



G&TCA

GATCA & Trusts Compliance Associates LLC

Practical Issues in Foreign Trust Administration for South Dakota Trustees

South Dakota Trustees Association Fall Forum 2024
Deadwood SD, 17 October 2024

Presented by: Peter Cotorceanu

peter.cotorceanu@gatcaandtrusts.com

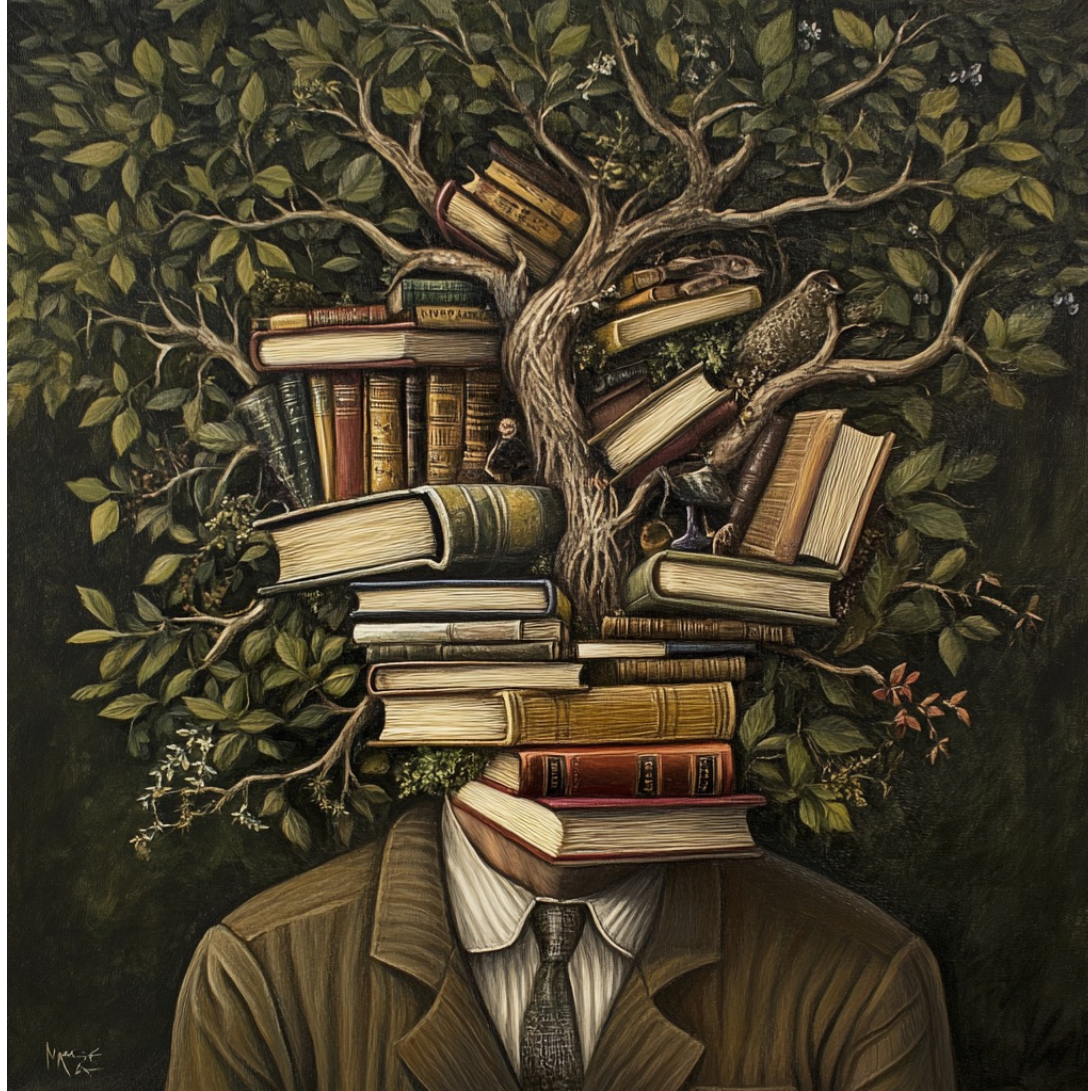
3 Takeaways



What is a “Foreign” Trust May Surprise You



Some Knowledge



Hic Sunt Dracones



On Tap Today



- What is a Foreign Trust?
- Why Use a Foreign Trust?
- FATCA Compliance
- FBARs and Form 8938

