

U.S. TAXATION OF FOREIGN TRUSTS “BOOTCAMP”

Fundamentals of U.S. Taxation for Foreign Trusts

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Webinar 1: What Type of Trust Do You Have?

Introduction to Classification of Trusts for U.S. Tax Purposes



What is a Trust for U.S. Tax Purposes?

No Uniform Definition in U.S. Tax Law

- The IRS Internal Revenue Code does not explicitly define a “**trust**.”
- Classification is based on regulations and administrative principles.

Regulatory Definition – Treas. Reg. § 301.7701-4(a)

- Provides that the term “**trust**” refers to an arrangement created by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.
- Generally, the purpose of the arrangement is to vest responsibility in trustees to protect and conserve property for beneficiaries who cannot share in the discharge of this responsibility.
- Not a business entity – focus on fiduciary duty.

What is a Trust for U.S. Tax Purposes?

Key Features of a Trust for U.S. Tax Purposes

- Fiduciary arrangement
- Trustee manages assets
- Beneficiaries are passive

Application to Some Non-U.S. Arrangements

- IRS Rev. Rul. 2013-14 (July 15, 2013): A *fideicomiso* (Mexican Land Trust) is **not a trust** for U.S. tax purposes where the trustee's sole function is to hold title and act at the direction of the beneficiary.
- IRS Chief Counsel Mem. AM2009-012 (Oct. 16, 2009): Liechtenstein *Anstalts* are generally classified as **business entities** and *Stiftungs* as **trusts**, subject to facts and circumstances.
- IRS Priv. Ltr. Rul. 201032021 (Aug. 13, 2010): U.S. tax classification depends on the **economic substance** of the usufruct arrangement, not its civil law label; the terms of the usufruct arrangement are determinative.

“Foreign” vs. “Domestic” Classification for Tax Residence

Why This Matters

- Determines U.S. tax treatment, reporting requirements, whether the “throwback tax” applies, and which “grantor trust” rules apply.

Two-Part Test for U.S. Tax Residency Classification

- Under Internal Revenue Code (“IRC”) §§ 7701(a)(30)(E) and (31)(B), a trust is classified “foreign” for U.S. tax purposes unless it meets both of the following: the **Court Test** and the **Control Test**.

Court Test – Key Concepts

Court Test for U.S. Tax Residency Classification

- A U.S. court must have “**primary supervision**” over trust administration.
- Safe harbor:
 - No direction for administration outside the U.S.
 - Administered exclusively in the U.S.
 - No automatic migration (“flee”) clause

Control Test – Key Concepts

Control Test for U.S. Tax Residency Classification

- All “**substantial decisions**” must be controlled by U.S. persons.
- No non-U.S. person may have veto power or investment control.
- Examples of substantial decisions:
 - Distribution decisions
 - Beneficiary selection
 - Trust termination
 - Trustee appointments/removals
 - Investment allocations

Foreign Grantor vs. Foreign Non-Grantor Classification

Why This Matters

- Determines who pays tax on the trust's income.
- Determines IRS tax filing and reporting obligations.

What Is a Grantor Trust

- Trust where someone (typically the grantor) is treated as the “**owner**” for U.S. tax purposes.
- Triggered by retained powers (IRC §§ 673–677) or automatic rule (IRC § 679).

Foreign Grantor Trust – Key Concepts

Foreign Grantor Trust with a U.S. Grantor

- Automatic Grantor Trust Rule under IRC § 679
 - Applies when U.S. grantor transfers property to a foreign trust that has **(or could at any time have)** U.S. beneficiaries.
 - No retained powers or control required—U.S. grantor ownership is automatic for U.S. tax purposes.
- “Retained Powers” Rule under IRC §§ 673–677
 - Applies when U.S. grantor keeps certain interests or controls and foreign trust explicitly prohibits U.S. beneficiaries.

Foreign Grantor Trust – Key Concepts

Foreign Grantor Trust with a Non-U.S. Grantor

- All foreign trusts with a non-U.S. grantor are classified as “**non-grantor trusts**” under IRC § 672(f)(1), unless either of the limited exceptions under IRC § 672(f)(2) applies:
 - The non-U.S. grantor retains a power to revest title to trust property alone (or with the consent of a related or subservient party), or
 - During the non-U.S. grantor’s lifetime, only the non-U.S. grantor or spouse may receive distributions of trust income or corpus.
- If neither limited exception applies → the trust is classified as a foreign non-grantor trust for U.S. tax purposes.

