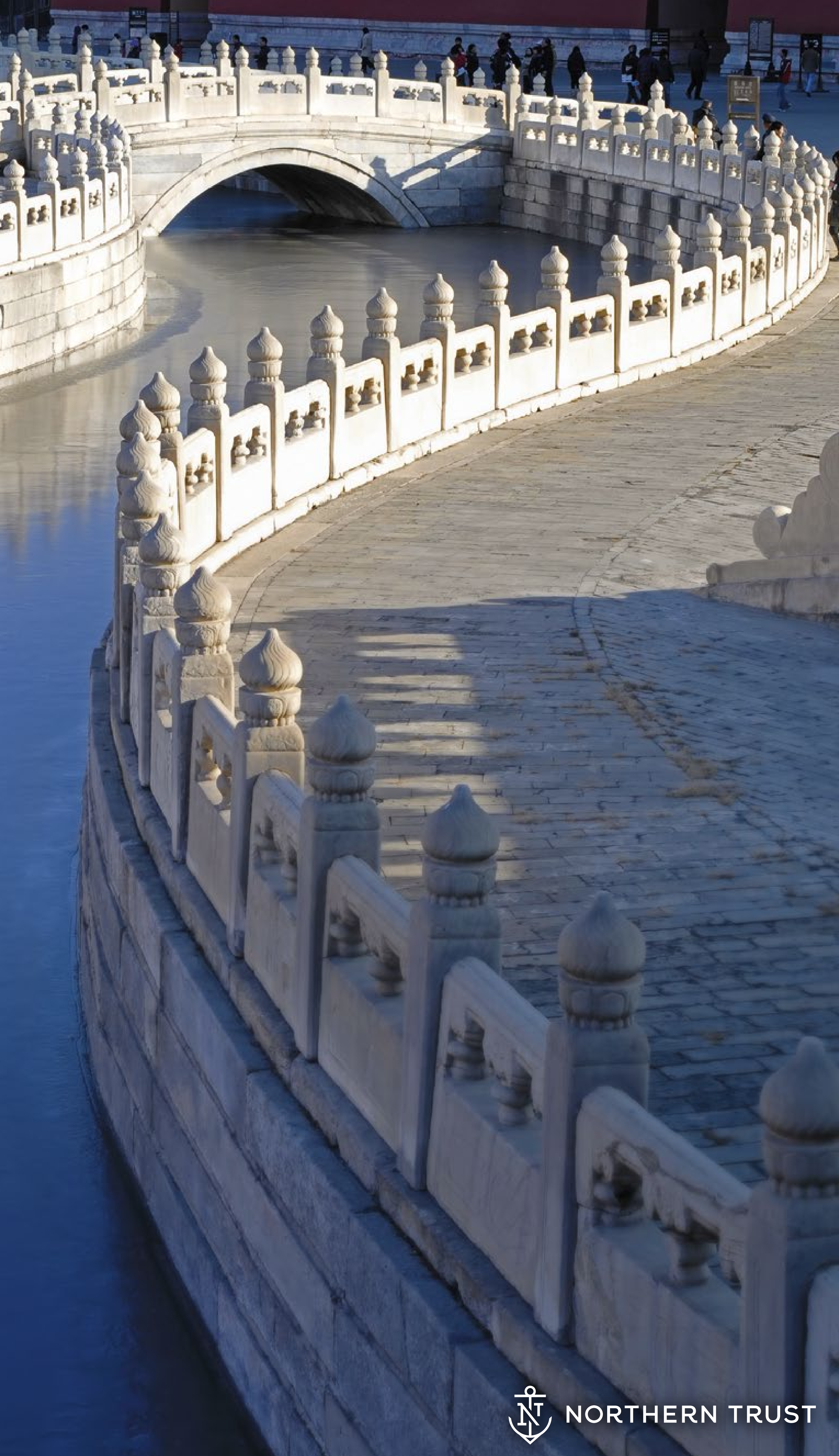
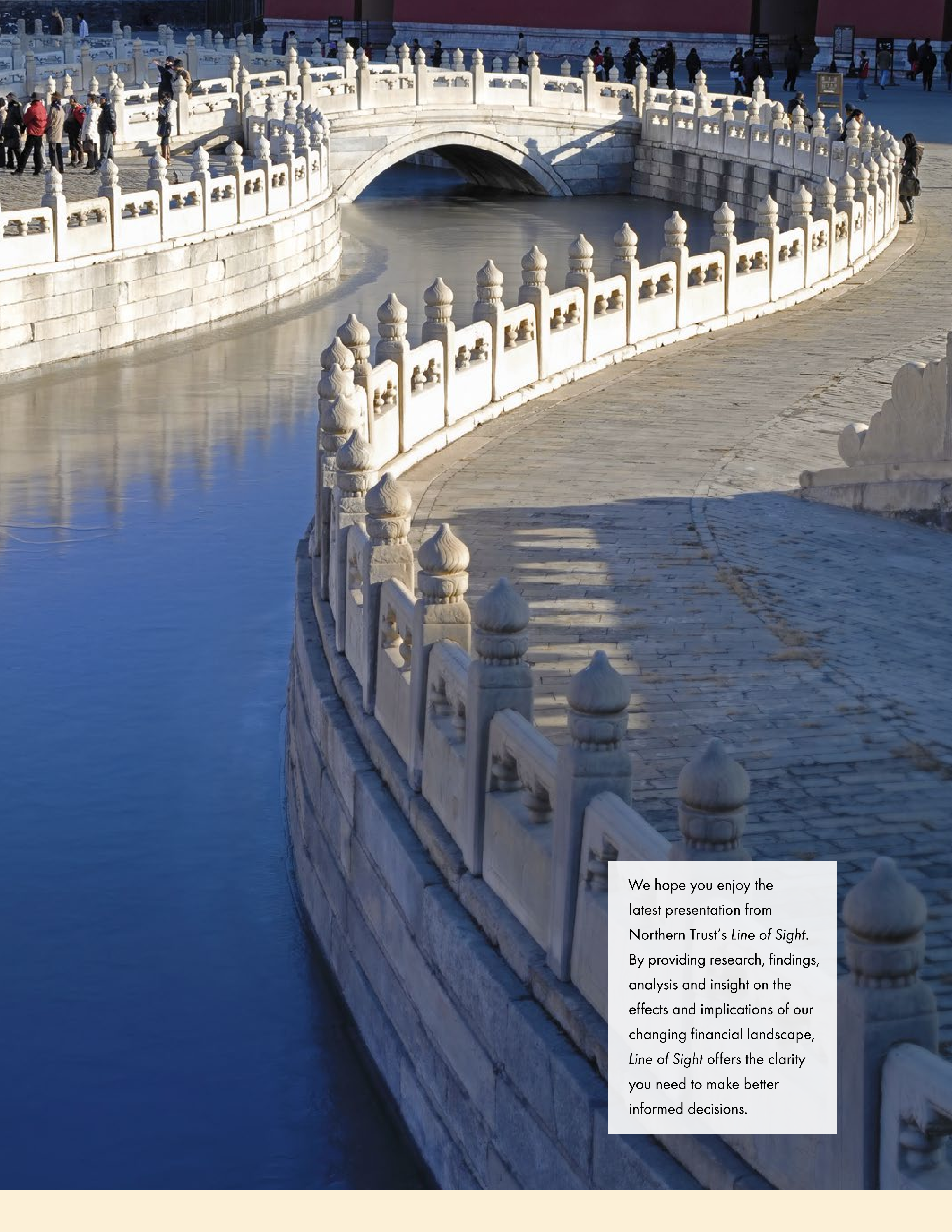


LINE OF SIGHT

Cross-Border Trusts

A Guide to Cross-Border Trust Design and Administration



We hope you enjoy the latest presentation from Northern Trust's *Line of Sight*. By providing research, findings, analysis and insight on the effects and implications of our changing financial landscape, *Line of Sight* offers the clarity you need to make better informed decisions.

LINE OF
SIGHT

CROSS-BORDER TRUSTS

A Guide to Cross-Border Trust Design and Administration

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Mobility is a fact of modern life that has many implications. One area of particular complexity is the U.S. taxation of trusts, grantors and beneficiaries with cross-border contacts. Another is the ever-increasing level of information reporting required for compliance purposes in an environment of scrutiny of international trust structures and emphasis on financial and tax reporting transparency.

This paper highlights many of the most significant aspects of the taxation of cross-border trusts and related compliance reporting from the U.S. perspective as well as the associated planning opportunities. The principal focus is on trusts with U.S. contacts, not on what are commonly referred to as "off-shore" trusts designed to have minimal U.S. contacts.

As one of the leading personal trust companies in the United States, with a strong and growing international presence, Northern Trust is committed to meeting the increasingly complex and sophisticated wealth management needs of our clients. We hope that you find this information helpful as you and your advisors endeavor to create wealth transfer legacies today, tomorrow and for generations to come.

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CROSS-BORDER TRUSTS

A Guide to Cross-Border Trust Design and Administration

MODERN CROSS-BORDER MOBILITY

It is increasingly common for families to own assets internationally, for executives to have international assignments and for families to have members who live abroad or are citizens of various countries. These cross-border circumstances give rise to a multitude of U.S. income, gift, estate and generation-skipping transfer tax consequences, particularly when trusts are involved. Consider some typical scenarios:

Incoming Trusts and Distributions

Parents are citizens and residents of China. They would like to make a substantial gift in trust for their daughter who is a Chinese citizen residing in the United States. If parents establish an irrevocable gift trust in the United States, will U.S. gift taxes apply and will the trust be subject to future estate or generation-skipping transfer taxes? How will the trust be taxed for U.S. income tax purposes?

Grandparents in Europe established trusts overseas for their grandchildren with a foreign trustee many years ago. Grandchild is a U.S. citizen and resident. Now that the grandchild is 21 she will receive a distribution from the trust. How will a distribution from the foreign trust to the U.S. beneficiary be taxed?

Resident's Trusts and Transfers

Husband is a U.S. citizen and resident and wife is a citizen of the United Kingdom who is resident in the United States (wife moved to the United States when the couple married a few years ago). They intend to retire in the United Kingdom and have assets in the United States and the United Kingdom. Will there be any U.S. gift taxes if they transfer property between themselves? What about transfers in trust during life or at death?

Outgoing Trusts and Distributions

U.S. grantor transfers property to a foreign trust for a U.S. beneficiary. What are the tax consequences to the grantor, the trust and the beneficiary?

Beneficiary of a U.S. trust is a Canadian resident and citizen. How are distributions from the trust taxed?

Beneficiary of a U.S. trust who was a U.S. citizen has chosen to expatriate. How will the beneficiary's decision to expatriate affect the beneficiary and the trust?

