A. Foreign grantor trusts:

1. **U.S. grantor (U.S. citizen or resident):** During his or her lifetime, the U.S. grantor must report all items of trust income and gain on his or her Form 1040, U.S. Individual Income Tax Return, for the year earned. The trust itself will not be subject to U.S. income tax.

A trust is considered a grantor trust when the grantor retains a certain degree of dominion and control over the assets of the trust and is thus treated as the owner of the trust for U.S. federal income tax purposes. A foreign trust is also considered a grantor trust for U.S. income tax purposes when a U.S. grantor makes a gratuitous transfer to a foreign trust which has one or more U.S. beneficiaries or potential U.S. beneficiaries of any portion of the trust. Most foreign trusts created by U.S. grantors have at least one current or future U.S. beneficiary. It is important to note that when a foreign trust is funded by a U.S. person, in most cases, the trust will be treated as having a U.S. beneficiary.

- a. **Obligations of the Trustee:** The trustee of a foreign grantor trust with a U.S. owner must file Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, with the IRS each year. Form 3520-A is due on March 15th. A six-month extension for Form 3520-A may be requested. The trustee must also send a "Foreign Grantor Trust Owner Statement" to each U.S. owner of a portion of the trust and a "Foreign Grantor Trust Beneficiary Statement" to each U.S. beneficiary who received a distribution during the taxable year. If the trustee does not file Form 3520-A as required, penalties are imposed on the U.S. grantor. In order to avoid penalties, the U.S. grantor may sign and file Form 3520-A.

Note that the term distribution also includes loans to the U.S. beneficiaries, other than those loans considered "qualified obligations," as well as the uncompensated use of trust property (treated as a deemed distribution of the fair rental value of the property used by the beneficiary). Finally, to avoid permitting the Internal Revenue Service ("IRS") to determine the taxable income of the U.S. beneficiary, it is recommended that foreign trusts with U.S. beneficiaries appoint a U.S. citizen, resident alien, or other U.S. entity to act as a U.S. agent.

- b. **Obligations of U.S. Owners:** A U.S. person who is treated as the owner of a foreign trust will be subject to U.S. income tax each year on the portion of the trust income he or she is considered to own. The U.S. owner must file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, to report any transfers to a foreign trust, and must also file the form (Form 3520) annually to report ownership of the foreign trust even if no transfer is made to the trust in that year. Form 3520 must be filed by the due date (including extensions) of the individual's Form 1040. The U.S. owner must attach to Form 3520 a copy of the "Foreign Grantor Trust Owner Statement" received from the Trustee.

A nonresident alien ("NRA") who transfers property directly or indirectly to a foreign trust within 5 years of becoming a U.S. resident is generally treated as making a transfer to the trust on the individual's U.S. residency starting date.

Each U.S. person treated as the owner of a foreign trust is responsible for ensuring that the trustee files Form 3520-A annually, and also must send a copy of the Foreign Grantor Trust Owner Statement to U.S. owners and a copy of the Foreign Grantor Trust Beneficiary Statement to all U.S. beneficiaries who receive distributions from the trust. As mentioned, if Form 3520-A is not filed, penalties are imposed on the U.S. owner.

2. **NRA grantor:** Current law substantially limits the ability of a NRA to be treated as the grantor of a trust under the grantor trust rules. However, the grantor trust rules continue to apply to a NRA grantor in certain limited circumstances. If a trust is a foreign grantor trust with a NRA owner, the filing requirements are as follows:
 - a. **Obligations of the Trustee:** The trustee should provide a Foreign Grantor Trust Beneficiary Statement to the U.S. recipient of any distribution, to report the amount of the distribution. This form does not need to be filed separately with the IRS.
 - b. **Obligations of the Non-U.S. Owner:** The non-U.S. owner is generally not subject to U.S. tax on trust income, unless that income is U.S. source income or income effectively connected with a trade or business in the United States (“effectively connected income”). If the trust has U.S. source income, the U.S. owner is responsible for filing Form 1040-NR, “Nonresident Alien Income Tax Return,” to report and pay any U.S. tax due on such income.
3. **U.S. beneficiaries:** A U.S. beneficiary who receives a distribution from a foreign grantor trust (whether the grantor is a U.S. person or a NRA) must file Form 3520 by the due date (including extensions) of the individual’s Form 1040. If a U.S. beneficiary receives a complete Foreign Grantor Trust Beneficiary Statement with respect to a distribution during the taxable year, this statement should be attached to Form 3520.

