

Foreign Non-Grantor Trusts: Taxation, Planning, and Reporting

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U.S. Tax Terminology Applicable to Trusts

U.S. Tax Terminology – “Grantors” and “Owners”

- ◆ The U.S. Internal Revenue Code and Treasury Regulations distinguish a trust’s “grantor” from its “owner”
- ◆ The “**grantor**” is the person who transferred (or who is deemed to have transferred) assets to a trust
- ◆ The “**owner**” is the person who is treated as “owning” a trust’s assets for U.S. income-tax purposes

U.S. Tax Terminology – “Grantor” Trusts and “Non-Grantor” Trusts

- ◆ To confuse matters, a trust’s “grantor” will not always be treated as its “owner,” and a trust’s “owner” may not necessarily be its “grantor,” but suffice it to say that:
 - If a trust has an “owner,” it is called a **“grantor trust”**
 - If a trust does not have an “owner,” it is called a **“non-grantor trust”**

Grantor Trust vs. Non-Grantor Trust: Classification

Classification as a Grantor Trust – U.S. Grantor

- ◆ For the following types of trusts, the **U.S. grantor** must retain certain controls over, or rights in, the trust assets under IRC §§ 673-677 to be treated as the trust’s “owner”:
 - Domestic trust
 - Foreign trust that **does not have** (and can **never** have) U.S. beneficiaries

Classification as a Grantor Trust – U.S. Grantor

- ◆ For the following type of trust, the **U.S. grantor** need not retain any controls over, or interests in, the trust assets to be treated as the trust’s “owner” (IRC § 679); grantor-trust status is automatic:
 - Foreign trust that **does have** (or could possibly ever have) U.S. beneficiaries

Classification as a Grantor Trust – Foreign Grantor

- ◆ For a **foreign grantor** to be treated as the “owner” of a foreign or domestic trust, one of the following conditions must be met (IRC § 672(f)(2)):
 - Grantor retains the power to re-vest title to the trust assets in himself; this power must be exercisable:
 - solely by the foreign grantor without the approval or consent of any other person, or
 - with the consent of a person who is related or subordinate and “subservient” to the grantor (certain relatives and employees are presumed to be “subservient”)

OR

- The only amounts distributable from the trust are distributable to the foreign grantor or to the foreign grantor’s spouse

Classification as a Grantor Trust – Someone Other than the Grantor as “Owner”

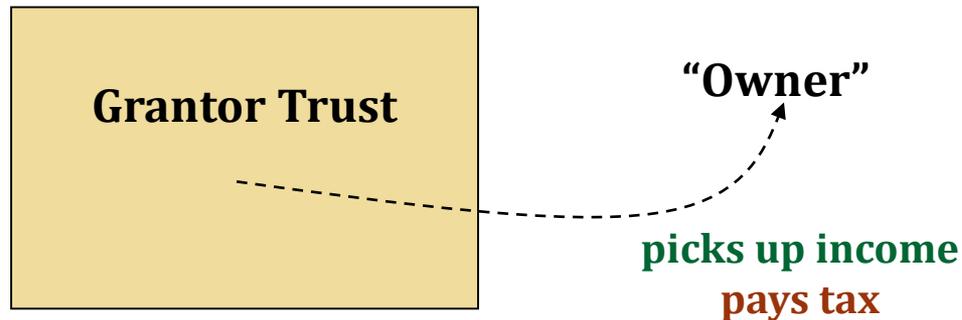
- ◆ **Someone other than the grantor** can be treated as the “owner” of a trust in two ways:
 - Holding a power (whether or not exercised) to vest trust assets in himself (if the trust’s grantor is not already treated as the trust’s owner)
 - Applies only if the “other person” is a **U.S. person** because foreign persons cannot be treated as trust “owners” unless they retain, **as grantor**, one of the rights under IRC § 672(f)(2)—power to re-vest title, or sole beneficial interest
 - Exercising a general power of appointment in favor of a grantor trust (even if the first trust is treated as owned by its grantor or by someone else)
 - A **foreign person** can be considered the owner of the second trust if he retains one of the rights under IRC § 672(f)(2)