This paper focuses on U.S. taxation related to trusts with U.S. contacts. However, it is important to keep in mind that the tax analysis and planning does not end with a consideration of U.S. taxes. Cross-border trust planning and administration will require a team of professionals who evaluates both the U.S. tax and planning issues and any foreign tax and planning considerations.

U.S. INCOME TAXATION

U.S. citizens and U.S. residents are subject to U.S. income taxation on their worldwide income. This broad tax umbrella extends to U.S. individuals, trusts and estates. In the case of a U.S. citizen, residence is not determinative of taxation, so even U.S. citizens who have long since departed the United States are subject to tax on their worldwide income. In addition, persons who are considered "residents" of the United States for income tax purposes are subject to the vast reach of U.S. income taxation on their worldwide income even if they are not U.S. citizens. This includes U.S. resident trusts and estates. Conversely, non-citizens not resident in the United States (often referred to for tax purposes as foreign persons or non-resident aliens) and foreign trusts and estates are only subject to U.S. income taxation of their U.S. "source income."

U.S. Citizen and U.S. Resident Individuals

For individuals, U.S. citizenship is determined by the U.S. Constitution, the Immigration and Nationality Act, and the related regulations and case law.[1] For purposes of taxes, however, U.S. residency is determined by the Internal Revenue Code (the "Code"), Treasury regulations, any applicable tax treaty and the related case law.

For U.S. income tax purposes, a resident alien is an individual who is a lawful permanent resident of the United States at any time during the year (a "green card holder"), meets the "substantial presence" test, or has made what is commonly referred to as a "first year election" to be taxed as a resident alien. [2]

Substantial Presence

An individual has a substantial presence in the United States if the individual is physically present in the United States for at least 183 days during the current year, or is physically present in the United States for at least 31 days during the current year and the sum of (i) the days he is physically present in the United States during the current year, plus (ii) one-third the number of days physically present in the United States during the first preceding calendar year, plus (iii) one-sixth the number of days physically present in the United States during the second preceding year, equals or exceeds 183 days.[3] The latter test is essentially a formula to establish a threshold weighted average of 183 days over a three-year period.

For example, if an individual is present in the United States for 122 days in year one, 122 days in year two and only 122 days in year three (the current year), she would still have substantial presence in the United States in year three since the weighted average for the three-year period equals 183 days.

	Days	Applicable Factor	Total
Year 1	122	1/6	20 1/3
Year 2	122	1/3	40 1/3
Year 3 (Current Year)	122	1	122
Weighted Average			183

U.S. Domestic and Foreign Trusts

A trust is treated as a "domestic trust" for U.S. income tax purposes if the trust is subject to supervision by a U.S. court, and the trust is controlled *solely* by a U.S. person or persons.[4] All other trusts are treated as "foreign trusts." [5]

Court Test

A trust satisfies the court test under a safe-harbor rule if the trust instrument does not direct that the trust be administered outside of the United States, the trust is in fact administered exclusively in the United States, and the trust is not subject to an automatic migration provision (a provision that requires migration from the United States if a U.S. court attempts to assert jurisdiction).[6] The "administration of the trust" means carrying out the duties under the governing instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing assets, defending the trust from suits by creditors, and determining the amount and timing of distributions.[7]

Control Test

A trust satisfies the control test if only U.S. persons can control the substantial (non-ministerial) decisions regarding the trust. Substantial decisions include (but are not limited to) decisions concerning:

- Whether and when to distribute income or corpus;
- The amount of distributions;
- The selection of a beneficiary;
- Whether a receipt is allocable to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate or abandon claims of the trust;
- Whether to sue on behalf of the trust or to defend suits against the trust;
- Whether to remove, add or replace a trustee;
- Whether to appoint a successor trustee to succeed a trustee who has died, resigned or otherwise ceased to act as a trustee (regardless of whether there is an unrestricted power to remove a trustee, unless the power is limited to removal/appointment of a U.S. person); and
- Investment decisions.

Decisions that are considered ministerial include decisions regarding details such as bookkeeping, the collection of rents, and the execution of investment decisions.[8]

PRACTICE TIP 1:

If it is intended that a trust be a domestic trust for U.S. income tax purposes, include a statement of this intention in the governing instrument and expressly provide that no non-U.S. person may exercise powers controlling substantial decisions. In the case of jointly held powers, provide that the decision of the U.S. person controls.

Inadvertent Changes

The regulations provide a 12-month grace period in the event of an inadvertent change in any person who has the power to make a substantial decision of the trust if such change would cause a domestic trust to become a foreign trust or vice versa. The trust is allowed 12 months to make necessary changes either with respect to the persons who control the substantial decisions or with respect to the residence of such persons to avoid a change in the trust's residency. An inadvertent change is the death, incapacity, resignation, change in residency or other change in the person who has a power to make a substantial decision of the trust.[9]

For example, at the death of an income beneficiary, a U.S. trust continues for the benefit of a non-U.S. person, who has the right to remove and replace the trustee with no requirement that the trustee must be a U.S. person. Unless the non-U.S. person renounces the right to remove and replace the trustee within 12 months, the non-U.S. person becomes a U.S. person or the governing instrument is effectively modified to require that any replacement trustee be a U.S. trustee, the trust would become a foreign trust.

PRACTICE TIP 2:

In order to maintain a current record of the status of a trust as a domestic trust or a foreign trust, include an analysis of the status of the trust in the periodic review of the trust.

Types of Trusts

Broadly speaking there are two types of trusts for U.S. income tax purposes – grantor trusts and non-grantor trusts. Under Subpart E of the Code (Grantor and Others Treated as Substantial Owners), income, deductions and credits of a grantor trust flow-through to the grantor of the trust (or in limited circumstances, to a beneficiary with significant powers over the trust property).[10] There are two types of non-grantor trusts – simple trusts that are required to distribute (or are deemed to distribute) all income currently, and complex trusts, which encompass all other non-grantor trusts.[11]

U.S. Grantor Foreign Trust with U.S. Beneficiary

When a U.S. person creates a foreign trust, during his lifetime the U.S. person is treated as the owner for U.S. income tax purposes if the foreign trust has a U.S. beneficiary, *regardless* of any powers the U.S. grantor may or may not have retained over the trust.[12] A trust is treated as having a U.S. beneficiary unless (i) no part of the income or corpus may be paid to or accumulated for the benefit of a U.S. person during the tax year and (ii) if the trust was terminated during the tax year, no part of the income or corpus would be distributed to a U.S. person.[13] In fact, the Internal Revenue Service may presume that a foreign trust created by a U.S. person has a U.S. beneficiary absent a showing to the contrary by the U.S. person creating the trust.[14]

Because of the perceived tax avoidance potential if a U.S person creates a foreign trust that benefits another U.S. person, the Code imposes grantor trust status so that the U.S.

grantor must report and pay tax on all items of income and deduction of the trust rather than the trust being treated as a separate foreign taxpayer. Thus, creation of a foreign trust by a U.S. person with a U.S. beneficiary is not an effective income tax planning strategy to shift income from a U.S. grantor. This deemed U.S. owner rule does not apply to transfers occurring by reason of death or certain transfers for fair market value.[15]

Foreign Grantor U.S. Domestic Trust

When a non-U.S. person creates a U.S. domestic trust, the non-U.S. person is treated as the owner of the assets of the trust (meaning that the trust is taxed as a flow-through grantor trust) only if (and only so long as) either the non-U.S. person has the power to revoke the trust without the approval or consent of any other person, or distributions of income and principal from the trust may only be made to the non-U.S. person who created the trust or the person's spouse while that non-U.S. person is living.[16] If the trust does not meet either of these criteria, it is deemed to be a "non-grantor trust" treated as a separate U.S. taxpayer.

Beneficiary as Owner of Trust

A beneficiary who is a U.S. person is treated as the owner of any part or all of the assets of a trust if the beneficiary has the power, exercisable alone, to vest any part or all of the corpus or the income of the trust in himself or herself, provided the grantor of the trust is not otherwise treated as the owner of the trust.[17] However, if a foreign beneficiary has these powers over a trust, the trust will be treated as a non-grantor trust taxed as a separate taxpayer.

"Incoming" Foreign Non-Grantor Trusts with U.S. Beneficiaries

A foreign non-grantor trust is subject to U.S. income taxation as a non-resident alien, meaning that it is subject to U.S. income tax, and U.S. income tax withholding, on U.S. source income accumulated by the trust.

If a foreign non-grantor trust has a U.S. beneficiary, special income tax rules apply to distributions to the U.S. beneficiary. A U.S. beneficiary of a foreign non-grantor trust is generally subject to U.S. income tax when a foreign non-grantor trust makes a distribution to or for the benefit of the U.S. beneficiary. The tax consequences of distributions from a foreign non-grantor trust to a U.S. beneficiary depend on whether the distribution is characterized as a distribution of the trust's "distributable net income" or "DNI," an accumulation distribution of undistributed net income, or a principal distribution. Unless the trustee provides the Internal Revenue Service or the U.S. beneficiary with adequate information regarding the foreign trust and any distributions, all distributions generally will be treated as accumulation distributions and taxed accordingly.[18]

Taxation of DNI (Current Income)

Generally distributions from a foreign non-grantor trust are first treated as distributions of the trust's DNI. Thus, the first step in determining whether and to what extent a distribution from a foreign non-grantor trust is taxed to the beneficiary is to determine the trust's DNI. Generally, for foreign non-grantor trusts, DNI is all of the current taxable income of the trust, both U.S. and non-U.S. income, and, unlike a U.S. trust, *includes* capital gains from the sale of assets.[19] Capital losses off-set capital gains, but are not offsets to ordinary income for purpose of computing DNI.[20]

A trust may make what is referred to as a "65-day election." With a 65-day election, if within the first 65 days of the taxable year of a trust, an amount is properly paid or credited to a beneficiary, the amount will be considered paid or credited on the last day of the preceding taxable year. A 65-day election may be used to purge a trust of an accumulation of income shortly following year-end. A 65-day election must be made by the trustee within the time and in the manner prescribed by the Internal Revenue Service in regulations.[21] As is discussed in greater detail below, making a 65-day election may be of particular benefit to a foreign non-grantor trust which seeks to minimize the accumulation of income and the associated tax complexity.

To the extent the foreign non-grantor trust distributes its DNI, the beneficiary must pay tax on the DNI. The character of DNI is the same for the beneficiary as for the trust. Thus, when a foreign non grantor trust's DNI is composed of dividends and realized capital gains, the dividends are taxed to the beneficiary as dividends and the capital gains are taxed to the beneficiary as capital gains at the applicable tax rates.

