U.S. Beneficiaries of Foreign Trusts – What Every Trustee and Attorney Should Know

STEP

Society of Trust and Estate Practitioners

STEP Bahamas

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CAVEAT

The information contained herein is provided for informational purposes only and is not intended to constitute the rendition of legal advice. No person should act upon this information without obtaining the opinion of United States legal counsel specializing in the area of international taxation.

Discussion Points

U.S. Tax Issues

Planning Strategies

U.S. Reporting Requirements

Pitfalls to Avoid

Who Is A U.S. Resident?

U.S. Resident / Nonresident

- RESIDENT

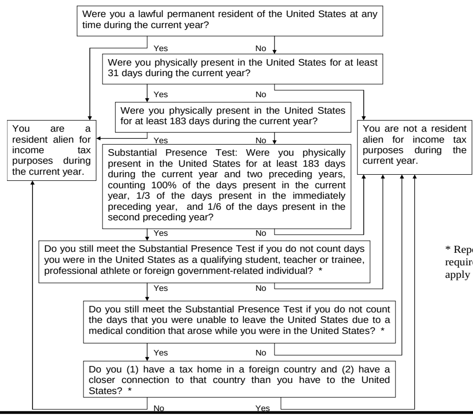
Why is he frowning?

- NONRESIDENT

Why is he smiling?

Resident For U.S. Income Tax Purposes

- Green Card
- Physical presence
- Substantial presence
- Election



* Reporting requirements apply

Explanation of Tests

- Lawful permanent resident ("Green Card" holder) of the U.S. at any time during the calendar year;
- Present in the U.S. for 183 days or more during the current calendar year ("Physical Presence Test"); or
- Present in the U.S. for more than 31 days and less than 183 days during the current calendar year, but meet the Substantial Presence Test
  – One meets the Substantial Presence Test if the sum of 100% of the days present in the U.S. during the current taxable year, 1/3 of the days present in the U.S. in the immediately preceding taxable year and 1/6 of the days present in the U.S. in the second immediately preceding taxable year equals or exceeds 183 days.

Exceptions

- Tax home is a foreign country and have a closer connection to the same foreign country
- Certain days not counted
- Treaty-based position

Resident For U.S. Estate and Gift Tax Purposes

- Domicile: means physical presence AND intent to remain indefinitely
- Facts and circumstances
- Treaty-based position

How Are They Taxed ?

U.S. Income Taxation of U.S. Citizens and Residents

- Income taxation on worldwide income.

U.S. Ownership of Foreign Corporations

Flow-through of income of CFC or PFIC

- Controlled Foreign Corporation ("CFC")
  - More than 50% of vote or value owned by United States residents
  - Applies only to 10% shareholders - a U.S. person who owns 10% or more of the total combined voting power
- Passive Foreign Investment Company ("PFIC")
  - More than 75% of gross income is passive income or average percentage of assets which produce or are held for production of passive income is at least 50%
  - Applies regardless of percentage of ownership

U.S. Income Taxation of Nonresident Aliens

- <u>Passive Income</u>
  - Fixed or determinable annual or periodic income (i.e. interest, dividends, rents, royalties, etc.)
  - Subject to 30% withholding tax on the gross amount at the time of payment
- <u>Effectively Connected Income</u>
  - Taxed on a net basis (after deductions) at graduated tax rates as they apply to United States residents.
- <u>Capital Gains</u>
  - United States Real Property Interests
  - Physically present in U.S. for 183 days and U.S. tax home

U.S. Estate & Gift Tax – U.S. Citizens and Residents

- Taxed on worldwide assets
- Resident aliens are subject to estate and gift tax at the same rates and in a similar manner as United States citizens

U.S. Estate Tax - Nonresident Aliens

- Nonresident aliens are subject to estate tax in a similar manner as U.S. citizens, except that the gross estate is limited to property situated within the U.S. and there are certain limitations on deductions and credits.

U.S. Gift Tax - Nonresident Aliens

- Nonresident aliens are subject to gift tax on gifts of real property and tangible personal property situated within the United States.
  - Gifts of intangible personal property are exempt
  - Cash is tangible personal property
  - Cash or property situated without the United States should not be required to be used to purchase property situated within the United States
  - Jointly held real estate is a gift tax trap for the unwary

Situs of Assets

- Stock
- Bank Deposits
- Real Property
- Tangible personal property
- Debt obligations
- Life Insurance

Applicable Credit Amount

- U.S. Estate and Gift Tax Applicable Credit Amounts (2007)
  - Nonresident Aliens
    - Estate: $13,000, or transfer of $60,000
    - Gift: $0
  - Residents
    - Estate: $780,800, or transfer of $2,000,000
    - Gift: $345,800, or transfer of $1,000,000

Applicable Credit Amount for Residents

Year of Transfer	Value of Excluded Property* (Estate Tax Only)	Maximum Gift & Estate Tax Rate
• 2007	$2,000,000	45%
• 2008	$2,000,000	45%
• 2009	$3,500,000	45%
• 2010	N/A	top individual income tax rate (only gifts)
• 2011	$1,000,000	55%

