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Sections of Real Property Probate and Trust Law
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Probate and Trust CLE
2:30 – 4:30 PM

Income and Transfer Tax Planning Group: Roundtable

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The New Era of the Hybrid Trust

The “new era of the hybrid trust” documents the greater willingness of grantors to cross national borders to create trusts for beneficiaries who live within those borders. While there are multiple permutations on the hybrid trust, this outline will focus on the foreign nongrantor trust created in the U.S. This trust type reflects a growing trend of non-U.S. grantors who want to tap into the benefits of particular U.S. state laws and court systems on behalf of their U.S. beneficiaries. As we will discuss below, the legislative actions in 1996 vastly improved the climate for such trusts. While these events created new opportunity for U.S. fiduciaries, and while definitions are clearer, challenges remain for tax professionals.

I. The Definitions of Foreign Trust

a. Pre - 1996 and Post-1996 Definition

- i. Pre-1996 there was scant authority in the U.S. to determine whether a trust was a “foreign trust.”
- ii. The Small Business Job Protection Act of 1996 (the “’96 Act”)¹ was enacted to add I.R.C. § 7701(a)(30)(E) and 7701(a)(31)(B). These provisions now clearly indicate that a trust is not a foreign trust if :

1. A court in the U.S. has “primary supervision” over the trust administration

and

¹ Pub. L. No 104-188, 110 Stat. 1755 (1996)

2. one or more U.S. persons has the power “to control all substantial decisions” of the trust.²

b. The Two-Pronged Test

i. The “Court Test”

1. Treasury Regulations § 301.7707-7 (effective for trusts with taxable years ending post February 2, 1999) flesh out the requirements for meeting the court test. Among other things, the trust instrument may not direct that the trust be administered outside the U.S., nor can it be subject to the type of migration provision described in Treasury Regulations § 301.7701-7 (c) (4)(ii). In brief, the trust must in fact be administered only in the U.S.³
2. Pursuant to the Treasury Regulations §301.7701-7(c)(3), the definition of “court” includes Federal, state and local courts; the court must have “primary supervision” or authority to render decisions regarding the “administration” of the trust. “Administration” refers to standard fiduciary, recordkeeping and investment duties.

ii. The “Control Test”

1. Where one or more U.S. persons must “have the authority to control all substantial decisions of the trust,”⁴ a U.S. person is defined as a citizen or resident of the United States, a “domestic” partnership or corporation, an estate or a trust primarily supervised by a court within the U.S.⁵
2. “Substantial decisions” are understood to be the full panoply of investment and administrative decisions that ordinarily reside in the trustee, including powers to control distributions, beneficiary selection, principal and income

² IRC§7701(a)(31)(B)

³ Treasury Regulations § 301.7701-7

⁴ I.R.C. § 7701(a)(31)(B)

⁵ I.R.C. § 7701(a)(30)

allocations, powers to terminate the trust and to appoint successor trustees, etc.⁶

II. The Characteristics of the Foreign Nongrantor Trust

a. Grantor vs. Nongrantor status

i. The '96 Act generally precludes grantor trust status under I.R.C. § 672(c) with the following exceptions:

1. The grantor retains the right- either alone or in conjunction with a related or subordinate party – to revoke the trust; or
2. the grantor and/or the grantor's spouse are the only permissible distributees during the grantor's life.

b. Tax Treatment of the Foreign Nongrantor Trust

i. Pursuant to I.R.C. § 641(b), the foreign nongrantor trust is taxed in the same manner as a nonresident alien individual not present in the U.S.

ii. Pursuant to I.R.C. § 872(a), gross income of such a trust is

1. U.S.- source income not connected with the conduct of a trade or a business in the U.S.; *and*
2. gross income that is connected with the conduct of a trade of business in the U.S.

iii. U.S.- source income is further defined as:

1. interest from the U.S., any agency of the U.S. and from U.S. corporations;
2. dividends from U.S. corporations;
3. rents and royalties from U.S. - based intellectual or other property; *and*
4. gains from the disposition of U.S. real estate.⁷

iv. There is an exception to the rule which includes interest in U.S. - source income. Pursuant to I.R.C. § 871(h), certain portfolio interest earned by

⁶ Treasury Regulations § 301.7701-7(d)(1)(ii)

⁷ I.R.C §§ 861(a)(1), (a)(2), (a)(4), (a)(5)

the foreign nongrantor trust on obligations of U.S. persons issued after July 18, 1984, is exempt from U.S. income tax.