No tax is payable by the beneficiary on distributions from a foreign grantor trust if a foreign grantor trust beneficiary statement is obtained by the beneficiary and attached to Form 3520. However, if no beneficiary statement is obtained by a U.S. beneficiary with respect to a distribution from a foreign grantor trust, the U.S. beneficiary will be required to pay U.S. income tax on such distribution.

B. Foreign nongrantor trusts:

All foreign trusts that are not grantor trusts are considered nongrantor trusts for U.S. purposes. For U.S. income tax purposes, foreign nongrantor trusts are not generally subject to U.S. tax, unless the trust earns U.S. source or effectively connected income.

1. **Obligations of the Trustee:** The trustee should provide a Foreign Nongrantor Trust Beneficiary Statement to the U.S. recipient of any distribution, which will report the amount of the distribution as well as the makeup of the distribution, including whether the distribution contains current year income (and the character of such income), prior year income, or corpus. Unlike a Foreign Grantor Trust with a U.S. owner, this statement is not filed with the IRS. If the trust earns U.S. source or effectively connected income, the trustee is responsible for filing Form 1040-NR, Nonresident Alien Income Tax Return, to report and pay any U.S. tax due on such income. Finally, to avoid permitting the IRS to determine the taxable income of the U.S. beneficiary, it is recommended that foreign trusts with U.S. beneficiaries appoint a U.S. citizen, resident alien, or other U.S. entity to act as a U.S. agent.
2. **Obligations of a U.S. Beneficiary:** The U.S. beneficiary of a foreign nongrantor trust who receives a distribution from such trust must file Form 3520 by the due date (including extensions) of the beneficiary’s Form 1040. If a U.S. beneficiary receives a Foreign Nongrantor Trust Beneficiary Statement with respect to a distribution during the taxable year, this statement should be attached to Form 3520. If no beneficiary statement is obtained by a U.S. beneficiary with respect to a distribution received from a foreign nongrantor trust, the U.S. beneficiary will be required to compute their U.S. income tax on such distribution by utilizing the “default” method, which may result in a higher amount of tax than if the beneficiary statement were obtained and the beneficiary was therefore able to utilize the “actual” method.

The U.S. beneficiary will be responsible for paying U.S. tax on current year trust income included in the distribution, and may be subject to an additional tax (known as a tax on accumulation distributions or “throwback tax”) on prior year trust income included in the distribution. In addition, an interest charge may be imposed on any accumulation distributions. The computations required when a distribution of accumulated income is made from a foreign nongrantor trust to a U.S. beneficiary are extremely complex. A tax advisor should be consulted any time a U.S. person receives a distribution from a foreign trust.

C. Use of Foreign Trust Property by a U.S. beneficiary

Effective March 18, 2010, the use of foreign trust property by a U.S. beneficiary is treated as a distribution from the trust. The amount of the deemed distribution will be based on the fair rental value of the assets utilized by the beneficiary. Some examples of trust assets that may be used by a beneficiary are: real property used by a beneficiary as a primary or vacation home and artwork or antique furniture owned by the trust which is used in a beneficiary's primary or vacation home. Such distributions are subject to the information reporting and income taxation rules described above.

III. Miscellaneous issues

A. Penalties for failure to file required foreign trust returns: The IRS imposes substantial penalties for failure to file information forms relating to foreign trusts (Forms 3520-A and 3520).