Taxation of UNI (Accumulated Income)

If a foreign non-grantor trust does not distribute all of its DNI to a beneficiary each year, the excess DNI is deemed accumulated for future distribution and is referred to as "undistributed net income" or "UNI."[22] If distributions to a U.S. beneficiary in a year exceed a foreign non grantor trust's current year DNI and there is UNI from prior years, the excess will be treated as an accumulation distribution to the extent of the prior years' UNI.

Accumulation distributions are subject to a special tax rule known as the "throwback rule." Although the throwback rule was repealed in 1996 with respect to U.S. trusts, it remains in effect for foreign trusts. The throwback rule is designed to impose on the U.S. beneficiary approximately the same income taxes that would have been imposed had the foreign non-grantor trust distributed its DNI each year. Thus, any tax benefit associated with timing distributions from a trust to correspond with a low tax rate year of the beneficiary is reduced or eliminated.

Having a distribution from a foreign non-grantor trust to a U.S. beneficiary characterized as an accumulation distribution is generally an unfavorable tax result because these accumulation distributions are taxed as ordinary income. Accumulated income does not

retain its character as dividends, capital gains, foreign income, etc. The U.S. beneficiary therefore loses the reduced tax rate on long-term capital gains and "qualified dividends" from U.S. domestic corporations and qualified foreign corporations.

For example, when a foreign non-grantor trust distributes DNI that includes realized long-term capital gains, the beneficiary will include the capital gain portion of the distribution in his or her income as capital gain. If, however, the foreign non-grantor trust accumulates the capital gains, they become part of the trust's UNI and lose their capital character. Upon distribution of the UNI in future years, the accumulated gains are taxed to the U.S. beneficiary as ordinary income.

In addition to paying tax on accumulation distributions from foreign non-grantor trusts, a U.S. beneficiary must also pay an interest charge on the accumulation distribution for each year of the accumulation.[23] This interest charge in essence captures the time value of the deferred payment of tax to the Internal Revenue Service. The interest charge on accumulation distributions is the same compound interest rate charged by the Internal Revenue Service for underpayments of tax. Where the accumulation distribution arises from UNI from several different years, the interest charge is based on the average number of years of accumulation. The interest charge is not deductible for purposes of computing the income tax.[24]

Type of Income	Current Year Distribution	Accumulation Distribution
Capital gain	Taxed to the beneficiary as capital gain income	Taxed to the beneficiary as ordinary income
Interest	Taxable and tax-exempt interest are taxed to the beneficiary as such	Taxed to the beneficiary as ordinary income
Dividends	Qualified and non-qualified dividends are taxed to the beneficiary as such	Taxed to the beneficiary as ordinary income

PRACTICE TIP 3:

When administering a foreign non-grantor trust with a U.S. beneficiary consider the timing of the recognition of capital gains by the trust, the timing of distributions to the U.S. beneficiary and the availability of the 65-day election to preserve the tax character of items of income and limit interest charges on accumulation distributions.

Accumulation Term

In calculating whether a trust has made an accumulation distribution, the Code requires that the taxpayer look back at any "preceding taxable year" in which the trust was a non-grantor trust. The term "preceding taxable year" serves to identify and limit the taxable years of a non-grantor trust to which an accumulation distribution may be allocated. For foreign non-grantor trusts created by U.S. persons, the term "preceding taxable year" is any taxable year after August 17, 1954.[25] If adequate records are not available an accumulation will be deemed to relate back to the earliest year in which a trust had UNI.[26] The Code generally provides an exception for amounts accumulated before a beneficiary was born or attained age twenty one. However, this exception does not apply to foreign non-grantor trusts. Consequently, accumulations can date back even before the birth of a U.S. beneficiary.[27]

Principal Distributions

To the extent a foreign non-grantor trust makes distributions in excess of its DNI and there is no UNI from prior years (or the distribution exceeds DNI and any UNI), the excess distribution is treated as a principal distribution or a distribution from the corpus of the trust, provided appropriate information is made available to the beneficiary identifying the composition of the distribution. Principal distributions are not subject to income tax.

"Outgoing" Distributions and Trusts

A U.S. non-grantor trust may make distributions to a non-resident alien beneficiary, a U.S. person may transfer property to a foreign trust or a formerly U.S. trust may become a foreign trust. Each circumstance gives rise to particular U.S. income tax consequences.

Distributions from U.S. Non-Grantor Trusts and U.S. Estates to Foreign Beneficiaries

A U.S. trust or estate that has a foreign beneficiary has additional income tax requirements. Subject to applicable treaty limitations, non-resident alien individuals or entities are subject to U.S. income tax on all income from whatever source that is effectively connected to the conduct of a U.S. business, and a flat tax of 30% on all fixed or determinable annual or periodic income from U.S. sources which is not connected to the conduct of any U.S. business.[28] The tax liability imposed by the Code is generally collected by way of withholding.[29] The duty to withhold is imposed on the persons, in whatever capacity, having control, receipt, custody, disposal or payment of the income items subject to withholding. A U.S. trust or estate that makes distributions to a foreign individual or foreign entity is required to withhold any U.S. income tax imposed on such distributions.

For a U.S. simple trust that makes distributions to a foreign beneficiary, the trust is required to withhold on the distributable net income or DNI which is includible in the gross income of the foreign beneficiary, to the extent the DNI includes income subject to withholding.[30] The trust withholds when a distribution is made to the foreign beneficiary. To the extent the trust is required to, but does not actually, distribute the income to a foreign beneficiary prior to year end, the trust must withhold on the foreign beneficiary's allocable share of DNI subject to withholding at the time the income is required to be reported.[31]

For a U.S. complex trust which makes distributions to a foreign beneficiary, the trust is required to withhold on the DNI includible in the gross income of the foreign beneficiary, to the extent the DNI consists of income subject to withholding and the income actually is, or is required to be, distributed currently. The trust withholds when a distribution is made to the foreign beneficiary, or if the distribution is required but not made prior to year end, at the time of reporting.

A U.S. estate is also required to withhold on the DNI includible in the gross income of a foreign beneficiary to the extent the DNI consists of income subject to withholding *and* the income is actually distributed.

For a U.S. grantor trust with a foreign owner, the trust must withhold on any income includible in the gross income of the foreign person who is treated as the owner of the trust to the extent such income consists of income subject to withholding. The withholding must occur at the time the income is received by, or credited to, the trust.[32]

A U.S. trust that makes distributions to an expatriate is subject to additional withholding rules (as discussed below).

Transfers to Foreign Trusts and Estates

Any U.S. person (any U.S. citizen or resident, U.S. domestic trust or estate) who transfers property to a foreign non-grantor trust or a foreign estate must recognize gain (if any) at the time of the transfer. Thus, the transfer of appreciated property to a foreign non-grantor trust will trigger income tax. The transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred.[33] The gain recognition rule applies even if the U.S. transferor might otherwise have been eligible to defer gain recognition under another Code provision.

If a trust changes from a U.S. trust to a foreign trust (for example, at the death of the grantor or beneficiary, or through the exercise of a power of appointment (whether limited or general)), there is a deemed transfer from the U.S. trust to a foreign trust, which triggers the gain recognition rule.[34] There is an exception to this rule for a trust that is treated as owned by a foreign person, after application of the rules regarding grantor trust treatment of a trust with a U.S. beneficiary discussed above.[35]

U.S. GIFT, ESTATE AND GENERATION-SKIPPING TRANSFER TAXATION

Citizenship and "domicile" are determinative of many aspects of U.S. gift, estate and generation-skipping transfer taxation. U.S. citizens (wherever they live) and U.S. "domiciliaries" (regardless of their citizenship) are subject to U.S. gift, estate and generation-skipping transfer taxes on their worldwide assets, whereas non-citizen non-domiciliaries are subject to U.S. gift, estate and generation-skipping transfer tax (collectively, "transfer taxes") on their U.S. "situs" assets. In the case of a married couple, transfers to a U.S. citizen spouse qualify for the unlimited marital deduction, whereas transfers to a non-citizen spouse only qualify for a $149,000 (adjusted for inflation for 2017) annual exclusion. Transfers at death only qualify for deferral of estate tax if the transfer is in a qualified domestic trust structure (or its equivalent).

Domicile for U.S. Transfer Taxes

Domicile for U.S. transfer tax purposes is not the same as residence for U.S. income tax purposes. Domicile is the place where the individual lives with no definite present intention of departing. Residence alone without a present intention to remain does not establish domicile and conversely, an intention to relocate without an actual move will not change domicile.[36] Factors considered in the determination of a person's domicile include the location of the person's principal home, personal effects and other tangible personal property, church and club memberships, place of business, bank accounts, voting registration and driver's license.[37] The substantial presence test that is used to establish residence for U.S. income tax purposes is *not* controlling for determining domicile for U.S. transfer tax purposes. Thus, an individual may be a resident for U.S. income tax purposes, but not a U.S. domiciliary for U.S. transfer tax purposes.

For example, consider the circumstance of a husband and wife, where the husband is a U.S. citizen but the wife is a U.K. resident. If the wife is living in the United States at present, but intends to return to the United Kingdom, she is a resident for purposes of U.S. income taxation but may still be a U.K. "resident" for U.S. transfer tax purposes.

For example, in the circumstance of the husband and wife, the wife may make unlimited gifts to husband during life and at death that qualify for the unlimited marital deduction with no immediate gift or estate tax consequences. In addition, she may make gifts of non-U.S. situs assets to others free of U.S. gift tax so long as she is neither a U.S. citizen nor a U.S. domiciliary for U.S. transfer tax purposes. However, gifts by the husband to the wife in excess of the annual $149,000 (adjusted for inflation for 2017) threshold will be subject to gift tax and transfers at death generally will be subject to estate tax unless made in a qualified domestic trust structure. In addition, gifts by the husband to others will be subject to gift tax regardless of the situs of the property.

Situs

For non-domiciliaries who are not U.S. citizens it is the site (or "situs" in legal terminology) of their property that determines whether they will be subject to U.S. transfer taxes. The definition of U.S. situs property for gift tax purposes is slightly different than the definition for estate tax purposes. For both gift and estate tax purposes, real property and tangible personal property physically located in the United States has a U.S. situs.[38] For gift tax purposes, intangible personal property does not have a U.S. situs, whatever its source or location.[39] For estate tax purposes, however, intangible personal property has a U.S. situs if it is derived from a U.S person or entity. Stock issued by a U.S. domestic corporation[40] and debt obligations issued by or enforceable against any U.S. person or entity[41] have a U.S. situs for estate tax purposes.

However, for policy reasons, many types of property are treated under the Code as not having a U.S. situs although located within the United States. Examples include deposits with U.S. banks and savings and loans,[42] life insurance proceeds paid by U.S. life insurance companies if the insured is a non-resident alien,[43] portfolio debt obligations issued after July 18, 1984,[44] and works of art on loan for exhibition.[45]

For example, a foreign person may make a transfer of stock in a U.S. corporation free of U.S. gift tax (and generation-skipping transfer tax). However, a transfer of U.S. stock by a foreign person at death will be subject to U.S. estate tax (and possibly generation-skipping transfer tax), absent an applicable treaty provision to the contrary.

