

# **Reporting Requirements of U.S. Persons Connected to Foreign Trusts and of Delaware (Foreign) Trusts<sup>1</sup>**

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This outline describes the reporting requirements applicable to U.S. persons who transfer assets to or receive distributions from foreign trusts or who receive gifts from foreign donors. It also covers the reporting requirements imposed on trustees of U.S.-owned foreign trusts, as well as on U.S. trustees of Delaware trusts that are treated as foreign trusts for U.S. tax purposes.

## **I. TRUST RESIDENCE AND GRANTOR/NONGRANTOR TRUST STATUS**

A full discussion of the U.S. tax treatment of foreign and domestic trusts and of the settlor and beneficiaries, is beyond the scope of this outline. However, a few key concepts are critical to understanding the reporting framework laid out in the following sections. The residence of a trust and its status as a grantor or nongrantor trust will impact how the trust and the grantor are taxed on its income and how U.S. beneficiaries are taxed on distributions.

### **A. Foreign Grantor Trusts.**

For U.S. federal income tax purposes, trusts are taxed either as grantor trusts or as nongrantor trusts. If a trust is a “grantor trust,” the trust is ignored for U.S. federal income tax purposes and the grantor is required to include its income, deductions, credits, gains and losses in his or her income under Section 671 of the Internal Revenue Code of 1986, as amended (the “Code”).<sup>3</sup>

1. If the grantor is a U.S. citizen or resident, he or she will be taxable in the U.S. on all of the trust’s income without regard to source. The U.S. grantor will have annual reporting requirements on IRS Form 3520-A if the trust is a foreign trust.
2. If the grantor is a nonresident alien, then he or she will be subject to federal income taxes only with respect to income of the trust from U.S. sources and

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<sup>3</sup> Unless otherwise provided, all Section references herein are to the Code and Treasury regulations promulgated thereunder.

income that is effectively connected with the conduct of a trade or business in the U.S.

3. In either case, distributions from a grantor trust to U.S. beneficiaries are treated as tax-free gifts from the grantor in the hands of the U.S. beneficiaries and thus do not carry out trust income to the beneficiaries.<sup>4</sup>
4. As discussed in more detail below, such gifts are reportable by the U.S. beneficiaries on IRS Form 3520 if the trust is a foreign trust or if the grantor is a nonresident alien.
5. Grantor trusts generally become nongrantor trusts upon the death of the grantor.
6. The grantor trust rules may not necessarily extend to all of the property held by a trust. It is possible for a portion of a trust to be treated as a grantor trust and for another portion to be treated as a nongrantor trust. Moreover, a grantor trust can have more than one grantor.<sup>5</sup>

#### **B. Foreign Nongrantor Trusts.**

1. A foreign nongrantor trust generally will not be taxed in the U.S. on income from non-U.S. sources unless the income is effectively connected with a U.S. trade or business.
2. Distributions from a foreign nongrantor trust to U.S. beneficiaries will carry out income to the U.S. beneficiaries, including foreign source income and capital gains that would not have been taxable to the trust itself.
3. Distributable net income that is distributed currently (or within the first 65 days of the year following the year in which it was earned by the trust if an election is timely made by the trust) generally will preserve its character in the hands of the beneficiaries.
4. If income is accumulated within the trust and distributed in a later tax year, then it will be taxed at higher effective tax rates as “undistributed net income”

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<sup>4</sup> Rev. Rul. 69-70, 1969-1 C.B. 182. Such gifts must nonetheless be reported as distributions from foreign trusts in Part III of IRS Form 3520, rather than as gifts from the nonresident grantors in Part IV.

<sup>5</sup> Because of the tax complications that can arise from “blended” status, planners intentionally structuring a trust as a grantor trust typically will try to ensure that there is only one grantor with respect to all of the income and corpus of the trust. A notable exception is where a married couple living in a community property jurisdiction, such as California or Texas, may be joint grantors of a grantor trust.

and potentially subject to an interest charge.<sup>6</sup>

5. The IRS Form 3520 reporting requirements for U.S. beneficiaries and trustees of foreign trusts discussed in the following sections are designed to ensure that this income is properly reported.

### **C. Key Differences Between Grantor Trust Rules for U.S. and Non-U.S. Grantors.**

1. Because of the favorable tax treatment of grantor trusts settled by nonresident aliens (i.e., foreign source income will not be taxable to the trust, the grantor or its U.S. beneficiaries), a trust settled and funded by a non-U.S. grantor will qualify as a grantor trust only under the following circumstances:
  - a. The grantor has the power to revoke the trust and revest the assets in himself either alone or with the consent of a related or subordinate party subservient to the grantor; or
  - b. During the grantor's lifetime, trust distributions may be made only to the grantor or the grantor's spouse (including certain payments in discharge of legal obligations of the grantor or the grantor's spouse).<sup>7</sup>
2. In contrast, because of the potential for a U.S. person to shift income outside of the U.S. taxing jurisdiction, it is very difficult to avoid grantor trust status when a foreign trust is settled and funded by a U.S. person.
  - a. In general, a trust settled and funded by a U.S. grantor may be considered a grantor trust either in whole or in part if the grantor retains one of the various "grantor powers" described in Sections 673 to 677.<sup>8</sup>
  - b. If the trust is a foreign trust, a U.S. person who, directly or indirectly, makes a gratuitous transfer to the trust is automatically treated as the owner of the trust under Section 679 for any taxable year in which the trust has a U.S. beneficiary or is deemed to have a U.S. beneficiary under very broad presumption rules laid out in Section 679(c)(1) and the regulations thereunder.

### **D. Trust Residence.**

The residence of a trust is determined according to a two-part test based on both

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<sup>6</sup> The punitive treatment of accumulation distributions generally does not apply to distributions from a U.S. nongrantor trust (unless it was previously a foreign nongrantor trust).

<sup>7</sup> Section 672(f)(2). There is also an exception for compensatory trusts.

<sup>8</sup> A U.S. beneficiary with certain withdrawal powers also can be considered a grantor under Section 678.

jurisdiction and control over the trust. Section 7701(a)(30)(E) defines the term “United States person” to include “any trust if:

1. A court within the United States is able to exercise “primary supervision” (but not necessarily exclusive jurisdiction) over the administration of the trust, and
2. One or more United States persons have the authority to control all “substantial decisions” of the trust.”

If the trust does not satisfy both the “court” test and the “control” test, it will be considered a foreign trust, which tends to create a structural bias towards foreign status.<sup>9</sup> This foreign-leaning test was introduced in conjunction with other provisions that tightened the rules governing the U.S. tax treatment of foreign trusts and introduced the reporting requirements discussed below for U.S. grantors and beneficiaries of foreign trusts.

### **E. Hybrid Trusts.**

It has become increasingly common for nonresidents to settle trusts in U.S. jurisdictions with strong privacy laws and minimal disclosure requirements, such as Delaware, but to structure the trusts so as to flunk the control test (e.g., by appointing a foreign protector) and remain foreign trusts for U.S. tax purposes. This might be desirable where there is an interest in keeping the trust foreign in the near term (e.g., because there are no current U.S. beneficiaries), but a significant likelihood of U.S. beneficiaries in the future and the settlor wants to have the option of quickly domesticating the trust. A common planning tool is to structure the trust as a foreign grantor trust during the grantor’s lifetime (so that foreign source and capital gains (other than from the sale of U.S. real estate) will not be taxable to the grantor, the trust or the U.S. beneficiaries) and then domesticate the structure for the U.S. beneficiaries after the grantor’s death to avoid some of the adverse tax consequences of foreign nongrantor trust status.

As discussed below, it is critical for Delaware trust companies serving as trustees of such hybrid trusts to be aware of their reporting obligations with respect to trust income and assets and distributions to any U.S. beneficiaries.

## **II. OVERVIEW OF REPORTING REQUIREMENTS**

### **A. Background.**

1. IRS Form 3520 and 3520-A Reporting Requirements

<sup>9</sup> Section 7701(a)(31)(B). Prior to 1997, the tax residence of a trust was determined under a more subjective “facts and circumstances” test which required an inquiry into whether the trust was more like a U.S. resident or nonresident alien based on factors such as the location of trust assets, trust administration and residence of the trustee. This test was replaced by the current two-part court and control test for tax years beginning after December 31, 1996 with the enactment of the Small Business Jobs Protection Act of 1996 (the “1996 Act”). See Pub. L. No. 104-188, § 1907, 110 Stat. 1755 (Aug. 20, 1996).

