Many U.S. citizens and residents do not realize that there may be U.S. income tax exposure and reporting requirements for U.S. beneficiaries of foreign trusts and U.S. recipients of gifts from foreign donors. This article will examine a U.S. trust beneficiary’s potential income tax exposure, a U.S. beneficiary’s reporting requirements, and a U.S. gift recipient’s reporting requirements.


Whether a grantor, a trust beneficiary (or his or her family) or the trust is subject to any U.S. income taxation depends on a variety of factors. First, whether the trust is considered a domestic or foreign trust for U.S. income tax purposes will determine what income, if any, is subject to U.S. taxation. Second, whether the trust is considered a “grantor” or “non-grantor” trust for U.S. income tax purposes will determine who is potentially liable for any U.S. income tax due (i.e., the trust, its grantor, or its beneficiaries).

A. Domestic Trust versus Foreign Trust.

Domestic trusts are generally subject to U.S. taxation on their worldwide income. As discussed in further detail below, the income tax due may be charged to the grantor, the trust, or the trust beneficiaries depending on the terms of the trust. Generally, the grantor will be subject to taxation in the case of a “grantor trust” and the trust (if the income is retained) or the trust beneficiaries (if the income is distributed) will be subject to taxation in the case of a “non-grantor trust.”

In contrast, a foreign trust is only subject to U.S. taxation on U.S.-source income. U.S.-source income includes: income from the active conduct of a U.S. trade or business; interest paid from U.S. residents and domestic corporations; dividends from domestic corporations; rentals and royalties from property located in the U.S.; and gains from the disposition of U.S. real estate.

A trust will be considered a domestic trust if it meets both of the following tests:

- **Court Test:** To satisfy the court test, a U.S. court must have the authority to address and exercise primary supervision over all substantial issues about the administration of the trust. Thus, a trust agreement that is governed exclusively under the laws of a foreign court will ordinarily not be considered a U.S. trust. The regulations also provide that a trust will not meet the court test if the trust instrument contains a provision causing the trust to migrate from the United States if a U.S. court attempts to exercise jurisdiction over it. Whether a U.S. court would honor such a provision when the regular jurisdictional requirements
were otherwise satisfied is unclear, but the inclusion of such a provision would ensure that the exercise of jurisdiction over the trust by a U.S. court, even if a majority of trustees were U.S. citizens or residents, would not change the foreign tax situs of the trust for U.S. tax purposes.

- **Control Test:** Under the control test, one or more U.S. persons must have the authority to control all substantial decisions of the trust. A trust will be deemed to satisfy the control test if there is a U.S. trustee that is able to control all decisions relating to trust distributions and trust investment decisions and there is no foreign person that is able to veto the U.S. trustee’s actions.

For a non-resident alien, the creation and funding of the trust with solely foreign property should not result in any U.S. taxation. However, if a U.S. citizen or resident serves as trustee of the trust, that person would likely meet the Control Test unless another foreign person is able to veto his or her actions. Thus, a trust document with a U.S. trustee should explicitly and clearly state that it is governed under the laws of a foreign jurisdiction and may want to include a migration clause to prevent it from also meeting the Court Test resulting in the trust being considered a domestic U.S. trust. Assuming that the trust does not meet either Control Test or the Court Test and does not earn any U.S.-source income, then it should not be subject to U.S. income taxation when that income is earned. However, because U.S. beneficiaries of foreign trusts are subject to U.S. income taxation on their worldwide income, distributions from the trust to any U.S. beneficiary may still be subject to U.S. income taxation.

