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Foreign Trusts:
Everything You Wanted to Know About the Taxation of Foreign Trusts But Were Afraid to Ask

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I. Introduction

The U.S. taxation of foreign trusts and trusts with foreign grantors was altered substantially by the Small Business Job Protection Act of 1996 ("1996 Small Business Act")[1] and the Taxpayer Relief Act of 1997 ("1997 TRA")[2] The relevant provisions of those Acts were enacted in an attempt to curb some of the serious foreign trust tax abuses that were perceived to exist before their enactment by the U.S. Treasury Department ("Treasury") and Internal Revenue Service ("IRS" or "Service"). This paper will attempt, in a general way, to describe the numerous changes made by those Acts and the regulations and other guidance issued in the ensuing 12 years that have resulted in the current regime for taxing foreign trusts and trusts with foreign grantors.

II. What is a Trust?

Before attempting to discuss the taxation of foreign trusts, it is necessary to understand what is considered to be a "trust" for U.S. tax purposes. Although there are numerous provisions throughout the Code[3] that refer to "trusts," the Code nowhere expressly defines what is a "trust," While most of us might believe that we can recognize a "trust" as a matter of law, the determination of trust status under the U.S. tax entity classification scheme is not always a simple matter. This is particularly true when one tries to classify an exotic foreign vehicle, such as a *foundation* (also frequently referred to as a *stiftung*), *usufruct*, *treuhand*, *establishment* or other similar construct. However, even determining the tax classification of what, at first glance, might appear to be a garden variety Anglo-Saxon trust is not always an easy task.

Generally, an arrangement will be treated as a "trust" if its purpose is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not "associates" in a joint enterprise for the conduct of a business for profit.[4] It is the presence of a business purpose and "associates" that courts have generally found to

[1] Pub. L. No. 104-188 (Aug. 20, 1996).

[2] Pub. L. No. 105-34 (Aug. 5, 1997).

[3] References to the "Code" and all section references are to provisions of the U.S. Internal Revenue Code of 1986, as amended, and to the Treasury regulations issued thereunder.

[4] Treas. Reg. § 301.7701-4(a).

distinguish an association taxable as a corporation from a trust.[5] Merely because an organization is technically organized in trust form will not change that organization's real character if the organization is more properly classified as a business entity.[6]

It is against this classification scheme that one must assess whether a foreign structure should be treated as a trust for U.S. tax purposes. There are few cases or rulings providing guidance. The best known case likely is Estate of O.T. Swan,[7] in which the Tax Court found that *stiftungs* organized in Liechtenstein and Switzerland should be treated as trusts for tax purposes. In PLR 9121035,[8] the IRS characterized a *usufruct* under German law as a foreign nongrantor trust. However, the finding (which is not precedent in all events) likely is limited to its facts. Most commentators consider a *usufruct* to be more in the nature of a life estate. Most of the other trust-like structures have not been officially classified.

III. Residence of Trusts

Under prior law, a trust was considered foreign or domestic based upon such factors as the residence of the trustee, the principal place of trust administration, the governing law of the trust, the nationality of the trust settlor and the beneficiaries, and the situs of trust assets.[9] The 1996 Small Business Act replaced this subjective "facts and circumstances" test with an objective test to determine whether a trust is foreign or domestic.

A trust will be considered *domestic* if (i) a U.S. court can exercise primary supervision over trust administration (the "court test"), and (ii) U.S. persons control all substantial trust decisions (the "control test").[10] All other trusts are foreign.[11] This trust residency definition is effective for taxable trust years beginning after December 31, 1996, unless the trustee elected to apply the new definition retroactively to August 20, 1996.

For purposes of the court test, the regulations provide that a U.S. court includes any federal, state, or local court located in the 50 states plus the District of Columbia; a court within a U.S. territory or possession is not a U.S. court.[12] A U.S. court is considered to have primary supervision if the court has or would have the authority to

[5] The seminal case is the Supreme Court's decision in Morrissey v. Commissioner, 296 U.S. 344 (1935). *See also* Estate of Beddell Trust v. Commissioner, 86 T.C. 1207 (1986), Elm Street Realty Trust v. Commissioner, 76 T.C. 803 (1981, *acq.* 1981-2 C.B. 1.

[6] Treas. reg. § 301.7701-4(b).

[7] 24 T.C. 829 (1955), *aff'd* 247 F.2d 144 (2d Cir. 1957). The IRS cited the Swan decision favorably in PLR 200302005.