- a. The 1996 Act expanded significantly the reporting requirements that apply to (i) a U.S. person who creates or transfers property to a foreign trust; (ii) a foreign trust that is treated as owned by a U.S. person under the grantor trust rules; (iii) a U.S. beneficiary who receives a distribution from a foreign trust; and (iv) a U.S. beneficiary who receives a gift from other foreign persons (including foreign individuals, estates, corporations and partnerships). The 1996 Act also restricted the circumstances under which a trust settled by a nonresident alien would qualify as a grantor trust to arrangements in which the trust was either revocable or limited distributions during the grantor's lifetime to the grantor and/or the grantor's spouse. The penalty framework for failing to comply with these reporting requirements was also significantly revised. The expanded requirements are set forth in Sections 6048 and 6039F and the penalty provisions are set forth in Section 6677.
- b. Unified reporting is available on IRS Form 3520 so that a U.S. transferor, grantor, or beneficiary may comply with foreign trust and foreign gift reporting requirements by completing relevant portions of the same form. In addition, a foreign trust with a U.S. owner is required to file IRS Form 3520-A to comply with its reporting requirements. Regulations have not been promulgated to date, but the IRS has issued guidance in Notice 97-34, upon which Forms 3520 and 3520-A are based.<sup>10</sup>
- c. The statute of limitations on assessments of tax imposed under the Code does not begin to run until a return required by Section 6048 is filed in respect of an event or period related to the information required to be reported. Under the current version of Section 6501(c)(8), failure to file returns required under Section 6048 with respect to a foreign trust can leave a taxpayer's entire tax return open to audit indefinitely. That is, the statute of limitations period is suspended and all items on the return will be subject to examination even if they do not deal with the items that caused the suspension to apply. However, if the failure to furnish the information required is due to reasonable cause and not willful neglect, the suspension of the assessment limitations period will apply only to the items related to that failure.

## 2. IRS Form 8938 Reporting Requirements<sup>11</sup>

<sup>10</sup> See I.R.S. Notice 97-34, 1997-1 C.B. 422 and instructions to Forms 3520 and 3520-A.

<sup>11</sup> FATCA also created new due diligence, record-keeping, withholding and reporting requirements for Foreign Financial Institutions (FFIs) with respect to their U.S. account holders in order to avoid 30 percent withholding. The FACTA withholding requirements applicable to a foreign trust are discussed later in this outline.

- a. FATCA<sup>12</sup> amended the penalty provisions of Section 6677, broadened the circumstances under which a U.S. transferor would be treated as an “owner” of a foreign trust under Section 679 and amended Section 643(i) to treat the rent-free use of trust property by the U.S. beneficiary of a foreign nongrantor trust as a constructive distribution reportable by (and potentially taxable to) the U.S. beneficiary. FATCA also enacted Section 6038D, which requires any individual holding specified foreign financial assets (SFFAs) to report information about such assets with his or her income tax return, effective for tax years beginning after March 18, 2010. Although the terms of the statute only apply to individuals, the provision authorized the issuance of regulations under which entities would also be subject to the reporting requirement. The filing obligation only applies where the taxpayer’s SFFAs have an aggregate value that exceeds an applicable threshold. An interest in a foreign entity, including a beneficial interest in a foreign trust, is an SFFA if the U.S. taxpayer knows of it or has reason to know of it.
- b. “Specified individuals” subject to IRS Form 8938 filing requirements with respect to SFFAs include U.S. citizens and residents (including part-year residents), nonresident aliens who make elections to be treated as residents for the purpose of filing a joint return and nonresidents who are bona fide residents of Puerto Rico or American Samoa.<sup>13</sup>
- c. The IRS Form 8938 filing requirements were extended to “specified domestic entities” for tax years beginning in 2016.<sup>14</sup> Specified domestic entities are domestic corporations, partnerships or trusts (as defined for U.S. tax purposes) formed or availed of for purposes of holding, directly or indirectly, SFFAs. A domestic trust meets the “formed or availed of” test if and only if the trust has one or more specified persons as a current beneficiary. A specified person is defined elsewhere to mean a specified individual or a specified domestic entity. A current beneficiary is, with respect to the taxable year, any person who at any time during the taxable year is entitled to (or who, at the discretion of any person, may receive) a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent that such power remains

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<sup>12</sup> The Foreign Account Tax Compliance Act provisions of the 2010 Hiring Incentives to Restore Employment Act (FATCA). Pub. L. No. 111-147, 124 Stat. 97 (Mar. 18, 2010).

<sup>13</sup> Temporary regulations were issued on December 19, 2011 addressing the reporting requirements under Section 6038D applicable to “specified individuals” with SFFAs (T.D. 9567). The 2011 temporary regulations were issued as final regulations on December 12, 2014 (T.D. 9706).

<sup>14</sup> Although proposed regulations addressing domestic entities were published in December 2011, final regulations imposing Form 8938 reporting requirements on “specified domestic entities” were not issued until February 22, 2016, effective February 23, 2016 for tax years beginning after December 31, 2015 (T.D. 9752). See also Notice 2013-10, 2013-8 I.R.B. 503.

unexercised at the end of the taxable year). Current beneficiaries also include holders of general powers of appointment, whether or not exercised, that were exercisable at any time during the taxable year.<sup>15</sup>

- d. There are exceptions to the Form 8938 filing requirements for grantor trusts because the grantor is treated as the owner of the trust's assets for Section 6038D reporting purposes. Also excluded are domestic trusts if the trustee (i) has supervisory authority over fiduciary obligations with respect to the SFFA of the trust, (ii) timely files annual returns for the trust and (iii) is either (A) a bank subject to U.S. bank regulatory oversight; or (B) a financial institution registered with and regulated or examined by the SEC; or (C) a domestic corporation that is regularly traded on an established securities market or an affiliate of a domestic corporation that is so traded.
3. Bank Secrecy Act (31 U.S.C. 5314): FinCEN Form 114 (Report of Foreign Bank and Financial Accounts)
    - a. A U.S. grantor or beneficiary of a foreign trust (or a U.S. trustee of a foreign trust) may have filing requirements in respect of any foreign financial accounts held directly or indirectly by the trust, on FinCen Form 114 (Report of Foreign Bank and Financial Accounts) *aka* FBAR. The FBAR requires disclosure of foreign financial accounts in which the filer has a financial interest or signature authority which exceed, in aggregate, \$10,000 in a calendar year. A foreign financial account includes a bank account, a securities account, a mutual fund or other pooled investment fund.
    - b. On February 24, 2011, final FBAR regulations were published.<sup>16</sup> The FBAR is filed separately from the U.S. filer's tax return and is due April 15th of the year following the year for which the FBAR is filed, with an indefinite extension granted to October 15th.<sup>17</sup>

## **B. Applicable Definitions.**

These definitions are culled from various Code sections but are based primarily on Notice 97-34 and Treasury regulations promulgated under Sections 679, 684, 6038D, 6048 and 7701 of the Code.

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<sup>15</sup> This does not include powers exercisable only on the death of the holder.

<sup>16</sup> 31 CFR part 103.

<sup>17</sup> The FBAR previously was due June 30th, but the deadline was moved up to April 15th (with an automatic extension to October 15th) for FBARs filed for 2016 and subsequent calendar years.

## 1. “Distribution”

Broadly defined to include any direct or indirect gratuitous transfer (such as through an intermediary who is not the grantor) of money or other property from a foreign trust, including a constructive distribution such as the payment or guarantee of a U.S. beneficiary's personal obligation with trust assets. The latter includes, for example, a credit card or check drawn on a trust account. Additionally, a payment for services or property in excess of the value of such services or property is a deemed distribution, and a loan of cash or marketable securities to a U.S. beneficiary (or a “related person” within the meaning of the relevant Code section) is treated as a distribution unless it is a “qualified obligation.” Moreover, the use of trust property without paying fair market rent is treated as a distribution.

## 2. “Foreign Trust” and “U.S. Trust”

A “U.S. trust” is a trust that meets a two-pronged test: (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more U.S. persons has authority to control all substantial decisions of the trust. A “foreign trust” is defined by exclusion to mean any trust other than a “U.S. trust.” As discussed previously, a Delaware trust can be structured to qualify as a foreign trust for U.S. tax purposes.

## 3. “Grantor”

Any person to the extent such person either (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer to a trust. If any person creates or funds a trust on behalf of another person, both persons are treated as “grantors” of the trust; however, a person who creates a trust but makes no gratuitous transfers to the trust will not generally be treated as an “owner” under the grantor trust rules.

## 4. “Grantor Trust”

A trust the assets of which are treated as owned by a grantor of the trust (and in certain limited cases, a U.S. beneficiary of the trust) under U.S. federal income tax principles. This would be the case if (i) a U.S. person retained one or more “grantor powers” described in Sections 673 through 677; or (ii) a U.S. person created a foreign trust having a U.S. beneficiary, under Section 679 of the Code; or (iii) a U.S. beneficiary had a withdrawal power described in Section 678 of the Code. A noncitizen nonresident will be treated as the owner of trust assets only under the narrow circumstances set forth in Section 672(f) of the Code (i.e., the trust must either be fully revocable by the grantor or restrict distributions during the grantor’s lifetime only to the grantor and/or the grantor’s spouse). If a person is treated as an “owner” of a trust, all items of income, deduction and credit, including capital gains realized by the trust are attributed to the person as if earned or paid directly by or to him or her whether or not actually received by him or her.



## 5. “Gratuitous Transfer”

Any direct or indirect transfer (such as through an intermediary) to a trust, including a constructive transfer, such as an assumption or satisfaction of a trust’s obligation to a third party. There is an exception for fair market value transfers; however, if the transferor is a grantor or a beneficiary of the trust (or a “related person” within the meaning of the relevant Code section), any obligation issued by the trust (or a related person) is disregarded unless it is a “qualified obligation.”

