

FOREIGN BENEFICIARIES of U.S TRUSTS

USC Gould School of Law
2019 Tax Institute
January 29, 2019

Karlin & Peebles, LLP

5900 Wilshire Boulevard, Suite 500

Los Angeles, CA 90036

323.852-0030 ● fax 310.388.5537

Michael Karlin – 323.852.0033 ● mjkarlin@karlinpeebles.com

Jeannette Yazedjian – 323.648.4651 ● jyazedjian@karlinpeebles.com

Maria Otero – 323.648.4648 ● motero@karlinpeebles.com

Items to Consider When You Encounter a Foreign Beneficiary

1. Each beneficiary's income tax filing status, both in the U.S. and in the country of residence.
2. Relevance of tax treaty provisions applicable to the beneficiaries in each foreign jurisdiction.
3. Applicable law changes, including the standards for making distributions and reporting them in the beneficiary's foreign jurisdiction.
4. Proper allocation of receipts and disbursements between income and principal under local law and governing instruments.

Domestic Trust or Foreign Trust

- A trust is domestic if:
 - ◆ A court within U.S. is able to exercise primary supervision over the administration of the trust (court test). See Treas. Reg § 301.7701-7(c)(3)
 - Trust does not direct that it must be administered outside U.S.
 - Trust exclusively administered in U.S.; and
 - Trust not subject to automatic migration clause (“flight” clause)
 - ◆ One or more U.S. persons have the authority to control **all** substantial decisions of the trust (control test). See Treas. Reg § 301.7701-7(d)(1)(ii)
 - Does a foreign person have veto/consent power?
 - Regs. allow trust 12 months from date of cessation as domestic trust to make changes to give control to U.S. persons.
- A trust is foreign if it is not domestic.

U.S. Taxation of Non-Grantor Trusts

- Income is taxed to the trust, the beneficiaries or partly to each depending on whether trust is simple or complex.
- Simple Trusts –
 - ◆ All income must be distributed currently;
 - ◆ No amounts may be paid to charity; and
 - ◆ No distributions are made other than of current income.
 - ◆ Trust receives a distribution deduction for current income it must pay to beneficiaries, whether or not actually distributed.
- Complex Trusts –
 - ◆ Not required to distribute all income currently;
 - ◆ Can distribute income or principal;
 - ◆ Can have a charitable beneficiary.
 - ◆ Trust receives a distribution deduction for current income required to be paid plus income actually distributed.
- Explicit authority in case law and IRS rulings, that the distribution deduction applies to distributions made to foreign beneficiaries.

U.S. Income Tax Treatment of Distributions To Beneficiaries

- In general, income or principal distributed to a beneficiary is treated as income to the beneficiary for U.S. income tax purposes to the extent that the trust has distributable net income (DNI) for the tax year.
- DNI, typically, is apportioned among multiple beneficiaries proportionately (unless trust instrument requires differently). Income beneficiaries treated as receiving proportionate share of each type of income.
- For U.S. income tax purposes, income has the same character in the hands of the beneficiary as it does in the hands of the trustee. Accordingly, whether a particular income item is taxable to a foreign beneficiary is determined at the trust level.

U.S. Income Tax Treatment of Distributions To Beneficiaries

- Income that might be included in DNI:
 - ◆ Dividends;
 - ◆ Interest;
 - ◆ Rents and royalties;
 - ◆ Annuity income;
 - ◆ Pension and other deferred income, including IRAs;
 - ◆ Most gambling winnings;
 - ◆ Cancellation of debt income;
 - ◆ Effectively connect income;
 - ◆ Original issue discount (OID) from the redemption of an OID obligation.
- Capital gains not included in DNI – however, if trust instrument allows fiduciary to allocate gains to income, fiduciary may want to consider doing so.

U.S. Income Tax Treatment of Distributions To Beneficiaries

- Specific income items distributed to a foreign beneficiary may not be subject to U.S. income tax:
 - ◆ Interest income is excluded from the statutory definition of Fixed, Determinable, Annual, Periodical Income (FDAP) under sections 871(h) (portfolio interest) and (i) (bank interest). Interest income earned by the trust is deductible if distributed to a foreign beneficiary but because the beneficiary is a nonresident alien, he will not be subject to U.S. income tax on the distribution. Therefore, the income is not subject to withholding tax (see Rev. Rul. 86-76).
 - ◆ Capital gains (other than for real property)
- However, remember that foreign jurisdiction likely to take a different position on character and taxation of distributions made to foreign beneficiary.

U.S. Income Tax Treatment of Distributions To Beneficiaries

- Foreign beneficiaries do not recognize U.S. source capital gains income.
- Some concepts to consider when drafting trusts with foreign beneficiaries:
 - ◆ Tier system
 - DNI first allocated to mandatory income beneficiaries. Any remaining DNI allocated among beneficiaries receiving other distributions.
 - ◆ Separate share rule
 - ◆ Specific Bequests – Section 663(a)(1)
 - Don't carry out DNI.