[8] 91 TNT 116-47 (Feb. 25, 1991).

[9] *See* Rev. Rul. 87-61, 1987-1 C.B. 765, citing B.W. Jones *v.* Commissioner, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943).

[10] Treas. Reg. § 7701(a)(30)(E).

[11] Treas. Reg. § 7701(a)(31)(B).

[12] Treas. Reg. § 301.7701-7(c).

determine substantially all issues concerning administration of the entire trust, *i.e.,* fiduciary decisions affecting the entire trust.[13]

The regulations contain a "safe harbor" test under which a trust is considered to meet the court test if:

(i) the trust deed does not direct that the trust be administered outside the United States;

(ii) the trust is, in fact, administered exclusively in the United States; and

(iii) the trust is not subject to an automatic "flee clause" pursuant to which the trust migrates from the United States in the event that a U.S. court attempts to assert jurisdiction over the trust's administration.

The control test will be considered to be satisfied if U.S. persons control all substantial decisions affecting the trust and no foreign person acting in any capacity can overcome the decisions of the controlling U.S. persons.[14] "Substantial decisions" generally means decisions that persons are authorized or required to make under the terms of the trust agreement or applicable law that are not merely ministerial. Such decisions include, for example, the amount and timing of distributions and whether to make them from income or corpus, the selection of beneficiaries, investment decisions, whether to terminate the trust, and decisions regarding trustee changes.

Note that the regulations afford a trust 12 months to replace persons with authority to make all substantial decisions for a trust in the event there is an inadvertent change in control that would cause the residency of the trust to change.[15] For this purpose, an "inadvertent change" includes the death, incapacity, resignation or change of residency of a person having power to control a trust's substantial decisions that was not anticipated and not intended to cause a change of trust residence. If a subsequent change of control is made within 12 months of the inadvertent change, the trust will be treated as maintaining its pre-change residency throughout the 12-month period. If not, the change of residency will be considered to have occurred on the date of the inadvertent change.[16]

[13] *Id.* Note that a court can have primary supervision, notwithstanding that another court has jurisdiction over a trustee, beneficiary, or trust property.

[14] Treas. Reg. § 301.7701-7(d).

[15] Treas. Reg. § 301.7701-7(d)(2).

[16] If, despite reasonable actions, a trust is unable to make curative changes within 12 months due to circumstances beyond its control and can establish reasonable cause, the trust may request a reasonable extension of time to make the necessary control changes. Granting of such a request is within the discretion of the IRS. *Id.*

IV. General Rules of Trust Taxation

The Code has several regimes for taxing trusts, depending upon whether they are "grantor," simple or complex trusts. In addition, there are several special rules applicable to foreign trusts or trusts having non-U.S. grantors.

If a trust is a grantor trust (within the meaning of sections 673 through 679 of the Code), its income and gains generally will be taxed to the grantor.[17] A trust having a U.S. grantor will be considered a grantor trust if, inter alia, the grantor or another non-adverse party retains certain interests or powers over the trust property. A foreign trust established by a U.S. person that has, *or may have,* U.S. beneficiaries will also be considered a grantor trust, even if the grantor has retained no interests in or powers over the trust.[18] In addition, a foreign trust established by a non-U.S. person who becomes a U.S. person within five years of transferring property to the trust, directly or indirectly, will be a grantor trust if, at the grantor's residency starting date, the trust has a U.S. beneficiary.[19]

If a trust (whether domestic or foreign) has a grantor that is not a U.S. person, more limited rules, introduced by the 1996 Small Business Act, apply in determining whether the trust will be treated as a grantor trust.[20] In such a case, a trust generally will be treated as a grantor trust only if: (i) it is revocable by the grantor (either alone or with the consent of a related or subordinate party who is subservient to the grantor); or (ii) distributions (whether of income or corpus) may be made only to the grantor or the grantor's spouse during the grantor's lifetime.[21] Trusts that were established on or before September 19, 1995 that were grantor trusts under the general rules of sections 676 (revocable trusts) or 677 (income for benefit of grantor or spouse)[22] are "grandfathered" as grantor trusts, provided that if any amounts were transferred to such trusts after September 19, 1995,[23] the portion of the trust attributable to such transfers is separately accounted for.[24]

In contrast, a non-grantor trust (whether domestic or foreign) is a separate taxpayer for U.S. federal income tax purposes. A non-grantor trust is generally taxed in the same manner as individuals, with certain modifications.[25] Thus, like a U.S.

