

Foreign Reporting – Have you told the IRS everything you need to?

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With the globalization that has occurred in all aspects of our lives today, there are increasing numbers of foreign persons who have ties to the United States. Conversely, many United States citizens have links to foreign countries. These ties can consist of residences in other countries, children and grandchildren who reside in other countries and investments in various types of property in several countries. The US system of taxation for both income and estate purposes is one of the most onerous in existence, in that a US citizen is taxed regardless of his residency. Thus, a US citizen who lives abroad is taxed for estate purposes upon all of his assets, even if none of the assets is held in the US. A non-US citizen is taxed on his worldwide property if he is a resident of the US at the time of his death. Furthermore, a non-US citizen must pay estate tax on any US property held at the time of his death, even if he is not a resident of the US. Trusts with Delaware trustees can be very useful in wealth transfer and estate planning for all of these individuals. Knowledge of the tax consequences of trusts that involve foreign persons is essential for the Delaware trustee and professionals advising clients with these trusts. This article will explore some of the reporting and tax issues that are associated with these trusts.

Is the trust a foreign or US trust?

Obviously, one of the first things that must be determined is whether the trust in question is a foreign or US trust under US tax law. The Internal Revenue Code contains a bright line definition for a US Trust – and then classifies any trust that is not a US trust as a foreign trust. To be a US trust, the trust must pass two tests – the Court test and the Control Test.

The Court Test

Under this test, a US Court must be able to exercise primary jurisdiction over the administration of the trust. This means that:

- The trust instrument cannot direct that the trust be administered outside of the US;
- Fiduciaries must “administer” the trust exclusively in the US; and
- The trust may not have an automatic migration provision (i.e., no flee clause).

The Control Test

To pass this test, a US person must control every substantial decision of the trust. A 50/50 split in control between US and non-US persons does not constitute US control. If a foreign person controls even one substantial decision concerning the trust, the trust will be deemed a foreign trust for US income tax purposes. If the intent is to create a foreign trust, there should be a clear provision for fiduciary succession.

Since a trust has to fail only one of the two tests to be classified as foreign, the document must be carefully scrutinized to determine whether the trust is actually a foreign or US trust – regardless of what the intention of the drafter of the documents may have been.

Grantor or Nongrantor Trust?

Once the trust professional has determined the residency of the trust, the next step to determine the tax and information reporting requirements is to classify the trust as a grantor or nongrantor trust. Generally, for US trusts, a grantor trust is any trust for which the grantor has retained powers under IRC §673-677, such as having the right to income from the trust and having the power to substitute assets of equal value to those held in the trust. However, if a foreign trust or foreign grantor is involved, there are additional rules that must be considered.

Under IRC §679, if a US person transfers assets to a trust for which there is at least one US beneficiary, the trust will be treated as a grantor trust and all income from it must be reported by the grantor on his or her US income tax return. Thus, the grantor need not retain any of the usual powers under §673-677 to be taxed on the earnings of the trust. If a US person creates a foreign trust that does not have a US beneficiary and retains powers under IRS §673-677, the trust will also be treated as a grantor trust.

The regular rules for what creates a grantor trust do not apply if the grantor is not a US citizen or resident. There are only three sets of circumstances that create a foreign grantor trust when the grantor is foreign:

- The trust is revocable;
- The only permissible beneficiaries during the lifetime of the grantor are the grantor or the grantor's spouse; or
- The trust is a compensatory (related to wages) trust.

It is not surprising that the regulations do not broadly allow a foreign grantor to create a US trust that is treated as a grantor trust. Since all income from a grantor trust is passed through to the grantor when the grantor is a foreign person, there is no income that is reported to the IRS, unless the trust has income effectively connected with the US. Furthermore, a foreign grantor trust can make a distribution to a US beneficiary and the distribution will not be taxable to the beneficiary for US tax purposes since all income is passed out to the foreign grantor.

Reporting Requirements

Depending upon the classification of the trust as foreign or US, grantor or nongrantor, there are several forms or statements that must be filed with the IRS. The remainder of this article will deal with some of the more common forms and reporting requirements.

Form 3520

This form is filed by a US person (which includes a US trust) in the following circumstances:

1. When the US person transfers property to a foreign trust
2. When the US person is treated as the owner of any part of the assets of a foreign trust
3. When the US person receives a distribution from a foreign trust
4. When the US person receives either:
 - More than \$100,000 from a non-resident alien or foreign estate that was treated as a gift, or
 - More than \$13,258 (indexed for inflation) from a foreign corporation or foreign partnership that was treated as a gift

Form 3520 is due on the filing date (including extensions) of the US person's tax return. The penalty for failure to file is 35% of the value of the property transferred. Additional penalties of \$10,000 apply for each 30-day period the form is not filed starting 90 days after the IRS has mailed a notification of failure to file.