Classification as a Non-Grantor Trust

- ◆ A foreign or domestic trust that does not meet the requirements of a grantor trust (and therefore has no “owner”) will be considered a non-grantor trust
- ◆ A foreign or domestic grantor trust will become a non-grantor trust upon the death of the owner (unless someone “other than the grantor” is deemed to be the owner under the grantor-trust rules)

Grantor Trust vs. Non-Grantor Trust: U.S. Tax Consequences

U.S. Tax Consequences – Grantor Trust



- ◆ The trust's "owner" is deemed to own the trust's income for U.S. tax purposes
- ◆ Income is currently taxable to the owner (whether or not it is distributed); and therefore, beneficiaries are not taxable on distributions
- ◆ If the owner is a **U.S. person**, the owner pays U.S. tax on the trust's worldwide income
- ◆ If the owner is a **foreign person**, U.S. tax is paid only on certain U.S.-sourced income (via source withholding)

U.S. Tax Consequences – Grantor Trust with Foreign Owner

- ◆ A trust properly characterized as having a **foreign owner**, and which does not invest in U.S. assets, can provide complete avoidance of U.S. tax on trust income during the grantor's life, even when it is distributed to U.S. beneficiaries
- ◆ **NOTE:** Foreign owner of grantor trust will be subject to U.S. estate tax on U.S.-situs assets in the trust

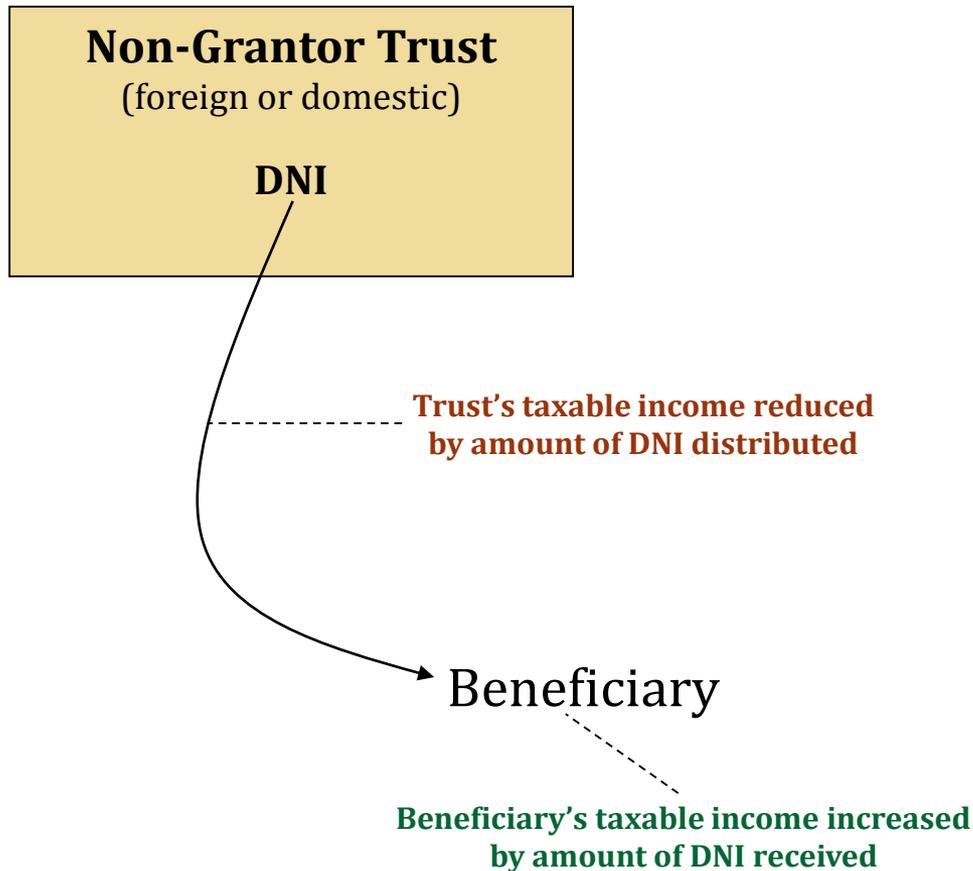
U.S. Tax Consequences – Non-Grantor Trust; Undistributed Income