[17] § 671.

[18] § 679.

[19] This rule, for so-called "pre-immigration trusts," was added to the Code by the 1996 Small Business Act. It is effective for transfers of property occurring after February 6, 1995. Prior to the addition of this rule, a foreign trust established by a nonresident alien, who later became a U.S. person, was not a grantor trust under § 679, absent a post-residence transfer in trust or the inclusion of provisions that would make the trust a grantor trust under other sections.

[20] *See generally* § 672(f).

[21] § 672(f)(2).

[22] Not including trusts that were grantor trusts under § 677(a)(3) (regarding application of trust income to insurance premiums on lives of grantor or spouse).

[23] 1996 Small Business Act § 1904(d)(2).

[24] *See* Notice 97-34, 1997-1 C.B. 422.

[25] § 641(b).

citizen or resident, a domestic trust will pay U.S. tax on its worldwide income and capital gains. Items of ordinary income (including, for example, rents, royalties, certain dividends and interest) generally are taxed at graduated rates of up to 35%, after the allowance of certain deductions and credits. Gains from the sale or exchange of capital assets (such as stock) held for more than 12 months generally are taxed at a long-term capital gain rate of 15%. Gains arising from the sale or exchange of capital assets held for twelve months or less are generally taxed at the trust's ordinary income tax rate. Like a nonresident alien, a foreign trust will pay U.S. income tax only on its income and certain gains from U.S. sources and on income or gain that is "effectively connected" to a U.S. trade or business.[26]

In calculating its taxable income, a trust will receive a deduction for distributions to its beneficiaries, to the extent that these distributions carry out the trust's "distributable net income" ("DNI") for the taxable year.[27] Any DNI so distributed will retain its character in the hands of the recipient beneficiaries and will be taxed to them.[28] In the case of domestic trusts, DNI consists of the trust's fiduciary accounting income, with certain adjustments.[29] Thus, any distributions of DNI by a domestic trust to beneficiaries will constitute ordinary income in their hands and will be taxed at their applicable income tax rate. Capital gains of a domestic trust generally do not enter into the DNI calculation and are usually taxed to the trust.[30] Any distributions by a domestic trust to beneficiaries in excess of DNI will be a non-taxable distribution of capital; thus, any accumulated income and gains of a domestic trust are taxed only to the trust and are not taxed again when distributed to a beneficiary.[31]

Foreign trusts must include both capital gain and ordinary income items in their DNI.[32] Distributions to beneficiaries are considered first to carry out the DNI of the current year (pro rata as to each item of income or gain) and will be taxed to the recipient beneficiaries.[33] 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.

In order for a trust to obtain a distribution deduction for a transfer of property to another trust, it must be clear that the transfer to the second trust represents a distribution to a "beneficiary." For this purpose, a beneficiary is defined to include "an heir, legatee, or devisee (*including an estate or trust*)."[34] Thus, it is specifically

[26] § 872(a).

[27] § 661(a).

[28] § 662(b). Because a trustee cannot know the exact amount of a trust's DNI until the close of the taxable year, and the calculation is complex, a trust may elect to treat distributions made in the first 65 days of the ensuing taxable year as having been made on the last day of the preceding taxable year. § 663(b).

[29] § 643(a).

[30] § 643(a)(3).

[31] § 665(c).

[32] § 643(a)(6).

[33] § 662(a), (b).

[34] *See* Treas. Reg. § 1.643(c)-1 (emphasis added).

contemplated that a trust can be a "beneficiary" and receive distributions of DNI. On the other hand, if the transfer represents only a division of the first trust into sub-trusts, then the second trust will be considered to have received a pro rata portion of each of the first trust's account items, including DNI, UNI and capital, and there will have been no distribution to a beneficiary that carries out trust income first.

Case law indicates that the determination of whether a transfer from one trust to another is a distribution to a new trust (as opposed to a sub-trust) is dependent in large part on whether the governing instrument of the existing trust permits and intends that transfers will be made to a new, separate trust, rather than continue to be held in the existing trust.[35] This requires an examination of the respective trust deeds and all surrounding circumstances. Assuming that the original trust deed contemplates transfers to other trusts for the benefit of beneficiaries, the critical factor appears to be whether there are material differences in the trusts.