Determining Tax Status of Beneficiary

- U.S. Persons: U.S. citizens, resident aliens (green card holders) and U.S. residents who meet the substantial presence test (IRC § 7701(b)).
- Individual who meets the presence test may establish closer connection to a foreign country if:
 - ◆ He was present in the United States for fewer than 183 days during the current year;
 - ◆ Maintains a tax home in a foreign country;
 - ◆ Has a closer connection to a foreign country (based on facts and circumstances);
 - ◆ Has not applied or taken affirmative actions to change his or her status to that of a green card holder.

Withholding Rules on Distributions to Foreign Beneficiaries

- Fiduciaries may be required to withhold tax on DNI distributed to a foreign beneficiary and are responsible for withholding the tax before the distribution is paid.
- Taxes are withheld when the distributions consist of amounts subject to withholding (i.e. the income portion, not corpus).
 - ◆ Guidance for tax withholding for simple and complex trusts found in Treas. Reg. 1.1441-5.
- The withholding requirements apply to foreign persons (nonresident aliens).

Withholding Rules on Distributions to Foreign Beneficiaries

- The withholding tax is ordinarily 30%.
- Tax withholding is required on amounts from U.S. sources and those amounts are reported on Form 1042-S, including:
 - ◆ FDAP income
 - ◆ Certain gains from the sale of timber, coal or domestic iron with a retained economic interest.
 - ◆ Gains related to contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property;
 - ◆ Distributions of effectively connect income from a publicly traded partnership;
 - ◆ Capital gains on the sale of U.S. real property interest.

Withholding Rules on Distributions to Foreign Beneficiaries

- A trust must withhold income taxes when distributions are made to a foreign beneficiary and report the taxes withheld on Form 1042 and 1042-S, which are due on March 15.
- Deposits of the tax withheld are made quarterly, monthly or annually depending on the amounts withheld.
- A U.S. fiduciary is required to request a Form W-8BEN from a foreign beneficiary. Form W-8BEN must include an Individual Taxpayer Identification Number (ITIN).

Withholding Rules on Distributions to Foreign Beneficiaries

- Obtaining an ITIN can be a difficult task.
- If a foreign beneficiary does not provide the Form 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.
- Lower withholding rates can apply per tax treaties. Each treaty needs to be carefully reviewed.

Withholding Rules on Distributions to Foreign Beneficiaries

- The following income items are exempt from tax withholding (note that they still need to be reported on Form 1042-S by category and code identification):
 - ◆ Interest on bank deposits, including bank deposit interest from foreign branches of U.S. banks or savings and loans;
 - ◆ Portfolio interest, including interest on most U.S. government obligations and most corporate bonds, as well as properly structured private obligations;
 - ◆ Interest and Original Issue Discount from short term obligations (i.e. those payable 183 days or less from the date of original issue).

Effect of Treaty Provisions to Reduce Withholding on Distributions

- Withholding rate can be less than 30%, under certain provisions in U.S. tax treaties.
- Separate Form 1042-S required for each income type if withholding rate varies.
- Form W-8BEN must be received from the beneficiary.
- Example of reduced withholding rate is the provision in recent U.S. tax treaties for a limit on the rate of tax (15%) on dividends.

Analysis of Specific Income Items

■ Capital Gains:

- ◆ Section 643(a): distributable net income encompasses the trust's taxable income, computed with certain modifications such as the subtraction of the trust's capital gains.
- ◆ Fiduciary is permitted to exercise discretion (if the trust instrument allows such discretion) in allocating realized capital gains to income in a consistent manner.
- ◆ If fiduciary allocates capital gains to income, those gains will be treated as included in distributable net income for the tax year and thus taxed to the beneficiaries.
- ◆ A nonresident alien beneficiary is not taxed on U.S. source capital gains in the U.S. (except if U.S. real property interest or, beginning in 2018, interest in partnership engaged in U.S. trade or business).

Analysis on Specific Income Items

- Capital Gains on Real Property:
 - ◆ Foreign beneficiaries can face severe tax consequences in terms of withholding for their allocations of Schedule K-1 trust or estate income from a passthrough entity that sold a U.S. real property interest at a gain.
 - ◆ Under IRC §1445(e)(4), the trustee of a domestic trust or the executor of a domestic estate must deduct a tax equal to 10% of the fair market value of the U.S. real property disposition that would constitute a taxable distribution to a foreign person beneficiary (based upon his or her pro rata share of the gain).
 - ◆ Could create cash flow issues.

What About Tax Consequences In the Country of Residence of the Foreign Beneficiary?

- Tax return preparers and fiduciaries should be cautious with foreign beneficiaries.
- Tax authorities in the foreign country in which the foreign beneficiary is domiciled may take the position that all the trust's income, not just the amount distributed, is taxable to their resident beneficiary taxpayer.
- Practitioners and fiduciaries should consult with local counsel in that particular foreign jurisdiction.