## 6. “Gross Reportable Amount”

The term has different meanings depending on the context in which it is used:

- a. The gross value of property involved in the creation of foreign trust or the gross value of property transferred to a foreign trust.
- b. The gross value of any portion of a foreign trust treated as owned by a U.S. person under the grantor trust rules or includable in the gross estate of a U.S. transferor for U.S. federal estate tax purposes.
- c. The gross value of assets deemed transferred at the time a U.S. trust (to which a U.S. person previously transferred property) becomes a foreign trust.
- d. The gross amount of distributions received by a U.S. person from a foreign trust.

## 7. “Reportable Event”

A “reportable event” occurs when either (i) a U.S. person creates a foreign trust or transfers property to a foreign trust (including a deemed transfer by reason of death), (ii) a U.S. person who is the grantor of a foreign grantor trust dies (causing the trust to become a foreign nongrantor trust), or (iii) any portion of the foreign trust was included in the gross estate of a U.S. person for U.S. federal estate tax purposes.

## 8. “Responsible Party”

A “responsible party” is (i) the grantor, in the case of the creation of an inter vivos trust; (ii) the transferor, in the case of a reportable event (other than by reason of death); or (iii) the executor, in any other case.

## 9. “U.S. Agent”

A U.S. person that has a binding contract with a foreign trust that allows the U.S. person to act as the trust's authorized U.S. agent, for purposes of applying Sections 7602, 7603, and 7604 of the Code, with respect to a request by the IRS to examine records or produce testimony or to respond to a summons by the IRS

for such records or testimony. The appointment of a U.S. agent precludes the IRS from re-characterizing the amounts required to be included in the gross income of a U.S. owner of any portion of a foreign trust or the amounts taxable to a U.S. beneficiary who receives a distribution from a foreign trust. Also, a foreign trust without a U.S. agent is required to make additional disclosures to the IRS.

#### 10. “U.S. Beneficiary”

A U.S. person who could possibly benefit (directly or indirectly) from the foreign trust. This encompasses situations where the U.S. person’s connection is through another entity – for example, as a shareholder, partner or beneficiary of a foreign corporation, partnership or estate that receives a benefit from the trust.

Importantly, a foreign trust created by a U.S. grantor is treated as having a U.S. beneficiary unless (i) no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of a U.S. person, directly or indirectly; and (ii) if the trust is terminated at any time during the tax year, no part of the income or corpus could be paid to or for the benefit of a U.S. person, directly or indirectly. FATCA amended Section 679 to create a rebuttable presumption that a foreign trust to which a U.S. person has transferred assets has a U.S. beneficiary. FATCA also expanded the circumstances in which such a trust has a U.S. beneficiary by looking to agreements and understandings and treating them as part of the trust itself and treating a discretionary trust as having a U.S. beneficiary unless distributions are restricted to an identifiable closed class which does not include a U.S. beneficiary.

#### 11. “U.S. Person”

This term refers to individuals who are U.S. citizens or residents, as well as U.S. partnerships, U.S. corporations, U.S. estates and U.S. trusts (as defined under the court and control test). A “U.S. resident” is an individual who either (i) holds a green card (whether or not he or she is physically present in the United States and for so long as such green card is not rescinded or relinquished); (ii) is generally physically present in the United States under a weighted 183-day count test (taking into account a fraction of the days spent in the immediately preceding two calendar years if the individual meets minimal presence requirements in the current calendar year); (iii) makes an affirmative election to be treated a U.S. resident; or (iv) with respect to Section 679, is a dual-resident taxpayer who elects to be treated as a nonresident in order to claim treaty benefits.<sup>18</sup>

- a. For FBAR purposes, the definition of “U.S. Person” includes partnerships,

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<sup>18</sup> In other words, although an individual may elect to be taxed as a nonresident alien under a treaty tie-break provision, he or she will still be considered to be a U.S. person for other purposes (including for purposes of determining the status of the trust, as well as application of the controlled foreign corporation rules to a corporation owned directly or indirectly by such individual. See Treasury Regulation § 301.7701(b)-7(a)(3).

corporations, trusts, limited liability companies and other entities formed under U.S. law, irrespective of their tax classification. Thus, a trust formed under U.S. law which is a foreign trust for tax purposes, or which is a grantor trust for income tax purposes, is still a U.S. Person.<sup>19</sup> U.S. law refers to the laws of the U.S., any state thereof, the District of Columbia, any territories and possessions of the U.S. and Indian lands.

- b. For IRS Form 8938 purposes, the term includes nonresident aliens who are residents of a U.S. possession and nonresident aliens who elect to be treated as residents in order to file a joint return. In certain situations, dual-resident taxpayers who elect under a treaty tie-breaker provision to be taxed in the U.S. as nonresident aliens may be required to file Form 8938, but the form is not required if such dual resident computes his or her U.S. income tax liability as a nonresident alien on the last day of the taxable year.

### **III. RELEVANT FILINGS BY THE U.S. GRANTOR OF A FOREIGN TRUST**

#### **A. Form 1040 (U.S. Individual Income Tax Return), Schedule B.**

1. A U.S. taxpayer must answer three questions on Schedule B: (1) whether the taxpayer had any foreign financial accounts during the taxable year, (2) where the foreign accounts were located and (3) whether the taxpayer received a distribution from, was the grantor of, or transferor to, a foreign trust.
2. This, in turn, may lead to the filing of the FBAR, Form 3520 and 8938.
3. If the foreign trust has any U.S. beneficiaries or is deemed to have any U.S. beneficiaries under the broad presumption rules of Section 679 (described in the previous section), then the U.S. grantor will have to report the foreign trust's income on his or her tax return.

#### **B. Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts), Part I.**

1. A U.S. transferor is required complete Part I of Form 3520 reporting the creation of, or transfer to, a foreign trust (a "reportable event"). In addition to an actual transfer, a "deemed transfer" can also occur by reason of (i) a nonresident transferor becoming a U.S. person within five years of the initial transfer, (ii) a U.S. trust becoming a foreign trust while the U.S. transferor is alive, or (iii) the death of a U.S. person who was treated as the owner of the foreign trust under the grantor trust rules.

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<sup>19</sup> Similarly, a single-member limited liability company that is disregarded for tax purposes may still be required to file an FBAR.

2. The Form 3520 requires the U.S. transferor to disclose the name, address and taxpayer identification number (TIN), if any, of the foreign trust and of the settlor (if different from the transferor) and of other trust owners, if any, and to provide a description and fair market value of the cash and property transferred to the foreign trust, its tax basis at the time of transfer, and the gain, if any, required to be realized as a result of the transfer. No gain is required to be realized if the trust is treated as “owned” by a person under the grantor trust rules.
3. Importantly, unless the foreign trust has appointed a U.S. agent, the Form 3520 also requires the U.S. transferor to disclose the names, addresses and TINs of all beneficiaries, trustees and any other persons with powers over the trust, and attach a copy of the trust documents including trust instrument, amendments, letter of wishes and financial statements.
4. The U.S. transferor is subject to a penalty equal to the greater of \$10,000 or 35 percent of the gross reportable amount (here, the gross value of property transferred to the foreign trust) unless the failure to file was due to reasonable cause and not willful neglect. Additionally, the statute of limitations will not begin to run on the U.S. transferor’s tax return for the period that includes the reportable event required to be disclosed in Part I until the Form 3520 is filed.
5. While the statute contemplates that notice be given within 90 days of this reportable event, instructions to Form 3520 permit the notice to be filed by the due date for the U.S. transferor’s income tax return, including extensions. Note that Form 3520 is filed separately from the U.S. transferor’s income tax return.

**C. Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return).**

1. A U.S. transferor may be required to file a gift tax return and pay gift tax if the transfer to the foreign trust constitutes a completed gift for U.S. federal gift tax purposes. In 2017, the federal unified transfer tax (including gift tax) exemption is \$5,490,000; and under current law this amount will be adjusted each year for inflation. In addition, each U.S. transferor can gift up to \$14,000 per year per donee (the 2017 figure) without decreasing any portion of his or her lifetime federal exemption.<sup>20</sup>
2. With respect to transfers in trust, the gift is complete only if the donor has no power to change the disposition of the trust property, whether for the benefit of himself or others. This requires the donor to have no power to: (1) revoke

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<sup>20</sup> The annual \$14,000 exclusion does not apply to gifts of future interests (i.e. the beneficiary must at least have a Crummy power in order to for the annual exclusion to apply).

the trust; (2) re-vest beneficial title to the trust property in himself; (3) name new beneficiaries; or (4) change the interests of beneficiaries between themselves, unless the power is a fiduciary power limited by an ascertainable standard.