Non-Grantor Trust

income not distributed
pays tax

- ◆ Undistributed income is considered to be “owned” by the trust itself
- ◆ If it’s a **U.S. trust**, it pays U.S. tax on worldwide income
 - Undistributed income in Year 1 becomes principal in Year 2
- ◆ If it’s a **foreign trust**, U.S. tax is paid only on certain U.S.-sourced income (via source withholding)
 - Undistributed income in Year 1 becomes undistributed net income (UNI) in Year 2

U.S. Tax Consequences – Non-Grantor Trust; Distributed Income



- ◆ In computing taxable income, the trust receives a deduction equal to **distributable net income (DNI)** actually distributed to beneficiaries
- ◆ The beneficiaries must include in income their pro-rata share of the portion of trust distributions that carry out DNI
- ◆ The DNI of a foreign non-grantor trust includes realized capital gains (unlike a U.S. non-grantor trust)

U.S. Tax Consequences – Foreign Non-Grantor Trust

- ◆ Because the foreign trust itself is subject to U.S. tax only on limited types of U.S.-source income, there's an opportunity for avoidance of U.S. tax on accumulated income that is distributed to U.S. beneficiaries
- ◆ Enter the “throwback” rules

Foreign Non-Grantor Trusts – The Throwback-Tax Problem

Foreign Non-Grantor Trusts – UNI & Accumulation Distributions

- ◆ DNI becomes **undistributed net income (UNI)** if not distributed within 65 days of year end
 - Foreign trusts only
 - If a foreign trust has U.S. beneficiaries, it must account for all of its historical income as if it were a U.S. trust
- ◆ Only “**accumulation distributions**” are subject to the throwback tax (distributions that exceed current-year DNI)

Foreign Non-Grantor Trusts – How the Throwback Tax Works

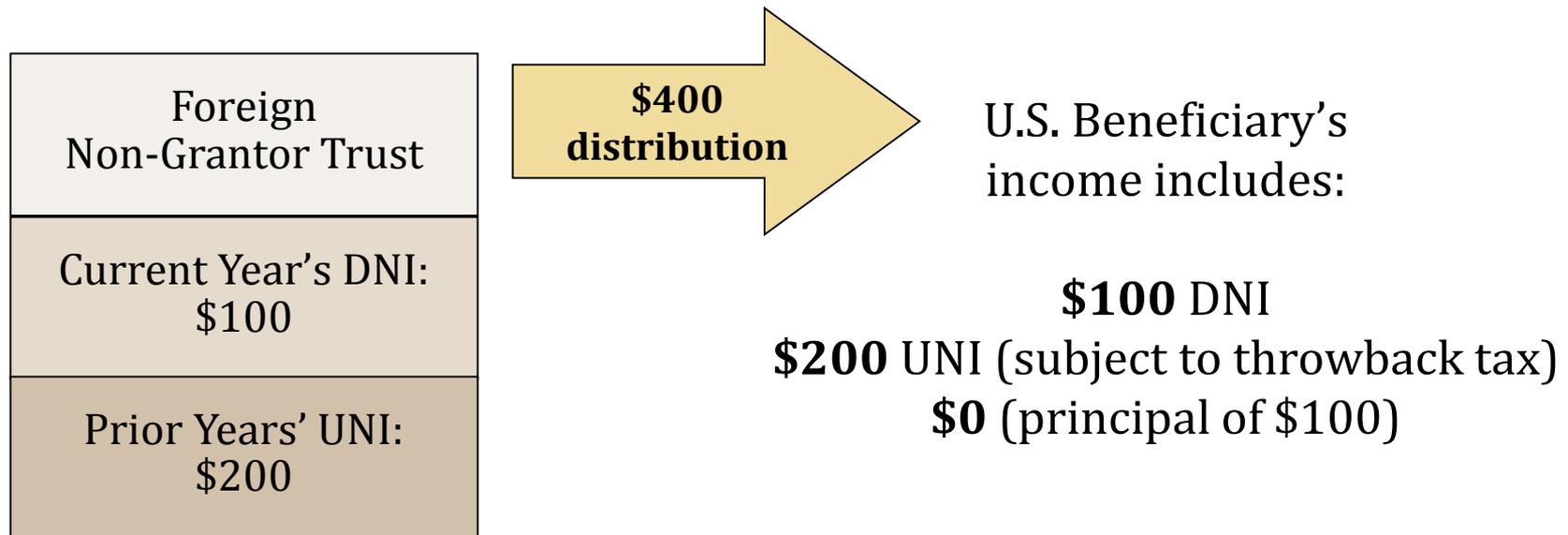
- ◆ The throwback regime captures the incremental amount of tax that would have been paid if DNI had been distributed (and taxed) to the beneficiary in the years in which it was earned
 - Regular income tax is imposed on the distribution in the U.S. beneficiary's hands, plus an interest charge on the tax
 - The interest charge is compounded over the length of time that the UNI accumulated in the trust
 - For years prior to 1996, 6% simple interest
 - For 1996 and after, the interest is compounded daily using federal underpayment rate in effect from time to time over the accumulation period (currently 3%)
 - Realized capital gains lose their character if not distributed currently

