

# *U.S. Income Tax Aspects Of Offshore Trusts*

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# *What is a Foreign (“Offshore”) Trust ?*

*Defined by reference to a “U.S. trust”*

*Any trust which is not a “U.S. trust”*

*U.S. trust*

*meets “court” test and*

*meets “control” test*

*Today’s presentation assumes trust is a foreign trust*

# *Trust Classification*

## *Grantor Trust*

*Depends on trust characteristics*

*Term “grantor” includes settlor and any person transferring assets to the trust (whether or not settlors)*

## *Nongrantor Trust*

*Any trust not classified as a grantor trust*

# Grantor Trust

## *Common Examples:*

*Trust is revocable*

*Trust benefits only the grantor or grantor's spouse during grantor's life*

*Grantor is a U.S. person and trust has/may have a U.S. beneficiary*

*Grantor of grantor trust treated as owner of all /portion trust assets and related income and expenses*

# *Nongrantor Trust*

*Any trust (or any portion thereof) not considered a grantor trust.*

*Nongrantor trusts are further classified as:*

*Simple trusts*

*Example: require annual income distribution*

*Complex trusts*

*Example: fully discretionary trusts*

*Classification relevant for U.S. beneficiaries and for withholding tax purposes*

# *U.S. Income Tax Treatment*

## *U.S. Grantor*

### *Grantor Trust*

*Grantor treated as owner of trust assets*

*trust income taxable to grantor*

*distributions not determinative*

*frequently trust settled by U.S. person is a grantor trust*

# *U.S. Income Tax Treatment U.S. Grantor*

## *Nongrantor Trust*

*Grantor not treated as owner of trust assets*

*Taxation of grantor depends on receipt of distribution*

# *U.S. Income Tax Treatment U.S. Beneficiaries*

## *Grantor Trust*

*U.S. beneficiaries not taxable*

*Distributions not determinative*

## *Nongrantor Trust*

*Distributions are determinative*

*Taxable distributions include current and prior year trust income*

*Distributions of trust corpus not taxable*



# *U.S. Income Tax Treatment U.S. Beneficiaries*

## *Nongrantor Trust*

*Distribution ordering rule generally applies for U.S. tax purposes:*

*first out of current year income (including capital gains)  
to extent thereof*

*next out of prior year income to extent thereof*

*last out of non taxable corpus*

*Distributions include:*

*payments in cash or other property*

*some loans*

# *U.S. Income Tax Treatment*

## *U.S. Persons*

### *Other Potential Tax Issues*

*Trust investment in holding companies / foreign mutual funds potentially characterized as:*

*Controlled foreign corporation (“CFC”)*

*Foreign personal holding company (“FPHC”)*

*Passive foreign investment company (“PFIC”)*

*Potential impact on U.S. persons:*

*Taxation without distribution*

*Additional reporting*

*Higher tax rate and interest penalty*

# *U.S. Income Tax Treatment - Trust*

## *Grantor Trust*

*Trust is not itself subject to tax*

*Assets considered owned by grantor therefore  
income, deductions, and credits taxable to  
grantor*

# *U.S. Income Tax Treatment - Trust*

## *Nongrantor Trust*

*Trust taxed on:*

*U.S. source investment (for example dividends and certain interest)*

*30% tax generally withheld at source*

*Tax return (Form 1040NR) not required unless tax not withheld or trust has U. S. trade or business income*

# *Foreign Trust Reporting Form 3520*

*Events requiring reporting by U.S. person:*

*Creation of or transfer to a foreign trust*

*Ownership of a grantor trust*

*Distribution received from a foreign trust*

*Gift or bequest received from a foreign person*

# *Foreign Trust Reporting Form 3520*

*Who files: Applicable U.S. person*

*Due Date: Extended due date of U.S. individual income tax return*

*Information needed from trustee:*

*Foreign trust beneficiary statement for each beneficiary*

*Foreign trust owner statement for each owner*

# *Foreign Trust Reporting Form 3520 Penalties*

*Penalties for failure to timely file, or provide correct / complete information:*

*Failure to report transfer to foreign trust - 35% of the value of property transferred*

*Failure to report receipt of distribution from foreign trust - 35% of the value of distribution received*

*Failure to report receipt of certain foreign gifts – 5% to 25% of the value of gift received*

# *Foreign Trust Reporting Form 3520-A*

*Event Requiring Reporting:*

*U.S. ownership of a grantor trust*

*Who Files:*

*Fiduciary of the foreign trust, signs and files Form 3520-A*

*Due Date: March 15 for calendar year trusts*



# *Foreign Trust Reporting Form 3520-A Penalties*

*Penalty for failure to timely file or provide correct / complete information:*

*5% of the gross value of trust's assets owned at the close of the year, payable by U.S grantor*

*Information needed from trustees:*

*Foreign Grantor Trust Owner and Beneficiary Statements*

*Attach trust agreement to Form 3520-A or appoint U.S. agent*

# *Offshore Voluntary Compliance Initiative*

*Applies to some U.S. taxpayers using offshore payment cards or other offshore financial arrangements (including foreign trusts)*

*Offers waiver of civil fraud and certain other penalties (including penalties for failure to file Form 3520 and 3520-A)*

# *Offshore Voluntary Compliance Initiative*

*To qualify taxpayers must:*

*meet eligibility requirements*

*send a written request to the IRS before April 15,  
2003*

*file or amend returns*

*pay tax and interest due certain civil penalties*

*provide additional information requested by the IRS*

# *Appointment of U.S. Agent*

## *Duty of U.S. Agent*

*Respond to request from the IRS for information*

## *Requirements*

*Binding agreement between trustees and U.S. agent*

*Agreement executed before due date of Form 3520-A*

*Agreement effective for statute of limitations*

## *Benefits*

*Fewer documents filed with Form 3520-A*

*May result in less onerous tax treatment*