V. Some Special Tax Rules Applicable to Foreign Trusts

The Code contains a number of special taxing provisions applicable to foreign trusts. Perhaps the most important of these, the "throwback rule" applicable to distributions of accumulated income from foreign trusts, predates the changes made by the 1996 Small Business Act, although that Act made certain changes to the rule. Others are provisions added to the Code by the 1996 legislation or the 1997 TRA.

A. "Throwback Rule"

If a foreign trust does not distribute all of its DNI in the current year, the after-tax portion of the undistributed DNI will become "undistributed net income" ("UNI").[36] In subsequent tax years, any distributions from the trust in excess of the DNI of the current taxable year will be considered to come next from UNI, if any, on a first-in, first-out basis. Only after DNI and UNI are exhausted are distributions considered to come from non-taxable trust capital.[37]

Distributions of the UNI of a foreign trust received by a U.S. beneficiary are taxed under the "throwback rule," which generally seeks to treat a beneficiary as having received the income in the year in which it was earned by the trust.[38] The throwback rule effectively results in tax being levied at the recipient's highest marginal income tax rate for the year in which the income or gain was earned by the trust. Thus, any capital gains accumulated by a foreign trust for distribution in a later taxable year lose their character and are treated as ordinary income. In addition, the throwback rule adds an interest charge to the taxes on a throwback distribution in order to off-set the benefits of tax

[35] *See, e.g.,* Lynchburg Trust & Savings Bank v. Commissioner, 68 F.2d 356 (4th Cir. 1934).

[36] § 665(a); Treas. Reg. § 1.665(a)-1A(b).

[37] §§ 665(b), 666.

[38] § 667. The throwback rule was formerly applicable to distributions of UNI from domestic trust, too, but this application was repealed by the 1997 TRA.

deferral.[39] The interest charge accrues for the period beginning with the year in which the income or gain is recognized and ending with the year that the UNI amount is distributed, and is assessed at the rate applicable to underpayments of tax, as adjusted, compounded daily.

Because of the draconian consequences of the throwback rule, which can leave little net economic benefit after tax and interest charges when long-accumulated earnings are distributed to U.S. beneficiaries, many foreign trusts having substantial UNI accounts distribute only DNI on a current basis, preferring to maintain their pool of UNI as an untaxed lode-stone to earn more current income. Even domesticating a foreign trust in the U.S., which no longer has a throwback rule for domestic trusts, does not avoid the consequences of the throwback rule. The throwback rule continues to apply to such a trust to the extent that trust distributions following domestication are made from the historic UNI account accumulated while the trust was a foreign trust.[40]

Thus, there is a general desire of foreign trusts (and domesticated foreign trusts) to find a means to access their accumulations without suffering the full economic consequences of the throwback rule. Because, following enactment of the 1996 Small Business Act, Treasury needed to provide guidance for U.S. beneficiaries receiving distributions from foreign trusts accompanied by no information to assist them with the proper reporting of the distribution, Treasury and the Service created the so-called "default method" as a means by which a beneficiary of a foreign trust having no knowledge of the character of receipts from the trust can report his receipts for U.S. tax purposes.[41] An incidental benefit of the default rule is that it allows foreign trusts with UNI accounts to distribute their accumulated earnings to U.S. beneficiaries without causing them to suffer the full economic consequences of the throwback rule, in particular the interest charge for the benefit of deferral. However, there can be some trade-offs in electing to use the default method. Once the default method is used, the actual character of *all* distributions (except those received in the last year of the trust) will be lost, and all distributions will be taxable at rates applicable to "ordinary income," even if the trust otherwise would be considered to distribute long-term capital gains, tax-exempt income, or even non-taxable trust capital.[42]

Under the default method, only tax on that portion of a foreign trust distribution that exceeds 125% of the average of the distributions received during the prior three years is subject to the compounded interest charge applicable to accumulation distributions. Thus, it should be possible economically to "model" distributions from a trust to ensure that no amount of a distribution ever exceeds 125% of the prior three-

[39] § 668.

[40] Rev. Rul. 91-6, 1991-1 C.B. 89.

[41] The default rule is wholly an administrative creation and has no statutory underpinning, other than the usual grant of authority to Treasury and the Service to issue regulations and rules that are necessary to carry out Congressional intent. The method is described only in the instructions to Form 3520.