For example, a foreign person may make a transfer of an American depository receipt of a foreign corporation (ADR) or a Puerto Rico Bond to a U.S. beneficiary either during life or at death free of U.S. transfer taxes, whereas a transfer of the stock of a U.S. corporation or a non-qualified U.S. municipal obligation at death would be subject to U.S. estate tax.

For example, parents who are residents and citizens of China may make a gift of non-U.S. situs assets to a U.S. trust for the benefit of their daughter. The trust may be created as a U.S. dynasty trust for the current benefit of the daughter and for the future benefit of multiple generations, not subject to future U.S. estate or generation-skipping transfer tax.

PRACTICE TIP 4:

When making investments for non-resident aliens take into consideration the differing U.S. estate tax treatment of U.S. and non-U.S. intangible property such as stocks and bonds.

The situs of interests in partnerships and limited liability companies is often difficult to determine. In the case of a partnership, if under the applicable law the partnership is not classified as a separate entity or is dissolved at the death of a partner, situs is determined by looking through the partnership to the underlying assets of the partnership. If the partnership is a separate legal entity that continues after the death of a partner, the look

through rule should not apply and the situs of the partnership interest itself must be determined. In the case of limited liability companies there is not yet any definitive precedent for the determination of the situs of a member's interest. One reasonable approach is to determine situs of an interest in a limited liability company classified as a partnership for income tax purposes under the situs rules for partnership interests, and to determine the situs of an interest in a limited liability company classified as a corporation for income tax purpose under the situs rules for corporate stock.

As with the determination of "residence," the situs rules described above may be modified by treaty.[46]

Deductions and Credits

U.S. transfer taxes are subject to numerous exemptions and credits of particular significance in cross-border transfer tax planning, including the marital deduction, the charitable deduction, the unified or applicable credit, and the foreign death tax credit.

Marital Deduction

In the case of a married couple, both of whom are U. S. citizens, the unlimited marital deduction permits assets to be transferred between the couple free of transfer taxes.[47] Thus, transfer taxes may be deferred in full until the death of the surviving spouse. However, the Technical and Miscellaneous Revenue Act of 1988 (referred to as TAMRA)[48] limited the circumstances under which assets may be transferred between spouses free of U. S. transfer taxes if either or both spouses are not U.S. citizens.[49] Transfer tax planning for the marital deduction in cases where either or both spouses are not U.S. citizens is discussed in greater detail below.

Charitable Deduction

A charitable transfer tax deduction is generally allowed for transfers for public, charitable and religious uses.[50] In the case of U.S. citizens and domiciliaries, the charitable deduction is allowed for transfers to foreign corporations and associations.[51] In the case of non-resident non-domiciliaries of the United States, the charitable deduction is only allowed for transfers to organizations created or organized in the United States, subject to applicable treaty rules.[52]

Applicable Exclusion

U.S. citizens and domiciliaries are allowed a gift and estate tax applicable exclusion by which $5,490,000 may be excluded from gift and estate tax in 2017. This applicable exclusion amount is adjusted for inflation annually.[53] The limitation is much lower for non-citizen non-domiciliaries. An estate tax credit of only $13,000 (an exclusion equivalent of $60,000) is allowed to non-citizen non-domiciliaries having assets situated in the United States.[54] However, under the applicable treaty, the credit may be increased to a pro rata share of the applicable credit amount available to U.S. citizens and domiciliaries.[55]

The pro rata share is calculated based on the relative value of the estate situated in the United States and the value of the gross worldwide assets of the decedent. Foreign donors and decedents currently are allowed the same generation-skipping transfer tax exemption that is available to U.S. citizens and domiciliaries.[56]

For example, in the case of a Canadian citizen and resident decedent with worldwide assets worth $10,000,000 and U.S. situs assets worth $2,000,000, 1/5th ($2,000,000/$10,000,000) of the applicable exclusion amount in the year of death would be available to the estate under the U.S./Canada treaty.

Annual Gifts

Like U.S. residents and citizens, a foreign person may make annual gifts up to $14,000 in 2017 (adjusted annually for inflation) of U.S. situs assets to a donee in 2017 without incurring U.S. gift tax.[57] However, a married foreign donor may not take advantage of the gift-splitting election.

Foreign Death Tax Credit

A credit for the amount of any "estate, inheritance, legacy or succession taxes" paid to a foreign country in respect of "property situated" in the foreign country and included in a decedent's gross estate is allowed for the estates of U.S. citizens and U.S. domiciled decedents.[58] No estate tax credit is allowed for foreign income taxes under the Code, although provisions may be made for a credit under the applicable treaty. The foreign death tax credit is not applicable to the estate tax on the U.S. assets of non-domiciled non-citizens of the United States. No foreign gift tax credit is allowed.

Qualified Domestic Trusts

The unlimited U.S. estate tax marital deduction not otherwise available for transfers to spouses who are not U.S. citizens may be preserved through the use of a "qualified domestic trust" (QDOT).[59] In addition, the deduction may be preserved if a non-QDOT trust is reformed to qualify as a QDOT, the surviving spouse establishes a QDOT and transfers or irrevocably assigns property passing to him or her from the deceased spouse to the QDOT or the surviving spouse becomes a U.S. citizen.[60]

Summary of QDOT Requirements

If property passes from a decedent to a QDOT, the QDOT must fulfill the requirements for a marital deduction general power of appointment trust, qualified terminable interest property trust, charitable remainder trust or estate trust.[61] If the surviving spouse transfers or irrevocably assigns to a QDOT property passing to him or her from the decedent in a form that would have qualified for the marital deduction had the surviving spouse been a U.S. citizen, the QDOT need not satisfy the marital deduction requirements. Every QDOT must satisfy the specific requirements outlined in the Code and the regulations applicable specifically to trusts for non-citizen spouses.[62]

A QDOT document must provide for the following:

- At least one of the trustees must be an individual citizen of the United States or a domestic corporation (United States Trustee),
- No distribution (other than an income distribution) may be made from the trust unless a United States Trustee has the right to withhold the QDOT tax from the distribution, subject only to limited exceptions,
- The trust must be maintained and administered under the laws of a state of the United States or the District of Columbia,
- The trust must be an "ordinary" trust (as distinguished from a business trust taxable as an association) as defined under Reg. § 301.7701-4(a), and
- The trust must include or incorporate by reference specific provisions securing the collection of the QDOT tax set forth in the regulations.[63]

The regulations include numerous governing instrument requirements and filing requirements to ensure collection of the QDOT tax. These requirements vary according to the size of the trust. Trusts having a fair market value at the death of the first decedent not in excess of two million dollars ("small trusts") are subject to one set of rules and trusts having a fair market value in excess of two million dollars ("large trusts") are subject to another.[64] The two million dollar threshold is determined after taking into account an exclusion for the spouse's personal residence(s) and related furnishings if an election is made claiming the exclusion.[65]

The governing instrument for a large trust must require that:

- At least one United States Trustee be a bank,
- The United States Trustee furnish a bond in favor of the Internal Revenue Service in an amount equal to 65% of the fair market value of the trust assets (without regard to any indebtedness) as finally determined for federal estate tax purposes, or
- The United States Trustee furnish a letter of credit in favor of the Internal Revenue Service in an amount equal to 65% of the fair market value of the trust assets (without regard to any indebtedness) as finally determined for federal estate tax purposes.

The U.S. branch of a foreign bank will satisfy the U.S. bank trustee requirement if the governing instrument also requires a United States Trustee to act as co-trustee.[67] If a bond is provided, the bond may not be cancelable and must be for a term of at least one year. The bond must be automatically renewable. A form of bond is prescribed under the regulations.[68] If a letter of credit is furnished, the letter of credit must be irrevocable and provide for sight payment. The letter of credit must be for a one year term and be automatically renewable. A form of letter of credit is prescribed under the regulations.[69]

PRACTICE TIP 5:

If it is not known that a non-citizen spouse will remain a non-citizen, include alternate QDOT trust provisions in the governing instrument to become effective dependent upon the citizenship of the surviving spouse at the first decedent's death.

PRACTICE TIP 6:

When making the choice between a U.S. bank trustee and a U.S. individual trustee, consideration should be given to the additional cost of the bond or letter of credit required if a bank does not act as trustee. It is possible that the additional cost of providing a bond or letter of credit will equal or exceed the fees customarily charged by a bank trustee. However, in some circumstances additional fiduciary fees may be charged for the administration of QDOTs given the additional tax compliance procedures required in connection with the administration of these trusts.

The governing instrument for a small trust must either include or incorporate by reference the tax collection language required for a large trust, or require that no more than 35% of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust, may consist of property located outside of the United States.[70]

Regardless of whether a large or small trust includes the required tax collection provisions, the trust will immediately cease to qualify as a QDOT if the trust utilizes any device or arrangement that has, as its principal purpose, the avoidance of liability for the QDOT tax or the prevention of the collection thereof.[71] In addition, the marital deduction will be disallowed if the value of the QDOT assets as reported on the federal estate tax return is less than 50% of the value thereof as finally determined, absent reasonable cause for the undervaluation and good faith.[72]

If the United States Trustee is an individual, the individual must have a tax home in the United States.[73] The United States Trustee must file an annual statement (Form 706-QDT) if the trust owns foreign real property (directly or indirectly) and does not satisfy the large trust security requirements, or if the personal residence exclusion applies and the personal residence is sold or no longer used as a personal residence.[74]

QDOT Election

The executor of the estate of the deceased spouse must make a timely election to have the trust qualify as a QDOT.[75] The election must be made on the last federal estate tax return filed before the due date (including extensions actually granted) or, if a timely return is not filed, on the first return filed after the due date, but no later than one year after the due date (including extensions). The election, once made, is irrevocable. An election may not be made with respect to a specific portion of an entire trust. However, if a trust is actually severed before the due date for the QDOT election, an election may be made with respect to one or more severed trusts.[76]

PRACTICE TIP 7:

Language permitting the trustee to sever a QDOT if necessary or desirable should be included in the trust instrument.

A protective QDOT election is only permitted if at the time the federal estate tax return is filed the executor reasonably believes that there is a bona fide issue concerning the residence or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the estate of the decedent or the amount or nature of the property passing to the surviving spouse.[77] If more than one QDOT is established with respect to a decedent the "designated filer" of the QDOT returns must be named on the estate tax return or on the first QDOT return.[78]

QDOT Reformation

A trust that does not otherwise qualify as a QDOT may be reformed according to authority to reform granted in the trust instrument if reformation is completed by the due date for filing the federal estate tax return (determined with regard to extensions) or by judicial action commenced on or before the due date for filing the federal estate tax return (determined with regard to extensions).[79]

PRACTICE TIP 8:

For the avoidance of doubt, consider including express authority in the governing instrument granting the trustee the power to reform the trust to comply with the QDOT requirements if necessary.