*Value of excluded property for gifts is $1,000,000 each year

Effective Tax Rates

- Effective U.S. Estate and Gift Tax Rates (2007)
  - Nonresident Aliens
    - Estate: 26% to 45%
    - Gift: 18% to 45%
  - Residents
    - Estate: 45%
    - Gift: 41% to 45%

Estate Tax Deductions

- Marital Deduction
  - Unlimited if surviving spouse is a U.S. citizen
  - Qualified Domestic Trust required if surviving spouse is not a United States citizen
- Mortgages
- Disclosure of entire gross estate

U.S. Gift Tax Annual Exclusion and Marital Deduction (2007)

- Gifts to:
  - Non-Spouse: $12,000
  - Non-United States Citizen Spouse: $125,000
  - U.S. Citizen Spouse: $12,000+ Unlimited Marital Deduction

U.S. Generation-Skipping Transfer Tax

- GST tax is in addition to estate and gift tax
- Applies only to transfers subject to U.S. estate and gift tax
- Tax = Rate * inclusion ratio; rate currently is 46%
- $2,000,000 exemption in 2007 (adjusted to equal Applicable Credit Amount)

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Reversion To Present Law

- THE 2001 ACT IS EFFECTIVE ONLY UNTIL DECEMBER 31, 2010.
- WITHOUT FURTHER LEGISLATIVE ACTION, ON JANUARY 1, 2011, PRE-ACT LAW WILL AGAIN APPLY (I.E., ESTATE TAX REPEAL ONLY IN 2010).

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Grantor Trust

vs.

Nongrantor Trust

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Domestic Trust vs. Foreign Trust

– Domestic Trust:

- Court Test: A court within the U.S. is able to exercise primary supervision over the administration of the trust; <u>AND</u>

- Control Test: One or more U.S. persons have the authority to control all substantial decisions of the trust.

– Foreign Trust: all other trusts

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Grantor Trust

- Difference between “Grantor” and “Owner”

- A trust is a grantor trust to the extent a person is treated as the owner of the assets of the trust for U.S. income tax purposes

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U.S. Citizen or Resident - Foreign or Domestic Trust

- If a U.S. person is the grantor of a trust, he will be treated as the owner of the assets of the trust to the extent he has retained any one of the following without the consent of an adverse party:
  – A power to revoke the trust
  – A right to control the beneficial enjoyment of the corpus or income
  – Certain administrative powers
  – A reversionary interest in either corpus or income (value must exceed 5% of the value of the relevant portion as of inception)
  – The right or power for the grantor or the grantor’s spouse to receive income or have income applied to the payment of premiums of life insurance policies of which grantor or the grantor’s spouse is the insured.
- A person other than a grantor can be treated as the owner of the assets of the trust

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U.S. Citizen or Resident - Foreign Trust

- A foreign trust will be a grantor trust if a U.S. person transfers property to a foreign trust and the trust has U.S. beneficiaries.
  – Exceptions:
    - Transfers by reason of death or for fair market value
    - Charitable trusts
  – Determination as to whether there is a U.S. beneficiary
  – NRA who becomes a U.S. resident

NRA – Foreign or Domestic Trust

- Must meet same tests as U.S. citizen or resident plus:
  - Revocable by grantor without consent of another person or with consent of subordinate person who is subservient to grantor (incapacity issue)
  - During lifetime of grantor, income or principal may only be distributed to grantor or spouse of grantor
  - Certain compensatory trusts

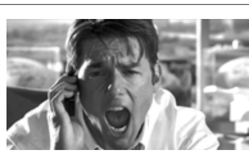
Income Taxation of The Trust and Its Beneficiaries

A Typical Trust Beneficiary

Income Taxation of Trusts and Beneficiaries

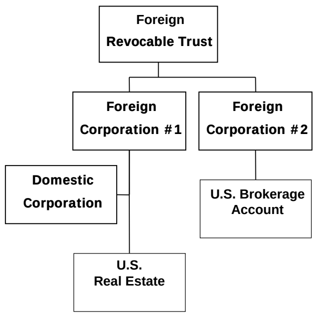
- Grantor Trust
  - Person treated as owner of assets is subject to U.S. income tax on current income (grantor trust does not have accumulated income)
- Non-Grantor Trust
  - Trust subject to U.S. income tax except that beneficiaries are taxed on receipt of distributions of income and income required to be distributed (whether or not actually distributed)
- Foreign vs. Domestic
  - Accumulation Distributions from foreign trust subject to throwback rules – U.S. income tax and interest charge
  - Accumulated income loses character
- CFC and PFIC

An Unhappy Trust Beneficiary



Planning Strategies

Common Structure For United States Assets



General Considerations for Foreign Trusts

- Issues in funding trust
- “Step-up in basis” issues
- Conversion to domestic trust (i.e., domestication, creation of new trust, distribution to stand-by trust, etc.)
- Provisions of Trust Deed
- Accountings which conform to U.S. standards
- Loans or guarantees

