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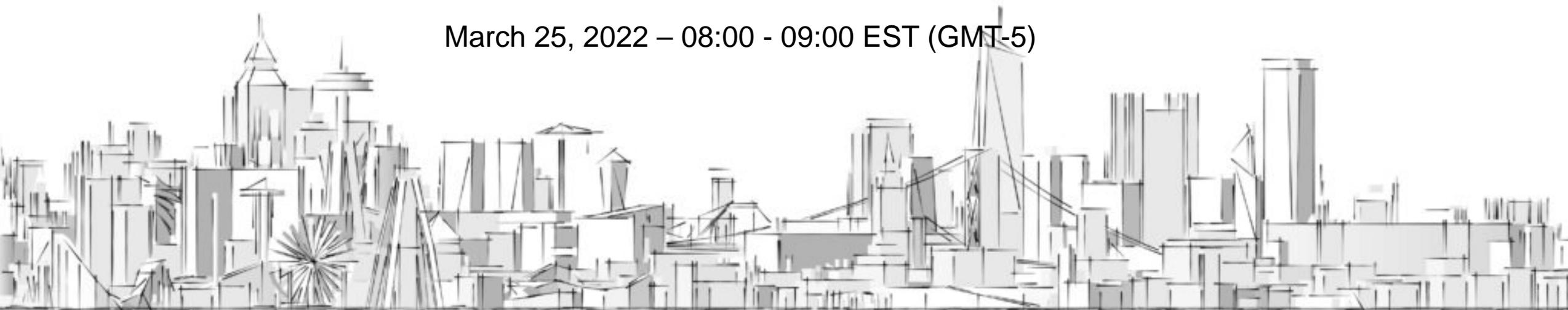
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FOREIGN TRUSTS FROM A U.S. PERSPECTIVE

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Severiano E. Ortiz

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Is it even a Trust?

There are arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries.

If not considered “trusts,” must apply default entity classification rules under Treas. Reg. § 301.7701-2 to determine how to treat the entity for U.S. tax purposes.

Types of “Trusts”

Treas. Reg. § 301.7701-4 – Trusts

- a) Ordinary Trusts
- b) Business Trusts
- c) Investment Trusts
- d) Liquidating Trusts
- e) Environmental Remediation Trusts



Types of “Trusts” | Ordinary Trusts

Treas. Reg. § 301.7701-4(a)

- “ Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees’ responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. ”
- Beneficiaries simply accept benefits and are not planners or creators of the arrangement

Types of “Trusts” | Business Trusts

Treas. Reg. § 301.7701-4(b)

These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code.

The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under Reg. § 301.7701-2.

Types of “Trusts” | Investment Trusts

Treas. Reg. § 301.7701-4(c)

Similar to a Business Trust, the arrangement could be considered an Investment Trust, i.e., a business entity under Reg. § 301.7701-2, if there is a power under the trust agreement to vary the investment of the certificate holders.

- Regulations provide a few examples; generally, it will be classified as a business entity, either with a single class of ownership or multiple classes of ownership, unless no power under trust to vary the investment of the certificate holders, where the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

Types of “Trusts” | Liquidating Trusts

Treas. Reg. § 301.7701-4(d)

This is in fact considered to be a “trust” for income tax purpose.

- An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose.
- A liquidating trust is treated as a trust for purposes of the IRC because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships.
- However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust.

Types of “Trusts” | Environmental Remediation Trusts

Treas. Reg. § 301.7701-4(e)

This is in fact considered to be a “trust” for income tax purpose.

- “If the organization is organized under state law as a trust;
- the primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws;
- all contributors to the trust have (at the time of contribution and thereafter) actual or potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and
- the trust is not a qualified settlement fund within the meaning of Reg. § 1.468B-1(a) of this chapter.”

Foreign or Domestic Trust? Not always clear

- U.S. law controls the classification of a foreign entity for U.S. tax purposes
- Trust formed outside the U.S. could still be a U.S. trust
- Trust formed inside the U.S. could still be a foreign trust
 - Even if its creator, trustees, beneficiaries, governing law, and assets are all located in the U.S.
- Control, residency/citizenship of grantors, beneficiaries, trustees, could all affect whether a trust is domestic or foreign
- U.S. applies two-part test to determine whether foreign or domestic
 - Default rule is that a trust is a foreign trust unless BOTH:
 - A court within the U.S. is able to exercise primary supervision over the administration of the trust (the “court test”), **and**
 - One or more U.S. persons have the authority to control **all** substantial decisions of the trust (the “control test”). I.R.C. § 7701(a)(30)(E)

Court Test

A court within the U.S. is able to exercise primary supervision over the administration of the trust (the “court test”).

