

Foreign Trusts – Reporting Obligations

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What is a Foreign Trust?

- By default, all trusts are foreign trusts unless:
 - A court within the US is able to exercise primary supervision over trust administration (“court test”)
 - US Persons control all substantial decisions pertaining to the trust (“control test”)

Court Test

- Choice of law (governing or administrative) not dispositive. Facts and circumstances.
- Safe harbor if:
 - Trust instrument does not direct that the trust be administered outside of the U.S.
 - Trust is in fact administered exclusively in the U.S.
 - Trust is not subject to an automatic migration provision (automatically changing situs if a U.S. court attempts to exercise jurisdiction)

Control Test – Substantial Decisions

- All decisions other than ministerial decisions, including (but not limited to):
 - Timing and amount of distributions
 - Selection of beneficiaries
 - Power to allocate between income and principal
 - Power to remove, add or replace a trustee
 - Power to appoint a successor trustee (unless power cannot be exercised in a manner that would alter the trust's residency)
 - Power to make investment decisions
 - May hire non-U.S. investment advisor if U.S. persons can terminate at will

Foreign Trust Status

- Older Trusts
 - Trusts that were treated as domestic trusts on August 19, 1996 may elect to continue to be treated as U.S. trusts.
 - Election may terminate if certain changes are made to the trust after 1996.
- Accidental Loss of U.S. Status
 - 12 months to correct

Foreign Grantor Trust

- **U.S. Grantor – IRC 679:** Virtually any foreign trust established by a U.S. person for one or more U.S. beneficiaries is treated as a grantor trust (grantor is treated as income tax owner of trust)
- **Non-U.S. Grantor – IRC 672(f):** Foreign grantor will not be recognized as the tax owner of a trust unless
 - (i) grantor has power to revest absolutely in himself title to trust property (without the consent of a non-subservient person), or
 - (ii) only grantor or spouse are permissible beneficiaries during grantor's lifetime

Overview of Forms

- **Form 1040** – Worldwide Income
- **Form 3520 / 3520-A** – Transfers to and from, and interests in, foreign trusts
- **FBAR** (FinCen Form 114) – Interests in or signature authority over foreign financial accounts
- **Form 8938** (FATCA) – Interests in “specified foreign financial assets” (includes interests in trusts)
- **Form 8621** (PFIC)
- **Form 5471** (CFC)
- **Form 8865** (CFP)
- **Form 8858** (FDE)

Form 1040

- Must report worldwide income.
- Schedule B, Part III references disclosing of foreign financial accounts.

Form 3520 / 3520-A

- **Part I:** Transfer by U.S. persons to foreign trust
- **Part II:** Annual report by U.S. grantor of foreign trust
 - **Form 3520-A:** Filed by trustee if U.S. owner
- **Part III:** Receipt of distributions by U.S. person from foreign trust
 - **Undistributed net income**
 - Foreign [Grantor Trust / Non-Grantor Trust] Beneficiary Statement
 - Uncompensated use of trust property
 - Qualified loans
- **Part IV:** Receipt by U.S. person of gift or bequest over \$100,000 (not trust distributions)

FBAR (FinCen Form 114)

- Financial interest in or signature authority over foreign financial accounts aggregating \$10k or more
 - Trustees: If U.S. persons
 - Grantor: If grantor trust
 - Beneficiaries: If –
 - Foreign nongrantor trust
 - Trustee/agent does not file FBAR
 - U.S. beneficiary has present financial interest in more than 50 percent of assets or receives more than 50% of current income
- **Now April 15 (may be extended)**
- Penalties

Form 8938 (FATCA)

- Filed with 1040
- Interests in “specified foreign financial assets”
 - Broader than FBAR – includes interests in foreign entities, including trusts
 - Interests in trusts
 - If discretionary, and no distributions, value is \$0
 - If discretionary distributions made, value equals distributions
 - Threshold: \$50,000 at end of year or \$75,000 during year (doubled if filing jointly, higher if living abroad)

Form 5471 – CFC

- Controlled Foreign Corporation = more than 50% of vote or value held by U.S. persons, each of which holds at least a 10% voting interest. Each 10% holder must file.
- U.S. shareholders must report shares, include proportionate Subpart F income
- Grantors: Deemed owners
- Beneficiaries (non-grantor trusts):
 - Indirectly deemed to own stock “proportionately.” Facts and circumstances.
 - Constructively own stock in proportion to actuarial interests.
- Unclear where discretionary, no distributions.

