

U.S. TAXATION OF FOREIGN TRUSTS “BOOTCAMP”

Webinar 2: U.S. Taxation of Foreign Grantor and Non-Grantor Trusts

PRESENTED BY:

AMY JETEL, J.D., ACTEC Fellow, STEP Board Member

Jetel Law, PLLC

and

MILAN SOLARZ-PATEL, J.D., LL.M. (Taxation)

Auric Private Client Advisory LLC

Recap of Trust Classification for U.S. Tax Purposes

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

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

“Domestic” vs. “Foreign” Trust Classification

- A trust is classified **“foreign”** for U.S. tax purposes, unless it meets both a court test and a control test.

Foreign “Grantor” vs. “Non-Grantor” Trust Classification

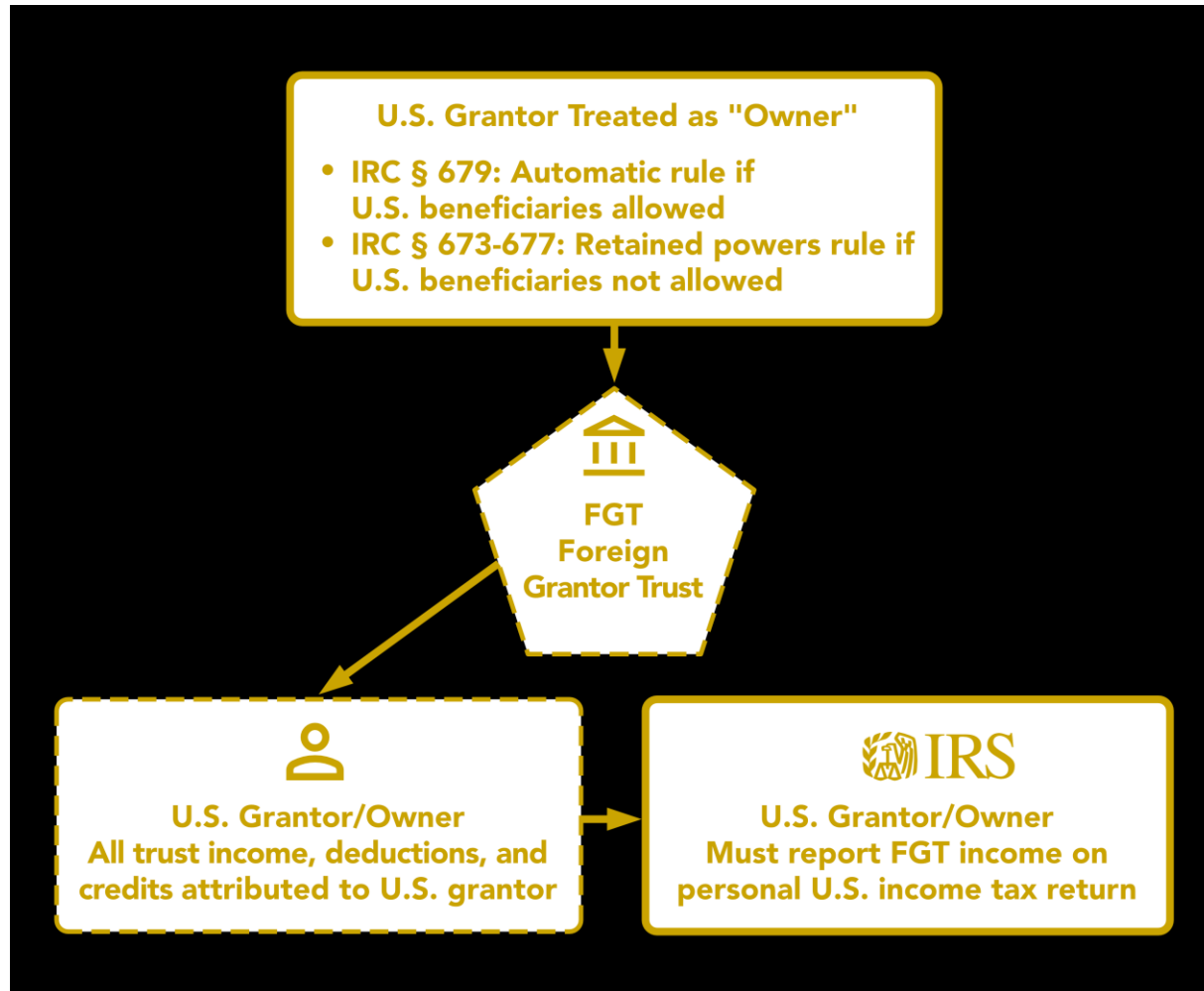
- **U.S. grantor:** automatic rule if U.S. beneficiaries allowed (IRC § 679) or retained powers if U.S. beneficiaries not allowed (IRC §§ 673–677).
- **Non-U.S. grantor:** general rule under IRC § 672(f)(1) and exceptions under IRC § 672(f)(2).
- Unless a foreign trust meets U.S. grantor or non-U.S. grantor rules, it is classified as a “foreign non-grantor trust” for U.S. tax purposes.