Non-trust Marital Transfers

If property passes directly to the non-citizen spouse at the death of the citizen spouse, the non-citizen spouse may preserve the estate tax marital deduction by making a timely transfer or irrevocable assignment of the property to a QDOT. The transfer or assignment must be completed by the date the federal estate tax return is filed, but no later than the last date on which the QDOT election may be made.

PRACTICE TIP 9:

There typically will be gift tax consequences to the spouse upon a post-mortem transfer to a QDOT. To avoid a completed gift upon a post-mortem transfer the spouse may reserve a special power of appointment over the trust.

If an annuity or similar arrangement is subject to assignment, assignment to the QDOT will be treated as a transfer to the QDOT regardless of the method of payment selected.[80]

"Nonassignable annuities and similar arrangements" will only qualify for QDOT treatment if the spouse agrees to pay the QDOT tax on the corpus portion of each payment as such payments are made or the spouse rolls the "corpus portion" of each payment into a QDOT. A "nonassignable annuity or similar arrangement" is a plan, annuity or other arrangement (whether qualified or not qualified) that generally qualifies for the marital deduction, the payments from which are not assignable to a QDOT under federal, state or foreign law or by the terms of the agreement itself. The regulations set forth the methodology for the computation of the corpus portion of each payment. This methodology is designed to approximate the portion of each payment representing corpus based upon the present value of the benefit, the expected term of the annuity, and the assumed rate of return.[81]

The appropriate elections must be made and agreements filed with the Internal Revenue Service. In addition, an Agreement to Pay Deferred Estate Tax must be filed with the federal estate tax return.[82]

Spouse Becomes a U.S. Citizen

If the non-citizen surviving spouse becomes a citizen of the United States before the due date for the federal estate tax return and was a resident of the United States at all times after the date of the decedent's death and before becoming a citizen of the United States, the unlimited estate tax marital deduction will be available without compliance with the QDOT requirements.[83]

The QDOT Tax

The Code imposes a tax upon distributions from a QDOT, subject to two significant exceptions. Distributions of income from a QDOT and distributions to the surviving spouse on account of hardship are not subject to the QDOT tax. "Income" means fiduciary accounting income determined under the governing instrument or applicable local law.[84] Income generally does not include capital gains or items of income in respect of a decedent.[85] Special rules apply in the case of unitrust amounts and state law principal and income adjustments.[86]

Hardship is narrowly defined to include only distributions to meet an immediate and substantial financial need relating to the spouse's health, maintenance or support or the health, education and support of any person the spouse is legally obligated to support. Note, however, that if the trust permits distributions for dependents it will not otherwise qualify as a marital deduction trust, which must be for the sole benefit of the spouse during the spouse's lifetime. If an alternative source of funds is reasonably available to the spouse, a distribution to meet the spouse's needs will not qualify as a distribution on account of hardship. Closely held business interests, real estate and tangible personal property are not considered sources that are reasonably available.[87]

In addition, the following types of miscellaneous distributions are not subject to the QDOT tax:

- Payments for ordinary and necessary trust administration expenses,
- Direct payments for taxes imposed on the QDOT,
- Reimbursement for income taxes paid with respect to annuity or similar arrangements transferred by the spouse to the QDOT, and
- Dispositions of trust assets for full and fair consideration.[88]

If the trustee pays the QDOT tax instead of withholding the QDOT tax from a taxable distribution, the payment will constitute an additional distribution subject to the QDOT tax.[89]

If a trust ceases to qualify as a QDOT, the full QDOT tax will be due as if the surviving spouse died on the date the trust ceased to qualify.[90] If the surviving spouse becomes a U.S. citizen, special rules provide for relief from further QDOT tax liability.[91]

PRACTICE TIP 10:

When drafting, the planner may provide for relief from the QDOT limitations in the event the spouse becomes a U.S. citizen and the requirements of the regulations are fulfilled.

The QDOT tax due upon a distribution subject to the tax is equal to the estate tax that would have been due had the distribution been taxable in the estate of the deceased spouse, calculated by grossing up all current and prior distributions to reach the highest marginal tax bracket and after taking into account all allowable credits.[92] Payment of the tax is required by April 15 of the year following the year of the distribution; provided that any tax due by reason of the death of the non-citizen spouse will be due nine months after the date of death. The trustees of the QDOT are jointly and severally liable for the QDOT tax.[93]

If the tax on the estate of the decedent has not finally been determined by the time the QDOT tax is due, a tentative tax is to be calculated using the highest marginal estate tax rate in effect at the time of the decedent's death. Upon final determination of the decedent's estate tax a refund of any overpayment of QDOT estate tax may be claimed.[94]

In order to eliminate double taxation where the QDOT tax is due upon the death of the surviving spouse and the QDOT is also taxable in the estate of the surviving spouse, the QDOT taxes paid are creditable in computing the surviving spouse's federal estate tax. The credit is computed without regard to the percentage limitations under Code § 2013 (Credit for Tax on Prior Transfers).[95]

Joint Tenancy Interests

Joint interests held by a U.S. citizen or resident decedent with a spouse who is not a U.S. citizen are includible in full in the gross estate of the deceased spouse unless contribution by the surviving spouse who is not a citizen of the United States can be established. Equal contribution is not presumed as in the case of joint interests held by spouses who are both U.S. citizens.[96]

Careful planning and recordkeeping is necessary if a joint tenancy is created or severed during life by married persons if either spouse is not a U.S. citizen because of the gift tax limitations discussed above. Although an increased annual exclusion is available for gifts to a non-citizen spouse, the unlimited marital deduction that U.S. citizen couples rely on when making gifts related to joint tenancy ownership is not available.

PRACTICE TIP 11:

Exercise care in creating or severing joint tenancy interests with a non-citizen spouse and maintain records of the contributions of each spouse to joint tenancy accounts and property.

TREATY CONSIDERATIONS

While there are many countries that have income tax treaties with the United States, there are many fewer that have gift, estate and generation-skipping transfer tax treaties with the United States. These treaties should be consulted when dealing with trusts with cross-border contacts, to see if they address the definition of residency and/or domicile, dual residency/citizenship, the taxable situs of assets, and transfer tax exemption/credits.

The United States has estate and gift tax treaties with the following countries (the treaties that provide for a pro-rated unified credit as discussed above are noted):

Australia (pro-rated unified credit)
Austria
Belgium
Canada (pro-rated unified credit)
Denmark
Finland (pro-rated unified credit)
France (pro-rated unified credit)
Germany (pro-rated unified credit)
Greece (pro-rated unified credit)
Ireland
Italy (pro-rated unified credit)
Japan (pro-rated unified credit)
Netherlands
Norway (pro-rated unified credit)
South Africa
Switzerland
United Kingdom

U.S. EXPATRIATES

Who is an Expatriate?

U.S. citizens and certain long-term resident aliens who renounce their citizenship or terminate their residency ("expatriates") may be subject to income and estate tax rules targeted toward expatriates. Long-term U.S. residents subject to this tax are alien individuals who were lawful permanent residents (green card holders) for at least eight taxable years during the 15-year period ending with the taxable year in which the individual ceases to be taxed as a resident of the United States. The applicable income and estate tax rules differ depending on the date of the expatriation. The following discussion focuses primarily on expatriation after June 16, 2008.[97]

The current expatriation rules apply to "covered expatriates."[98] An expatriate is deemed to be a covered expatriate if:

- His average annual net income tax for the five taxable years prior to expatriation is greater than $162,000, adjusted for inflation for 2017 (the "tax liability test"),[99]
- His net worth as of the date of expatriation is $2,000,000 or more (the "net worth test"), or
- He does not substantiate compliance with the federal income tax rules for the prior five-year period.

In addition to the income and transfer tax consequences discussed below, expatriates also risk being re-classified as U.S. residents for income and transfer tax purposes, if during the 10 year period following expatriation, the individual is physically present in the United States for more than 30 days.[100]

Income Tax Implications

For individuals who expatriate after June 16, 2008, the Code provides a mark-to-market exit tax (a gain recognition tax) on the expatriate.[101] The net gain on the deemed sale is recognized to the extent it exceeds $699,000, adjusted for inflation for 2017.[102]

The deemed disposition rule does not apply to interests in non-grantor trusts and certain deferred compensation, but separate withholding rules apply. If an expatriate is the beneficiary of a non-grantor trust on the day before the expatriation date, following the expatriation date, if the trustee distributes (directly or indirectly) property to the expatriate, the trustee must deduct and withhold an amount equal to 30% of the taxable portion of the distribution, and if the distribution is in kind, recognize gain if the fair market value of the property exceeds its adjusted basis. The expatriate is deemed to have waived any right to claim any withholding reductions under any U.S. tax treaty unless the covered expatriate agrees to some other treatment that the Internal Revenue Service determines is reasonable. Similarly, deferred compensation not subject to tax at the time of exit is subject to withholding when actually paid.

Transfer Tax Implications

For individuals who expatriate after June 16, 2008, new Code § 2801 imposes taxes on certain gifts and bequests received from a "covered expatriate." This tax is imposed on the U.S. donee or beneficiary of the gift or bequest.

The tax applies to any "covered gift or bequest" valued in excess of the annual exclusion amount in effect for gift tax purposes in the year of the transfer. A "covered gift or bequest" is any property acquired by gift, directly or indirectly, from an individual who, at the time of the gift, is a covered expatriate and any property acquired, directly or indirectly, by reason of the death of an individual who, immediately before his death, was a covered expatriate. The tax under Code § 2801 is paid by the person who receives the covered gift or bequest. Although a covered gift is similar to a net gift, because the recipient of the covered gift is liable for the tax on the gift, neither the Heroes Act (Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. 110-245), which introduced this code section, nor the committee reports state that the value of a covered gift is computed in the same way as the value of a net gift.

U.S. COMPLIANCE CONSIDERATIONS

Grantors, trustees and beneficiaries of foreign trusts and trusts that hold foreign financial accounts are subject to U.S. tax and non-tax reporting and compliance requirements in addition to or in connection with their customary income tax reporting on Forms 1040, 1040NR or 1041. Following is a summary of various significant reporting forms and who is required to file the forms. This is an ever-changing area of the law that requires diligent attention to ongoing developments. The following list does not include reporting requirements with respect to interests in foreign corporations or foreign partnerships. If a foreign estate or trust has an interest in a foreign partnership or a foreign corporation, it will be necessary to separately consider the applicability of any reporting requirements with respect to those interests.