- v. Pursuant to I.R.C. § 871 (i), there is no U.S. income tax to the foreign nongrantor trust on interest from a U.S. bank, insurance company, etc.
- vi. Neither of the above exceptions apply if the interest so described is derived in connection with the conduct of a trade or business.
- vii. Pursuant to I.R.C. § 873(a), U.S. taxable income attributed to the conduct of a U.S. trade or business is permitted deductions related to the conduct of that trade or business.
- viii. Foreign nongrantor trusts conducting a U.S. trade or business that pay any foreign income tax on income generated by such trade or business may take either a credit against such foreign tax⁸ or a deduction.⁹
- ix. Tax Rates and Withholding
 - 1. Pursuant to I.R.C. § 871(a) U.S. - source income not connected to a U.S. trade or business is taxed at a rate of 30%.
 - 2. Pursuant to I.R.C. § 871(b)(1) income attributable to a trade of business is subject to the same tax rates generally applied to trusts, as set forth in I.R.C § 1(e).
 - 3. Pursuant to I.R.C. § 1441(a), 30% withholding at the source is required regarding U.S.- source income earned by any nonresident individual or foreign partnership. Query whether this provision also applies to the foreign nongrantor trust?
 - 4. Foreign nongrantor trusts which earn income from a U.S. trade or business are not required to withhold.
 - 5. An income tax treaty between the resident country of the settlor and the U.S. can vary withholding amounts, so the existence of such treaties must be researched.
- x. Tax Reporting Requirements

⁸ I.R.C. § 901(b)(4)

⁹ I.R.C. § 164(a)(3)

1. Such requirements for the foreign nongrantor trust are found in I.R.C. §§ 664(a) and 6654(1). Such trusts are on a calendar taxable year and must make estimated tax payments.
2. The trustee(s) of a foreign nongrantor trust must file Form 1040NR if such trust derived income from a U.S. trade or business or U.S. - source income was not fully withheld.¹⁰
3. Form 1040NR must be filed on the 15th day of the sixth month after the close of the year if there is no office in the U.S. and on the fifteenth day of the fourth month after the close of the year if there is a U.S. office.”¹¹

c. Taxation of U.S. Beneficiaries of Foreign Nongrantor Trusts

- i. The U.S. beneficiary of a foreign nongrantor trust is taxed on amounts of the trust income required to be distributed to him or her to the extent of the trust’s distributable net income (“DNI”), whether the trust is a simple or complex trust.¹²
- ii. Pursuant to I.R.C. § 643(e), any property distributed in kind is the lesser of the property’s basis in the hands of the trustee or its fair market value on the distribution date, unless the trustee elects to recognize gain equivalent to the difference between basis and fair market value.
- iii. Pursuant to I.R.C. § 643(a)(6)(c), foreign nongrantor trust DNI includes capital gains.
- iv. Throwback rules are applied to “accumulation distributions,” as defined in I.R.C. § 665(b), as distributions exceeding DNI, less trust accounting income required to be distributed currently.
- v. Pursuant to I.R.C. § 643(i), loans by the foreign trust to U.S. grantors or beneficiaries or to those U.S. individuals related to U.S. grantors or beneficiaries are treated as distributions.

d. U.S. Beneficiary Reporting

¹⁰ Treasury Regulations § 1.6012 – 1(b)

¹¹ I.R.C. § 1.6072-1

¹² I.R.C. §§ 651(a), 662(a)(1), 662(a)(2)

- i. U.S. persons receiving distributions from foreign trusts- grantor or nongrantor- must report details of such distribution on Form 3520.¹³ This form is due on the same date as the beneficiary's tax return and receives companion extensions.
- ii. The penalty of failure to report is 35% of the amount distributed.¹⁴
- iii. Form 4970 must be attached to Form 3520 if the U.S. beneficiary receives an accumulation distribution; such form is used to calculate the throwback tax.
- iv. The trustee should give a Foreign Nongrantor Trust Beneficiary Statement to each U.S. beneficiary, who received a distribution.
- v. Planning Opportunity: There is an exception to the reporting requirement for qualified medical and tuition payments, as classified pursuant to I.R.C § 2503 (e).

III. Choice of Jurisdiction and the Non-U.S. Settlor: the Transfer Tax Advantage

a. Gift Tax and Generation Skipping Transfer Tax ("GST")

- i. The first advantage is that pursuant to I.R.C. § 2501 (a)(2), the gift tax does not apply to gifts of intangible property made by non-U.S. donors to U.S. donees.
- ii. As no gift tax applies, there would be no GST lifetime transfers to skip persons.¹⁵

b. Estate Tax and the Perpetuities Question

- i. By the same token, bequests of certain U.S. - source intangible property, such as stock issued by a non-U.S. corporation, would be includible in the estate of a non-U.S. individual.¹⁶

¹³ I.R.C. § 6048(c), added by the '96 Act.

¹⁴ Sec I.R.C. § 6677. Notice 97-34, 1997 - 1 C.B. 422 describes the information required to be reported and provides the beneficiary a default method to calculate the accumulation distribution if insufficient information is provided by the trustee.

¹⁵ See Treasury Regulations § 26.2663-2

¹⁶ I.R.C. § 2104(a)

- ii. Given the advantages of lifetime giving of certain U.S. - source assets by non-U.S. donors to U.S. donees, there is considerable appeal to establishing the foreign nongrantor trust in a jurisdiction, such as Delaware, South Dakota or Alaska, where the trust is perpetual, thereby avoiding an estate tax at each generational level.
- iii. For example, if Delaware is the chosen jurisdiction, the foreign nongrantor trust may be created with a Delaware resident trustee and a non- U.S. “protector” who has authority to make one or more “substantial decisions” of the trust.

Foreign Non-Grantor Trust in U.S.