Foreign Non-Grantor Trust – Key Concepts

U.S. Taxation of Foreign Non-Grantor Trusts

- A foreign trust determined not to be a “grantor” trust under IRC §§ 671-679 will be treated as a foreign non-grantor trust for U.S. tax purposes.
- A foreign non-grantor trust is treated as a separate taxpayer for U.S. tax purposes.
- U.S. beneficiaries of a foreign non-grantor trust are subject to U.S. tax ordering rules on distributions of trust income (current and accumulated) and trust corpus (principal), which is discussed further in Webinar 2.
- Accumulated income distributed to U.S. beneficiaries is subject to the punitive “throwback tax rules” and its accompanying interest charge, which is discussed further in Webinar 2.

“Simple” vs. “Complex” Trusts

Limited Relevance to Foreign Trusts

- These terms primarily apply to “domestic” non-grantor trusts.

U.S. Tax Definitions

- A “**simple**” trust must distribute all income currently and cannot make charitable contributions or distribute principal during the year.
- A “**complex**” trust is any trust that does not meet all of the requirements of a simple trust. It may accumulate income, distribute principal, or make charitable contributions.

Application to Foreign Non-Grantor Trust

- Most foreign non-grantor trusts are classified as complex trusts due to discretionary powers and ability to accumulate income.

Summary of U.S. Trust Classification

Step	Classification	Key Question	Result / Notes
1	Is arrangement a " Trust " for U.S. Tax Purposes?	Is there an arrangement where a trustee holds title for beneficiaries?	If Yes , proceed to Step 2
2	Is trust " Domestic " or " Foreign " for U.S. Tax Residency Purposes?	Does it meet <u>both</u> the Court Test and Control Test ?	If <u>both</u> Yes → " Domestic " Trust If <u>either</u> or <u>both</u> No → " Foreign " Trust (default rule)
3	Foreign Grantor Trust with U.S. Grantor	Does " foreign " trust have (or could have) U.S. beneficiaries for automatic grantor status under IRC § 679, or, if U.S. beneficiaries are explicitly prohibited, does U.S. grantor retain certain powers under IRC §§ 673–677?	If <u>either</u> Yes → Foreign " Grantor " Trust If <u>both</u> No → Foreign " Non-Grantor " Trust
4	Foreign Grantor Trust with Non-U.S. Grantor	Does the non-U.S. grantor retain a power to revest alone (or with related/subservient party) or are only the non-U.S. grantor or spouse permitted beneficiaries?	If <u>either</u> Yes → Foreign " Grantor " Trust If <u>both</u> No → Foreign " Non-Grantor " Trust
5	" Simple " vs. " Complex " Trust?	Can trust accumulate income, distribute principal, or make charitable contributions?	If No → " Simple " Trust If Yes → " Complex " Trust – most foreign trusts are classified complex

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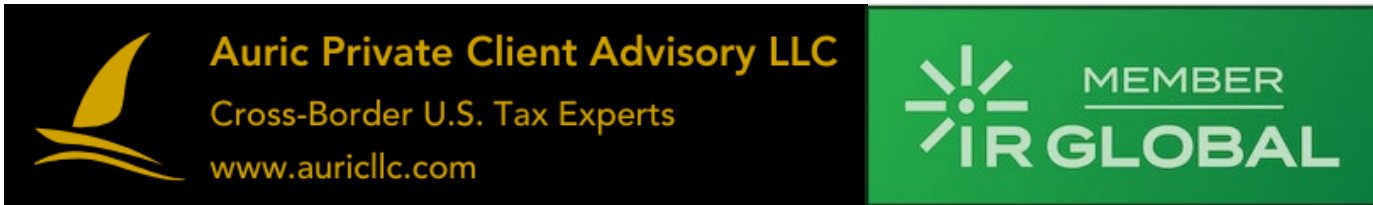
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