[42] This reflects that the default method was designed principally to be used by beneficiaries obtaining no information from a trust as to the character or vintage of distributions received.

year average distribution. When it comes time to consider how to, effectively, "bail out" the trust's UNI account, the trustees can employ investment strategies to create sufficient DNI in each year of the three-year averaging period that will enable them comfortably to distribute the remaining UNI to beneficiaries electing to report their receipts under the default method over the remaining years of the trust. Obviously, this will depend upon the value of the UNI account, the number of trust years remaining, and the trustees' ability to generate sufficient income during the averaging period, among other things.

Once a trust's default distributions have carried out all UNI, the trustees can elect to terminate the trust. In the last year, the trust is once again entitled to use the "actual" method in determining the tax consequences of the distributions to the beneficiaries. If only capital or other non-taxable items remain (*e.g.,* tax-exempt income), the final year distributions to beneficiaries will be tax-free.

B. Section 684

A second major provision that, effectively, applies only to transfers to foreign trusts is found in section 684, which was added to the Code by the 1997 TRA. The section generally provides that any transfer of property by a U.S. person to a foreign trust is treated as a taxable exchange of the property, except in certain circumstances.[43] Concurrent with the enactment of section 684, the 1997 TRA repealed former sections 1491-1494, which had imposed a 35% "excise tax" on transfers by U.S. persons to foreign trusts and certain foreign corporations. The repeal of the excise tax, for which there was little guidance or precedent, was widely welcomed by practitioners, since it imposed a potential[44] significant tax without the recognition of gain or consequent basis step-up in the property.

The principal statutory exception to section 684's gain recognition rule is for transfers to foreign trusts if any person is treated as owner of the trust under the grantor trust rules. Thus, for example, a transfer by a U.S. person to a foreign trust that is treated as a grantor trust as to the transferor under section 679 does not result in gain recognition.[45] Additional exceptions to section 684's gain recognition rule are provided by regulation for transfers: (i) to a foreign charitable trust described in section 501(c)(3) (without regard to the requirements of section 508); (ii) for fair market value to a

[43] Note that § 684 results only in the recognition of gain on the transfer of appreciated assets; losses are not recognized.

[44] There were a variety of means by which to legitimately avoid the imposition of the § 1491 excise tax. Thus, it was rarely imposed, generally only in the case of inadvertent transfers or transfers by taxpeyers who were not well advised.

[45] § 684(b), as applicable to transfers on or before December 31, 2009.

foreign trust that is not considered a related trust[46]; and (iii) by reason of the death of the U.S. transferor if the trust is considered to be within the decedent's estate and takes a stepped-up basis in the property pursuant to section 1014(a).[47] In addition, there is an exception for distributions to a foreign trust in respect of interests held by the trust in non-trust entities (*e.g.*, dividends on U.S. securities or distributions from U.S. partnerships) or certain investment or commercial trusts.[48]

Section 684 also provides that an outbound trust "migration," by which a domestic trust becomes a foreign trust, is treated as a taxable transfer by the domestic trust of all property to a foreign trust immediately before the trust's change of residence status, unless one of section 684's exception, described above, applies.[49]

C. Loans from Foreign Trusts; Intermediary Transfers

Several other special rules, generally of an "anti-abuse" nature, were added to the Code by the 1996 Small Business Act. These include the rules pertaining to the treatment of loans from foreign trusts, found in section 643(i), and those pertaining to distributions through "intermediaries" found in section 643(h).

Except as provided in regulations, loans of cash (including foreign currencies) or marketable securities by a foreign trust to any grantor, beneficiary or other U.S. person related to a grantor or beneficiary[50] is now treated as a trust distribution, generally taxable under the normal trust rules.[51] However, if the loan within the ambit of section 643(i) is made to a person other than a grantor or beneficiary, it will be treated as a distribution to the grantor or beneficiary to whom the person is related.

As yet, Treasury has not issued any regulations under section 643(i) to indicate what loans might be excepted from the reach of the provision. The legislative history to the provision suggested that Congress intended that commercially reasonable loans

[46] For this purpose, "fair market value" is defined generally to include the value of property and services received from the trust. An interest in the trust is not considered "property" and only certain "qualified obligations" given by the trust will be taken into consideration.

[47] Treas. Reg. § 1.684-3(a)-(c).

[48] Treas. Reg. § 1.684-3(f).

[49] *See* Treas. Reg. § 1.684-4. Note that, on a trust migration, gains *and losses* are considered realized. Note also that a trust is provided with the curative 12-month period previously described in the case of an inadvertent migration resulting in a change of trust residence. *See* Treas. Reg. § 301.7701-7(d)(2).

