

Coming to America?

Kent D Lawson outlines the key US tax rules regarding foreign trusts



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Traveling to the US with a foreign trust can result in an exorbitant tax bill. The US tax rules regarding foreign trusts often apply unexpectedly when the settlor or beneficiary of a foreign trust moves to the US. The rules can also apply unexpectedly when family members outside the US stop taking distributions from a foreign trust and family members in US become next in line to receive distributions.

The US rules regarding foreign trusts seek to prevent US residents from deferring taxes by putting assets in entities outside the US. Similar rules can also apply to foreign corporations that are owned by foreign trusts. It was once possible to let wealth grow tax-free in a foreign trust structure until it was repatriated by distributions to US residents. Because of the power of compounding, tax deferral could double the growth in a family's wealth over a generation. The current rules have evolved over the years to prevent tax deferral in most instances. When a settlor or beneficiary moves to the US, anti-deferral rules can have drastic consequences. Without good planning, they can wipe out nearly all the wealth in a foreign trust structure.

The rules regarding both foreign trusts and corporations are similar. They function in three main ways: (1) gain recognition on transfer of appreciated assets by a US person to a foreign entity; (2) elimination of tax deferral by treating a foreign entity as a pass-through; and (3) elimination of tax deferral by imposing an interest charge on back takes at the time of distributions. The rules are summarized in the table above.

It is helpful to discuss these rules in the context of some of the key questions that arise when someone arrives in the US with a foreign trust.

US income tax rules and forms applicable in foreign trust structures

	Foreign trust	Foreign corporation
1. Gain recognition	Gain on transfer to nongrantor trust § 684	Gain on transfer to corporation § 367
2. Pass-through	Grantor trust rules §§ 671-679	CFC rules §§ 951-959
3. Interest charge	Throwback rules §§ 665-668	PFIC rules §§ 1291-1298

Section references are to the US Internal Revenue Code.

Is the trust a grantor trust?

Often a person arriving in the US is surprised to learn that he will be treated as the grantor of a grantor trust. A grantor is a person who directly or indirectly funds a trust. The US rules tax the grantor as though the grantor owns the trust's assets directly, regardless of whether or not income is paid out of the trust. As a result, tax deferral is eliminated.

Whether a trust is a grantor trust generally depends upon the extent to which a grantor keeps the right to benefit from or control a trust's assets. The rules, codified in sections 673 through 678, look at five different types of rights a grantor might have. Often a trust can be a grantor trust even if the grantor cannot exercise a right directly. The rules can attribute rights to the grantor that are held by others, including trustees.

Under section 679, any foreign trust funded by a US resident is a grantor trust if the trust has a US beneficiary. A foreign trust is deemed to have a US beneficiary if it could be amended to add one. The rule also applies to nonresidents who become US residents within five years of funding a foreign trust.

Because of section 679, nongrantor trusts with US grantors are rare. As a result, the rule codified in section 684 that triggers gain recognition on the transfer of appreciated assets by a US resident to a nongrantor foreign trust seldom applies.

If a trust is a grantor trust, the tax consequences of distributions to US beneficiaries are straightforward. There is no tax as a result of distributions because all of the trust's income is taxed currently to the grantor.

How does the trust's accounting look?

Often the beneficiary of a nongrantor foreign trust who moves to the US can be shocked by the amount of US tax on distributions. The US taxes distributions from nongrantor trusts to US beneficiaries on distributions of current and accumulated income. Distributions of capital are tax-free. Consequently, the tax consequences of distributions to US beneficiaries turn on the trust accounting.

Distributions of accumulated income are subject to the "throw back rules," which are codified in sections 665 through 668. The rules impose an interest charge by "throwing back" the distribution into the first years in which the trust accumulated income. They then impose an interest charge as though tax was owed on the accumulated income in those years. The rules are intended to eliminate tax deferral. The interest charge can be astronomical if a trust has been in place many years.

In offshore jurisdictions, trust accounting is often done so that separate capital and income accounts are maintained. This accounting looks deceptively similar to what is required for US tax purposes. There are, however, often important differences between what is typically done in an offshore trust's financial statements and what is required for US tax purposes.

Two frequent differences are worth mentioning. The first is that a foreign trust's capital gains are included in income for US tax purposes rather than in capital. The second difference is that for US tax purposes, a trustee cannot designate distributions as coming from income or capital. For US tax purposes, the character of distributions each

year is determined by an ordering rule. Current income is deemed to be distributed before accumulated income. In turn, accumulated income is deemed distributed before capital.

Minimizing distributions of accumulated income is one of the main problems in planning for US beneficiaries. The extent of the problem and the available solutions depend largely on the trust accounting.

Is there an underlying company?

US beneficiaries and settlors are also often shocked to learn that the anti-deferral rules that apply to shareholders of a foreign corporation can apply to them if a trust owns a foreign corporation. The rules can attribute ownership in the company to US grantors and beneficiaries. As a result, beneficiaries of a trust can have phantom income that is taxable to them even if they have not received it. Three sets of rules can apply if a trust owns a foreign corporation.

The first set of rules, codified in section 367, can trigger gain on the transfer of appreciated assets to a foreign corporation by a US person. It can apply where the trust owning the company is a grantor trust and

the grantor is a US resident.

The second set of rules is the controlled foreign corporation or CFC rules. They are codified in sections 951 through 959 and eliminate tax deferral by treating certain types of income as though it passes through directly to US beneficiaries. The CFC rules apply to US beneficiaries who are each considered to own 10 percent or more of the underlying company if together these same beneficiaries are considered to own more than 50 percent of the company. The CFC rules apply only to certain types of income known as Subpart F income. The definition of Subpart F income is technical. It primarily includes passive income and income from transactions with related parties.

The third set of rules is the passive foreign investment company or PFIC rules. If the CFC rules do not apply to a US beneficiary, then the PFIC rules may. The PFIC rules are codified in sections 1291 through 1298. They eliminate tax deferral by imposing tax and an interest charge on US beneficiaries when distributions are made from a company.

In order for the PFIC rules to apply, 50 percent of a trust's assets or 75 percent of

its gross income must be passive. Unlike the CFC rules, the PFIC rules do not apply when the company has income. Instead, they apply when shares are sold, when dividends are paid, or when the company is liquidated. Like the throwback rules, the PFIC rules eliminate tax deferral by imposing an interest charge as though income was taxable in earlier years. Because the PFIC rules impose an interest charge, they often result in a tax that is much higher than the CFC rules. (For more on these rules see Pamela Goldfarb's article on p.17)

Are there other issues?

This article highlights some of the main US income tax issues that arise when someone comes to the US with a foreign trust. It is important to emphasize that there are usually additional issues. Gift and estate tax issues are often part of the analysis. Often foreign entities must be reported to the US Internal Revenue Service even if no tax is owed.

As soon as it looks like a foreign trust may have US tax issues, it is best to seek a US tax advisor with specialized expertise. The sooner problems are identified, the more easily they can be solved. ■

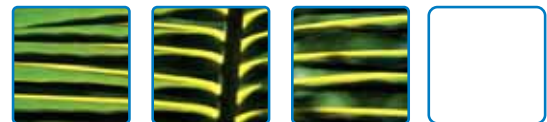
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