Around the Globe: Taxation of Distributions from a U.S. Trust to a French Beneficiary

- Since August 1, 2011, Article 1649 AB § 1 of the French Tax Code provides that the trustee of a trust with a French tax resident settlor, a French tax resident beneficiary or with property or right located in France, has an annual obligation to report the establishment, modification or termination of the Trust, as well as the contents of its portfolio.

Around the Globe: French Beneficiary

- This provision puts an obligation on trustees to declare the creation, modification and revocation of any trust if the settlor, one of its beneficiaries is a French resident or if any portion of the trust's assets is situated in France.
- The trustees are also required to disclose the terms of the trust in order to inform French tax authorities if the trust is revocable or not, discretionary or not, grantor or non-grantor.

Around the Globe: French Beneficiary

- The trustees are required to report the market value of the whole of the trust assets at January 1 of each year.
- The return must be filed by the trustee at the latest on June 15 of each year.
- Failure by a trustee to comply carried a fine of 5% of the assets held in trust or 12.5% depending on the tax years.
- The settlor and the beneficiaries are jointly liable with the trustees for this fine.

Around the Globe: French Beneficiary

- On March 16, 2017, the French Supreme Constitutional Court (Conseil Constitutionnel) ruled that the 12.5% penalty was unconstitutional.
- The Conseil Constitutionnel held that this uncapped penalty, equal to a fixed percentage of the assets and rights in trust, and applicable to each failure to comply, even when no French tax has been avoided in relation to such assets and rights, was disproportionate to the gravity of the facts which the penalty intends to sanction.

Around the Globe: French Beneficiary

- Concurrently, the Conseil Constitutionnel held that the minimum fixed penalty of €20,000 is constitutional and proportionate to the objective.
- Note that the penalty is imposed for each failure to report to the French authorities the establishment, modification or termination of the Trust.
- It does not matter if it is a revocable trust.

Around the Globe: Taxation of Distributions from a U.S. Trust to a Belgian Beneficiary

- Belgium income taxation of trusts is governed by the “Cayman Tax” law (CTL) enacted in 2015.
- CTL has introduced “pass-thru” tax treatment of income generated through foreign private wealth structures referred to in the law as “legal constructions”.
- Trusts fall within this definition.

Around the Globe: Belgian Beneficiary

- Pursuant to the CTL, income tax may be imposed on the “Founders” of a trust or on “Third Party Beneficiaries”.
- The CTL produces several adverse tax consequences relating to double taxation. It does not allow for relief from double taxation where foreign taxes (read U.S. taxes in our case) are paid on trust income.
- The tax rate is 30% on the distribution.

Around the Globe: Taxation of Distributions from a U.S. Trust to a Dutch Beneficiary

- Trusts are treated as transparent entities.
- During the settlor's lifetime, the assets are attributed to the settlor for tax purposes. If the settlor is a Dutch resident, the settlor will be taxed on the trust's income.
 - ◆ Distributions from the trust during settlor's lifetime to the beneficiaries, are donations by the settlor.
- Upon the settlor's death, the assets are attributed to the settlor's heirs pro rata (unless heir can demonstrate that she will never be a beneficiary of the trust).
 - ◆ If the heirs are Dutch residents, the heirs will be taxed on the trust's income.
- Revocable and irrevocable trusts are treated the same.

Around the Globe: Taxation of Distributions from a U.S. Trust to a U.K. Beneficiary

- Offshore Trusts – exposure to U.K. tax is limited if:
 - ◆ Trustees are all non-U.K. residents
 - ◆ Some trustees are non-U.K. resident and settlor was non-U.K. resident when trust was set up
- U.K. resident beneficiaries of a non-resident trust taxed if they receive distributions or other benefits from the trust, to the extent there are income or gains in the trust.
 - ◆ Income and gains accumulate in the trust and are “matched” with amounts distributed to the beneficiaries in question (income first, then gains) and give rise to income tax and capital gains tax accordingly
 - ◆ Under new rules (as of April 6, 2018), can no longer wash out gains with distributions to non-U.K. beneficiaries

Around the Globe: U.K. Beneficiary

- How are U.S. revocable trusts viewed from a U.K. Perspective?
 - ◆ Are assets rebased at the settlor's death?
 - ◆ Do income and gains arise from the date of settlement or the date of death?
- Is U.K. beneficiary an income beneficiary or a discretionary beneficiary?
- Relevant Property Trusts – where the trust holds UK situs assets, trust will be fall within the relevant property regime and will potentially be subject to periodic IHT charges on each 10 year anniversary of the trust, or exit charges when UK situs assets leave the trust. These charges can be at a rate of up to 6 per cent on the value of the UK situs assets. In addition, an extensive UK IHT return will be required.
- No relief for double taxation under treaty, but beneficiary may be able to claim credit on tax return for withholding tax paid by trustee on distribution to beneficiary.

Around the Globe: U.K. Beneficiary

- Essential that trustees provide proper accounting of income and gains for each year from commencement of the trust.
 - ◆ May need to engage specialist to calculate the historic income and gains position of the trust, and to update it each year, in order to enable the U.K. resident beneficiary to determine her U.K. tax position.
- U.K. tax year runs from April 6 to April 5