Foreign Non-Grantor Trusts with UNI – Throwback Tax is Nearly Impossible to Avoid

- ◆ Once a foreign non-grantor trust has UNI, it remains in the trust until it is distributed
 - UNI can be distributed to a foreign beneficiary without triggering the throwback tax (but beware of closed loophole below)
- ◆ All loopholes for improperly avoiding throwback have been closed
 - Distributing funds to a foreign beneficiary who then “gifts” it to a U.S. beneficiary is an accumulation distribution to the U.S. beneficiary
 - Transferring funds from one trust to another trust can be considered an accumulation distribution directly to the beneficiaries in some cases
 - Rent-free use of trust property will carry out DNI and UNI

Accumulation Distributions from Foreign Non-Grantor Trusts – Tiering Rule

- ◆ **DNI** is distributed first until depleted; then
- ◆ **UNI** is deemed distributed until depleted; then
- ◆ Non-taxable **principal** is distributed.



Planning Around the Throwback Tax: Avoid the Creation of UNI

Avoiding the Creation of UNI

- ◆ Distribute all DNI within 65 days of year end

Avoiding the Creation of UNI

- ◆ Invest trust assets in tax-exempt bonds
 - Tax-exempt income is not included in DNI (and therefore does not create UNI if accumulated)

Avoiding the Creation of UNI

- ◆ Adopt a “buy and hold” investment strategy
 - Capital gains are included in DNI only when realized (but should be distributed in the year of realization to avoid losing their character and becoming UNI).

Avoiding the Creation of UNI

- ◆ Invest trust assets in private-placement life insurance (PPLI) policies
 - The following are tax free, and therefore to not generate DNI (or UNI)
 - Income and investment returns within policy
 - Death benefit proceeds
 - Withdrawals of premiums up to basis*
 - Policy loans*

* If policy is structured as a non-MEC

Avoiding the Creation of UNI – PPLI Options

- ◆ Non-Modified Endowment Contract (Non-MEC)
 - Withdrawals from a Non-MEC **do not** generate DNI, and therefore do not accumulate as UNI in later years
- ◆ Modified Endowment Contract (MEC)
 - Withdrawals from a MEC **do** generate DNI, and should not be made unless the trustee intends to distribute the funds to the beneficiaries in the year of withdrawal