With changes in tax law, there have been increasing activities to domesticate foreign trusts with US grantors and/or beneficiaries. There are presently no IRS regulations that govern the filing requirements for a foreign trust that domesticates. Since there is no distribution, it can be argued that Form 3520 is not required. Most authorities believe it is advantageous to file Form 3520 to avoid the possibility of the IRS assessing the 35% penalty plus monthly penalties later. If the domestication of a foreign trust is accomplished under the Delaware decanting provisions, there again are no clear guidelines under IRC regulations as to whether a Form 3520 must be filed. However, it could be argued that the decanting to a new trust did involve a distribution so that the form is required. Again, it is generally suggested that Form 3520 be filed to avoid the substantial penalty.

Form 3520-A and Beneficiary Statements

This form is filed by a foreign trust with at least one US person who is treated as an owner of part of the trust. Thus, the trust must be a foreign trust that is a grantor trust under the grantor trust rules under IRC §673-679. The return is due March 15 – one month earlier than most IRS

forms for trusts and individuals. The US owner must attach page 3 of Form 3520-A to his Form 3520. The penalty for failure to file is 5% of the gross value of the assets that are treated as owned by the US person.

A foreign nongrantor trust that has made distributions to a US beneficiary must report to the beneficiary the amount and type of income included in the distributions. The US beneficiary must then report these amounts on a Form 3520, include any income on the appropriate income tax return for the beneficiary (Form 1040, 1041, etc.), and attach the statement to Form 3520. The amounts are reported on a statement that resembles a K-1. It must report all of the distributions and any income in the distributions, as well as required information concerning US agents and inspection of the books and records. The statement is not sent to the IRS.

If a foreign grantor trust makes distributions to a US beneficiary and is not required to file Form 3520-A, it should issue a statement, called a Foreign Grantor Trust Beneficiary Statement, to the beneficiary showing the total amounts distributed. Page 4 of Form 3520-A can be used as the statement. Since all income from the trust will be taxed to the grantor, there will be no income reported on the statement. The US beneficiary must report the amounts listed on the statement on his or her Form 3520.

Form 1040NR

A foreign trust that receives US income that is effectively connected with a trade or business must file Form 1040NR to report the income and pay the tax. The trust files 1040NR because the IRS has not developed the equivalent of a Form 1041 for a foreign trust. The IRS has recently approved a joint project with the AICPA Foreign Trust Task Force to develop a new Form 1041NR.

Withholding Requirements

If a foreign trust holds US assets, such as stocks of US companies, the payor of income generated by the assets must withhold US taxes on the income. The rate of withholding depends upon the country of residence of the ultimate recipient of the income, the treaty between that country and the US and the type of income being paid. For assets held through brokers, the trustee must file the correct forms to allow the broker to withhold the correct tax. The trust files Form W-8IMY to indicate it is a pass-through entity and the beneficiary files Form W-8BEN, to establish the correct rate of withholding.

If there has not been withholding at the source of the income, a US trust must withhold taxes on any distributions of income to foreign beneficiaries. Capital gains are usually exempt from US

taxation for a foreign person, but gains from the sale of US real property interests held in a US trust that are distributed to a foreign beneficiary are subject to withholding (FIRPTA rules).

Treasury Department Form TDF 90-22.1

This form is filed by any US trust that has more than \$10,000 in assets held in a foreign bank account. The account number and location of the account are listed on the form. The return is due June 30 and is filed with the Treasury Department, not the IRS. Some authorities believe that the form must also be filed if the trust owns life insurance policies issued by offshore companies.

Employer Identification Number

If a trust will be filing any forms with the IRS, it must have an Employer Identification Number, or EIN. A foreign nongrantor trust does not need an EIN unless it has US source income. A foreign trust with a US grantor does need an EIN, since it must file forms with the IRS, such as a 3520-A. A trust cannot file any forms with the IRS by using the grantor's social security number. The EIN for a foreign trust cannot be obtained over the internet. The Form SS-4 can be mailed to the IRS or the number may be obtained via telephone. If a trust has a foreign grantor, the grantor is not required to obtain an ITIN (Individual Taxpayer Identification Number) before the IRS will issue an EIN for the trust. An EIN for a trust with a foreign grantor can be obtained only by calling the Philadelphia office of the IRS at 215-516-6999.

Conclusion

The reporting requirements for US trusts with foreign transactions, foreign trusts with US transactions and/or US beneficiaries and for US beneficiaries of foreign trusts are very complex and the failure to comply with the requirements can be very costly. The IRS has not been as "kind and gentle" regarding these reporting requirements as in the past, so care must be taken to ensure that all of the requirements have been met.