3. The U.S. federal gift tax return is due generally when the income tax return is due.

#### **IV. RELEVANT FILINGS BY THE U.S. OWNER OF A FOREIGN TRUST**

##### **A. Form 3520, Part II.**

1. If the U.S. transferor retains any “grantor trust powers” over the foreign trust or if the foreign trust is treated as having a U.S. beneficiary for the year in question (under the expansive definition set out above as amended by FATCA), the U.S. transferor is treated as the owner of the foreign trust under the grantor trust rules. In this case, the U.S. owner is required to comply with additional reporting requirements in Part II of Form 3520, applicable to U.S. owners of foreign trusts and must make an annual filing for each year in which he or she is treated as an owner. The U.S. owner must also include the income of the portion of the trust of which he or she is owner in his or her gross income.
2. The Form 3520 requires the U.S. owner to provide the fair market value of the foreign trust the U.S. owner is treated as owning and to attach a separate statement (Foreign Grantor Trust Owner Statement) showing the amount of income attributable to him or her for U.S. federal income tax purposes.
3. The U.S. owner is also responsible for ensuring that the foreign trust makes an annual return on Form 3520-A and furnishes him (and other U.S. owners) with the Foreign Grantor Trust Owner Statement (discussed below) and the U.S. beneficiaries who received distributions in that year with the Foreign Grantor Trust Beneficiary Statement (discussed below).
4. Importantly, unless the foreign trust has appointed a U.S. agent, the Secretary may re-determine the amounts required to be taken into account with respect to the foreign trust by the U.S. owner. Thus, for example, the Secretary may find the U.S. owner of a portion of a foreign trust to be treated as the owner of the entire trust for the year in question.
5. The U.S. owner is subject to a penalty equal to the greater of \$10,000 or five percent of the gross reportable amount (here, gross value of any portion of a foreign trust treated as owned by a U.S. person under the grantor trust rules) for failure to comply unless the failure was due to reasonable cause and not willful neglect. Additionally, the statute of limitations will not begin to run on the U.S. owner’s tax return for the relevant period until Forms 3520 and

3520-A are filed.

6. For purposes of this filing, the Form 3520 is due on the same day that the income tax return is due, including extensions. However, as previously noted, the Form 3520 is filed separately.

## **B. FBAR.**

1. A U.S. owner will be required to complete the FBAR if he or she has a financial interest in, or signature authority over, any foreign financial accounts held directly or indirectly in the trust that exceed the reporting threshold.
2. A U.S. person has a “financial interest” in a financial account if his or her ownership or control over the owner of record rises to such a level that the U.S. person is deemed to have a financial interest. The latter category includes foreign financial accounts in the name of a trust if the U.S. person is treated as the owner of the trust under the grantor trust rules. If the trust owns 50 percent or more of a corporation or has an interest in 50 percent or more of a partnership with a foreign financial account, the trust’s ownership is attributed to the U.S. person for FBAR purposes.
3. Penalties range from \$10,000 for nonwillful violations to the greater of (i) \$100,000 or (ii) 50 percent of the value of the account for willful violations. The IRS released interim FBAR guidance on May 13, 2015 indicating how the penalties should be applied in case of multiple FBAR violations, *i.e.*, over several years and/or with respect to several foreign accounts.
4. Effective July 1, 2013, the FBAR must be filed electronically through FinCEN’s BSA E-filing system.
5. The FBAR is a separate filing from the income tax return. Historically, it was due June 30th with no extensions allowed. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015<sup>21</sup> changed the standard FBAR due date to April 15th beginning with the 2016 calendar year reports which are due in 2017. It also provides authority to grant a 6-month extension to October 15th and potential penalty relief for first time filers. In order to reduce the administrative burden and facilitate compliance, FinCEN granted all filers an automatic extension to October 15th every year, without the need for specific requests, until further notice.<sup>22</sup> This automatic extension is limited to FBARs and does not cover any other information returns.

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<sup>21</sup> Pub. L. No. 114-41, 129 Stat. 443 (July 31, 2015).

<sup>22</sup> FBARs for 2016 could have been submitted as late as Monday, October 16, 2017.

### **C. Form 8938 (Statement of Specified Foreign Financial Assets).**

1. A U.S. owner is required to complete this form if his or her interest in the foreign trust, when combined with other SFFAs, exceeds the applicable reporting threshold.
2. A U.S. person has an interest in a SFFA, including a foreign trust, based on potential tax attributes or transactions related to the account that would be reported on the individual's tax return. The U.S. owner of a foreign trust grantor has an interest in the trust for purposes of this definition. However, short-form reporting on the Form 8938 is available, because the grantor is already filing a Form 3520 in respect of the same trust. In this case the grantor need only complete Part IV of Form 8938.
3. Penalties range from \$10,000 for a taxpayer's initial failure to file a correct and complete Form 8938 to \$50,000 for continued noncompliance after notification by the IRS. The negligence penalty imposed by Section 6662 is increased from 20 percent to 40 percent for a deficiency attributable to an unreported foreign financial asset.
4. The statute of limitations does not run until the Form 8938 is filed with respect to events and periods related to information required to be reported on the Form. Further, the statute of limitations on assessment is increased from three years to six years if the taxpayer omitted more than \$5,000 of gross income attributable to a SFFA, even if the reporting threshold was not met.
5. The Form 8938 is due when the income tax return is due, including extensions, and is filed with the income tax return.

### **D. Other Foreign Information Returns**

If the trust is a foreign grantor trust and owns certain interests in foreign entities, the U.S. grantor may have additional reporting obligations with respect to the trust's interests in such entities. He or she also may have phantom income exposure under the passive foreign investment company and controlled foreign corporation rules. These rules and additional reporting requirements are discussed below in Section IX.

## **V. RELEVANT FILINGS BY THE EXECUTOR OF A U.S. DECEDENT'S ESTATE IN RESPECT OF A FOREIGN TRUST**

### **A. Form 3520, Part I.**

1. A transfer can occur as a result of the death of a U.S. person if he or she was treated as the owner of a foreign trust. In this case, the U.S. person is deemed to make the transfer the moment before death, and the executor will be required to file Form 3520 on behalf of the U.S. person. There is a penalty equal to the greater of \$10,000 or 35 percent of the gross reportable amount

(here, the gross value of the property transferred to the trust by reason of death) unless the failure to comply was due to reasonable cause and not willful neglect.

2. This is one of the few situations where taxable gain can be generated by reason of death. A full discussion of Sections 679 and 684 is beyond the scope of this outline, but trustees should be aware that when the U.S. grantor of a foreign grantor trust (including a foreign trust that is considered a grantor trust by reason of Section 679) dies, the U.S. grantor will be deemed to have sold the trust's assets in a taxable sale immediately prior to death. To the extent that the trust holds both appreciated assets and assets that have lost value, only the gains will be recognized and there will be no offset for losses. This gain will have to be reported on the grantor's final tax return.
3. Additionally, an executor of a U.S. grantor's estate may be required to file Form 3520 on behalf of the estate (i) if the U.S. grantor was treated as the owner of the foreign trust under the grantor trust rules (including under Section 679) or (ii) if any portion of the foreign trust is includable in the gross estate of the U.S. grantor for U.S. federal estate tax purposes.<sup>23</sup> There is a penalty equal to the greater of \$10,000 or 35 percent of the gross reportable amount (here, the gross value of the property transferred as a result of death or includable in the decedent's gross estate) unless the failure to comply was due to reasonable cause and not willful neglect. Additionally, if a reportable event is required to be disclosed in Part I, the statute of limitations on the associated tax return will not begin to run unless Form 3520 is filed.
4. The instructions to the Form permit the notice to be filed by the due date for the U.S. transferor's income tax return (including extensions).

**B. Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return).**

1. The executor of a U.S. transferor's gross estate may also be required to file a U.S. federal estate tax return and pay estate tax if the transfer arises as a result of death of the transferor and the property is required to be included in the transferor's gross estate. In 2017, the federal unified transfer tax (including estate tax) exemption is \$5,490,000; and under current law this amount will be adjusted each year for inflation.
2. The U.S. federal estate tax return is due within nine (9) months of the

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<sup>23</sup> Not all grantor trust powers would pull the trust assets back into the U.S. grantor's estate. For example, as discussed above, Section 679 treats the U.S. grantor of a foreign trust as the owner of any portion of the trust that is attributable to the property transferred by such U.S. grantor (directly or indirectly), for any year in which the foreign trust has a beneficiary who is a U.S. person without regard to any "strings" retained by the U.S. grantor.



decedent's date of death unless an extension is granted.

### **C. FBAR.**

If the U.S. decedent was treated as an owner of the foreign trust under the grantor trust rules, his or her executor may have FBAR filing obligations in respect of the trust's direct or indirect foreign financial accounts, in addition to reporting the income of the trust on the decedent's final income tax return.