[50] A person is treated as related to another person if the relationship would result in loss disallowance under the rules of §§ 267 or 707(b). For this purpose, § 267(b)(4) is applied as if an individual's family includes the spouses of family members. § 643(i)(2)(B).

[51] Note that under § 643(e), the amount of a distribution of property in kind is limited, absent an election for the trust to recognize gain on the distribution, to the lesser of the trust's basis in the property (increased by any gain recognized on the distribution) or the property's fair market value. This might present opportunities on the distribution of marketable securities.

should be outside the provision.[52] In Notice 97-34,[53] the Service announced that "qualified obligations" would be excepted from the general rule of section 643(i). For this purpose, a "qualified obligation" is any obligation that is: (i) in writing; (ii) has a maturity that does not exceed five years (and cannot be extended); (iii) all payments are made only in U.S. dollars; and (iv) the yield to maturity is between 100 and 130 percent of the applicable adjusted federal rate. In addition, the obligor or related grantor or beneficiary must extend the period for assessment to a date three years beyond the obligation's maturity date and must, in addition, report the ongoing status of the obligation, including principal and interest payments, on Form 3520, discussed below.[54]

Finally, it should be noted that the repayment of a foreign trust loan treated as a distribution is disregarded for tax purposes.[55] The potential consequences of this provision are uncertain. However, the clear implication of this is that the reporting U.S. person cannot deduct interest payments for any tax purposes either. This could come as a surprise to an obligor other than a trust grantor or beneficiary.

The provision relating to distributions through intermediaries, section 643(h), is more complex, if less bewildering. Even prior to the changes made by the 1996 Small Business Act, the Code contained a rule which sought to block the avoidance of U.S. tax on indirect distributions via intermediaries from foreign trusts created by U.S. persons.[56] New section 643(h) expands the scope of the provision to include indirect distributions through intermediaries from foreign trusts established by anyone. However, the provision expressly excludes distributions made through the trust's grantor, who cannot be an intermediary for purposes of the rule.

Treasury has issued regulations under the new intermediary rule. In general, they characterize distributions from foreign trusts as made via an intermediary only if the intermediary is considered to have received the property pursuant to a plan having a principal purpose of avoiding U.S. tax. Such a purpose will be deemed to exist if:

(1) if the U.S. person receiving property from the intermediary is related to the trust's grantor or has another relationship with the grantor from which it may reasonably be inferred that the grantor would make a gratuitous transfer to the U.S. person;

(2) the U.S. person receives from the intermediary within a four-year period commencing 24 months before and ending 24 months after the intermediary received property from the foreign trust either the property the intermediary received or the proceeds therefrom; and

[52] *See* H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 334 (1996).

[53] Notice 97-34, note 24, *supra*, at § V.A.

[54] *Id.*

[55] § 643(i)(3).

[56] Former § 665(c).

(3) the U.S. person is unable to demonstrate that (i) the intermediary has a relationship with the grantor that from which it is reasonable to infer that the intermediary would make a gratuitous transfer to the U.S. person, (ii) the intermediary acted independently of the grantor and trustee, (iii) the intermediary is not an agent of the U.S. person under general agency principles, and (iv) the U.S. person timely reported the receipt as a large foreign gift or bequest if the amount exceeded $100,000 and the intermediary is a foreign person.[57]

The examples in the regulations indicate that the facts and circumstances will be closely scrutinized to determine if the presumption is overcome.[58] If either the transfer from the foreign trust to the intermediary or from the intermediary to the U.S. person is not considered to be a gratuitous transfer because, for example, it is made in a fair market value exchange, the intermediary rule won't apply. Nor does it apply if the aggregate value of transfers received from foreign trusts (directly or through intermediaries) during the taxable year does not exceed $10,000.

Finally, note that the timing and amount of an indirect transfer via an intermediary will be affected depending upon whether the intermediary is considered to be an agent of the foreign trust or U.S. person.