U.S. Taxation of a Foreign Grantor Trust with U.S. Grantor

U.S. Grantor Treated as Owner

- U.S. grantor treated as “**owner**” under automatic rule if there are any actual U.S. beneficiaries or they are not explicitly prohibited (IRC § 679) or retained powers if U.S. beneficiaries explicitly prohibited (IRC §§ 673–677).
- All trust income, deductions, and credits attributed to U.S. grantor.
- A foreign grantor trust with a U.S. grantor **must report** the trust’s income on the U.S. grantor’s personal U.S. income tax return.

U.S. Taxation of a Foreign Grantor Trust with U.S. Grantor

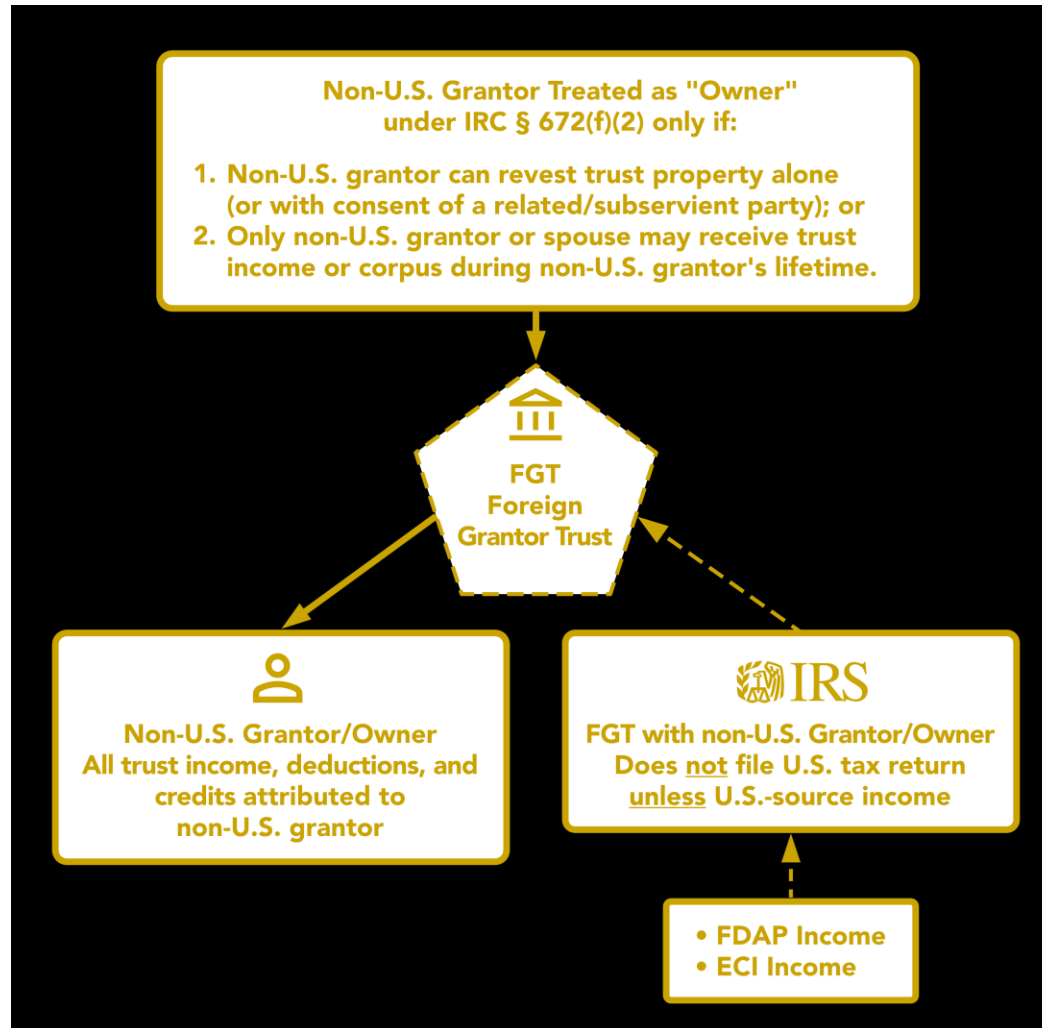


U.S. Taxation of a Foreign Grantor Trust with Non-U.S. Grantor

Non-U.S. Grantor Treated as Owner

- Non-U.S. grantor treated as “**owner**” under IRC § 672(f)(2) only if:
 - non-U.S. grantor can revest trust property alone (or with the consent of a related or subservient party); or
 - only non-U.S. grantor or spouse may receive trust income or corpus during non-U.S. grantor’s lifetime.