**B. Foreign Grantor Trust versus Foreign Non-Grantor Trust.**

A trust will be characterized as a foreign grantor trust only under two conditions: (1) the grantor reserves the right to revoke the trust solely or with the consent of a related or subordinate party (and revest the title assets to himself); or (2) the amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor. Under these circumstances, the income of the trust is taxed to the grantor. As discussed above, if the grantor is a non-resident alien and does not have any U.S.-sourced income, then the grantor will not be subject to U.S. income tax. Moreover, distributions to a U.S. beneficiary by a foreign grantor trust will generally be treated as tax-free gifts to the U.S. beneficiary by the grantor. As discussed in further detail below, any U.S. beneficiary will nonetheless be required to meet certain U.S. reporting requirements because it is a distribution. A foreign grantor trust will generally become a foreign non-grantor trust upon the death of the grantor.

Any trust that does not meet the definition of a foreign grantor trust is a foreign non-grantor trust. A foreign non-grantor trust is generally taxed as if it were a nonresident alien who is not present in the U.S. at any time (i.e., only taxed on U.S.-source income). However, the U.S. beneficiaries of a foreign non-grantor trust are subject to special tax rules that do not apply to the beneficiaries of domestic trusts.

1. **Distributable Net Income.**

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U.S. beneficiaries are generally taxed on distributions of income from trusts. The taxable income is based on the "distributable net income" of the trust (which includes both ordinary income and capital gains regardless of whether it is U.S.-source or foreign-source) that flows through to the beneficiary in the form of payments from the trust. Distributions to beneficiaries are considered first to carry out the distributable net income of the current year (pro rata as to each item of income or gain) and will be taxed to the recipient beneficiaries. The character of such distributable net income distributions will reflect the character of the income as received by the foreign non-grantor trust. Thus, the ordinary income portion generally will be taxed to the beneficiaries at their respective graduated income tax rates, while the long-term capital gain portion will be taxed at the 15% capital gains rate.

2. **Throwback Tax.**

Many foreign non-grantor trusts are intended to accumulate income for the benefit of the beneficiaries. The U.S. tax rules are structured to prevent foreign trusts from accumulating income for the benefit of U.S. beneficiaries in order to defer payments of income and thereby avoid the U.S. tax on distributable net income. Thus, in any year in which a U.S. beneficiary receives a distribution from a foreign non-grantor trust and income was earned in a prior year, the taxpayer must perform a special calculation to compute the "throwback tax." The throwback tax is designed to recapture the tax that would have been paid if the income had been distributed to the beneficiary in the year it was earned rather than accumulated in the trust. The distribution is deemed to have been a payment of the earliest income accumulation and is taxed at a rate designed to replicate the beneficiary’s tax rate over the years the distribution of the income was deferred.

3. **Interest Charge.**

In addition to the “throw back” itself, there is also an interest charge, again designed to replicate the interest on a late payment of tax by the beneficiary of a domestic trust. This interest rate is based on a weighted average of the years in which income accumulations have occurred.

4. **Loans from Foreign Trusts and Use of Foreign Trust Property.**

Loans to U.S. beneficiaries from foreign non-grantor trusts are generally treated as distributions and are therefore potentially subject to U.S. income tax. For purposes of this rule, loans to persons related to a U.S. beneficiary (such as siblings, ancestors, descendants and spouses) are treated as if they were made to the beneficiary. However, certain loan transactions can be structured in such a way as to avoid being treated as deemed distributions: they must be in writing; the term must not exceed five years; all payments must be denominated in U.S. dollars; the yield to maturity of the obligation must not be less than one hundred percent and no more than one hundred thirty percent of the applicable Federal rate; the U.S. beneficiary must agree to extend the period for assessment on income attributable to the loan; and the U.S. person must
report the loan to the Internal Revenue Service for each year the obligation is outstanding.\textsuperscript{20}

Similarly, the use of any trust property by U.S. beneficiaries and persons related to a U.S. beneficiary (such as siblings, ancestors, descendants and spouses) is treated as a distribution of trust property equal to the fair market value of the use of such property.\textsuperscript{21} However, if the U.S. beneficiary or related person pays the fair market value for the use of the trust property within a reasonable period of time, then it will not be treated as a trust distribution.\textsuperscript{22}