## **VI. RELEVANT FILINGS BY THE TRUSTEE OF A FOREIGN TRUST WITH U.S. OWNER OR WITH U.S. BENEFICIARIES**

### **A. Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner).**

1. A foreign trust with a U.S. owner (e.g., a foreign trust that is a grantor trust under Section 679) is required to make an annual information return on Form 3520-A.
2. The Form 3520-A requires the trustee to provide a complete accounting of the activities of the foreign trust (including distributions to U.S. owners and U.S. beneficiaries and provide their names, TINs, dates of distribution and fair market values) for the year on an income statement. The income statement is required to be determined under U.S. income tax principles, often necessitating the foreign trustee to retain a U.S. accountant or U.S. tax attorney to complete the Form 3520-A on its behalf.
3. The Form 3520-A requires the trustee to show all assets and liabilities on hand at the beginning of the tax year and close of tax year at their fair market values. For this purpose, an appraisal is unnecessary; a good faith estimate of value will suffice.
4. Importantly, unless the foreign trust has appointed a U.S. agent, the trustee is required to provide a summary of the terms of the trust, including oral agreements or understandings with the trustee, whether or not legally enforceable, and a copy of all trust documents, including the trust instrument, amendments and letter of wishes.
5. The trustee's failure to comply results in a penalty levied on the U.S. owner equal to the greater of \$10,000 or 5 percent of the gross reportable amount (here, gross value of any portion of a foreign trust treated as owned by a U.S. person under the grantor trust rules) for failure to comply unless the failure was due to reasonable cause and not willful neglect.<sup>24</sup> Failure to file

<sup>24</sup> FATCA shifts the burden of compliance to the U.S. owner by amending Section 6048(b) to provide that the U.S. owner shall "submit such information as the Secretary shall prescribe with respect to such trust for such year," whereas previously the U.S. owner was "responsible to ensure" that the required information was disclosed.

Form 3520-A can prevent the statute of limitations from running on the U.S. owner's tax return for the relevant period.

6. For purposes of this filing, the Form 3520-A is due by the fifteenth (15<sup>th</sup>) day of the 3<sup>rd</sup> month after the end of the foreign trust's tax year unless an extension is granted. IRS Form 7004 must be filed to request an extension; it is not automatically granted with the filing of an extension request for Form 1040.
7. A Delaware trust company agreeing to serve as trustee of a trust that will qualify as a foreign trust for U.S. tax purposes should be prepared to work with the U.S. owner to complete these filings.

**B. Foreign Grantor Trust Owner Statement.**

1. The Foreign Grantor Trust Owner Statement sets forth a good faith estimate of fair market value of the assets of the trust treated as owned by the U.S. owner and the net income attributable to the U.S. owner, both determined under U.S. federal income tax principles.
2. Unless the foreign trust has appointed a U.S. agent, the Secretary may re-determine the amounts required to be taken into income with respect to the foreign trust by the U.S. owner.
3. The Foreign Grantor Trust Owner Statement must be provided to U.S. owners by the fifteenth (15<sup>th</sup>) day of the 3<sup>rd</sup> month after the end of the foreign trust's tax year.

**C. Foreign Grantor Trust Beneficiary Statement or Foreign Nongrantor Trust Beneficiary Statement.**

1. The trustee of a foreign grantor trust must prepare a Foreign Grantor Trust Beneficiary Statement including, among other things:
  - a. an explanation of the facts and law that establishes that the foreign trust is a grantor trust;
  - b. a statement identifying whether the grantor of the foreign trust is an individual, trust, corporation or partnership and whether the grantor is a U.S. person or a foreign person;
  - c. a description of the property (including cash) distributed or deemed distributed to the U.S. beneficiary during the tax year and the fair market value of such property; and
  - d. unless the trust has appointed a U.S. agent, a statement that upon request, the trustee will permit the IRS or the U.S. beneficiary to inspect such of the trust's books and records as are necessary to establish the appropriate treatment of any distribution or deemed distribution for U.S. federal tax

purposes.

2. The trustee of a foreign nongrantor trust must prepare a Foreign Nongrantor Beneficiary Statement including, among other things:
  - a. a statement identifying whether any grantor of the trust is an individual, trust, corporation or partnership and whether the grantor is a U.S. person or a foreign person;
  - b. a description of the property (including cash) distributed or deemed distributed to the U.S. beneficiary during the tax year and the fair market value of such property;
  - c. an explanation of the appropriate tax treatment of any distribution or deemed distribution for U.S. federal tax purposes, or sufficient information to enable the U.S. beneficiary to establish such appropriate tax treatment; and
  - d. unless the trust has appointed a U.S. agent, a statement that upon request, the trustee will permit the IRS or the U.S. beneficiary to inspect such of the trust's books and records as are necessary to establish the appropriate treatment of any distribution or deemed distribution for U.S. federal tax purposes.
3. The Beneficiary Statement must be provided to the U.S. beneficiaries who received distributions in that year by the fifteenth (15<sup>th</sup>) day of the 3<sup>rd</sup> month after the end of the foreign trust's tax year.

#### **D. FBAR.**

For purposes of the FBAR, a trust established under the laws of the U.S. is required to file an FBAR in respect of the trust's direct and indirect foreign financial accounts, as the trustee is owner of legal record and the trust is a U.S. person. As stated above, it does not matter if the trust is a grantor or nongrantor trust or a foreign or domestic trust for U.S. tax purposes. However, if the trust is a foreign grantor trust owned by a U.S. person, the grantor also has an FBAR filing obligation.

### **VII. RELEVANT FILINGS BY U.S. BENEFICIARIES OF A FOREIGN TRUST**

#### **A. Form 3520, Part III.**

1. A U.S. beneficiary who receives a distribution from a foreign trust must report the distribution on Form 3520, Part III and obtain a Foreign Grantor Trust Beneficiary Statement or Foreign Nongrantor Trust Beneficiary Statement, as the case may be, from the trustee. There are exceptions for (i) distributions that are taxable as compensation for services rendered that are reported on the recipient's income tax return and (ii) distributions to U.S. charities which have

an IRS determination letter recognizing their tax-exempt status.

- a. If a complete Foreign Grantor Trust Beneficiary Statement is provided, the U.S. beneficiary may treat the distribution as a non-taxable gift.
  - b. If a complete Foreign Nongrantor Trust Beneficiary Statement is provided, the U.S. beneficiary may determine the U.S. federal income tax consequences of the distribution in line with the information provided on the Beneficiary Statement.
2. Generally, unless a Beneficiary Statement is provided, any distribution from a foreign trust to a U.S. beneficiary, whether of income or principal, is treated as an accumulation distribution. An accumulation distribution is taxable under throwback rules at ordinary income rates, and a three-out-of-five-year averaging method is utilized to calculate the tax under the throwback rules. An interest charge is levied on the tax.
- a. There is an exception to this rule that allows the U.S. beneficiary to avoid treating the entire amount received as an accumulation distribution if the U.S. beneficiary can provide certain information regarding actual distributions from the trust for the prior three years under a so-called “default method.”
  - b. Under the default method, a portion of the distribution is treated as a current distribution based on the average of distributions received from the trust over the prior 3 years, with the excess amount of the distribution treated as an accumulation distribution.
3. It is not clear whether loans from a foreign trust which are not “qualified obligations” or below market use of trust property, both of which are “deemed distributions”, are reportable if the trust is a grantor trust. Under Section 643(i), this deemed distribution rule does not apply to grantor trusts; however, the Foreign Grantor Trust Beneficiary Statement (page 4 of Form 3520-A), appears to require such reporting. As a policy matter, since distributions from foreign grantor trusts are reportable, there is no reason to treat deemed distributions differently.
4. The failure to comply results in a penalty levied on the U.S. beneficiary equal to the greater of \$10,000 or 35 percent of the gross reportable amount (here, the gross value of distribution) for failure to comply unless the failure was due to reasonable cause and not willful neglect. Failure to file also can prevent the statute of limitations from running on the U.S. beneficiary’s tax return.

## **B. FBAR.**

1. If a U.S. beneficiary has a more than 50 percent *present* beneficial interest in

the assets of the trust or receives more than 50 percent of the *current* income of the trust, he or she is deemed to have a financial interest in the foreign financial accounts held directly and indirectly in the trust for purposes of FBAR reporting. The preamble to the final FBAR regulations clarifies that (i) discretionary beneficiaries who receive no distributions from a trust and (ii) remainder beneficiaries, do not meet the threshold for FBAR reporting.

2. A U.S. beneficiary may not have to file an FBAR to report financial accounts of the trust if the trust, trustee or agent of the trust is a U.S. person and files an FBAR report in respect of the accounts held directly and directly in the trust.

### C. Form 8938.

Interests in foreign estates and trusts potentially are reportable as SFFAs.—~~However, there are, but~~ special valuation rules ~~for valuing interests in foreign trusts and estates where the beneficiary does not apply~~. Under the valuation rules, a beneficial interest in a foreign trust or foreign estate is not a specified foreign financial asset unless the U.S. individual knows or has reason to know of ~~this or her interest~~ based on readily accessible information. Receipt of a distribution from the foreign trust or foreign estate is deemed to be actual knowledge of the interest. Once established as a specified foreign financial asset, the value is the sum of (i) the fair market value of all property distributed to the beneficiary during the year plus (ii) the value of the beneficiary’s right to receive mandatory distributions from the foreign trust, as determined under ~~IRC~~ Section 7520. However, a discretionary beneficiary who does not receive a distribution from the trust in a given year generally would report the value of his or her interest in the trust as zero. The Form 8938 instructions provide, in pertinent part: “If you received no distributions during the tax year and do not know or have reason to know based on readily accessible information the fair market value of your interest as of the last day of the tax year, use a value of zero as the maximum value of the asset.”

It is ~~not clear~~debatable whether a U.S. beneficiary of a grantor trust owned by another person ~~w~~should be subject to Form 8938 filing, as the tax attributes of the trust reside with the grantor. However, it is the position of the IRS that such a U.S. beneficiary has a Form 8938 filing obligation.