- All income, deductions, and credits attributed to non-U.S. grantor.
- A foreign grantor trust with a non-U.S. grantor **does not report** the trust’s income on a U.S. income tax return unless it has U.S.-source income.
- U.S. beneficiaries are **not taxed** on distributions from a foreign grantor trust with a non-U.S. grantor, although the distribution **must be reported** for U.S. tax purposes.

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

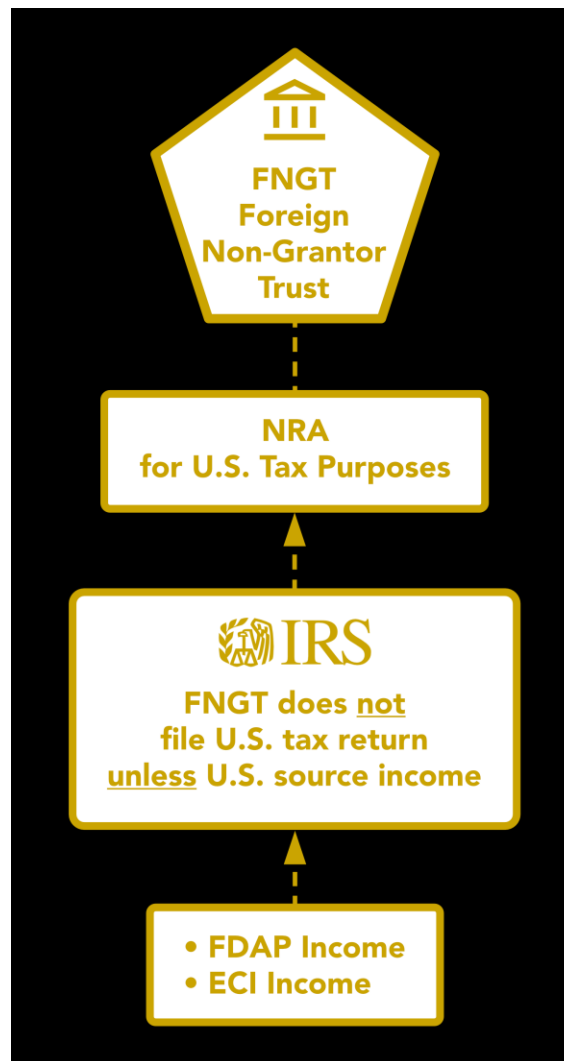


U.S. Taxation of a Foreign Non-Grantor Trust

Foreign Non-U.S. Grantor Trust Treated as Separate Taxpayer

- A foreign non-grantor trust is treated as a separate taxpayer for U.S. tax purposes.
- Classified as a nonresident alien (“NRA”) for U.S. tax purposes.
- For an NRA, only U.S.-source income is subject to U.S. income taxation:
 - **FDAP** income (e.g., interest, dividends, rents) is generally subject to 30% withholding (unless reduced by treaty).
 - **ECI** (effectively connected income) is taxed on a net basis at graduated rates.