Thus, whether any U.S. income tax is due will depend on if the trust is a foreign grantor trust or a foreign non-grantor trust. If it is a foreign grantor trust, then the grantor will be personally liable for any tax on U.S.-source income, but the U.S. beneficiaries will not be subject to U.S. income taxation on distributions from the trust or the use of trust property. Rather, it will be considered a non-taxable gift from the grantor the U.S. beneficiary that is subject to U.S. reporting requirements. On the other hand, if it is a foreign non-grantor trust, then the trust will be liable for any U.S.-source income (unless it makes a distribution of the income to the beneficiaries). In addition, to the extent that the trust has earned income (in the current year or previous years) or realized any capital gains, the U.S. beneficiary (and his or her family) would be subject to U.S. income taxation on any distributions from the trust. And the U.S. beneficiary must pay fair market rental value to use any trust property or it will be considered a distribution of trust property subject to U.S. income taxation.

C. Special Taxing Regimes.

If the foreign trust has investments in foreign corporations, the presence of a U.S. beneficiary may have the unfortunate effect of subjecting the U.S. beneficiary to two special U.S. taxing regimes: those applicable to "controlled foreign corporations" ("CFCs") and those applicable to "passive foreign investment companies" ("PFICs"). The CFC rules (which generally preempt the PFIC rules) subject certain types of income allocable to a "U.S. Shareholder" (as specially defined) to immediate U.S. taxation, whether or not distributed, and characterize certain gains upon disposition of the stock as ordinary income. Unless certain exceptions apply, the PFIC rules are designed to penalize U.S. taxpayers on "excess distributions" from a PFIC or upon a disposition of PFIC stock, imposing the highest ordinary income rates and an interest charge.

II. Reporting Obligations of U.S. Beneficiaries and Trustees\textsuperscript{23}

A. Form 3520 Filing

Any U.S. person that receives (directly or indirectly) a distribution from a foreign trust during a taxable year must meet certain reporting requirements, regardless of whether the U.S. beneficiary is subject to U.S. taxation.\textsuperscript{24} Importantly, it does not matter whether the U.S. person receiving the distribution is a named beneficiary of the trust document. It also does not matter whether the trust is a grantor or non-grantor trust.\textsuperscript{25} The U.S.
person who receives the distribution from a foreign trust must include Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) with his or her tax return. Unless the U.S. beneficiary obtains one of the statements described below, the entire amount of the distribution will be considered taxable (rather than just the amount equal to the income and/or capital gains of the trust). Failing to report a trust distribution carries with it a penalty of 35% of the gross value of the distribution.26

The trustee of the foreign trust should furnish to the U.S. beneficiary a “Foreign Grantor Trust Beneficiary Statement” or “Foreign Non-Grantor Trust Beneficiary Statement”, which will be attached by the U.S. beneficiary to their Form 3520. This is often done by the trustee completing Form 3520-A, which includes providing the name of the trust, description and fair market value of the property distributed, and tax owed by the beneficiary or explanation of why the trust should be treated as a grantor trust taxable to someone other than the U.S. beneficiary.

B. Report of Foreign Bank and Financial Accounts

The Report of Foreign Bank and Financial Accounts (“FBAR”) Filings on Form TD-F 90-22.1 are generally required to be made by U.S. persons who have reportable financial interests in or signature authority over a foreign financial account (“FFA”). A U.S. person who has more than a 50% present beneficial interest in a trust’s income or assets may be deemed to have an FFA interest and may be required to make an FBAR filing. The beneficial interest in the assets of the trust must be a “present” beneficial interest for the FBAR to apply. A beneficiary of a purely discretionary trust (i.e., where trust distributions are made solely in the discretion of a trustee) does not have a “present” interest. However, with respect to the trust income, a beneficiary who receives more than 50% of trust’s “current” (i.e., annual) income has a financial interest that is reportable on the FBAR. For these purposes, a trust beneficiary of a foreign non-grantor trust may receive an exemption from FBAR reporting if a trustee who is a U.S. person makes an FBAR filing disclosing the trust’s FFAs and provides information as required. In addition, if the trustee is a U.S. person, then an FBAR filing may be required even if the U.S. beneficiary does not have a reportable financial interest.

