



Non-U.S. Trusts with U.S. Beneficiaries

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U.S. Trust vs Non-U.S. Trust (“Foreign Trust”)

- **U.S. Trust** – Two requirements:
 - U.S. court can exercise primary supervision over trust administration (“Court Test”), **and**
 - One or more U.S. persons can control all substantial trust decisions (“Control Test”)
- **Foreign Trust:** All other trusts
- **Note:** Residency of trust creator, beneficiaries and location of property are irrelevant



Court Test (“Safe Harbor”)

- Trust instrument does not direct that the trust be administered outside the U.S.
- Trust is administered exclusively in the U.S., and
- Trust is not subject to automatic migration if a U.S. court attempts to assert jurisdiction over trust administration



Control Test

- Substantial Decisions:
 - Timing and amount of distributions
 - Selection of beneficiaries
 - Allocation of receipts between income and principal
 - Whether to terminate the trust
 - Removal, addition or replacement of trustees
 - Appointment of a successor trustee
 - Investment decisions
 - Compromise, arbitrate or abandon claims and whether to sue or defend suits



Foreign Grantor Trust

- **Grantor Trust:** Pass-through entity – Trust’s creator (“grantor”) is responsible for reporting the trust’s income and paying the tax
 - Foreign Grantor: Pays U.S. income tax on U.S.- source income only
 - U.S. Grantor: Pays U.S. income tax on the trust’s worldwide income
 - Distributions to U.S. beneficiaries aren’t taxable
- **Examples:**
 - Foreign Trust with U.S. grantor and U.S. beneficiary
 - Foreign or U.S. Trust that is revocable by grantor



Foreign Nongrantor Trust

- Trust is a separate tax-paying entity that pays tax only on its undistributed U.S.- source income
 - Distributions are taxable to U.S. beneficiaries up to the amount of the trust's distributable net income (generally, its taxable income from both U.S. and non-U.S. sources)
 - Distributions taxable to the U.S. beneficiaries are deductible by the trust



Tax Implications of Distributions to U.S. Beneficiaries

- Throwback Rule: Discourages use of foreign trust as tax deferral device for U.S. beneficiaries
- Non-U.S. source income accumulated in a foreign trust is not subject to U.S. income tax
- **Throwback Rule:** When prior year income is distributed to U.S. beneficiaries, those beneficiaries are subject to both U.S. income tax and a nondeductible interest charge



More on the Throwback Rule

- Once the current year distribution exceeds the trust's distributable net income, it is treated as being paid from prior year undistributed income ("accumulation distribution")
- This accumulation distribution is generally taxed at the highest income tax rate that would have applied if the income had been distributed to the beneficiary in the year it was received
 - Any accumulated long-term capital gain loses its favorable character and is taxed at the higher ordinary income tax rates
- The beneficiary is also subject to a non-deductible interest charge on the accumulation distribution based on how long it was retained by the trust



Strategies that Don't Work to Avoid Throwback Rule

- Loans from foreign trust to U.S. beneficiary: generally treated as a distribution unless loan meets very strict guidelines
- Distributions made to a foreign beneficiary instead of the U.S. beneficiary; foreign beneficiary subsequently transfers the funds to the U.S. beneficiary (Exception: \$10,000 or less for all such transfers)



U.S. Information Reporting Rules: U.S. Beneficiaries and U.S. Grantors

- U.S. beneficiaries are required to report distributions received from a foreign trust on Form 3520
- U.S. grantors of foreign grantor trusts are required to annually file Forms 3520 and 3520-A
- U.S. grantors of foreign trusts (both grantor and nongrantor) are required to file Form 3520 to report the creation of and transfers to the trusts



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