U.S. tax issues hidden in foreign trust inventories

By Kathryn von Matthiessen

Purchasers of foreign trust inventories should be warned that many complicated tax issues may be lurking in the history of trust structures with U.S. beneficiaries, some not too far below the surface.

Such issues include identification of the real "grantor", accurate classification of the grantor trust status of each trust and status as a foreign or domestic trust for U.S. tax purposes, as well as proper U.S. tax planning for foreign trusts with U.S. beneficiaries in the trust documents.

Kathryn von Matthiessen

Definitions under U.S. tax law

To fully grasp these issues and the complexity of the analysis required, it is helpful to review some simple definitions under U.S. tax law.

Foreign grantor trust

If a foreign trust company is the trustee of a trust, it will most likely be classified as a "foreign trust" for U.S. tax purposes. However, confirmation of this fact must be made on a trust-by-trust basis.

A foreign trust is a grantor trust (which means income is taxable to the grantor) only if (1) the grantor retains the right, exercisable either alone or with the consent of another person who is a related or subordinate party who is subservient to the grantor, to revoke the trust; or (2) the only amounts which may be distributed from the trust during the grantor's life are amounts distributable to the grantor or their spouse. Another way of thinking about foreign grantor trust status is that the foreign grantor is deemed to "own" the assets of the trust for U.S. income tax purposes.

The rules for a trust with a foreign grantor to qualify as a "grantor" trust are much narrower than the rules for a trust with a U.S. grantor to qualify as a "grantor" trust for U.S. tax policy reasons.

A foreign grantor will not be within the U.S. tax system with respect to the trust's income unless the trust is, for example, engaged in a U.S. trade or business or has U.S. source income. If the grantor is treated as the owner of the assets of a foreign trust for U.S. income tax purposes, no distribution from such trust made to the U.S. beneficiary would be taxable income to the U.S. beneficiary. The U.S. beneficiaries of a foreign trust which qualifies for foreign grantor trust status benefit from the ability to receive distributions from the trust which are not subject to U.S. income tax during the life of the foreign grantor, and the foreign grantor may be outside of the U.S. tax system as well.

In addition, U.S. beneficiaries of a foreign grantor trust are not subject to the throwback rules upon receiving a distribution during the life of the foreign grantor.

Foreign non-grantor trust and throwback rules

A foreign non-grantor trust is a foreign trust which is not a foreign grantor trust. The throwback rules are essentially an anti-deferral regime for U.S. beneficiaries of foreign trusts which are NOT foreign grantor trusts so that U.S. beneficiaries may not benefit from the deferral of tax that has occurred in the trust offshore when the beneficiary receives a distribution.

If a U.S. beneficiary receives a distribution from a foreign non-grantor trust that is comprised of income or gain earned and accumulated by the trust in a prior year, the U.S. beneficiary may be subject to both an interest charge and the back tax of the throwback rules.

Tax issues

These concepts are important to understand a number of "tax traps" that can create problems for trustees and U.S. beneficiaries of a foreign trust unless a qualified U.S. tax attorney has provided thorough and accurate advice concerning the foreign trust. Two of these tax traps are highlighted below.

Tax trap 1: identifying the "real" grantor

A person is the "grantor" of a trust to the extent that they either created the trust

...next page

or made a gratuitous transfer to the trust. In order to achieve favourable grantor trust status, only the person who actually contributed the assets to the trust may be treated as the "owner" of the assets for U.S. income tax purposes.

Members of foreign families commonly hold assets for each other, so it is important to understand the true source of funds and whether there were any nominee agreements in place. If the person who has the power to revoke the trust or is (or whose spouse is) the beneficiary of the trust is not the "real" contributor of the assets, the trust will not qualify for foreign grantor trust status. Similarly, if a married person who contributed assets to the trust was from a jurisdiction with a community property regime, then his spouse may be a partial grantor. Without proper drafting of the trust instrument, full grantor trust status could be lost.

If a foreign corporation was the grantor and the trust was funded for a business reason of the corporation, the corporation will be respected as the grantor. If the trust was funded for personal reasons of one or more shareholders, the shareholder who had a personal reason for the funding of the trust will be treated as the real grantor.

If a foreign trust is not categorised correctly as a foreign grantor or non-grantor trust, a U.S. beneficiary cannot report distributions properly for U.S. tax purposes and the foreign trustee cannot meet its obligation to provide the correct information to the U.S. beneficiary.

Tax trap 2: failure to plan for the death of the foreign grantor

Ideally, a foreign grantor trust will be drafted to provide for a step-up in basis for the assets of the trust to fair market value upon the death of the foreign grantor. There are specific provisions in the United States Internal Revenue Code that permit a step-up in basis of foreign situs assets held in a foreign trust. The foreign grantor must have the power to direct trust income. This power should be coupled with either a power to revoke the

trust or the power to alter, amend or terminate the trust. Matching the power to revoke the trust with foreign grantor trust status is relatively simple since a power to revoke is one of the tests for foreign grantor trust status. Matching a power to alter, amend or terminate with a trust where only the grantor or the grantor's spouse may be a beneficiary is much more difficult. These provisions are often overlooked in foreign grantor trusts. A foreign trust also should be drafted to provide for foreign grantor trust status to continue upon the incapacity of the grantor.

Other issues beyond the scope of this article are timely and accurate identification of U.S. beneficiaries, the U.S. anti-deferral regimes for foreign corporations in which U.S. beneficiaries may have an indirect interest through a foreign trust and exit strategies from ownership of these foreign corporations.

It is critical for a foreign trust company to address all of these issues when acquiring a new inventory of trusts by having an experienced U.S. tax attorney review each trust in the inventory. In this review, the attorney should determine on a case-by-case basis the status for U.S. tax purposes of each trust, as well as highlighting any potential problems, pitfalls or ambiguities for U.S. tax purposes that should be addressed and resolved.

To access a more comprehensive version of this article as well as other publications by Cantor & Webb legal professionals, please visit www.cantorwebb.com.

Kathryn von Matthiessen is a partner at the law firm of Cantor & Webb, a GGI member, which focuses on the representation of international private clients in the areas of taxation, estate planning and tax compliance. Kathryn von Matthiessen focuses primarily on sophisticated personal and estate planning for high-net-worth individuals and the administration of complex estate and trusts, including advising international trust companies on reporting obligations concerning U.S. matters.

The Miami-based law firm of Cantor & Webb services high-net-worth private clients, predominantly from Canada, the Caribbean, Europe and Latin America.

GGI member firm
Cantor & Webb
Law Firm, Tax, Fiduciary & Estate Planning
Miami (FL), USA
Kathryn von Matthiessen
E: kathryn@cantorwebb.com
W: www.cantorwebb.com