B. Gain recognition upon transfer to a foreign trust: The transfer by a U.S. person to a foreign nongrantor trust may be treated as a sale or exchange of the property transferred to the trust. If these rules apply, the U.S. transferor must recognize gain and pay U.S. tax on the transfer of appreciated assets to a foreign trust. The rules requiring gain recognition do not apply to transfers to any trust in which that U.S. transferor is considered the grantor (i.e., a foreign grantor trust with U.S. owner). However, upon the death of the U.S. owner or upon the U.S. owner becoming a nonresident alien for U.S. income tax purposes, the trust may cease to be considered a grantor trust and will become a foreign nongrantor trust. The gain recognition rule applies upon such change in trust status, and therefore the trust or estate of the settlor will generally be responsible for paying U.S. tax on any appreciation inherent in trust assets as of the date of the owner's death.

C. U.S. taxation of interests in foreign corporations and informational disclosure: U.S. tax law contains several antideferral regimes regarding Controlled Foreign Corporations ("CFC") and Passive Foreign Investment Companies ("PFIC"), which prevent U.S. taxpayers from eliminating or deferring U.S. tax by holding interests in foreign corporations which are not subject to current U.S. taxation. Under these provisions, certain income of a foreign corporation may be included in income of a U.S. person that owns an interest in the corporation, even if an actual distribution has not been made. Stock directly or indirectly owned by a trust is considered to be owned proportionally by the beneficiaries of the trust for these purposes. A discussion of the CFC and PFIC rules and filing requirements are beyond the scope of this publication. In addition to the possible application of the anti-deferral regimes, information reporting may be required by U.S. taxpayers with interests in foreign trusts that own certain interests in foreign corporations or partnerships.

D. Distributions by foreign trusts through intermediaries: Any property (including cash) that is transferred to a U.S. person by an intermediary who has received property from a foreign trust is treated as property transferred directly by the foreign trust to the U.S. person if the intermediary received the property from the foreign trust pursuant to a plan of which a principal purpose was U.S. tax avoidance. Several factors will cause a transfer to be deemed made pursuant to a plan, a principal purpose of which was tax avoidance. A discussion of these rules is outside the scope of this publication.

E. Taxpayer identification number for foreign trusts that file U.S. tax returns: If a trustee is required to file a U.S. tax return on behalf of a foreign trust (e.g., Form 3520-A or Form 1040-NR), the trustee must obtain a taxpayer identification number for the trust.

F. Report of foreign bank accounts and other foreign financial assets: Each U.S. person who has a financial interest in or signature authority over certain financial accounts in a foreign country, including bank, securities, or other types of financial accounts, is required to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR form"). A U.S. trustee of a foreign trust generally has signature authority over and/or a financial interest in the trust's foreign accounts and thus, must file the FBAR form. A trust's U.S. owner and/or U.S. beneficiary may also be required to file such form to report either a financial interest in or signatory authority over foreign accounts. Failure to file the FBAR form may result in the imposition of civil and criminal penalties.

In addition to the FBAR filing requirements, the United States now requires disclosure of certain foreign financial assets with an aggregate value of over \$50,000. Foreign financial assets includes foreign accounts, foreign stocks and securities, foreign financial instruments or contracts and interests in certain foreign entities, including foreign trusts.

To disclose these specified foreign financial assets, the IRS has issued Form 8938, Statement of Specified Foreign Financial Assets (each a SFFA). The thresholds for filing Form 8938 vary based on an individual's filing status. This new form is the result of Congress' enactment of Internal Revenue Code (IRC) Section 6038D as part of the Hiring Incentives to Restore Employment (HIRE) Act in 2010.

In general, SFFAs include:

- Financial accounts maintained by foreign financial institutions, or
- To the extent held for investment and not held in a financial account:
 - Stock or securities issued by a person other than a U.S. person; and
 - Financial instruments or contracts that have an issuer or counterparty other than a U.S. person; and
- Any interest in a foreign entity.

The new reporting requirements generally took effect for most individuals starting with the 2011 tax year.

Although there are similarities between the types of financial accounts required to be reported on Form 8938 and FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (the current "FBAR" form), the new Form 8938 does not eliminate, replace or change a taxpayer's obligation to file the FBAR.

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Deloitte Tax LLP has a team of professionals who specialize in foreign trusts and foreign trust reporting. Additional information can be obtained by contacting Karen Brodsky, Dawn Angermaier, Jennifer Rooney or Jennifer Einziger in our New York office at +1 212 436 2000.

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