Reporting and Withholding on Distributions from U.S. Trusts to Non-resident Alien Beneficiaries

A U.S. trust or estate reports the tax withheld for a foreign beneficiary on Form 1042 and 1042-S, which are due March 15. The tax withheld that historically was required to be deposited with either a Federal Reserve Bank or an authorized financial institution is now required to be made by electronic funds transfer payment or same day wire. The Internal Revenue Service no longer permits a check and deposit coupon to be presented to a bank. Deposits of the tax withheld are made quarter-monthly, monthly or annually depending on the amounts withheld.[103]

A U.S. fiduciary is required to request a Form W-8BEN from a foreign beneficiary.[104] If a foreign beneficiary does not provide the W-8BEN, withholding is required at the 30% tax rate regardless of any reduced withholding rate or modified withholding rules provided by an applicable tax treaty.[105]

Report of Foreign Bank and Financial Accounts (FBAR)

A U.S. grantor, trustee or beneficiary ordinarily will be required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts or FBAR, if the U.S. grantor, trustee or beneficiary has a financial interest in or signature authority over a foreign financial account and the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year. This reporting is required pursuant to the Bank Secrecy Act, not the Code.[106] As of September 30, 2013, FinCEN Form 114 supersedes TDF 90-22.1 (the FBAR form used in prior years). However, authority to assess the penalties for failure to file has been delegated to the Internal Revenue Service.

A foreign financial account is a financial account located outside the United States. A financial account includes, but is not limited to, a securities brokerage, savings, demand, checking, deposit, time deposit, commodity futures or options account, a life insurance policy or annuity with a cash value, and shares in a mutual fund or similar pooled fund.

In the case of a grantor trust, the U.S. grantor treated as the owner of a trust under the Code sections 671through 679 (the "grantor trust rules") is treated as having a financial interest in any foreign financial accounts owned or held by the trust. In the case of a non-grantor trust, a U.S. beneficiary is treated as having a financial interest in any foreign accounts owned or held by the trust if the U.S. beneficiary has a beneficial interest in

more than 50% of the assets or income of the trust. However, if the trust, trustee or agent of a non-grantor trust is a U.S. person who files a Form 114 disclosing the trust's foreign financial accounts, the trust beneficiary is not required to file a Form 114. In addition, the owner or beneficiary of an individual retirement account is not required to report a foreign financial account held in the individual retirement account.

For tax years beginning after December 31, 2015, FinCEN Form 114 is due on April 15, and there is an available six-month extension period, ending October 15. An extension of time to file an income tax return does not extend the time for filing the FBAR.

Civil penalties for a non-willful failure to file are not to exceed $10,000 per violation. Civil penalties for a willful violation can range up to the greater of $100,000 or 5% of the amount in the account at the time of the violation.[107] Criminal penalties can range up to a $500,000 fine or 10 years imprisonment or both. There have been a series of offshore voluntary disclosure initiatives with varying requirements and penalty waivers. In addition to the available extension period for filing Form 114, for tax years beginning after December 31, 2015, the Secretary of the Treasury has discretion to waive late filing penalties assessable against first time filers who miss the deadline for requesting the new extension.

Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520)

Form 3520 is used by U.S. persons to report certain transactions with foreign trusts, ownership of foreign trusts under the grantor trust rules and receipt of certain large gifts or bequests from foreign persons.

Form 3520 is required to be filed under a number of circumstances. A U.S. person is required to file Form 3520 for a calendar year if during the year:

- He/she is the "responsible party" for reporting a "reportable event" or held an outstanding obligation of a foreign trust (or of a person related to the trust) that they treated as a "qualified obligation,"
- He/she is a U.S. person who is treated as the owner of any part of the assets of a foreign trust under the grantor trust rules,
- He/she is a U.S. person who received a distribution from a foreign trust, either directly or indirectly, or a related foreign trust held an outstanding obligation they issued (or an obligation of a person related to them) that they treated as a qualified obligation,
- He/she is a U.S. person who received more than a $100,000 gift or bequest from a non-resident alien or a foreign estate or received gifts of more than $15,797 (for 2017) from foreign corporations or foreign partnerships, or
- He/she is a U.S. person who received a gift (or bequest) of more than the annual gift tax exclusion amount ($14,000 in 2017) from a "covered expatriate."

There are limited exceptions to filing with respect to tax-exempt trusts, transactions for fair-market value, compensation for services and similar transactions.

Form 3520 is due when the income tax return is due, including extensions (or when Form 706 is due in the case of a U.S. decedent). A maximum six-month extension is available for tax years beginning after December 31, 2015.

The penalties for failure to file Form 3520 are significant. The initial penalty is the greater of (i) $10,000 or (ii) 35% of the gross value of any property transferred to a foreign trust that is required to be reported, 35% of the gross value of distributions from a foreign trust that is required to be reported, or 5% of the gross value of the portion of a trust's assets treated as owned by a U.S. person that is required to be reported. In the case of the failure to report large gifts or bequests from foreign persons, the penalty is 5% of 25%. These penalties may be waived if the failure to file was for reasonable cause and not willful neglect.[108] An additional accuracy-related penalty may be imposed for undisclosed foreign financial asset understatements.[109] This penalty may be waived if a person can show reasonable cause for the failure to report and the person acted in good faith.[110]

Annual Information Return of Foreign Trust with a U.S. Owner (Form 3520-A)

Form 3520-A is the annual information return of a foreign trust with a U.S. owner. The form provides information about the trust, the U.S. person who is treated as an owner under the grantor trust rules of Code sections 671-679 and the U.S. beneficiaries. A foreign grantor "trust" is required to file the form and provide annual statements to the U.S. owner and U.S. beneficiaries (technically, a trust isn't an entity and can't file, it is the trustee who files). The U.S. owner is responsible for either seeing that the trust files, or filing in its place. Filing is required by March 15. If a foreign grantor trust fails to file a required return or furnish correct statements to a U.S. grantor and beneficiary, the U.S. owner is subject to an initial penalty of the greater of $10,000 or 5% of the gross value of the portion of the assets of the trust treated as owned by him.[111] The U.S. owner also may be subject to additional penalties, including penalties for undisclosed foreign financial asset understatements.[112] Penalties may be waived if the failure to file was due to reasonable cause and not willful neglect.

Foreign Account Tax Compliance Act (FATCA) and Statement of Specified Foreign Financial Assets (Form 8938)

Form 8938 is new for tax years beginning after March 18, 2010 (effectively, the 2011 tax year for calendar year individual taxpayers). The purpose of this form is to report the ownership of specified foreign financial assets if the total value of those assets exceeds the statutory reporting threshold. The reporting requirement was enacted as part of the Foreign Account Tax Compliance Act (FATCA) provisions of the Hiring Incentives to Restore Employment (HIRE) Act signed into law in 2010. The final regulations were published on December 12, 2014, retroactive for tax years ending after December 19, 2011.

Form 8938 must be filed by persons who are required to file a U.S. income tax return and who are one of the following: a U.S. citizen, a U.S. resident alien, a non-resident alien who elects to be treated as a resident alien to file a joint income tax return, or a non-resident alien who is a bona fide resident of American Samoa or Puerto Rico. Entity filing requirements (including for trusts) are included in the final regulations and an extended phase-in timeline has been announced.

The thresholds for filing are as follows:

Status	Foreign Financial Assets
Living in the United States and either unmarried or married filing separate returns	More than $50,000 on the last day of the tax year or more than $75,000 at any time during the year
Living in the United States and married filing a joint return	More than $100,000 on the last day of the tax year or more than $150,000 at any time during the year
Living abroad and either unmarried or married filing separate returns	More than $200,000 on the last day of the tax year or more than $300,000 at any time during the year
Living abroad and married filing a joint return	More than $400,000 on the last day of the tax year or more than $600,000 at any time during the tax year

The assets required to be reported are financial accounts maintained by a foreign financial institution and stock or securities issued by a non-U.S. person that are held for investment, any interest in a foreign entity (including a trust), and any financial instrument or contract with an issuer or counterparty that is not a U.S. person. Assets held by a U.S. custodian are not required to be reported on Form 8938. In addition, a foreign financial asset is not required to be reported on Form 8938 if the asset is required to be reported (and is reported) on a timely filed Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts), Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporation), Form 8621 (Information Return by Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund), Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships) or Form 8891 (U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans). However, a person is required to identify on Form 8938 the forms on which he reported the assets and how many of the forms he filed and is required to include the value of the assets reported elsewhere to determine whether the person meets the applicable filing threshold for Form 8938.

For purposes of Form 8938 filing, a person generally is deemed to be the owner of assets held in a grantor trust of which he is treated as the owner under the grantor trust rules. The beneficiary of a foreign non-grantor trust or a foreign estate is required to report his interest if he knows of the interest or has reason to know of the interest based

on information that is readily available to him. A person will be deemed to know of his interest if he received a distribution from a trust. If a person is the beneficiary of a foreign trust, the maximum value of his interest in the trust is the sum of (i) the value of the cash or other property distributed to him during the year, and (ii) the actuarial valuation of his *right* as a beneficiary to receive mandatory distributions as of the last day of the tax year. If a person has an interest in a foreign estate, the maximum value of the interest is the fair market value of the interest as of the last day of the tax year. The treatment of contingent and discretionary interests remains to be fully addressed.

Form 8938 is attached to and is required to be filed by the due date of a person's annual income tax return, including extensions.

There is a $10,000 fine for failure to file form 8938, and if the failure continues for more than 90 days after the Internal Revenue Service mails a notice of failure to file, an additional penalty of $10,000 applies for each 30-day period during which the failure continues, with a maximum total penalty is $60,000. Additional accuracy-related and criminal penalties may also apply. Penalties may be excused if the failure to report was due to reasonable cause and not willful neglect, determined on a case-by-case facts and circumstances basis.

FATCA also imposes new and substantial obligations on a broad range of financial institutions – including trusts and related entities. FATCA seeks to increase tax transparency by U.S. citizens and residents by inducing Foreign Financial Institutions (FFIs) to report on U.S. owners of offshore accounts. This reporting is sent to the Internal Revenue Service or to the FFI's local government under the terms of a Model 1 Intergovernmental Agreement (IGA) between the United States and that jurisdiction, if applicable. If an FFI does not comply, FATCA imposes a 30% withholding tax on certain U.S.-source payments, beginning July 1, 2014.

Under the FATCA regulations and the IGAs, non-U.S. trusts or other entities that derive a substantial portion of their income from investments and that are professionally managed generally will be considered FFIs. FFIs generally will be required to meet a variety of initial registration and on-going compliance obligations. Passive investment entities such as trusts that are not professionally managed will likely be considered passive "non-financial foreign entities" (NFFEs) instead of FFIs. In order to avoid FATCA withholding, a passive NFFE generally must provide either a certification that it does not have any substantial U.S. owners, or provide the name, address and TIN of each substantial U.S. owner.