On Tap Today

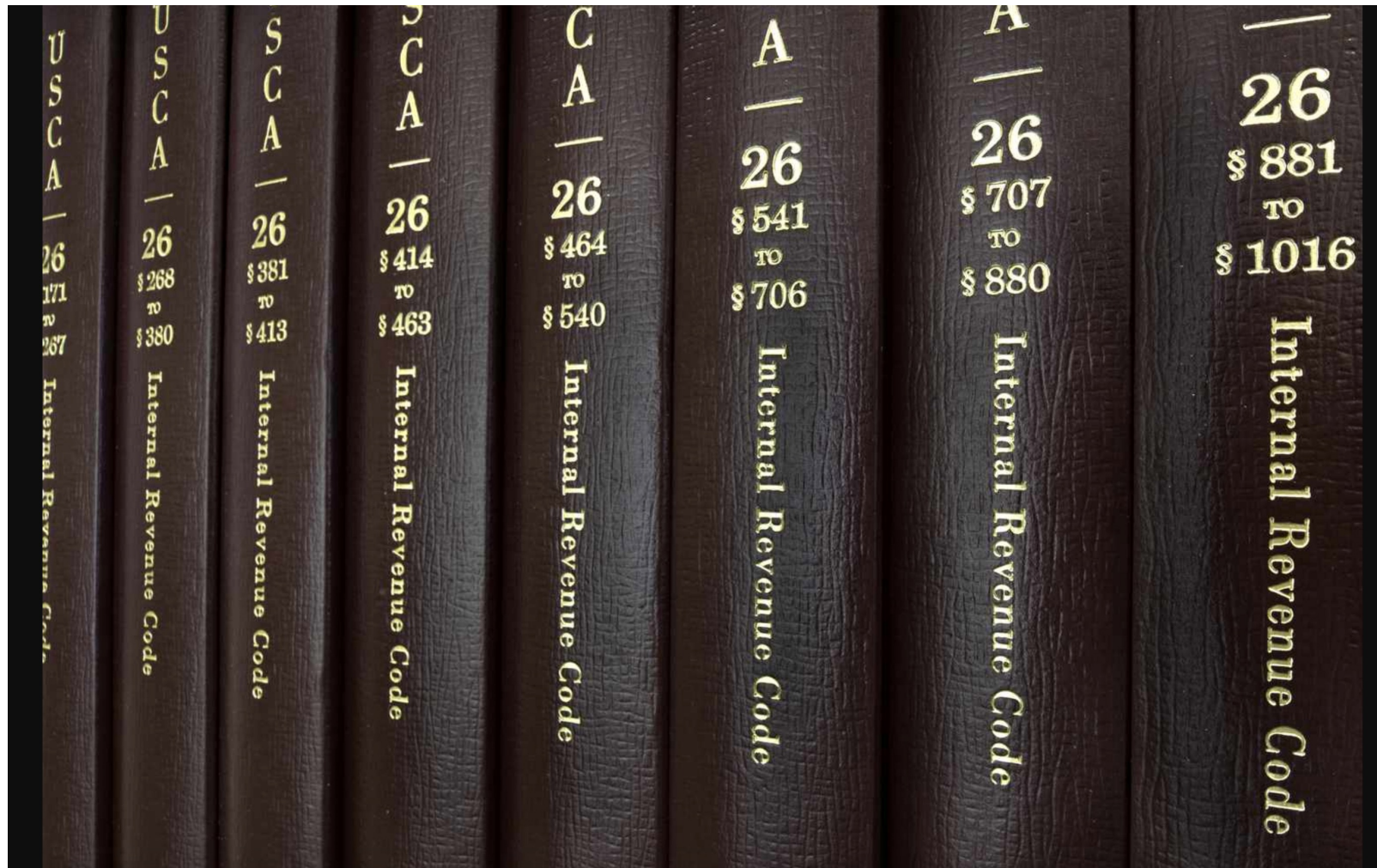


- Grantor and Non-Grantor Trust Status
- Accumulation Distributions
- IRS Forms 3520 and 3520-A
- Basis Step Up



What is a Foreign Trust?

“Foreign” in What Sense?



Foreign or U.S.?

- Trustee:



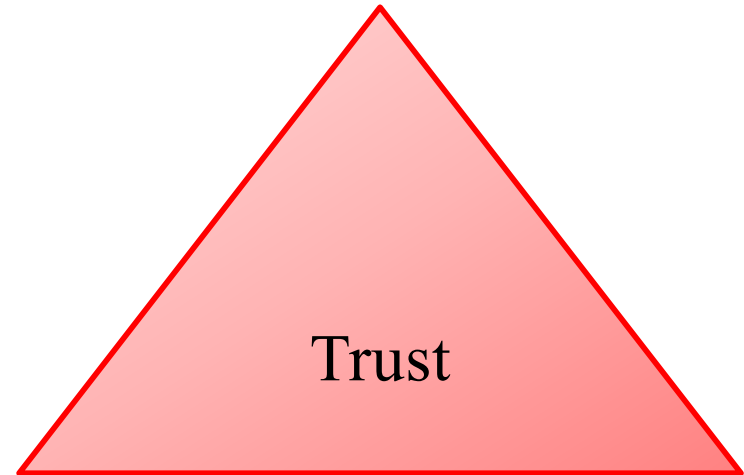
- Law:



- Bank Account:



- Settlor and all Benes:



Investment Manager



“Flee Clause”



Foreign or U.S.?

- Trustee:



- Law:



- Bank Account:



- Settlor and all Benes:



INVESTMENT ADVISOR



“Flee Clause”



The “Court” and “Control” Tests

- Must satisfy *both* to be a U.S. (i.e., not a “foreign”) trust
- **Court Test:**
 - A U.S. court can exercise primary supervision over the administration of the trust
- **Control Test:**
 - One or more U.S. persons have the power to control *all* “substantial decisions” of the trust

Court Test—Flee Clauses

- A U.S. court doesn't have primary supervision over the administration of a trust if the trust has a **flee clause** that would automatically migrate the trust outside the U.S. if a U.S. court attempts to assert jurisdiction or otherwise supervise the administration of the trust
- **Exception:** If the automatic migration is triggered only in the case of foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S.

Substantial Decisions (1/2)

- Whether and when to distribute income or corpus
- The amount of any distribution
- The selection of a beneficiary
- The power to make investment decisions; however, if a U.S. person (trustee, protector, etc.) appoints a foreign investment advisor and can remove that advisor, the appointment of the foreign advisor will not make the trust foreign
- Whether a receipt is allocable to income or principal
- Whether to terminate the trust

Substantial Decisions (2/2)

- 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 name a successor to a trustee, provided, however, that the power solely to name a successor will not be considered a substantial decision if it is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic or vice versa

Foreign Trust by Surprise?



Ch-ch-changes

- If an “inadvertent” change causes a change in the U.S. or foreign status of a trust, the trust has 12 months from the date of the change to make necessary changes to avoid a change in the trust’s U.S. or foreign status.
- “Inadvertent change” means the death, incapacity, resignation, or change in residency that was not intended to change the residency of the trust.



Why Use a Foreign Trust?