Planning For Foreign Grantor Trusts

- Consider disregarded entity or partnership
- Consider “stepping-up” basis and paying dividends if trust owns a corporation
- Address incapacity of grantor
- Consider using grantor as intermediary

Planning for Foreign Nongrantor Trusts

- Conversion to domestic trust, in whole or in part
- Distributions of specific property or pecuniary amount in three installments or less
- Liquidation of underlying company or checking-the-box
- Sale of shares of underlying company to non-U.S. person
- Distribution of all DNI each year

Planning for Nongrantor Trusts (Cont’d)

- Distributions to NRA Beneficiaries
- “In Kind” distributions of appreciated property
- Utilization of life insurance products
- Accounting Income Exception
- Default Calculation Rules

United States Reporting Requirements

U.S. Treasury Department Form TD F 90-22.1

- Report of Foreign Bank and Financial Accounts
- Must be filed by a US person who has a financial interest in or signature authority or other authority over any foreign financial accounts if the aggregate value of these accounts exceeds US$10,000.00 at any time during the calendar year
- Due on or before June 30th of succeeding year
- Applies to certain trust beneficiaries

IRS Form 3520

- Responsible party must file to report a "reportable event"
- U.S. person must file if:
  - Treated as the owner of any assets of a foreign trust under the grantor trust rules
  - Transferred property to foreign trust
  - Received more than $100,000 from a NRA or foreign estate (including foreign persons related to such NRA or foreign estate)
  - Received more than $10,000 (adjusted for inflation) from a foreign corporation or foreign partnership (including foreign persons related to such entity) that were treated as gifts
  - Received a distribution from a foreign trust
  - A party to certain loans
- Due the same day as the US person's personal income tax return, including extensions
- Significant penalties apply

IRS Form 3520-A

- Must be filed by a foreign trust if a U.S. person is treated as the owner of the assets of the trust
- Sets forth a full and complete accounting of all trust activities, trust operations and other relevant information
  - Foreign Grantor Trust Owner Statement
  - Foreign Grantor Trust Beneficiary Statement
- Due the 15th day of the 3rd month after the end of the trust's tax year
- Significant penalties apply

Ownership of Foreign Corporations

- U.S. beneficiaries of a trust may be deemed to own the shares of a foreign corporation which are owned by the trust
  - CFC (IRS Form 5471)
  - PFIC (IRS Form 8621)

Pitfalls to Avoid

- General Power of Appointment in favor of U.S. person
- Failure to timely file reporting requirements
- Gift paid from account owned by foreign corporation or foreign partnership
- Trying to predict the entire future
- Failing to plan in advance

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AUDITING FOREIGN TRUSTS

At the request of a number of trust companies, Cantor & Webb P.A. has developed a systemized approach to the review and determination of the United States tax and reporting issues of foreign trusts which may have beneficiaries who are or are about to become United States taxpayers.

Upon our being retained, we begin each trust audit by sending our specialized trust audit questionnaire to the trust company. This questionnaire is specifically designed to solicit pertinent information which significantly reduces the amount of time necessary for us to review various trust documents. After reviewing the completed questionnaire with the trust company, we then review the inventory of all trust documents, including, but not limited to, the trust deed, the letter(s) of wishes and trust accountings.

Upon completion of our review, we are then in a position to provide the following advice:

1. Whether for United States tax purposes the trust is considered to be a foreign trust or a domestic trust and under what circumstances that status may be changed.

2. The extent to which the trust is (and has been) a grantor trust and/or a nongrantor trust for United States income tax purposes.

3. Who (if anyone) is treated as a grantor of the trust and who (if anyone) is treated as the owner of the assets of the trust, and under what circumstances that result may change.

4. The United States income, estate, gift and generation skipping transfer tax consequences to the settlor and each beneficiary who is a United States person, whether due to (a) powers or rights in connection with the trust or the entities owned by the trust and/or (b) the direct or indirect receipt of distributions from the trust. There may also be state income tax consequences depending upon whether and in which state in the United States the beneficiary may be resident.

5. The United States reporting requirements, if any, of the trustees, the settlor(s) and the beneficiaries of the trust (i.e., Internal Revenue Service Forms 3520, 3520-A, TD F 90-22.1, 8621, 5471, 1040, 1041, etc.). There may also be state reporting requirements depending upon whether and in which state in the United States the relevant person may be resident.

6. What changes should be made to the trust deed, letter of wishes and/or the entities owned by the trust.

7. In which manner should the trust company maintain the trust and the entities owned by the trust in a tax efficient manner aimed at minimizing future tax and reporting consequences.

8. What type and situs of investment structures should not be held through the trust.

9. What procedures should be followed for making any additions to the trust so as to avoid adverse tax consequences and reporting requirements.

Trust companies have found our trust audit to be a very useful tool to assure themselves and their clients that their trust inventory has been properly reviewed and that important United States tax and reporting issues have been properly addressed.

Should you wish to discuss how we may arrange for a trust audit for your trust company, kindly contact:

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