THE DEVIL IS IN THE DETAIL

IRS TAX FORMS FOR U.S. BENEFICIARIES OF FOREIGN TRUSTS

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Tax Advice Disclosure

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Things to Consider

- Terms of the trust
- Date U.S. beneficiaries come into existence
- Distributable net income ("DNI") and Undistributed net income ("UNI")
- Holdings/assets of the foreign trust
  - Brokerage accounts
  - Passive foreign investment companies ("PFIC")
  - Controlled foreign corporations ("CFC")
  - Foreign partnerships
- "Check-the-box" elections
- Plan for distributions to U.S. beneficiaries
  - List of all beneficiaries of the trust and country of tax domicile
  - Plan to distribute annual DNI either directly or to a U.S. trust

IRS Forms

- FBAR (Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts)
  - Required under Bank Secrecy Act of 1970; governing body is U.S. Treasury's Financial Crimes Enforcement Network ("FinCEN")
  - Filed separately from income tax return
  - Due June 30 each year; no extensions available, but an amended FBAR can be filed
  - Penalty for not filing timely is $10,000; willful failure is greater of $100,000 or 50% of highest account balances
  - A U.S. person includes U.S. entities
  - Filing required for all U.S. persons that have a *financial interest* or *signature authority* over foreign financial accounts with a <u>total value</u> of at least $10,000
  - Must determine maximum value during the year of <u>each account</u>

IRS Forms

- Form 8938
  - New for tax years beginning March 18, 2010 or later
  - Similar to FBAR, but no reporting for signature authority
  - Due on the due date of the beneficiary's U.S. income tax return (including extensions); filed with the income tax return
  - Penalty for not filing timely is $10,000
  - Filing requirements
    - Individuals only until IRS issues regulations for entities
    - Unmarried taxpayer or married filing separately and living in U.S. – total value of specified foreign financial assets ("SFFA") of at least $50,000 on last day of the tax year or at least $75,000 at any time during the year
    - Married filing joint and living in U.S. – total value of SFFA of at least $100,000 on last day of the tax year or at least $150,000 at any time during the year
    - Taxpayers living outside U.S. - total value of SFFA of at least $200,000 on last day of the tax year or at least $300,000 at any time during the year ($400,000 and $600,000, respectively, for married filing jointly)

IRS Forms

- Form 3520
  - Due on the due date of the beneficiary's U.S. income tax return (including extensions); filed separately from the income tax return and as attachment to income tax return
  - Penalty for not filing timely - greater of $10,000 or 35% of the gross value of the distributions received for failure to report the distributions
  - Items to report
    - Loans – "qualified obligations" to beneficiary or related person
      - In writing
      - Term does not exceed five years (including options to renew)
      - All payments are denominated in US dollars
      - The yield to maturity is at least 100% of the Applicable Federal Rate ("AFR") and not greater than 130% of the AFR
      - U.S. person agrees to:
        - Extend the period for assessment of income or transfer tax related to the transfer and any tax changes for each year the obligation exists
        - A date not earlier than three years after maturity, unless the maturity date is not later than the end of the beneficiary's tax year, and is paid within this period
      - Beneficiary reports the status of the obligation on Form 3520, including principal and interest payments

IRS Forms

- Distributions
  - Actual and constructive transfers (includes use of a trust credit card)
  - A loan that is not a qualified obligation is a distribution
  - Rent-free use of trust property by the U.S. beneficiary or a related U.S. person (IRC Section 643(i))
  - Calculating taxable amount
    - Share of DNI and UNI as it relates to pro-rata share of total distributions
    - DNI is calculated the same as for a U.S. trust, except that DNI of foreign trust includes realized capital gains and losses
    - DNI also includes foreign income
    - Must determine DNI for each prior year in order to calculate UNI
    - UNI subject to throwback rules (see Form 4970 with Schedule J)
  - Foreign Nongrantor Trust Beneficiary Statement (“FNGTBS”)
    - Beneficial to U.S. beneficiary to receive a FNGTBS
    - If beneficiary does not receive FNGTBS, beneficiary must use default calculation to determine taxable amount of the distribution
    - Must be attached to Form 3520
    - Must include sufficient information for beneficiary to complete other related forms (8621, 5471, etc.)

