WIGGIN
WIGGIN AND DANA

ADVISORY

PART II

If you have any questions about this Advisory, please contact:

MICHAEL T. CLEAR
203.363.7675
mclear@wiggin.com

ROBERT W. BENJAMIN
212.551.2602
rbenjamin@wiggin.com

DANIEL L. DANIELS
203.363.7665
ddaniels@wiggin.com

SETH E. ELLIS
561.910.7510
sellis@wiggin.com

HELEN C. HEINTZ
203.363.7607
hheintz@wiggin.com

DAVID W. KESNER
203.498.4406
dkesner@wiggin.com

LEONARD LEADER
203.363.7602
lleader@wiggin.com

VANESSA L. MACZKO
203.363.7667
vmaczko@wiggin.com

ERIN D. NICHOLLS
203.498.4319
enicholls@wiggin.com

CAROLYN A. REERS
203.363.7668
creers@wiggin.com

SERIES: INTERNATIONAL ESTATE PLANNING

U.S. INCOME TAXATION OF FOREIGN TRUSTS – BEWARE!

Authors: Carolyn A. Reers and Mi-Hae K. Russo

In a **previous Wiggin and Dana LLP advisory**, we addressed what constitutes a "foreign trust" under the Internal Revenue Code (IRC).[1] We now explore the tax consequences of a foreign trust, as well as the differences between a foreign **grantor trust** and a foreign **non-grantor trust**.

There are many benefits of having an individual who is neither a citizen nor a domiciliary of the United States (herein a "non-U.S. Person") create a multigenerational trust for U.S. beneficiaries. If non-U.S. situs assets are transferred to a properly structured trust, the trust assets will not be subject to estate, gift or generation-skipping transfer (GST) taxes under current law. Further, for estate, gift and GST tax purposes, it does not matter whether such a trust is established under the laws of a state of the United States or a foreign country. However, for income tax purposes, careful consideration must be given when structuring these trusts and selecting applicable law.

TYPES OF FOREIGN TRUSTS

The U.S. income taxation of a foreign trust depends on whether the trust is characterized as a grantor trust or non-grantor trust under the Internal Revenue Code.

U.S. Person as Grantor

If a U.S. citizen or resident (herein a "U.S. Person") creates a trust governed by the laws of a U.S. state, then the usual "grantor trust" rules apply that effectively tax the income and gain of the trust to the U.S. grantor as a result of certain powers reserved to the grantor under the trust agreement.[2] If the trust is a foreign trust, then the trust will also qualify as a grantor trust if the U.S. grantor directly or indirectly makes a transfer of property to the trust and the trust has a U.S. beneficiary at any time during the taxable year.[3]

CONTINUED

1 A trust is by default defined as a "foreign trust" unless it satisfies both a "court" test and a "control" test defined as follows: (1) a court within the United States is able to exercise primary supervision over the administration of the trust, and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. IRC § 7701(a)(30)(E)

2 IRC §§ 671-677

3 IRC § 679

U.S. INCOME TAXATION OF FOREIGN TRUSTS – BEWARE!

MATTHEW E. SMITH
203.363.7639
msmith@wiggin.com

WILLIAM M. BROMLEY
561.910.7530
wbromley@wiggin.com

GEORGE R. FREUND
561.910.7500
gfreund@wiggin.com

KATERYNA BAKHNAK
212.551.2855
kbakhnak@wiggin.com

JOSEPH BENDEL
561.910.7544
jbendel@wiggin.com

MARY MARGARET COLLEARY
212.551.2637
mcolleary@wiggin.com

RUTH FORTUNE
203.363.7658
rfortune@wiggin.com

ASHTON C. MALKIN
561.910.7500
amalkin@wiggin.com

MARISSA A. O'LOUGHLIN
203.363.7674
moloughlin@wiggin.com

KAITLYN A. PACELLI
203.363.7635
kpacelli@wiggin.com

ANDREW S. PHILBIN
203.363.7606
aphilbin@wiggin.com

MI-HAE K. RUSSO
212.551.2619
mrusso@wiggin.com

Non-U.S. Person as Grantor

When the grantor is a non-U.S. Person, it is more difficult for the trust to qualify as a grantor trust. A foreign trust will only be a grantor trust (and taxed to the non-U.S. grantor rather than to the trust or to the trust's beneficiaries) if either of the following applies:

1. The grantor has the power to revoke the trust and revest its assets in himself or herself, without the consent of any person, or with the consent of a related or subordinate person who is subservient the grantor[4]; or
2. During the grantor's lifetime, the grantor and/or the grantor's spouse are the sole beneficiaries of the trust.

When the non-U.S. grantor dies, a foreign trust that previously qualified as a grantor trust under one of the two attributes above will no longer be a grantor trust.[5]

INCOME TAX CONSEQUENCES OF A FOREIGN NON-GRANTOR TRUST

If a trust becomes a foreign non-grantor trust when the grantor dies, a U.S. anti-deferral regime known as the "throwback tax" regime must be considered. This regime will tax prior years' undistributed income through trust distributions to U.S. beneficiaries that may occur years later. Because most income accumulated in a foreign non-grantor trust escapes U.S. tax [6], the throwback tax works to discourage the tax-free accumulation of income in the trust when the trust has U.S. beneficiaries.

U.S. beneficiaries of a foreign non-grantor trust who receive distributions from the trust are subject to U.S. federal (and state) income tax upon receipt of trust distributions to the extent of the pro-rata share of the trust's net income earned in that year. Notably, the net income of a foreign trust includes both capital gain and foreign source income, even though neither would generally be taxable to a foreign trust. The character of the income is preserved, however, and capital gain is taxable at the lower capital gain rates applicable in the U.S.

When income is not distributed in the same year it is earned, things get more complex. Distributions to U.S. beneficiaries will carry out "old" undistributed net income (UNI) and capital gain at U.S. ordinary income tax rates, with an interest charge from the date the income or gain was actually earned or recognized through the date of distribution. The interest charge is pegged to the rate applicable to the underpayment of tax and is compounded daily. This tax-effect can be quite punitive.

CONTINUED

4 IRC § 672(f)(2)(A)(i)

5 IRC § 672(f)(2)(A)(ii)

6 A foreign non-grantor trust is taxed as a non-U.S. Person and thus is subject to U.S. income tax only on U.S.-source investment income (e.g., dividends from U.S. companies) and U.S. trade or business income. It is not subject to U.S. income tax on most U.S. interest income, U.S.-source capital gain or non-U.S. source income. IRC §§ 641(b), 871

U.S. INCOME TAXATION OF FOREIGN TRUSTS – BEWARE!

This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

There are ways, however, with proper planning that the adverse U.S. tax effect of a foreign trust can be mitigated or avoided. Some include:

1. Distribute all income and capital gains in the year it is earned.
2. Time the realization of capital gains into years when distributions are anticipated.
3. Invest the trust assets in a manner where little income is produced, e.g., in a U.S. compliant life insurance policy.
4. Rather than leaving distributions to be made within the discretion of the Trustees, draft the trust to provide that a specific sum is payable in not more than three installments to the U.S. beneficiaries per a specific exception provided under IRC § 663(a)(1)).
5. Structure the trust to require that all income be paid annually to a non-U.S. beneficiary and give the U.S. beneficiaries a discretionary interest in the principal. So long as the trust does not recognize capital gains, a discretionary distribution to a U.S. beneficiary in the same year that income is paid to a non-U.S. beneficiary would not carry out any income, new or old.
6. If regular, annual distributions are not desirable, require that annual income and capital gain be distributed to a U.S. trust. This way, the income is retained in trust but is taxable in the same year as earned, thus avoiding the punitive tax regime.

There are more sophisticated planning tools as well, such as so-called "stripping distributions," but qualified tax counsel is needed to navigate these rules successfully. And, as usual, the best results are achieved when planning is done prior to making transfers or establishing trusts.