**Planning Around the Throwback Tax:
How to Get Cash to the Beneficiaries
without Distributing UNI**

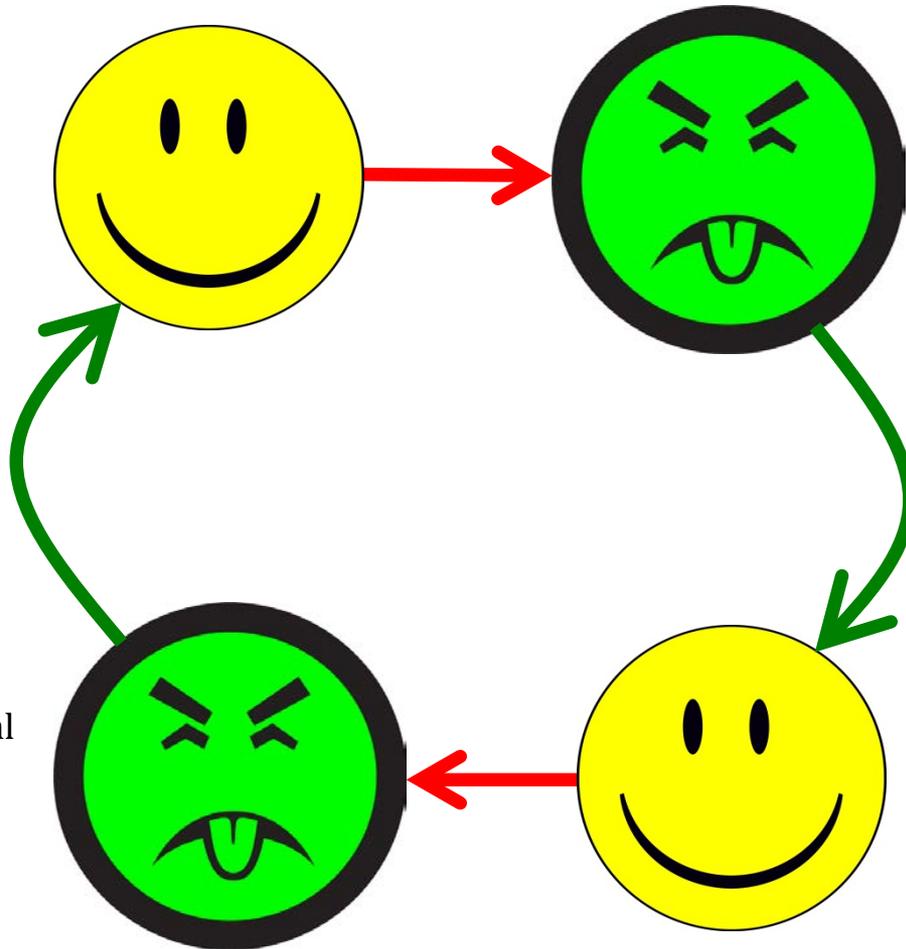
Deferring the Distribution of UNI – Caveats

- ◆ There are options for distributing funds to U.S. beneficiaries without carrying UNI out of the trust
- ◆ These options only defer the distribution of UNI, and do not “cleanse” the trust of UNI
- ◆ Because the throwback tax consists of an interest charge computed over the accumulation period, it could be argued that it is better to distribute the UNI sooner rather than later
 - The tax hit of delaying distribution of UNI vs. currently distributing UNI should be quantified before making a decision
 - Also, the loss of trust assets to the throwback tax and corresponding reduction of the trust’s earning power should be weighed before distributing all UNI

UNI: To Distribute or Not to Distribute?

Distribute:

- be free of UNI worries forever
- have flexibility to make principal distributions or allow below-market use of trust property



Don't Distribute:

- no ability to get principal out of the trust
- UNI worries are forever hanging over the beneficiaries

Distribute:

- reduce the trust's earning capacity and size of DNI distributions
- write a sickeningly large check to the IRS

Don't Distribute:

- maintain earning capacity of trust and size of DNI distributions
- gratification of not paying Uncle Sam a large windfall?

Non-MEC Life Insurance Planning

- ◆ The trustee can take tax-free withdrawals or loans from a Non-MEC (which do not generate DNI)
- ◆ The trustee can then **lend** the proceeds to the beneficiaries under a promissory note that meets the U.S. “qualified obligation” rules (to prevent the loan from being a distribution)
- ◆ The interest income would be considered DNI to the trust, which must be distributed to avoid creating more UNI
- ◆ **NOTE:** A distribution of Non-MEC proceeds from a withdrawal, loan, or death benefit **will carry out UNI** to the extent that the distribution exceeds DNI earned from other trust assets