C. Foreign Account Tax Compliance Act

FATCA Entity Reporting: FACTA imposes a 30% withholding tax on payments to “foreign financial institutions” (“FFIs”) that do not comply with certain disclosure requirements about their U.S. account holders. A foreign trust that invests (directly or indirectly) in securities and other financial interests may, under certain circumstances, be treated as an FFI if the trustee is a trust company or if an entity, such as a bank or other financial institution, is acting as the investment advisor. In that case, the trust may have to register with the Internal Revenue Service and receive a global intermediary identification number.
FATCA Individual Reporting: A U.S. person who holds an interest in a specified foreign financial asset must disclose such interest on Form 8938 if the aggregate value of all such assets exceeds certain threshold amounts (e.g., in the case of a married individual, $100,000 on the last day of the tax year, or $150,000 at any time during the year). A foreign financial asset includes an interest in a foreign trust, although special valuation rules may apply. Typically, assets are reported only when and as a trust makes a distribution to a U.S. beneficiary, the amount of the distribution being the reportable asset. This disclosure requirement is in addition to the FBAR requirement described above.

III. Gifting

U.S. persons that receive gifts from foreign individuals or entities may have to report such transfers on Form 3520 (Part IV Lines 62-64). Generally, a U.S. person must report: (1) any gifts from a non-resident individual or foreign estate that collectively exceed $100,000; and (2) any gifts from foreign corporations and foreign partnerships that collectively exceed $10,000 (adjusted for inflation). In calculating the $100,000 threshold, the U.S. person must aggregate gifts from different, foreign nonresident aliens and foreign estates if he or she knows (or has reason to know) that one of those persons is acting as the nominee for the other person.

IV. Conclusion

Working with U.S. clients that are the beneficiaries of foreign trusts comes with certain unique challenges. Any U.S. person that directly or indirectly receives a distribution from a foreign trust, regardless of whether they are named in the trust document, or that receives certain gifts from a foreign donor must file Form 3520. In addition, because U.S. beneficiaries are subject to U.S. income taxation on their worldwide income, distributions from foreign non-grantor trusts and the uncompensated use of trust property may be subject to U.S. income taxation under a special regime. Thus, it is important to determine whether any client has received a distribution or gift from abroad.

1 Landon is a partner at Prather Ebner LLP in Chicago focusing on international issues in estate planning.
2 IRC § 641.
3 IRC § 641(b).
4 IRC § 861.
5 IRC 7701(a)(30)(E).
6 Treas. Reg. § 301.7701-7(a)(i).
7 Treas. Reg. § 301.7701-7(c)(4)(ii).
8 Treas. Reg. § 301.7701-7(a)(ii).
9 IRC § 672(f)(2)(A).
10 IRC § 641(b). Note, however, that a foreign tax credit or deduction may be available to reduce or eliminate double taxation if a foreign tax is paid on the U.S.-source income. Similarly, an income tax treaty may reduce or eliminate the income tax.
11 Note, however, that a foreign tax credit or deduction may be available to reduce or eliminate double taxation if a foreign tax is paid on the income. Similarly, an income tax treaty may reduce or eliminate the income tax.
12 IRC § 643(a)(6).
13 IRC § 662.
14 IRC § 662(a).
15 IRC § 662(b).
16 IRC § 667.
17 IRC § 668.
18 IRC § 643(i)(1).
19 IRC § 643(i)(2)(B).
20 IRS Notice 97-34, Section V(A).
21 IRC § 643(i)(1).
22 IRC § 643(i)(2)(E).
23 There may be additional reporting requirements if the trust later invests in U.S. property or a U.S. person becomes the owner of any trust property.
24 IRC § 6048(e)(1).
25 IRC § 6048(d)(1).
26 IRC § 6677(a)(2).
27 IRC § 6039F.