U.S. Taxation of a Foreign Non-Grantor Trust

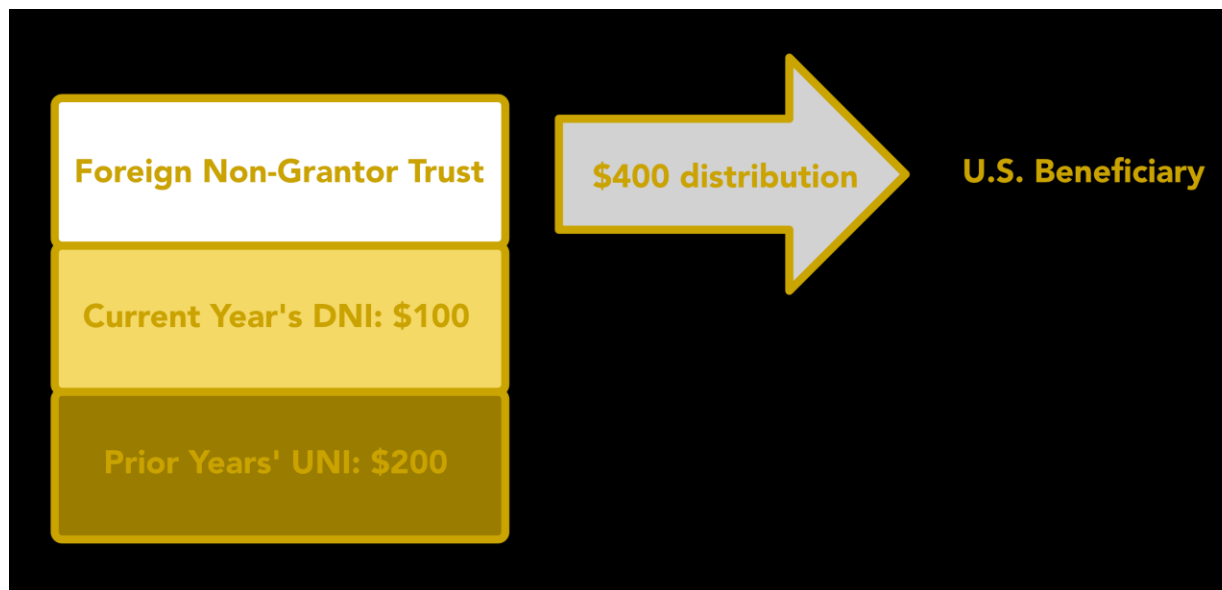


U.S. Taxation for U.S. Beneficiaries of a Foreign Non-Grantor Trust

Ordering Rules for U.S. Taxation on Distributions to U.S. Beneficiaries

- U.S. beneficiaries are subject to U.S. taxation ordering rules for any distributions of trust income (current and accumulated) and trust corpus (principal) from a foreign non-grantor trust as follows:
 - First, on distributable net income (“**DNI**”) to the extent there is DNI, which in general means the trust’s current-year income.
 - Then, on undistributed net income (“**UNI**”) to the extent there is UNI, which in general means trust income from prior years that was accumulated and not distributed until the current year, which is subject to the punitive “throwback tax rules” and its accompanying interest charge.
 - Last, on trust corpus (principal) to the extent distributed, which in general is not taxable when distributed to U.S. beneficiaries.

Foreign Non-Grantor Trust Ordering Rules



DNI is distributed first until depleted: \$100 (ordinary tax)
UNI is deemed distributed until depleted: \$200 (throwback tax and interest)
Corpus (trust principal) is last: \$100 (non-taxable)

U.S. Taxation for U.S. Beneficiaries of a Foreign Non-Grantor Trust

Taxation of DNI for U.S. Beneficiaries

- DNI generally includes **all income earned** by the trust during the current year, including:
 - Interest, dividends, and rents
 - Capital gains (for foreign non-grantor trusts)
- DNI **retains U.S. tax character** in the hands of U.S. beneficiaries.
 - For example, qualified dividends remain qualified; long-term capital gains are taxed at preferential rates.
- U.S. beneficiaries must report their **pro-rata share of DNI** on their personal U.S. tax return (Form 3520) in the same category of income earned by the trust.
- If distributions are **less than or equal to DNI**, no throwback tax or interest charge applies.