- Consideration must be given to all the terms of the trust instrument
- Stating that trust is to be administered outside the U.S., fails this test
- If silent on jurisdiction, may be U.S., unless subject to an automatic migration/flee clause.

Will satisfy the Court Test if each of the following is met:

1. The court with primary supervision over the trust must be within the 50 States or the District of Columbia.
2. The U.S. court must be “able to exercise” its authority over the trust (i.e. render judgments, orders, or resolve issues related to the administration).
3. The U.S. court must have “primary supervision” over the trust (i.e. must have authority regarding substantially all of the issues related to administration. Treas. Reg. § 301.7701-7(c)(3).
 1. U.S. and Foreign country could both have primary and be okay.

Court Test (Con't)

If desire is to establish a foreign trust, doing so through this test is more difficult than planning through the Control Test.

Safe Harbor Regulations exist, however, to satisfy the Court Test if:

- The trust is registered with a State court under provisions similar to Article VII of the Uniform Probate Code, or
- The trust is created pursuant to a will probated in the U.S. and all fiduciaries have been qualified, or
- The trustee or fiduciary of the trust takes affirmative steps with a U.S. court to cause the administration of the trust to be subject to the primary supervision of that U.S. court.

Treas. Reg. § 301.7701-7(c)(4)(i)

Control Test

One or more U.S. persons have the authority to control all substantial decisions of the trust (the “control test”)

Substantial decisions means “a decision that persons are authorized or required to make under the terms of the trust instrument and applicable law that are not ministerial. These include, but are not limited to:

- A. Whether and when to distribute income or corpus;
- B. The amount of any distributions;
- C. The selection of a beneficiary;
- D. Whether a receipt is allocable to income or principal;
- E. Whether to terminate the trust;
- F. Whether to compromise, arbitrate, or abandon claims of the trust;
- G. Whether to sue on behalf of the trust or to defend suits against the trust;

Control Test (Con't)

- H. Whether to remove, add, or replace a trustee;
- I. Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and
- J. Investment decisions; however, if a U.S. person under § 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the U.S. person if the U.S. person can terminate the investment advisor's power to make investment decisions at will.

Treas. Reg. § 301.7701-7(d)(ii).

Control Test (Con't)

The term “**Control**” also means:

Having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether U.S. persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

Treas. Reg. § 301.7701-7(d)(iii).

Grantor Trust vs. Non-Grantor Trust

There are two types of trusts:

- **Grantor Trust:** Considered wholly owned by the grantor and is treated as an extension of the grantor. Thus, all items of income, deduction and credit of the trust are includable in the grantor's income as if the assets were owned by the grantor personally. (I.R.C. § 671)
- **Non-Grantor Trust:** Considered a separate taxpayer

Generally speaking, the trust will be a non-grantor trust unless the grantor or another person is treated as the owner of that trust's assets because the grantor, trustee, or beneficiary has certain powers over the trust's income or corpus.

So, need to answer the **following questions:**

1. Who is the "Grantor?"
2. Does the "Grantor" have sufficient powers over the trust to make it a grantor trust?

First Question | Who is the Grantor?

Who is the “Grantor?”

Any person (individual or entity) who “creates a trust, or directly or indirectly makes a gratuitous transfer . . . of property to a trust. Entity grantors require business purpose.” Treas. Reg. § 1.671-2(e).

Caution: Many complex rules exist to shift the deemed owner of the trust and potentially alter the “grantor.”

Examples:

- Where a foreign person would be treated as the owner of any portion of a trust with a U.S. beneficiary, if such U.S. beneficiary transfers (directly or indirectly) property (other than in a sale for FMV) to such foreign person, then that U.S. beneficiary shall be treated as the grantor of such portion transferred. I.R.C. § 672(f)(5).
- If a U.S. person transfers (directly or indirectly) property to a foreign trust, such person shall be treated as the owner for his taxable year of that property if for such year there is a U.S. person beneficiary (i.e. a distinct U.S. person). I.R.C. § 679(a) (with certain exceptions).
 - **[NRA deemed to be U.S. Person]** - If NRA transfers property to a foreign trust and becomes a U.S. income tax resident within 5 years following the transfer, such person will be deemed to have made the transfer on such person’s U.S. residency starting date; i.e. deemed to have been a transfer of property into a trust by a U.S. person. I.R.C. § 679(a)(4).
 - **[Deemed to have U.S. Beneficiary]** – Deemed to have U.S. beneficiary unless trust explicitly excludes any benefit to U.S. persons, and no part of trust income or corpus would go to or for the benefit of a U.S. person upon termination of the trust at any time during the taxable year. I.R.C. § 679(c)

Second Question | Does the Grantor Have Sufficient Powers?