VI. Tax Reporting for Transactions with Foreign Trusts

In order to assist the IRS to improve its administration of the tax rules pertaining to transactions involving foreign trusts, a major objective of the 1996 Small Business Act was to enhance the reporting of such transactions. Reporting was relatively sparse and infrequent under prior law, in substantial part because the penalties for failure to file required returns were nominal, amounting to only $1,000 per missed return. Accordingly, besides increasing the transactions required to be reported, Congress significantly increased the penalties for failure to report in order to provide a powerful inducement to taxpayers to file required reports. This initially sent chills through the affected taxpayer community, which were magnified as many foreign fiduciaries threatened at first not to cooperate, as necessary, claiming the reporting to be both an unwarranted extraterritorial exercise of U.S. sovereignty and a breach of the bank secrecy and confidentiality laws existing throughout the offshore financial centers where most of the fiduciaries are found. However, the IRS persevered in its enforcement efforts under the new law, and 12 years later, foreign trust reporting, although still frequently difficult and expensive, is quite robust.[59]

[57] Treas. Reg. § 1.643(h)-1(a)(2).

[58] *See, e.g.,* Treas. Reg. § 1.643(h)-1(g), Examples 2, 3 and 6.

[59] It is irrefutable that the efforts of the IRS in this regard were significantly assisted by the continuing efforts of international organizations like the Financial Action Task Force and OECD to combat global money-laundering, improve financial regulation in the offshore financial centers and curb tax haven abuses.

The foreign trust reporting rules introduced by the 1996 Small Business Act are found principally in section 6048. That section requires disclosure by U.S. persons of the following information pertaining to transactions involving foreign trusts:

(1) A "responsible party" (*i.e.*, grantor, transferor or executor) must provide notice of (i) the creation of a foreign trust by a U.S. person, (ii) the transfer of money or property to a foreign trust, including by reason of death, (iii) the death of a U.S. person treated as "owner" of a foreign trust under the grantor trust rules or if any portion of a foreign trust was included in the decedent's estate.[60]

(2) U.S. persons treated as "owners" of a foreign trust must annually file a return confirming such status and must also ensure that the trust files a return providing a full and complete accounting of all trust activities and operations and provides an annual statement to the owner and any U.S. person who receives a distribution from the trust.[61]

(3) U.S. beneficiaries of a foreign trust who receive any distribution during a taxable year, whether or not taxable, must disclose such receipt. If the disclosure is not accompanied by adequate records to determine the proper tax treatment of the distribution, the IRS is authorized to treat the entire distribution as an accumulation distribution subject to a somewhat modified version of the "throwback rule" previously described.[62]

The reporting of these transactions by grantors, transferors, owners and beneficiaries is done principally on a revised and greatly expanded Form 3520, an omnibus reporting form which efficiently organizes the various information disclosures required by the statutory provision into separate sections.[63] Form 3520, if due from a

[60] § 6048(a). Transfers for fair market value consideration and to certain deferred compensation trusts and trusts *determined* by the IRS to be described in § 501(c)(3) are excepted.

[61] § 6048(b). The owner's disclosure is filed on Form 3520. It should be supported by a "foreign grantor trust owner's statement" ("FGTOS") obtained from the trustees. A form of the FGTOS is attached to Form 3520-A. The trust's return is filed on Form 3520-A. It is intended that the trust's return be prepared and signed by the trustees, but if they are reluctant to do so, the IRS has accepted Forms 3520-A prepared at the direction of , and signed by, the trust owner. Note that, if the trust does not designate a limited "United States agent" (frequently the trust's owner for grantor trust purposes) for service of process by the IRS, the IRS is authorized to determine the tax consequences of the trust to the owner. Thus, it is recommended that such foreign trusts always appoint an agent in the form required by the IRS. A principal benefit of appointing a U.S. agent is that the trust deed and ancillary documents do not have to be provided the IRS unless specifically requested.

[62] § 6048(c). In order to avoid characterization as an accumulation distribution, a beneficiary must obtain and provide a statement from the trustees in a form required by the IRS. Depending upon the status of the trust, this might be a "foreign nongrantor trust beneficiary statement" ("FNGTBS") or a "foreign grantor trust beneficiary statement" ("FGTBS"). The information required to be included in these forms is set forth in the instruction to Form 3520, and a form of a FGTBS is attached to Form 3520-A. *See also* Notice 97-34, note 24, *supra.*

[63] Form 3520 is also used to report the receipt by U.S. persons of large foreign gifts and bequests, as required by § 6039F, which was also added to the Code by the 1996 Small Business Act. The statutory provision requires that the receipt of all such gifts in a taxable year in excess of $10,000 must be disclosed. However, in Notice 97-34, note 24, *supra*, the IRS announced that gifts and bequests from foreign

taxpayer, is required to be filed on or before the due date (with extensions) for a taxpayer's income tax return. A trust's return on Form 3520-A, required in the case of a foreign grantor trust with a U.S. owner, is required to be filed on or before March 15 of each year for the preceding year. The difference in the filing dates is confusing and a trap for the unwary. Numerous commentators have recommended to Treasury and the IRS that the due dates for filing the two trust reporting forms be made uniform.