U.S. Taxation for U.S. Beneficiaries of a Foreign Non-Grantor Trust

“Accumulation Distributions” and the “Throwback Tax” Rules

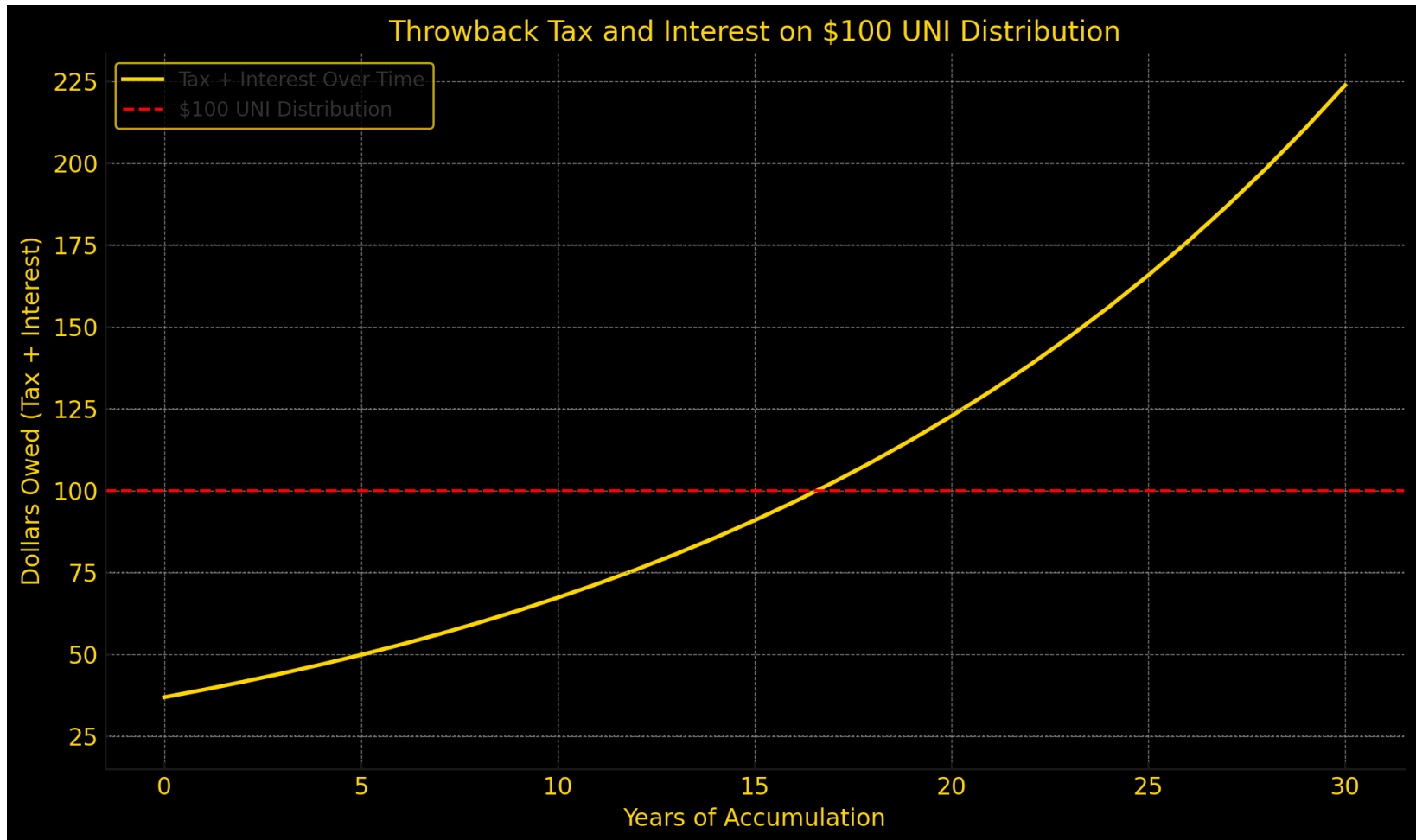
- If a foreign non-grantor trust distributes more than its current-year DNI, the excess is treated as an “**accumulation distribution**” to the extent of UNI (accumulated income that has not been previously distributed).
- Accumulation distributions are subject to the so-called “**throwback tax**” rules, an anti-deferral regime that aims to recreate the tax the U.S. beneficiary would have paid had the UNI (accumulated income) been distributed in the years it was earned.
- Negative U.S. tax consequences:
 - Certain types of reduced tax income recharacterized as ordinary income (e.g., long-term capital gains and qualified dividends).
 - Interest charge applies from the year the income was earned until distributed.
- The throwback tax applies only to the extent there is UNI.