### D. Other Foreign Information Returns

If the trust is a foreign nongrantor trust and owns certain interests in foreign entities, U.S. beneficiaries potentially may have additional reporting obligations with respect to their “indirect” or “constructive” interests in such entities. They also may have phantom income exposure under the passive foreign investment company and controlled foreign corporation rules. These rules and additional reporting requirements are discussed below in Section IX.

## VIII. RELEVANT FILINGS FOR U.S. RECIPIENTS OF GIFTS FROM FOREIGN PERSONS

### A. Form 3520, Part IV.

1. A U.S. recipient of a gift from a foreign person that exceeds certain “threshold amounts” must report the gift on Form 3520, Part IV. There are exceptions for “qualified transfers” under Section 2503(e) or trust distributions otherwise reportable under Section 6048. A U.S. nongrantor trust must report the receipt of a distribution from a foreign trust on Form 3520, Part IV; a U.S. beneficiary of the trust does not have to report unless he is treated as the owner under the grantor trust rules, *e.g.*, he has a Section 678 withdrawal power.
2. The threshold amount is \$100,000, in the case of a foreign individual or foreign estate donor. By comparison, the threshold amount is \$10,000 (this amount is indexed for inflation and is \$15,797 for 2017), in the case of a foreign partnership or foreign corporation donor.
3. Gifts are aggregated if the U.S. recipient knows or has reason to know the foreign donors are related (within the meaning of the Code). If the threshold amount is met, the recipient is required to identify separately each gift in excess of \$5,000, but not the donor. In contrast, the \$10,000 threshold requires identification of each gift and each donor.
4. If a gift is not reported, the Secretary may determine the tax consequences of the gift. In addition, the recipient is subject to a penalty equal to 5 percent of the reportable amount (here, the value of the gift) for each month the gift is not reported (but not to exceed 25 percent).<sup>25</sup>
5. Gifts from foreign partnerships and corporations may be re-characterized as taxable distributions under the Code and should be avoided.

### B. Gifts from Covered Expatriates.

1. A U.S. recipient of a “covered gift or bequest”<sup>26</sup> may have to pay tax on it at the highest marginal rate in effect for gifts and bequests, if it does not fall within one of the exceptions for annual exclusion gifts, marital or charitable transfers and is not otherwise reported on the foreign donor’s gift or estate tax

<sup>25</sup> Unlike the other portions of Form 3520, failure to report a gift in Part IV does not appear to impact the limitation period for the U.S. recipient’s tax return.

<sup>26</sup> Section 877A enacted new rules applicable to U.S. citizens and “long-term residents” who surrender their citizenship or green cards and meet certain net worth or income tax liability thresholds at the time of expatriation or cannot certify tax compliance for the 5 prior years. One of the rules is the imposition of a succession tax on future gifts or bequests made by such “covered expatriates” to U.S. persons. Section 2801(e). A discussion of the covered expatriation tax regime is beyond the scope of this outline.

return as a gift of a U.S. situs asset.

2. Even though the Section 2801 tax applies to covered gifts and bequests received on or after June 17, 2008, the IRS deferred the due date for reporting and paying the tax until a reasonable period of time after final regulations are issued.<sup>27</sup> Proposed regulations were issued on September 10, 2015 inviting comments and to date, a number of comments have been received from organizations, including the ABA and ACTEC. Under the proposed regulations, a U.S. recipient of a distribution from a foreign trust is allowed a deduction under Section 164 in the year in which the Section 2801 tax is paid or accrued.
3. Form 3520, Part IV asks whether the U.S. donee received a gift or bequest from a covered expatriate. If the answer is “yes,” IRS Form 708 (U.S. Return of Tax for Gifts and Bequests Received from Expatriates) must be filed, but the Form will be available only after final regulations are issued.

## **IX. FILING IN RESPECT OF UNDERLYING STRUCTURES**

### **A. Foreign “Blocker” Corporations.**

If the foreign trust is settled by a nonresident who has retained powers under Section 2036 – 2038 of the Code which would cause the trust assets to be included in his or her estate, most U.S. investments will be made by the trust through a foreign corporation. Provided corporate formalities are respected, the corporation will “block” the imposition of the U.S. estate tax with respect to the U.S. situs assets. In that case, the foreign corporation will be required to provide a Form W-8BEN-E to the withholding agent. Items of fixed, determinable, annual or periodical income from U.S. sources (FDAP) and U.S. income taxes withheld generally will be reportable by the withholding agent on IRS Form 1042-S (Foreign Person’s U.S. Source Income Subject to Withholding). If the foreign trust itself holds the U.S. investments and is a complex nongrantor trust, the trust would provide its own Form W-8BEN-E.

It is not tax-efficient for a foreign nongrantor trust with U.S. beneficiaries to invest through a foreign corporation and in most cases, after the foreign grantor’s death the corporation will be replaced by a domestic entity that is tax transparent, such as a limited liability company. However, to the extent that a foreign trust holds an interest in a foreign blocker corporation or a foreign partnership, the U.S. beneficiary or U.S. grantor may have additional reporting requirements on Forms 5471, 8865 and/or 8621 each of which is mentioned briefly below.<sup>28</sup> A detailed discussion of the same is beyond the scope of this outline, but it should be noted that failure to file the required information returns can prevent

<sup>27</sup> Notice 2009-85, 2009-45 I.R.B. 598.

<sup>28</sup> IRS Form 8858 may be required if the foreign trust owns a foreign disregarded entity or is required to file Forms 5471 or 8865 with respect to a controlled foreign corporation or controlled foreign partnership that in turn owns a foreign disregarded entity.

the statute of limitations from running on the affected U.S. person's tax return.

**B. Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations).**

1. A U.S. person who owns more than 50 percent of the vote or value of a foreign corporation, or who acquires 10 percent of the same, or who is a "U.S. shareholder" of a Controlled Foreign Corporation (CFC),<sup>29</sup> may be subject to annual Form 5471 filing requirements. The Form 5471 filing requirements are complicated and the level of disclosure varies, depending on which category the filer falls into.
2. Form 5471 is due when the income tax return is due, including extensions.

**C. Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships).**

1. A U.S. person who owns, directly or indirectly, more than 50 percent of the capital or profits interest in a foreign partnership, or who acquires 10 percent of a partnership owned more than 50 percent by U.S. persons, among others, may be subject to Form 8865 filing requirements.
2. The Form 8865 is the corollary to Form 5471, applicable to U.S.-owned foreign partnerships instead of foreign corporations.

**D. Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund).**

1. A U.S. direct or indirect shareholder of a Passive Foreign Investment Company (PFIC)<sup>30</sup> may be required to make a return on Form 8621 for any year in which

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<sup>29</sup> A foreign corporation is a CFC if more than 50 percent of either the vote or the value of its stock is owned (or treated as owned) by U.S. shareholders. For these purposes, a "U.S. shareholder" is defined to include any U.S. person (including a U.S. citizen or resident) who owns, directly, indirectly or constructively (e.g., through an interest in a trust), 10 percent or more of the voting stock of the foreign corporation. The U.S. shareholders of a CFC are subject to current U.S. federal income taxation, at ordinary income tax rates, on their proportionate shares of the corporation's "Subpart F income." Subpart F income is defined to include most types of passive income such as dividends, interest, royalties, rents, annuities, net gains (not net losses) from trading in stocks and securities, net gains from certain commodities transactions and certain foreign currency gains. Subpart F income also includes certain types of related party sales, services, insurance and oil and gas-related income.

<sup>30</sup> A PFIC generally is defined to include any foreign corporation where, for a given taxable year, either (i) the foreign corporation derives 75 percent or more of its gross income from passive sources, or (ii) 50 percent or more of the foreign corporation's assets produce passive income or are held for the production of passive income. In the absence of applicable elections, U.S. shareholders of a PFIC, whether direct or indirect (such as through a trust), generally are subject to U.S. federal income tax, at ordinary income tax rates, on any gain from the direct or indirect sale or exchange of their stock in a PFIC. Additional interest charges may apply. However, with certain exceptions, a "U.S. shareholder" of a CFC will not be subject to the PFIC rules with respect to the same stock.



he or she directly or indirectly disposes of PFIC stock or receives an “excess distribution” with respect to the PFIC stock, or for any year in which he or she makes Qualifying Electing Fund (QEF) election to include the income and gains of the PFIC into the U.S. shareholder’s current income or a mark-to-market election for PFIC stock which is regularly traded on an exchange or market.

2. FATCA amended the Code to require an annual filing of Form 8621 in the absence of a taxable transaction. On December 31, 2013, temporary and proposed regulations were issued which included guidance under Section 1298(f) on the annual filing requirements for shareholders of PFICs. The regulations generally are effective for taxable years of shareholders ending on or after December 31, 2013. Final regulations published on December 28, 2016 introduced a filing exception for dual resident taxpayers who elect to determine their U.S. income tax liabilities as nonresident aliens.