Due to the complexities in this area, we recommend seeking guidance from professional advisors.

OECD COMMON REPORTING STANDARD (CRS)

The Organisation for Economic Co-operation and Development (OECD) determined in 2014 that the concept of FATCA should be extended on a global basis, to provide an automatic exchange under a Common Reporting Standard (CRS) of ownership and asset information to combat tax evasion on a global scale. So far, more than 90 participating jurisdictions have adopted CRS, which became effective in the "early adopter" nations on January 1, 2016 (there are varying dates for adoption and reporting). CRS has a broad scope across three dimensions designed to prevent its circumvention:

- Financial institutions required to report under CRS include banks, custodians, brokers, certain collective investment vehicles and certain insurance companies.
- The accounts financial institutions are required to report include accounts held by individuals and entities, including trusts and foundations. Passive entities are required to report on the individuals who ultimately control the entities ("controlling persons").
- The financial information required to be reported includes all types of investment income, account balances and sales proceeds from financial assets.

Although the United States is a member of the OECD, to date it has not adopted CRS, likely because it receives under FATCA all of the inbound tax information that it needs and does not want the Internal Revenue Service to incur the expense of forwarding all of the CRS-compelled data to each of the participating jurisdictions.

GLOSSARY

Many common terms have specialized meanings under the Code. Following are the definitions under the Code of terms that frequently arise in the context of cross-border trusts.

Fiduciary

A guardian, trustee, executor, administrator, receiver, conservator or any person acting in a fiduciary capacity for any person.[115]

Foreign estate

An estate the income of which, from sources without the United States, is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under Subtitle A (Income Taxes) of the Code.[116]

Foreign trust

Any trust other than a trust described as a "United States person."[117]

Non-resident alien

An individual is a non-resident alien if the individual is neither a citizen of the United States nor a resident of the United States.[118]

Person

Includes an individual, trust, estate, partnership, association, company or corporation.[119]

Presence in the United States

Subject to certain exceptions (e.g., commuters from Mexico and Canada), an individual shall be treated as present in the United States on any day in which the individual is physically present in the United States at any time during the day.[120]

Resident alien

An alien individual is treated as a resident of the United States with respect to a calendar year if (and only if) the individual (i) is a lawful permanent resident of the United States at any time during the calendar year; (ii) meets the "substantial presence test"; or (iii) makes a "first year election."[121]

Substantial presence test

Subject to certain exceptions, an individual meets the substantial presence test with respect to any calendar year (referred to as the "current year") if (i) the individual was present in the United States on at least 31 days during the calendar year, and (ii) the sum of the number of days on which the individual was present in the United States during the current year and the two preceding calendar years (when computed with the applicable multiplier as follows), equals or exceeds 183 days:

In the case of day is:	The applicable multiplier is:
Current year	1
1st preceding year	1/3
2nd preceding year	1/6[122]

United States person

A citizen or resident of the United States; a domestic partnership; a domestic corporation; any estate (other than a foreign estate); and any trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more United States persons have the authority to control all substantial decisions of the trust.[123]

ABOUT THE AUTHOR

Suzanne L. Shier is the Wealth Planning Advisory Services Practice Executive and Chief Tax Strategist/Tax Counsel for Wealth Management at Northern Trust. In this capacity, she is responsible for leading the Wealth Management wealth planning group and for providing thought leadership on federal tax issues of interest to clients, with a special emphasis on tax policy and legislation, charitable giving, cross-border trust design and fiduciary law.

Prior to joining Northern Trust, Suzanne spent 26 years as a partner at Chapman and Cutler LLP in Chicago, ultimately leading the firm's trusts and estates practice group, representing individuals, charitable organizations and corporate fiduciaries in a full range of estate planning and fiduciary services, including cross-border planning and fiduciary administration matters.

She is an adjunct professor in the Master of Laws in Taxation Program at Northwestern University Law School and also a frequent speaker and author. She has been quoted in publications such as The Wall Street Journal and Bloomberg and has received numerous professional honors and recognitions. Suzanne earned her bachelor's degree with distinction in economics and sociology from the University of Michigan in 1982. She received her law degree, cum laude, from the Loyola University Chicago School of Law in 1985 and a master of laws in taxation from the DePaul University College of Law in 1997.

In the civic community, Suzanne is actively involved in many diversity and education initiatives, including serving on the board of directors of Gads Hill Center, as a trustee of Hope College and as chairperson of the board of directors of Chicago Scholars, a college access program for high potential urban students. She is also a fellow of the American College of Trust and Estate Counsel (where she is a member of the international committee) and a member of the International Bar Association, the Society of Trust and Estate Practitioners, the American Bar Association and the Chicago Estate Planning Council.

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ABOUT NORTHERN TRUST

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ENDNOTES

1 "Dual citizens" (individuals who are citizens of the U.S. and another country) are taxed as U.S. citizens and any other citizenship is generally ignored for U.S. tax purposes. *U.S. v. Matheson*, 532 F.2d 809 (2d Cir.); *Vriniotis Estate v. Comr.*, 79 T.C. 298 (1982). An applicable treaty may change this tax treatment.

2 Code § 7701(b) is not applicable to trusts because it only applies to individuals.

3 Treas. Reg. § 301.7701(b)-1(a).

4 Code § 7701(a)(30)(E).

5 Code § 7701(a)(31)(B).

6 Treas. Reg. § 301.7701-7(c)(1).

7 Treas. Reg. § 301.7701-7(c)(3)(v).

8 Treas. Reg. § 301.7701-7(d)(1)(ii).

9 Treas. Reg. § 301.7701-7(d)(2).

10 Code §§ 671-679.

11 Code §§ 651, 661.

12 Code § 679.

13 Code § 679(c)(2)(C).

14 Code § 679(d).

15 Code § 679(a)(2).

16 Code § 672(f).

17 Code § 678.

18 A beneficiary reporting a distribution from a foreign trust without adequate information from the trustee regarding the trust or the distribution may elect a default averaging method to compute the tax and interest charges on Form 3520. However, if the default averaging method is used for one year, it is required to be used for subsequent years, even if adequate information to compute the actual tax and interest is available for the subsequent years.

19 Code § 643(a)(3), (a)(6)(C).

20 Code § 643(a)(6)(C).

21 Code § 663(b); Reg. §§ 1.663(b)-1, 1.663(b)-2. If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the Internal Revenue Service center, with which a return by the trust would be filed if the trust were required to file for the taxable year.

22 UNI, for any taxable year, is defined as the amount by which the trust's DNI exceeds (1) the amount distributed to the beneficiary and (2) the amount of tax imposed on the trust for the DNI. Code § 665(a).

23 Code § 668.

24 Code § 668(c).

25 Code § 665(e)(1).

26 Code § 666(d).

27 Code § 664(b).

28 Code §§ 871(a) and 881(a). Income taxable under these provisions includes interest, dividends, royalties, compensations and other fixed or determinable annual or periodic income and certain gains.

29 The withholding rules are found at Code §§ 1441, 1442, and 1443.

30 Treas. Reg. § 1.1441-2(a). Treasury Regulation § 1.1441-2(a) states that the income subject to withholding means amounts from sources within the U.S. that constitutes either fixed or determinable annual or periodic income ("FDAP income"). The regulation defines FDAP income as all income included in gross income under Code § 61 (i.e., all income unless it is specifically excluded by the Code). There are several exceptions to this all-inclusive rule. One important exception is for gains. There is no withholding required for gains derived from the sale of property (including market discount and option premiums) except for gains described in Code § 631(b) or (c) (relating to the treatment of gains on the disposition of timber, coal or domestic iron ore with a retained economic interest) and gains subject to the 30% tax under Code § 871(a)(1)(D) or Code § 881(a)(4) (relating to contingent payments received from the sale or exchange of patents, copyrights and similar intangible property). Treas. Reg. § 1.1441-2(b)(2)(i). Other items of income which are excluded from the withholding requirements are: (1) non-U.S. source income; (2) portfolio interest paid on a debt obligation; (3) bank deposit interest; (4) interest or OID on a short-term OID obligation; and (5) insurance premiums paid on a contract subject to Code § 4271 excise tax or paid to a foreign insurer. Treas. Reg. § 1.1441-2(a), (b)(2)(ii).

31 Treas. Reg. § 1-1441-5(b)(2)(ii). Because DNI cannot be correctly determined until the end of the year, the trust may make a reasonable estimate of the portion of any distribution that constitutes DNI consisting of income subject to withholding and apply the appropriate rate of withholding to the estimated amount. No penalties are imposed for failure to withhold and deposit the tax if the trust's estimate was reasonable.

32 Treas. Reg. § 1.1441-5(b)(2)(iv).

33 Code § 684(a)(1).

34 Code § 684(c).

35 See Code § 672(f).

36 Treas. Reg. § 20.0-1(b)(1).

37 *Farmers Loan and Trust Co. v. United States*, 60 F.2d 618 (S.D.N.Y. 1932)

38 Treas. Reg. §§ 20.2104-1(a)(1), (2), 25.2511-3(b)(1), (2). Currency is treated as tangible personal property. Treas. Reg. §§ 20.2104-1(a)(7), 25.2511-3(b)(4)(iv).

39 Code § 2501(a)(2). In PLR 9119049, the Internal Revenue Service ruled that a mutual fund, which consisted of municipal bonds and securities, was intangible personal property and the non-resident alien was not subject to U.S. gift tax.

40 Treas. Reg. §§ 20.2104 1(a)(5), 25.2511-3(b)(3). In TAM 9748004, the Internal Revenue Service ruled that shares in an open-ended U.S. investment company (i.e., a mutual fund) are treated as stock of a U.S. domestic corporation for purposes of the situs rules.

41 Treas. Reg. §§ 20.2104-1(a)(7), 25.2511 3(b)(4).

42 Code §§ 2105(b)(1), 871(i)(3). U.S. bank deposits include money in a checking, savings or unrestricted agency account and certificates of deposit. See *Estate of Gade*, 10 T.C. 585 (1948); *Estate of Forni*, 47 B.T.A. 76 (1942); Rev. Rul 82-193, 1982-2 C.B. 219. Cash in a bank's safe deposit box is not a U.S. bank deposit. Rev. Rul. 55-143, 1955-1 C.B. 465. In addition, funds held by a bank in a fiduciary capacity where the beneficiary's access is restricted do not constitute U.S. bank deposits. Rev. Rul. 69-596, 1969-2 C.B. 179. A brokerage firm is not in the banking business, and cash held by a U.S. brokerage firm will still have a U.S. situs. Rev. Rul. 65-245, 1965-2 C.B. 379.