U.S. Taxation for U.S. Beneficiaries of a Foreign Non-Grantor Trust

Overview of Throwback Tax Mechanics

- The throwback tax includes:
 - Regular U.S. income tax (loss of character) on the distribution, and
 - An interest charge on that tax, compounded daily from the year of accumulation.
- Interest rate:
 - For UNI accumulated before 1996: 6% simple interest.
 - For UNI accumulated after 1996: compounded daily at the federal underpayment rate (currently 7% = federal short-term rate + 3%).
- Practical effect: long-accumulated UNI may be significantly reduced or entirely consumed by throwback tax and accompanying interest charge.
- If full trust records are unavailable, the “default” method must be used (Form 3520, Schedule A).

Throwback Tax and Interest Sample Time Graph



Mitigating the Throwback Tax – Part 1

Internal Revenue Code “Election” Strategies

- Distribute all DNI from the foreign non-grantor trust each year:
 - Elect “65-day” rule to treat distributions as prior-year DNI.
 - “Credit” DNI that is not determinable within the 65-day period.
- Elect “default” method of calculating distributions:
 - Distribution within 125% of the 3-year average avoids throwback tax.
 - Once elected calculation method cannot be changed.
- IRC §645 election to treat a foreign grantor trust as a foreign estate for at least 2 years after the non-U.S. grantor’s death.

Mitigating the Throwback Tax – Part 2

Distribution Strategies

- Distribute appreciated property (not cash) to U.S. beneficiaries.
- Distribute a “specific sum of money or specific property” payable in 3 or fewer installments.
- A “mandatory income” distribution will not carry out UNI to U.S. beneficiaries, even if it exceeds DNI.
- Make charitable distributions:
 - Distributions to a foundation managed by the U.S. beneficiaries.
 - Distributions to a foreign charity are permissible.
- Strategic distributions to non-U.S. beneficiaries.
 - Need to consider IRC § 643(h) “anti-intermediary rule.”

Mitigating the Throwback Tax – Part 3

Restructuring & Investment Strategies

- Grant a “general power of appointment” (GPOA) to another non-U.S. person to resettle the trust or appoint trust assets.
- Domesticate, decant, or restructure the trust.
- Invest in U.S. tax-exempt bonds.
- Adopt “buy-and-hold” investment strategy.
- Invest through “private-placement life insurance” (PPLI) policy.

Our Contact Information



A boutique law firm dedicated to providing sophisticated international estate and tax planning advice to high-net-worth clients.

Amy Jetel, Esq.

Attorney-at-Law

mobile: 281.406.4749

office: 512.370.2747

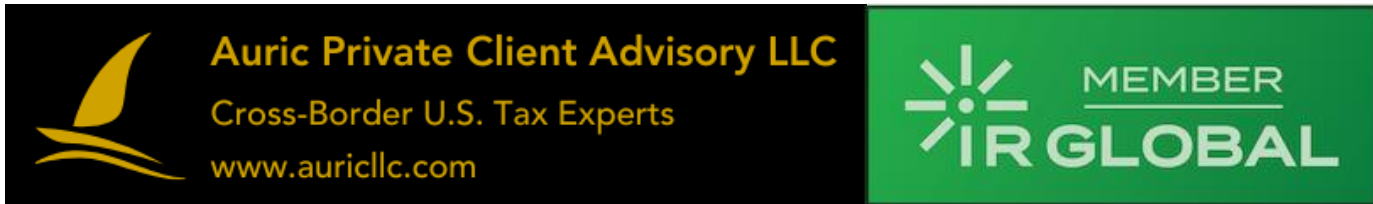
email: amy@jetel-law.com

Jetel Law, PLLC

2630 Exposition Blvd. | Suite 203 | Austin, Texas 78703

www.jetel-law.com

Our Contact Information



A boutique tax advisory firm focused on cross-border U.S. tax compliance and reporting for trusts, estates, private clients, family offices, and closely held businesses.

Milan Solarz-Patel

Founder & Chief Tax Advisor (CTA)

Mobile: +1 (917) 439-3912

E-mail: milan@auricllc.com

Auric Private Client Advisory LLC

3948 Market St., No. 24676 | Minneapolis, MN 55424 | USA

www.auricllc.com

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