Does the “Grantor” have sufficient powers over the trust to make it a grantor trust?

If the “grantor” is a U.S. income tax resident, the trust is a grantor trust if the grantor (or spouse) satisfies the criteria under §§ 671 through 679; namely,

- Grantor retains a reversionary interest in the income or principal (I.R.C. § 673)
- Grantor or non-adverse party has power over beneficial enjoyment with some exceptions (I.R.C. § 674)
- Grantor or non-adverse party has power to purchase, exchange or deal with or to permit another person to deal with the trust without adequate and full consideration (I.R.C. § 675)
- Grantor or non-adverse party can borrow from trust without adequate interest or without adequate security (I.R.C. § 675)
- Any person who is not a fiduciary can acquire trust assets by substituting assets of equivalent value (I.R.C. § 675)

Second Question | Does the Grantor Have Sufficient Powers?

- Grantor or non-adverse party has power to revoke and revest in grantor (I.R.C. § 676)
- Grantor or non-adverse party has power to distribute income to grantor or spouse (I.R.C. § 677)
- Distribution from a foreign trust may be made to or accumulated for a U.S. beneficiary during taxable year (I.R.C. § 679)

Second Question | Does the Grantor Have Sufficient Powers?

Does the “Grantor” have sufficient powers over the trust to make it a grantor trust?

If the “grantor” is ***NOT*** a *U.S. income tax resident*, the trust is a grantor trust if the grantor satisfies the criteria under I.R.C. § 672(f); namely,

- The trust deed must provide that all payments of income or corpus are payable only to the grantor or his spouse during the grantor’s lifetime, ***or***
- The grantor is able to revest himself of all trust property at any time.
- Note different rules if grantor is not a U.S. income tax resident. This addresses concerns that trusts would be structured as foreign owned, thus avoiding U.S. income tax unless ECI or U.S. Source. Thus, limitations were made in 1996 as to whether a foreign person would be deemed to own the trust.

Considerations

Grantor Trusts:

- Potential migration from foreign to domestic or reverse (filings etc.)
- Change from grantor to non-grantor upon death (Throwback rules, CFCs, PFICs, etc.)

Non-Grantor Trusts:

Domestic Non-Grantor Trusts (“DNGT”):

- Filings done on Form 1041
- Distributions (gains allocated to principle rather than distributable net income)
- Transfers to DNGT potentially subject to U.S. gift tax or income tax (i.e. FIRPTA)

Foreign Non-Grantor Trusts (“FNGT”):

- Filings done on Form 1040NR (if earning ECI or U.S. Source) and may also include Form 3520 or Form 3520A
- Distributions (gains allocated to distributable net income)
 - Later distributions from undistributed net income subject to draconian “throwback tax” rules; i.e., loss of capital gain treatment and subject to prior year interest charges.
- Transfers to a FNGT by a U.S. person are treated as a sale and taxable to the transferor. I.R.C. § 684
- Transfers to FNGT potentially subject to U.S. gift tax or income tax (i.e. FIRPTA)



Thank you for your attention

Questions?



Speaker

Severiano E. Ortiz, J.D., LL.M., CPA, TEP

Severiano is a Partner in the Washington, D.C. office of Kozusko Harris Vetter Wareh Duncan LLP (“KHD”). Severiano practices in the area of tax law, advising institutional and private clients, both domestic and international, in individual and business tax planning matters. He focuses on cross-border transactions and tax efficient restructurings. He advises clients regarding tax developments affecting their business, both globally and domestically. He also advises clients regarding their individual and family cross-border planning and restructuring needs: pre-immigration; expatriation; cross-border income, gift, and estate; offshore compliance.

Severiano E. Ortiz
Partner

Kozusko Harris Duncan

+1 202.454.6721
sortiz@kozlaw.com
Washington, D.C., USA

Practice

- Int’l Private Client Services
- International Tax Services

Education

- Northwestern University School of Law, LL.M., Taxation
- Northwestern University School of Law, J.D.

Bar Admission

- Washington, D.C.
- Virginia
- Illinois

- Jacksonville University, B.S. / B.A.