THE COMPLEXITIES OF FOREIGN TRUST REPORTING

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February 2020
Foreign trusts have been a topic of increased scrutiny in recent years and can be traps for the unwary. In fact, on May 21, 2018, the IRS Large Business and International Division added foreign trust information reporting to its compliance campaigns and is targeting this area in its efforts to improve compliance. This article provides a broad overview of the reporting obligations with respect to foreign trusts.

A foreign trust is a trust that is governed by a foreign jurisdiction or has a foreign trustee that can control all substantial decisions of the trust. Foreign trusts are subject to different Federal tax reporting rules than domestic trusts.

In general, the reporting rules apply to a U.S. person who:

- Creates a foreign trust
- Transfers any money or property to a foreign trust
- Receives a distribution from a foreign trust
- Is treated as the U.S. owner of a foreign trust
- Is a beneficiary who receives a current distribution from a foreign trust

Tax consequences can apply to the U.S. owner and U.S. beneficiaries. In addition, there may be reporting obligations on the trust itself, if it has U.S. source income.

A U.S. owner or U.S. beneficiary is a person who is considered a U.S. citizen or resident for income tax purposes. This includes a U.S. citizen, green card holder or someone that meets the substantial presence test in any tax year.

Foreign Grantor Trusts
A foreign trust is considered a grantor trust for U.S. income tax purposes when a U.S. grantor makes a gratuitous transfer to a foreign trust that has one or more U.S. beneficiaries or potential beneficiaries of any portion of the trust. The trustee of a foreign grantor trust with a U.S. owner is required to file Form 3520-A, Annual Information Return of Foreign Trust with U.S. Owner, with the IRS each year. Such form includes an accounting of the trust's activities for the year. The Form 3520-A is due on March 15th and a six-month extension may be requested.

The trustee should also provide a “Foreign Grantor Trust Owner Statement” to each U.S. owner of a portion of the trust and a “Foreign Grantor Trust Beneficiary Statement” to each U.S. beneficiary who received a distribution during the taxable year.

The trustee must file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, to report any transfers to the foreign trust. Form 3520 must also be filed each year to report ownership of the foreign trust even if no transfer is made. Form 3520 is required to be filed by the due date of the individual’s Form 1040 including extensions.

U.S. beneficiaries of a foreign grantor trust who receive any distribution during the taxable year must also file Form 3520 to disclose the amount and source of the distribution. In addition, the Form 3520 discloses the amount of taxable income that is includible on his or her income tax return. The U.S. beneficiary is also required to disclose the fact that a distribution was received on Form 1040, Schedule B, Part III.

Foreign Non-Grantor Trusts
Foreign non-grantor trusts generally are not subject to U.S. income tax unless the trust earns U.S. source or effectively connected income. Such income is taxed at graduated rates applicable to domestic trusts. Depending upon the investments that the trust holds as well as treaty considerations, the Trusts may be subject to non-resident withholding. Foreign information disclosures may be required as well.

The trustee should provide a Foreign Non-Grantor Trust Beneficiary Statement to a U.S. recipient that received a distribution which reports the amount of the distribution as well as a breakdown of the character of the income. The U.S. beneficiary is required to report the distribution received on Form 3520. In addition, the U.S. beneficiary must pay income tax on the current year trust income included in the distribution and may also be subject to an additional tax (“throwback tax”) to the extent the distribution includes undistributed income from a prior year. Further, in order to deter trusts that do not distribute income currently, an interest charge may be imposed.

Other Reporting Requirements
Form 3520 is also used to report annual gifts or bequests more than $100,000 received by U.S. persons from foreign persons or gifts received from foreign entities in excess of $16,076 annually.

The ownership of foreign trusts and foreign financial accounts by US persons may require other reporting requirements such as FINCEN 114, Report of Foreign Bank and Financial Accounts, Form 8938, Statement of Specified Foreign Assets, and Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

A foreign trust may be an excellent tool for asset protection purposes or foreign tax purposes, but U.S. owners and beneficiaries should be aware of the Federal tax reporting requirements and pay all taxes due even though the trust is domiciled overseas. This is a highly complex area of U.S. taxation and clients should consult their tax advisor.
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