#### **E. Form BE-10 (Benchmark Survey of U.S. Direct Investment Abroad).**

This form is issued by the Department of Commerce’s Bureau of Economic Analysis. It is required to be filed every five years with respect to any U.S. person’s ownership of a foreign corporation. The form would apply with respect to the acquisition or funding of the foreign corporation by the Delaware trust irrespective of its tax status as a foreign or U.S. trust or as a grantor trust or a nongrantor trust. The last filing cycle was in 2015 (for 2014 transactions), so the next Form BE-10 will not be due until 2020 (for the 2019 tax year).

### **X. ADDITIONAL REPORTING TO ADVANCE TRANSPARENCY INITIATIVES**

#### **A. General.**

In recent years, there has been growing concern about the ability of non-U.S. investors to hide assets from tax authorities in their home countries by using U.S. limited liability companies formed in states with minimal beneficial owner reporting requirements. Such concerns have been exacerbated by the United States’ failure so far to agree to commit to the automatic exchange of information under the Common Reporting Standard (discussed in the next section).

1. A report issued by the European Parliament in March 2017 described this situation in blunt terms: “The United States of America (USA) is seen as an emerging leading tax and secrecy haven for rich foreigners. By resisting new global disclosure standards, it provides an array of secrecy and tax-free facilities for non-residents at federal and state levels, notably in Nevada, Delaware, Wyoming, and South Dakota.” Similar concerns were raised by the Financial Action Task Force (FATF) in its Mutual Evaluation Report of the United States issued in December 2016.
2. The IRS and Treasury Department have responded to these concerns by introducing new filing requirements for U.S. disregarded entities with foreign

owners under Section 6038A. The new Section 6038A reporting requirements were introduced as part of a broader effort by the IRS and the Treasury Department to combat money laundering and increase transparency and were intended to prevent foreign taxpayers from exploiting the lack of transparency in many U.S. jurisdictions to hide assets “offshore” from tax authorities in their countries or to launder the proceeds of illegal activities. However, they are likely to reach a wide range of activities that otherwise would have no tax significance. A detailed discussion of the new reporting requirements is beyond the scope of this outline, but a high level overview is provided below.

#### **B. Section 6038A (Form 5472) for Foreign-Owned Disregarded Entities.**

1. If a foreign nongrantor trust is the sole owner of a U.S. limited liability company or other disregarded entity formed in the U.S., then the U.S. disregarded entity may be required to obtain an EIN and file Form 5472 information returns identifying its foreign beneficial owner(s) and reporting any related party “reportable transactions” beginning with tax years starting in 2017. The limited liability company or other disregarded entity also will be subject to record-keeping and other compliance requirements.<sup>31</sup>
2. The new reporting requirements are effective for tax years beginning on or after January 1, 2017 and ending on or after December 31, 2017. Thus, reporting will not be required until 2018. As of the date of this writing, Form 5472 has not yet been updated to reflect the new reporting requirements, but an updated form is expected sometime in late 2017.
3. The range of transactions that can trigger a Form 5472 filing obligation in the case of a foreign-owned disregarded entity is expansive and includes any property sales, licenses, leases, loans, assignments and remunerated services, as well as any amounts paid or received in connection with the formation, dissolution, acquisition and disposition of the entity.<sup>32</sup> The new rules are specifically intended to capture transactions that would not have any income tax significance. For example, transfers in and out of the disregarded entity will be reportable even if it holds only non-U.S. assets. Each reporting failure is subject to a \$10,000 penalty.
4. Obtaining an EIN for the U.S. disregarded entity could present further complications if the owners or other responsible persons do not already have ITINs or SSNs. The Protecting Americans From Tax Hikes (PATH) Act of

<sup>31</sup> T.D. 9796, 81 Fed. Reg. 89849 (Dec. 13, 2016).

<sup>32</sup> The preamble to the proposed regulations confirmed that the regulations were specifically intended to capture transactions that did not otherwise have income tax significance.

2015,<sup>33</sup> established new limitations for returns filed after December 18, 2015. The PATH Act amended Section 6109 to provide expiration dates for ITINs. ITINs issued after December 31, 2012 will expire if they are not used on a tax return for three consecutive years.

5. Because these rules focus on foreign tax ownership, the new reporting requirements would apply to a U.S. limited liability company owned by a Delaware trust that either is a grantor trust with a foreign grantor or that is structured as a foreign nongrantor trust for U.S. tax purposes.

## **XI. FATCA AND COMMON REPORTING STANDARD (CRS)**

### **A. FATCA.**

1. FATCA created third-party reporting by requiring certain foreign financial institutions (FFIs) to identify, document and report their U.S. account holders to the IRS. Additionally, many non-financial foreign entities (NFFEs) are required to identify their U.S. owners to withholding agents (or certify that they do not have any substantial U.S. owners) on IRS Form W-8BEN-E. Depending on which category the entity falls into—either an FFI or NFFE—the compliance rules and obligations under FATCA vary. If the FFI or NFFE is a resident of a country that has an intergovernmental agreement (IGA) with the U.S., it would look to the procedures in the applicable IGA (and the country’s local laws), which may modify the reporting, self-certification and withholding obligations for the trust under FATCA.
2. Accordingly, a foreign trust and each of its underlying foreign entities must determine their classification and obligations under FATCA. FATCA requires that all “withholding agents” withhold a 30 percent tax on any “withholdable payments” to foreign entities unless they have complied (or are deemed to have complied) with the requirements of FATCA.<sup>34</sup>
3. A “withholdable payment” is defined in Section 1473(1) to mean, subject to certain exceptions: (i) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income (*i.e.*, FDAP), if such payment is from sources within the United States; and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States (although pursuant to the final regulations, this second category of withholdable payment is effective only for

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<sup>33</sup> Passed as part of the Consolidated Appropriations Act, 2016, P.L. 114-113.

<sup>34</sup> Section 1471(a), Treasury Regulation §1.1471-2(a); Section 1472(a), Treasury Regulation § 1.1472-1.

sales or dispositions after December 31, 2018).<sup>35</sup>

## **B. Delaware Trust.**

1. If a Delaware trust is classified as a foreign trust for U.S. tax purposes, it must determine its FATCA classification and compliance obligations under the applicable Treasury regulations.
2. An FFI is generally defined as any one of five different types of financial institutions listed in the regulations,<sup>36</sup> the most significant of which in the foreign trust structure context is the “investment entity” category. An “investment entity” is defined as an entity that either (1) conducts a business of investing, reinvesting, or trading in financial assets or otherwise investing administering or managing funds, money or financial assets for customers (investment entity activities), and receives 50 percent or more of its gross income during the relevant period from such investment entity activities, or (2) is “managed by” another financial institution and receives more than 50 percent of its gross income during the relevant period from investment entity activities. An entity is “managed by” another entity if the managing entity performs, either directly or through a third-party service provider, any of the investment entity activities on behalf of the managed entity.
3. A foreign trust with a trust company serving as trustee will therefore be classified as an FFI. As an FFI, the trust must become FATCA compliant in order to avoid FATCA withholding pursuant to the Treasury regulations. This can be done by either becoming a “participating FFI” or a “deemed compliant FFI.”
  - a. To become a participating FFI, the trustee, on behalf of the trust, would have to register it with the IRS, obtain a GIIN and agree to undertake due diligence and reporting obligations under FATCA.
  - b. In the alternative, the trust company could agree to sponsor the FFI so that it qualifies as a deemed compliant FFI. Among the categories of deemed compliant FFIs are (i) the owner-documented FFI, (ii) the sponsored investment entity and (iii) the sponsored, closely held investment vehicle. The sponsored entity (trust) is not required to register with the IRS in order to qualify as either an owner-documented FFI or sponsored closely-held investment vehicle (certified deemed compliant FFI). However, both the

<sup>35</sup> Treasury Regulation § 1.1473-1(a)(1)(ii); Notice 2015-66 (delaying the start of withholding on gross proceeds and foreign passthru payments, among other things). Importantly, the definition of FDAP income includes bank deposit interest and portfolio interest, which are not subject to U.S. tax if earned by a nonresident alien. Similarly, it includes gross proceeds of sale of U.S. securities which are not generally taxable to a nonresident alien.

<sup>36</sup> Treasury Regulation § 1.1471-5(d) and (e).

sponsored entity and the trust company must register in order for the sponsored entity to qualify as a sponsored investment entity (registered deemed compliant FFI). There are specific requirements provided in the Treasury regulations requiring, in each case, the agreement of another entity (either a withholding agent or sponsoring entity) to do the FATCA reporting on the trust's behalf.<sup>37</sup> For example, if the trustee were to sponsor the trust as a sponsored, closely held investment vehicle, the trust would not have to register directly with the IRS or obtain a separate GIIN. Instead, as sponsoring entity, the trustee would become responsible for the annual FATCA reporting, if any, which is due by March 31st for the prior calendar year.

- c. The FATCA Report (IRS Form 8966) must be filed if the trust has any reportable "U.S. accounts" in the applicable tax year. A trust has a "U.S. account" (irrespective of whether the trust is a grantor or nongrantor trust) if a U.S. beneficiary (i) is treated as an owner under the grantor trust rules, (ii) is entitled to a mandatory distribution from the trust, or (iii) receives a discretionary distribution from the trust.