IRS Forms

- Form 3520-A (generally for foreign grantor trusts)
  - Due on March 15; extension available until September 15; filed separately from income tax return
  - Penalty for not filing timely - greater of $10,000 or 5% of the gross value of portion of trust assets treated as owned by the U.S. person
  - U.S. owner of a foreign trust must file Form 3520-A
  - Grantor trust is any trust to the extent that the assets of the trust are treated as owned by a person other than the trust.
  - An owner of a foreign trust is the person that is treated as owning any of the assets of a foreign trust under the grantor trust rules.
  - Under IRC Section 679(c), a trust shall be treated as having a U.S. beneficiary for the taxable year unless
    - No part of the income or corpus of the trust may be paid or accumulated during the taxable year to, or for the benefit of, a U.S. person (includes a U.S. person's interest in the trust that is contingent on a future event)
    - If the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to, or for the benefit of, a U.S. person

IRS Forms

- Foreign Grantor Trust Beneficiary Statement needed for each U.S. beneficiary who receives a distribution from the foreign grantor trust (not issued to the owner of the trust)

IRS Forms

- Form 8621 – Passive Foreign Investment Company (“PFIC”)
  - Included with income tax return
  - Corporations can generally be a PFIC
  - CFC rules supersede PFIC rules
  - Partnerships (flow-through entities) are generally not PFIC’s
  - Unit trusts are generally PFIC’s
  - Foreign mutual funds are PFIC’s
  - Foreign hedge funds are PFIC’s unless election filed with IRS to be a partnership

IRS Forms

- A foreign corporation is a passive foreign investment company if:
  - At least 75% of its gross income is passive income, or
  - The average percentage of assets by value that produces passive income, or held for production of passive income, is at least 50% of all assets
- Default treatment is as IRC Section 1291 fund
  - Amounts received from a PFIC are not separately categorized as interest income, dividend income, or return of capital
  - Sales of shares or an interest in a PFIC are reported separately
    - Gains do not get capital gain treatment
    - Losses are lost for tax purposes
  - PFIC distributions are allocated over the entire holding period
    - It is a PFIC on purchase when there is a direct or indirect U.S. owner or beneficiary
    - An existing holding becomes a PFIC on the date when the trust has a U.S. beneficiary

IRS Forms

- Tax treatment
  - Part IV line 10d is reported as ordinary dividends subject to taxpayer's ordinary tax rate
  - Part IV line 10f is reported as other income (not capital gain income) subject to taxpayer's ordinary tax rate
    - If a loss, not reportable at all, so no tax benefit
  - Line 11b - allocable to current year and pre-PFIC years, reported as other income subject to taxpayer's ordinary tax rate
  - Line 11c – 10e less 11b, allocated to each prior year; tax calculated using the highest tax rate in effect for each prior year
  - Line 11f – interest on line 11e

IRS Forms

- Most common PFIC elections
  - Qualified Electing Fund (“QEF”)
    - Make QEF election if able to obtain net ordinary income and capital gain (taxed at capital gain rate)
    - Almost like treating the PFIC as a K-1 investment
    - Taxed at taxpayer’s current year tax rate
  - Deemed Sale election
    - Generally elected when a QEF was not made for prior years of the PFIC
    - Deemed sale – obtain current market value and report as if sold, then make a QEF election for current and future years
  - Mark-to-Market election
    - Reporting, and paying tax on, unrealized gain at the end of the PFIC’s tax year
    - Also allows a loss
    - Taxed at taxpayer’s ordinary tax rate for the current year

IRS Forms

- Form 5471
  - Included with income tax return
  - Penalty for not filing timely is $10,000
  - Used for U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations
  - Under IRC Section 6046(c), ownership of stock includes stock owned directly or indirectly
  - Indirectly includes through a entity structure or by attribution (i.e. spouse, siblings, ancestors, lineal descendants)

IRS Forms

- Form 8865
  - Reporting of ownership in a foreign partnership
  - Due on the due date of the beneficiary's U.S. income tax return (including extensions) as attachment to beneficiary's income tax return
  - Penalty for not filing timely is $10,000
  - Under IRC Section 267(c), ownership includes constructive ownership

Elections

- "Check-the-box" election
  - If foreign trust owns a foreign corporation, it may be useful to elect to treat the corporation as a disregarded entity
  - If foreign trust owns a PFIC that is a privately held company (i.e. family owned), consider family authorization to elect to treat as a partnership for U.S. tax purposes
- IRC Section 645 election
  - Election if the trust is the result of death and was a foreign grantor/ revocable trust
  - Election is to treat the revocable trust as part of the foreign estate for two years
  - Benefit – foreign income is not part of DNI calculation since it is part of the foreign estate; still must calculate DNI as it relates to U.S. source income, including dividends from U.S. stocks, etc.

Planning

- Planning for distributions to U.S. beneficiaries
  - If there are non-U.S. beneficiaries, consider distributing to them first to pass out all UNI
  - Consider distributing annually to get annual DNI out of the trust
    - Directly to beneficiaries
    - A new U.S. trust for the benefit of the U.S. beneficiaries – avoids accumulating UNI
    - Especially when there are realized long-term capital gains to keep capital gain treatment; if not distributed and becomes part of UNI, it loses capital gain treatment and is included in ordinary income in future year of distribution
  - Pre-immigration – if the incoming U.S. taxpayer plans to take a distribution, it should be done prior to coming to the U.S.

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