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WHAT EVERY TRUSTEE NEEDS TO KNOW ABOUT FOREIGN TRUSTS WITH U.S. BENEFICIARIES

By Hal J. Webb and Steven L. Cantor

A variety of U.S. federal tax and reporting issues arise when a U.S. person is or becomes a beneficiary of a foreign trust. This article highlights what every trustee of a foreign trust with U.S. beneficiaries needs to know in order to understand the U.S. federal tax payment obligations and reporting requirements of the trust, the settlor(s) and the U.S. beneficiaries.

A trustee of a foreign trust with U.S. beneficiaries needs to know:

1. Whether the trust is considered to be a foreign trust or a domestic trust and under what circumstances that status may be changed.

A domestic trust is any trust for which both (i) one or more U.S. persons has the power to make all substantial decisions concerning the trust (i.e. to whom to make distributions, to remove the trustee, to change the governing law, etc.) and (ii) the jurisdiction for court supervision of the primary administration of the trust is within the U.S. A foreign trust is any trust which is not a domestic trust.

2. Whether and to what extent the trust is, has been and will be a grantor trust or a nongrantor trust.

A grantor trust is a trust for which a person (such as the settlor) is treated as the owner of the assets of the trust for U.S. federal income tax purposes. A trust which is not a grantor trust is a nongrantor trust. A nongrantor trust is a trust which is treated as owning its assets for U.S. federal income tax purposes rather than having ownership of its assets attributed to another person.

A person is the “grantor” of a trust to the extent that he or she either created the trust or made a gratuitous transfer to the trust. Thus, the settlor of a trust is a “grantor” of that trust. A foreign trust settled solely by a nonresident alien (who was the only transferor of property to the trust) is treated as a grantor trust while and to the extent that either (a) the settlor has the power to revert title in the assets of the trust in himself without the approval or consent of another person or with the consent of a related or subordinate party who is subservient to the grantor or (b) distributions may be made only to the settlor and/or the spouse of the settlor during the lifetime of the settlor. Certain compensatory trusts settled by a nonresident alien may also be grantor trusts, and a special grandfather rule applies to trusts created before September 20, 1995.

A person other than the grantor is treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself. This rule does not apply, however, to (i) a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence or (ii) a power that requires the consent of any other person, whether or not adverse to the power holder.

3. The U.S. income, estate, gift and generation skipping transfer tax consequences to the settlor and each U.S. beneficiary, whether due to (a) powers or rights in connection with the trust or the entities owned directly or indirectly by the trust and/or (b) the direct or indirect receipt of distributions from the trust.

Many foreign trusts contain provisions which provide an individual with various powers over the trust in the capacity as a protector or otherwise. If, for example, a U.S. person is a beneficiary of a trust and has the power to remove and replace the trustee of the trust without any restrictions as to the reason for the removal or as to who can serve as the new or additional trustee, such power may be treated as a general power of appointment over the assets of the trust with adverse tax consequences (particularly if the trustee can make discretionary distributions). Any power over a trust should be carefully considered before the trust instrument is executed in order to determine whether there would be any U.S. tax consequences in connection with such power if the power holder is or becomes a U.S. person.

4. The U.S. federal reporting requirements, if any, of the trust, the settlor(s) and the beneficiaries of the trust (i.e., Internal Revenue Service Forms 3520, 3520-A, 8621, 5471, 1040, 1041, and U.S. Treasury Department Form TD F 90-22.1).

Merely relying upon a representation by a settlor or beneficiary as to his or her compliance with tax and reporting requirements is not sufficient for the trustee. Each trustee should require proof of compliance.

5. The manner in which the trustee maintains the trust and the entities owned by the trust could affect the tax payment obligations and reporting requirements for the U.S. beneficiaries.

For various reasons, most trusts hold title to assets indirectly through a wholly-owned foreign corporation. Holding title to assets in this manner triggers various U.S. tax issues, particularly if the foreign corporation is ever treated as a passive foreign investment company or a controlled foreign corporation. Accordingly, tax planning should be done to minimize or eliminate the impact of the passive foreign investment company or controlled foreign corporation tax regimes.

6. The type and situs of investments held directly or indirectly by the trust could affect the tax payment obligations and reporting requirements for the U.S. beneficiaries.

The type and situs of investments held by a foreign trust (or a holding company owned by the trust) could trigger U.S. federal tax payment obligations and/or reporting requirements for the U.S. beneficiaries of the trust regardless of whether they receive a distribution or have a fixed interest in the trust. For example, if a foreign trust owns an offshore mutual fund which is treated as a passive foreign investment company, under certain circumstances the U.S. beneficiaries of the trust could be treated as indirectly owning such fund for U.S. federal tax purposes.

7. If the trust is not funded properly, the estate of the settlor of the trust could be subject to U.S. federal estate tax.

When funding the trust, the settlor should not directly or indirectly transfer to the trust (or any entity owned by the trust) assets which are “situated within the U.S.” Only assets which are not “situated within the U.S.” should be transferred directly or indirectly to the trust or any entity owned by the trust. Otherwise, part or all of the assets of the trust could be subject to U.S. federal estate tax when the settlor dies.

Although it is unnecessary for a trustee to become an expert on U.S. international taxation and income taxation of trusts, it is important for a trustee of a foreign trust with U.S. beneficiaries to be aware of the issues raised in this article. Although these issues are complex and extensive, even a basic understanding of the U.S. federal tax and reporting concepts and obligations should enable a trustee of a foreign trust with U.S. beneficiaries to more easily perform their duties and understand planning opportunities.