### **C. Foreign Blocker Corporation.**

#### 1. General

Foreign blocker corporations often are formed in tax haven jurisdictions so as not to subject the income to another layer of tax. Most tax haven jurisdictions (Bermuda being a notable exception) have entered into Model 1 IGAs with the U.S. A Model 1 IGA requires reporting to the FATCA partner jurisdiction which then reports that information to the IRS on an automatic basis. Exchange of information under a Model 1 IGA may be on a reciprocal or nonreciprocal basis.

#### 2. Model I IGA

A "Financial Institution" under the IGA is defined similar to the Treasury regulations and includes an "investment entity FFI," that conducts as a business (or

is managed by an entity that conducts as a business) one or more of the investment

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<sup>37</sup> The requirements for an owner-documented FFI appear in Treasury Regulation § 1.1471-5(f)(3), and a withholding agent may treat a payee as an owner-documented FFI if it receives the documentation and meets the due diligence requirements as provided in Treasury Regulation § 1.1471-3(d)(6). The requirements for a sponsored FFI appear in Treasury Regulation § 1.1471-5(f)(1)(i)(F) (sponsored investment entities) and Temp. Treasury Regulation § 1.1471-5T(f)(2)(iii) (sponsored, closely held investment vehicles).

entity activities for or on behalf of a customer. The Model 1 IGA also provides for participating FFIs and deemed compliant FFIs and allows for sponsored entities.

### 3. NFFE or FFI

Most blocker corporations will be considered investment entities. Whether the foreign blocker is an FFI (subject to FATCA reporting obligations) or a passive NFFE (required to provide U.S. owner information to FFI, but not subject to FATCA reporting obligations itself) will largely depend on whether it is managed by an FFI.

## **D. CRS.**

1. The OECD has developed CRS to facilitate the collection and reporting of information about accounts held at financial institutions in participating jurisdictions. These standards are similar to the standards used in the FATCA Model 1 IGAs. However, unlike FATCA, CRS is not enforced by a system of withholding. Instead, the automatic exchange of information will be the sole enforcement mechanism (as is the case under the IGAs). This information exchange will be governed by treaties and local statutes adopted in participating jurisdictions.
2. A Delaware trust is not subject to CRS reporting requirements because the U.S. has not agreed to adopt CRS. However, if the trust owns any entities or accounts in one or more of the jurisdictions that have adopted CRS, then there is a good chance that the controlling persons will have their information reported back to their home countries. This is because if an account holder of an FFI is an entity resident in a non-CRS jurisdiction, including the United States, the FFI must treat the account as held by a "Passive NFE," and thus must report information about controlling persons of the entity who are residents of a CRS jurisdiction.
3. Controlling persons of a trust under CRS are defined in OECD guidance as including the settlor, trustee, beneficiaries, protectors or any other natural persons exercising ultimate effective control over the trust, which would include an investment advisor or distribution advisor. However, paragraph 228 of the CRS Handbook issued by the OECD states that where beneficiaries are not individually named but are identified as a class, the CRS does not require that all possible members of the class be reported as controlling persons. Rather, when a member of a class of beneficiaries receives a distribution from the trust, this will be a change of circumstances, prompting additional due diligence and reporting as necessary. In addition, paragraph 229 of the CRS Handbook states that both mandatory and discretionary beneficiaries are included within the definition of controlling person, and unlike FATCA reporting, discretionary beneficiaries who have not received a distribution in a reporting year are reported under CRS. However, paragraph 229 further states that when implementing CRS, a jurisdiction may allow reporting financial institutions to

align the scope of the beneficiaries of a trust reported as controlling persons with the scope of the beneficiaries of a trust treated as reportable persons of a trust. In such a case, only discretionary beneficiaries who receive a distribution would have to be reported as controlling persons.<sup>38</sup>

4. It is important to note that as participating jurisdictions move towards full implementation of CRS, it will be the implementing legislation and regulations of the jurisdiction, and not the CRS Handbook, that will govern reporting requirements under CRS.
5. The only way to avoid CRS reporting with a Delaware trust is to completely avoid foreign entities and foreign accounts (and foreign fund investments) and own solely domestic entities and domestic accounts. Because of the limitations on grantor trust status for trusts settled by non-U.S. persons, it is difficult to structure a trust with a non-U.S. grantor as a grantor trust (with the attendant benefit of preventing foreign source income and most capital gains from being taxable to the trust, the non-U.S. grantor or the U.S. beneficiaries during the grantor's lifetime) without it being included in the grantor's estate, necessitating the use of a foreign blocker for U.S. situs assets.
6. It is important for the settlor to consult with local counsel as to his non-U.S. tax and CRS compliance obligations before funding the trust. Both settlors and trustees should be aware that transferring assets out of a CRS jurisdiction to a jurisdiction that has not adopted CRS for the purpose of avoiding CRS is itself reportable and potentially subject to civil and criminal sanctions.

## **XII. CHECKLIST OF BASIC REPORTING FOR A FOREIGN TRUST STRUCTURE**

### **A. U.S. Settlor.**

A U.S. Settlor of a foreign trust:

1. Must report the creation of the trust and any transfer of property to the trust

<sup>38</sup> OECD guidance on the common reporting standard is available at <https://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-financial-account-information-common-reporting-standard.pdf>. See Section C. at paragraph 4 defining the term "Equity Interest": "In the case of a trust that is a Financial Institution, an Equity Interest is considered to be held by any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust. A Reportable Person will be treated as being a beneficiary of a trust if such Reportable Person has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust." See also the OECD Standard for Automatic Exchange of Financial Information in Tax Matters - Implementation Handbook at <https://www.oecd.org/tax/exchange-of-tax-information/implementation-handbook-standard-for-automatic-exchange-of-financial-information-in-tax-matters.pdf>.

on Form 3520, Part I;

2. Must report all the income and gain of the trust on his U.S. income tax return, if the trust is a grantor trust with respect to him on Form 3520, Part II;
3. Must ensure that the trustee files Form 3520-A with the IRS, furnishes the Settlor with a Foreign Grantor Trust Owner Statement, and furnishes each U.S. beneficiary who receives a distribution with a Foreign Grantor Trust Beneficiary Statement, if the trust is a grantor trust;
4. May be subject to U.S. income tax on an indirect disposition of PFIC stock held by the trust or an "excess distribution" received by the trust with respect to that PFIC stock or Subpart F inclusion of any underlying CFCs and have reporting on Forms 8621 and 5471 respectively;
5. May be subject to U.S. income tax on a deemed sale of the trust assets at his death under Section 684, unless the trust assets are included in his U.S. taxable estate;
6. May be subject to U.S. estate tax at his death on the value of trust assets included in his estate unless he has made a completed gift on funding the trust;
7. Will have to file an FBAR with respect to foreign financial accounts held by the trust; and
8. Will have to file a Form 8938 with respect to the trust.

**B. U.S. Beneficiary.**

A U.S. beneficiary of a foreign trust:

1. Must report any distribution received from the trust on Form 3520, Part III;
2. Must receive either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement from the trustee if he receives a distribution from the trust;
3. Must file Form 8938 to report his or her interest in the trust if he or she receives distributions or otherwise has a mandatory right to them;
4. If the trust is a nongrantor trust, may be subject to U.S. income tax on an indirect disposition of PFIC stock held by the trust or an "excess distribution" received by the trust with respect to PFIC stock or Subpart F inclusion with respect to a CFC, if he or she is deemed to indirectly own any stock and additional reporting on Forms 8621 or 5471, as the case may be;
5. May have to file an FBAR to report his or her interest in foreign financial accounts held by the trust if he or she has more than a 50 percent interest in



the income or assets, unless the U.S. trustee or trust files in respect of same;  
and

6. May have to file Form 708 (once released) if the distribution is attributable to a covered gift or covered bequest previously made to the foreign trust.

**C. U.S. Trustee.**

A U.S. trustee of a foreign (Delaware) trust:

1. Must file Form 3520-A annually and provide the U.S. grantor with a Foreign Grantor Trust Owner Statement (if the trust is a U.S.-owned foreign grantor trust) and U.S. beneficiaries who receive distributions with either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement;
2. Must file an FBAR to report a financial interest in foreign financial accounts held directly or indirectly by the trust;
3. Must file Form 8938 if the trust holds an interest in a SFFA and the trust has one or more specified persons as a current beneficiary;
4. Must become FATCA compliant and file Form 8966 to report the U.S. account holders of the trust;
5. Identify controlling persons if prompted to do so by a financial institution where an underlying foreign entity has an account if the account or entity is resident in a CRS jurisdiction; and
6. If there is a U.S. disregarded entity under the trust, ensure that it files Form 5472.

<b>Summary report:</b>	
<b>Litéra® Change-Pro TDC 7.5.0.145 Document comparison done on 10/10/2017 10:18:51 PM</b>	
<b>Style name:</b> 1 - Dbl Underline, Strike, Moves	
<b>Intelligent Table Comparison:</b> Active	
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<del>Delete</del>	6
<del>Move From</del>	0
<u>Move To</u>	0
Table Insert	0
Table Delete	0
Table moves to	0
Table moves from	0
Embedded Graphics (Visio, ChemDraw, Images etc.)	0
Embedded Excel	0
Format changes	0
<b>Total Changes:</b>	<b>13</b>