43 Code § 2105, Reg. §§ 20.2105-1(g),(h), 25.2511-3(b)(4).

44 Code §§ 2105(b)(3), 871(h). The types of obligations that can qualify as portfolio debt obligations include U.S. government obligations; obligations issued by agencies of the U.S.; obligations issued by states, counties, cities and public authorities; and obligations of U.S. corporations and partnerships. However, it is unlikely that debt obligations issued by a U.S. individual would qualify. See Code § 871(h)(2), (3). In TAM 9748004, the Internal Revenue Service held that a unit investment trust which held portfolio debt obligations was treated as non-U.S. situs property under Code § 2105(b)(3).

45 Code § 2105(c).

46 Reg. § 20.2104-1(c).

47 Code §§ 2056, 2523.

48 P.L. 100-647.

49 Code §§ 2056(d), 2523(i).

50 Code §§ 2055, 2522(a).

51 Reg. §§20.2055-1(a), 25.2522(a)-(1)(a)

52 Code §§ 2106(a)(2), 2522(b), Reg. §§ 20.2106 1(a)(2)(i), 25.2522(b)-1.

53 Code § 2010.

54 Code § 2102(b)(2).

55 Code § 2102(b)(3).

56 Code § 2631.

57 Code § 2503(b).

[58] Code § 2014(a).

[59] Code § 2056(d)(2).

[60] Code § 2056(d)(2)-(5).

[61] Code § 2056)(b)(5), (b)(7), (b)(8); Reg. § 20.2056(c)-2(b)(1)(i)-(iii).

[62] Code § 2056A(a).

[63] Code § 2056A(a), Reg. § 20.2056A-2(a); Rev. Proc. 96-54, IRB 1996-50 (12/9/96).

[64] Reg. § 20.2056A-2(d).

[65] Reg. § 20.2056A-2(d)(1)(iv).

[66] Reg. § 20.2056A-2(d)(1)(i)(A)-(C).

[67] Reg. § 20.2056A-2(d)(1)(i)(A).

[68] Reg. § 20.2056A-2(d)(1)(i)(B).

[69] Reg. § 20.2056A-2(d)(1)(i)(C).

[70] Reg. § 20.2056A-2(d)(1)(ii); Rev. Proc. 96-54, IRB 1996-50 (12/9/96).

[71] Reg. § 20.2056A-2(d)(1)(v).

[72] Reg. § 20.2056A-2(d)(1)(i)(D).

[73] Reg. § 20.2056A-2(d)(2).

[74] Reg. § 20.2056A-2(d)(3).

[75] Code § 2056A(a)(3), Reg. § 20.2056A-1(a)(2).

[76] Reg. § 20.2056A-3(b).

[77] Reg. § 20.2056A-3(c).

[78] Reg. § 20.2056A-9.

[79] Code § 2056(d)(5), Reg. § 2056A-4(a).

[80] Reg. § 20.2056A-4(b)(7)(i).

[81] Internal Revenue Service Final Regulation (TD 8612), Guidance on Changes to Marital Deduction Provisions of Estate and Gift Tax, issued 8/21/95 at p. 13.

[82] Reg. § 20.2056A-4(c).

[83] Code § 2056(d)(4), Reg. § 20.2056A-1(b).

[84] Code §§ 643(b), 2056A(b)(3)(A), Reg. § 20.2056-5(c)(2).

[85] Reg. § 20.2056A-5(c)(2).

[86] Reg. § 1.643(b)-1.

[87] Reg. § 20.2056A-5(c)(1).

[88] Reg. § 20.2056A-5(c)(3).

[89] Reg. § 20.2056A-5(b).

[90] Code § 2056A(b)(4), Reg. § 20.2056A-5(b)(3).

[91] Code § 2056A(b)(12), Reg. §20.2056A-10.

[92] Code § 2056A(b)(2), Reg. §20.2056A-6.

[93] Code § 2056A(b)(6), Reg. § 20.2056A-11(d).

[94] Code § 2056A(b)(2)(B).

[95] Code § 2056(d)(3), Reg. §20.2056A-7.

[96] Code §§ 2040(a), 2056(d)(2), 2523(i), Reg. §§20.2056A-8, 25.2523(i)-2.

[97] For individuals who expatriated on or before June 16, 2008, the expatriate is subject to tax under Code § 877 on all their U.S. source income, just like all other non-resident aliens; however, the definition of U.S. source income is broader and the U.S. source income is taxed at the graduated rates applicable to U.S. citizens and residents rather than the flat 30% or lesser treaty rate for non-resident aliens. If the tax liability calculated under Code § 877 exceeds the liability under Code § 871 (which is the general tax provision for non-resident aliens), the taxpayer must pay the tax as calculated under Code § 877 (i.e., the taxpayer must pay the greater of the two taxes).

[98] Code § 877.

[99] This amount is $162,000 in 2017.

[100] Code § 877(g)(1).

[101] Code § 877A.

[102] This amount is $699,000 in 2017.

[103] Payments of the tax withheld are made quarter-monthly, monthly or annually depending on the amounts withheld. If the amount withheld is less than $200 in the taxable year, the payment is made when the agent files the annual 1042 form. If the withholding agent has withheld between $200 and $2,000 at the end of any month, the payment is made 15 days after the end of the month. If the withholding agent has withheld $2,000 or more at the end of any quarter-monthly period, the payment must be made 3 banking business days after the end of the quarter-monthly period. Quarter-monthly periods fall on the 7th, 15th, 22nd and last day of each month.

[104] A Form W-8BEN is valid for the year in which it is signed plus the following three full calendar years. A change in circumstances that makes the form incorrect (i.e., a change of address to a different country or the United States, or a change in telephone number to a U.S. telephone number) will invalidate the form at any time. A Form W-8BEN may have unlimited validity if provided to document status as a non-U.S. person, the individual does not have a U.S. address or telephone number and is not making a claim for reduced tax rates under an income tax treaty.

[105] Treas. Reg. § 1.1441-6. The foreign beneficiary may also need to acquire a taxpayer identification number from the Internal Revenue Service in order to claim certain treaty benefits. See Treas. Reg. § 1.1441-6(c)(2).

[106] 31 U.S.C § 5314; 31 C.F.R. 103.

[107] *Williams*, CA 4 07/20/2012 110 AFTR2d ¶2012-5639.

[108] Code § 6677.

[109] Code § 6039F.

[110] Code § 6662(j).

[111] Code § 6677.

[112] Code § 6662(j).

[113] Temp. Reg. § 1.6038D-8T.

[114] *Id.*

[115] Code § 7701(a)(6).

[116] Code § 7701(a)(31)(A).

[117] Code § 7701(a)(31)(B).

[118] Code § 7701(b)(1)(B).

[119] Code § 7701(a)(1).

[120] Code § 7701(b)(7).

[121] Code § 7701(b)(1)(A).

[122] Code § 7701(b)(3).

[123] Code § 7701(a)(30).

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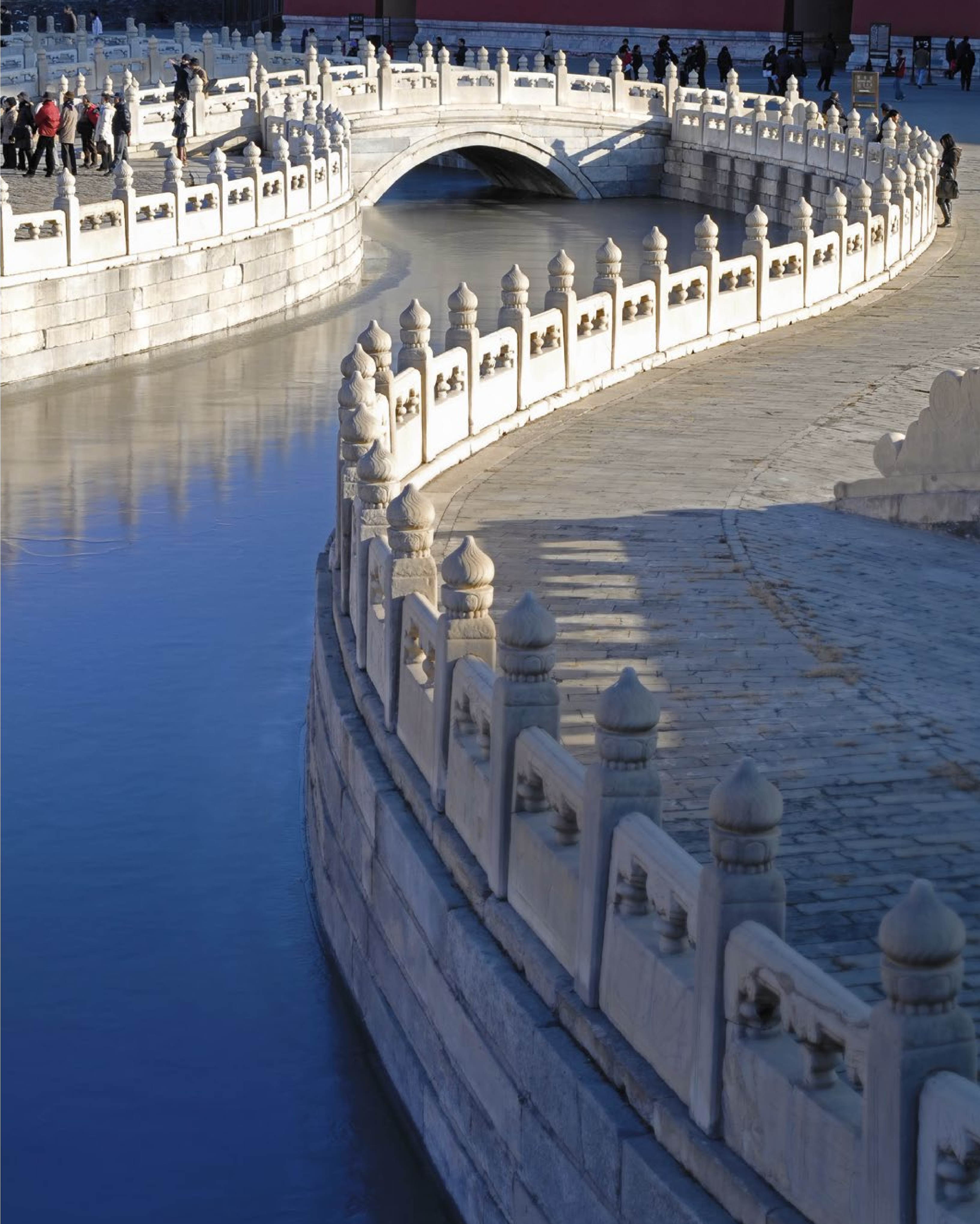

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