As indicated above, the penalties for failure to file (or timely file) the several trust information returns are significant and are found in section 6677. The penalty for failure to file notice of a transfer in trust under section 6048(a) or receipt of a trust distribution under section 6048(c) is 35% of the gross value of property transferred to the trust or received, respectively.[64] If a U.S. owner of a foreign trust fails to ensure that a trust return is filed on Form 3520-A, the applicable penalty is equal to 5% of the gross value of assets considered owned by the taxpayer at the end of the year in question.[65] Additional penalties of $10,000 per month can accrue for continued failure to report after receipt of a notice from the IRS. In all cases, the penalties may be abated if the taxpayer can demonstrate that the failure to timely file a required information return was due to "reasonable cause." The fact that a foreign jurisdiction would impose a civil or criminal penalty for disclosing the information is expressly not considered to be reasonable cause.[66]

Finally, in addition to Forms 3520 and 3520-A, an owner or beneficiary of a foreign trust may be required to disclose their financial interest in or signature authority over foreign financial accounts held by the trust, including bank and brokerage accounts, on Form 90-22.1 ("FBAR"). The instructions to the current FBAR state that a U.S. person is considered to have a "financial interest" in accounts held by a trust in which such person has either a present beneficial interest in more than 50% of the assets or from which the person receives more than 50% of the current income. Although the financial account reporting is authorized under the Bank Secrecy Act and not the Code, so that it is uncertain whether the import of the Code's grantor trust rules are applicable, it generally is prudent that grantors considered to "own" more than 50% of a trust's assets for tax purposes file the form.[67] This is especially true in light of fact

individuals must be reported in any year only to the extent that aggregate gifts from such individual exceeds $100,000 (which is not indexed annually). Purported gifts from foreign partnerships and corporations must still be disclosed if they exceed $10,000 in any taxable year (which figure is indexed). Note that any gift or bequest received from a foreign trust is reported under the rules applicable to distributions from foreign trusts. The large gift reporting provision also contains a steep penalty of 5% per month up to 25% for failure to disclose such gifts and bequests. As with the other reporting penalties, the penalty is abated for "reasonable cause" shown by a taxpayer.

[64] § 6677(a), (c).

[65] § 6677(b), (c).

[66] § 6677(d).

[67] From January 1, 2009, a U.S. grantor's liability to file the form may become clearer. A new version of the FBAR, applicable from that date, adds an instruction that indicates that a U.S. person who established a foreign trust will be considered to have a financial interest in the trust's financial accounts if the trust has a "protector" responsible for monitoring the actions of the trustees and with authority to influence decisions of the trustees or to replace the trustees.

that since around 2002, the IRS has been responsible for administration and processing of the FBAR reporting program. There are also significant penalties for failure to timely file the form, and there has been much recent enforcement activity in light of the news of substantial previously undisclosed U.S. ownership of foreign financial accounts.

VII. CONCLUSION

The rules pertaining to the taxation of foreign trust are complex. Despite the changes made by the 1996 Small Business Act and 1997 TRA, there are many issues that are not specifically addressed by the statutory provisions and for which, as yet, there is no further public guidance and little, if any, applicable precedent. In view of the continuing concerns expressed by Congress regarding tax haven abuses, which could lead to new tax-related provisions regarding the foreign activities of U.S. taxpayers,[68] and current IRS offshore enforcement activities pertaining to tax haven abuses in the offshore financial centers, U.S. tax and estate planning practitioners are well advised to have at least a fundamental understanding of the tax rules applicable to foreign trusts.

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[68] *See, e.g.,* the proposed and much discussed "Stop Tax Haven Abuse Act," S. 681, 110th Cong., 1st Sess. (2007). The bill would, *inter alia,* amend the Code to (i) create legal presumptions against the validity of transactions involving "offshore secrecy jurisdictions" (*i.e.*, tax havens identified by Treasury), (ii) increase the period for review and assessment of tax returns involving transactions in such jurisdictions, and (iii) disallow tax adviser opinions validating transactions involving such jurisdictions.