

## Foreign Trusts Primer

**Take-Away:** If a trust is classified as a *foreign trust*, it might be taxed either to its settlor or beneficiary as a *grantor trust* for income tax reporting purposes.

**Background:** The Tax Code uses a specific definition for a *foreign trust* and, to be expected, these trusts are taxed much differently than a domestic trust. In May, 2024, the IRS published proposed regulations that deal with *foreign trusts*, along with the treatment of the receipt of large foreign gifts, all of which are aimed to close perceived abuses regarding *foreign trusts*. The proposed regulations also require new rules on reporting obligations and when a *foreign trust* is either domesticated, or it migrates to the U.S.

**Taxation of a *Foreign Trust*:** The tax consequences of a *foreign trust* can be complicated or more often, come as a surprise. Every *foreign trust* is a *grantor trust* if it has a U.S. donor and a U.S. beneficiary. The U.S. owner of the *foreign grantor trust* is subject to U.S. income tax on the portion of the trust income that he/she is considered to own.

**Owner:** A U.S. individual who is treated as the owner of a *foreign trust* is treated as the grantor of a *grantor trust*. Consequently, he/she is tax on the trust's income, whether it is distributed. [IRC 671-679.] IRC 679 applies to *foreign trusts*; it expressly treats as an owner of the trust a U.S. person who transfers assets to a *foreign trust* or is presumed to have a U.S. beneficiary of the trust. Each U.S. owner of a *foreign trust* must receive a Foreign Grantor Trust Owner Statement [Form 3520-A] from the *foreign trust*, which will include information about the trust's income that the owner must report on his/her own U.S. income tax return. A *foreign grantor trust* with a foreign grantor will only be taxed on income from its U.S. sources.

**Beneficiary:** A U.S. beneficiary who receives a distribution from a *foreign non-grantor trust* will report the beneficiary's share of the trust's distributable net income (DNI.) Depending on whether the U.S. beneficiary is a beneficiary of a *grantor* or a *non-grantor trust*, the beneficiary must receive a Foreign Grantor Trust Beneficiary Statement or a Foreign Non-Grantor Trust Beneficiary Statement, which includes information about the taxability of distributions that the beneficiary has received.

**Gain Recognition:** Gain must be recognized on certain transfers of appreciated assets to a *foreign trust* by a U.S. person, creating an immediate income tax liability on that *phantom* gain. [IRC 684.]

**5-Year Rule:** If a nonresident alien individual becomes a U.S. person and the individual has a residency starting date [this technical date is determined under IRC 7701(b)(2)(A)] within five years after directly or indirectly transferring property to a *foreign trust* (the original transfer), that individual having transferred property to the *foreign trust* is treated as the owner of the percentage portion of the trust attributed to his/her share, starting on their residency date.

**Throwback Rule:** A *foreign trust* is subject to throwback rules. Under the throwback rules, a beneficiary who receives an accumulation distribution is taxed as if the trust had made the distribution in the year that it accumulated the income (perhaps at a marginally higher income tax bracket.)

*Foreign Trust Defined:* A trust is treated as a domestic trust, and not a *foreign trust*, if it passes a control test. That test requires that a U.S. person has *control* over all *substantial decisions* of the trust. In addition, the trust must pass a court trust, which requires a U.S. court to have primary jurisdiction over the trust's administration. While the court test is relatively easy to understand and apply, the control test will require a 'facts and circumstances' determination, which is not always clear may lead to much guesswork.

Aside: In the U.S., the concept of *nationality* is not used {except, maybe, in MAGA circles.}. Rather, a trust is situated at a specific jurisdiction, and a trustee and trust beneficiaries are *domiciled* in a certain jurisdiction. In contrast, *nationality* is primarily used in an international law context.

*Foreign Trust Confusion:* Unfortunately, some entities are not U.S. trusts, but they look like them. Trusts are commonly used for estate planning in the U.S. However, many civil law countries do not recognize trusts and have often enacted laws to provide for other types of entities or arrangements to accomplish similar objectives achieved using a trust. *Waqfs and fideicomisos*, as examples, do not exist in the U.S., yet each of these structures must be analyzed under U.S. laws and the foreign country to determine how that structure will be treated for U.S. tax purposes and if it will be treated as a *foreign trust*. These foreign entities, like an LLC, can file an entity classification election on Form 8832 and elect its tax treatment for U.S. tax purposes.

Form 3520: A Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Foreign Gifts is required to be filed by a U.S. person in several different situations. Those situations include: (i) The person creates or transfers money or property to a *foreign trust* or a loan is made by them to the *foreign trust*; (ii) The person receives distributions from a *foreign trust*, receives the uncompensated use of property held by a *foreign trust*, or receives a loan from a *foreign trust*; (iii) The person is treated as the U.S. owner of a *foreign trust* under the existing *grantor trust* rules; or (iv) The person receives certain large gifts or bequests from *foreign persons*.

Conclusion: This is just an overview of an extremely broad and complex set of tax rules that apply to *foreign trusts*. There are both income tax reporting and information reporting rules that apply to transactions with a *foreign trust*. And to be expected, there are significant penalties associated with the failure to report either the income or the required information. The bottom line is to proceed with a high abundance of caution if you think you are dealing with a *foreign trust* or a bizarre entity formed in another country that might fit within the Tax Code's definition of a *foreign trust*.

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