Form 8621 – PFIC

- Passive foreign investment company = foreign corporation meeting income test (75% or more of gross income is passive) or asset test (50% or more of assets are held for production of passive income)
- Deemed shareholder must report shares, pay tax on excess distributions
- Grantors: Deemed owners
- Beneficiaries (non-grantor trusts): indirectly own “proportionate amount” of the trust’s stock
 - Unreasonable to take position that neither trust nor beneficiaries are deemed owners
 - No need to report unless (1) QEF or MTM election applies, or (2) excess distribution

“Red Flag” Checklist

- Foreign Trust?
 - Foreign fiduciaries?
 - Foreign non-fiduciaries with power (e.g., trustee appointment / removal)?
 - Grantor Trust?
 - If US grantor still living, almost certainly
 - Trustee reporting on 3520-A?
- Making Distributions? Loans? Use of property?
 - 3520
 - 8938 (FATCA)
- Foreign financial accounts? - FBAR
- Interests in foreign entities? – PFIC, CFC, etc.

Case Study #1 - Facts

- Two U.S. beneficiaries of U.K. trust. Grantor (father) deceased.
- U.K. trust holds various investment assets, including foreign mutual funds and U.K. bank accounts.
- No mandatory distributions, but trustees traditionally distribute 50% of accounting income to each beneficiary.
- Trustees also make loans to beneficiaries from time to time (not “qualified obligations”).

Case Study #1 - Reporting

- **Form 1040:** Report worldwide income
- **Form 3520 (Part III):** Report receipt of trust distribution.
 - Need Foreign Nongrantor Trust Beneficiary Statement (or must use default calculation).
 - If loans are not “qualified obligations”, must report as distributions.
 - May be UNI, which may be carried out if distributions exceed accounting income
- **FBAR:** Report values of trust’s foreign financial accounts (unless Trustee or US agent files)
- **Form 8938:** Value of beneficial interest in trust = amount of distributions.
- **Form 8621:** May need to file for each PFIC.

Case Study #2 - Facts

- Central American father of U.S. and non-U.S. beneficiary establishes revocable trust for himself and his descendants. Trustee in Bermuda.
- May revoke trust with 30 days' notice to Trustee. During 30 day period, Trustee may continue to exercise distribution and decanting powers.
- Trust holds controlling interest in BVI company investing in mining operations abroad, and foreign investment accounts.
- Trustee, at father's request, makes occasional loans (not "qualified obligations") or distributions from trust to U.S. son.

Case Study #2 - Reporting

- **Form 3520 (Part III):** Loans treated as distributions.
 - NOT grantor trust (revocation power effectively requires Trustee's consent)
 - Requires Foreign Nongrantor Trust Beneficiary Statement or must use default method to apportion between ordinary income and UNI accumulation distribution
- **FBAR:** Probably not, but maybe
- **Form 8938:** Value of son's beneficial interest equals amount of distributions in given year
- **Form 5741:** Maybe (facts and circumstances)

Case Study #3 – Facts

- Massachusetts nongrantor trust owns apartment in Cambridge
- Massachusetts attorney is trustee
- Grantor's brother, in Ireland, has power to remove and replace trustee
- Grantor's son lives in apartment rent-free

Case Study #3 – Reporting

- **Form 3520:**
 - Trust is foreign trust
 - Uncompensated use of trust property is deemed distribution (carrying out DNI, possibly UNI)
 - Must get Foreign Nongrantor Trust Beneficiary Statement or use default calculation method
- **Form 8938:** Value of interest in trust unclear, but reportable if beneficiary otherwise meets threshold



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