MEC Life Insurance Planning

- ◆ Withdrawals from a MEC are considered ordinary income (i.e., DNI) in the year of withdrawal
- ◆ The trustee can make a distribution to the beneficiaries equal to the amount of the withdrawal
 - Beneficiaries who are under age 59½ will pay income tax plus a 10% “early-withdrawal” penalty
 - Beneficiaries who are over age 59½ will pay income tax
- ◆ **NOTE:** A distribution as described above will not carry out UNI to a beneficiary because the entire MEC withdrawal is DNI

Mandatory Income Distributions

- ◆ A “mandatory income” distribution will not carry out UNI to the beneficiaries, even if it exceeds DNI
 - Regulatory exception to the definition of an “accumulation distribution”
- ◆ A trust’s “income” for trust-accounting purposes (TAI) can exceed its DNI for income-tax purposes
 - TAI can include items that are not included in DNI
 - Some expenses can be deducted against DNI for tax purposes, but are allocable to principal for TAI purposes

Mandatory Income Distributions

- ◆ Depending on the terms of the trust, it may be possible to amend the trust document to:
 - include mandatory-income distribution provisions
 - require allocation of certain receipts to TAI that normally wouldn't be allocated to TAI
- ◆ Without a specific requirement in the trust instrument, foreign trustees are unwilling to make a discretionary decision to deviate from default trust-accounting principles

“Specific Gift” Distributions

- ◆ A distribution of a “specific sum of money or specific property” that is payable in 3 or fewer installments does not carry out DNI or UNI
 - Another regulatory exception to the definition of an “accumulation distribution”; but also doesn’t carry out DNI under the IRC
- ◆ Not easily incorporated into an existing trust because the specific sum or money or specific property must be ascertainable under the terms of the trust instrument on the trust’s inception date
- ◆ Possible to decant to a new trust that contains specific-gift distributions?

Charitable Distributions

- ◆ Possible to distribute all assets to a foundation that is managed by the beneficiaries
- ◆ Unlike the typical rules for charitable deductions, can be paid to a foreign charity

Tax Reporting for Foreign Non-Grantor Trusts and their Beneficiaries

Foreign Non-Grantor Trust Tax Reporting – Beneficiary

- ◆ **Form 3520** (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts)
 - To report distributions
- ◆ **Form 4970** (Tax on Accumulation Distribution of Trusts)
 - Attached to Form 3520

Foreign Non-Grantor Trust Tax Reporting – Beneficiary

- ◆ **Form 8938** (Statement of Foreign Financial Assets)
 - Attached to beneficiary's Form 1040
 - Value reported is actual distributions plus actuarial interest of right to receive mandatory distributions
 - Interest in fully discretionary trust where no distributions made: value is \$0
- ◆ **FinCEN Form 114** (formerly TD F 90-22.1) “FBAR”
 - Beneficiary reports a financial interest in foreign accounts owned by the trust if the beneficiary:
 - Has a >50% present beneficial interest in the trust, or
 - Receives >50% of the trust's current income during the year

Foreign Non-Grantor Trust Tax Reporting – Trustee

- ◆ **Form 1040NR** (U.S. Nonresident Alien Income Tax Return)
 - If the trust has U.S.-source income, and the tax was fully not withheld at source
 - This form is designed for individuals, and so appropriate adjustments must be made on the form
- ◆ **Foreign Non-Grantor Trust Beneficiary Statement**
 - Given to the beneficiary to attach to his Form 3520
 - Not a requirement, but helps the beneficiary bolster his position with respect to the tax treatment of distributions from the trust

Foreign Non-Grantor Trust Tax Reporting – Trustee

◆ Appointment of U.S. Agent

- If the trustee wishes to issue a Foreign Non-Grantor Trust Beneficiary Statement, it will want to appoint a U.S. tax agent to prevent the trustee from having to give the IRS authority to inspect the trustee's records (which would otherwise be a required statement on the FNGT Beneficiary Statement)

◆ Form 2848 (Power of Attorney)

- A trustee who has issued a Foreign Non-Grantor Trust Beneficiary Statement and appointed a U.S. tax agent may want to give that agent the authority to communicate directly with the IRS on the trustee's behalf

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