Pros and Cons

- **U.S. Settlers:**
 - Pros: ?
 - Cons: Foreign Trust reporting obligations:
 - IRS **Form 3520**:

Form 3520 (Rev. December 2023) Department of the Treasury Internal Revenue Service	Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts Go to www.irs.gov/Form3520 for instructions and the latest information.	OMB No. 1545-0159
--	---	-------------------

- Plus (if a grantor trust), IRS **Form 3520-A**:

Form 3520-A (Rev. December 2023) Department of the Treasury Internal Revenue Service	Annual Information Return of Foreign Trust With a U.S. Owner (Under section 6048(b)) Go to www.irs.gov/Form3520A for instructions and the latest information.	OMB No. 1545-0159
--	---	-------------------

Pros and Cons

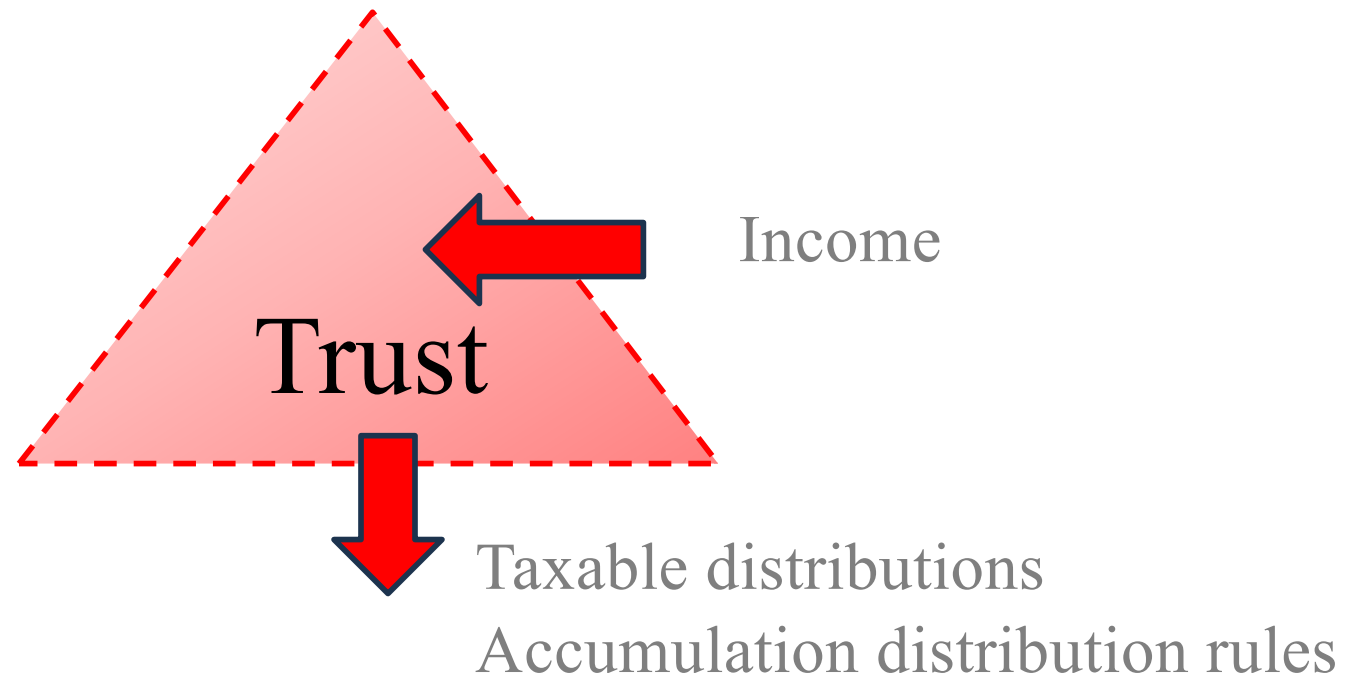
- **Non-U.S. Settlers:**
 - Cons: ?
 - Pros:
 - Non-U.S. settlor or protector can keep certain powers (e.g., right to revoke the trust, remove and replace trustee, serve as investment manager, etc.) while still using a U.S. trustee
 - If the trust has U.S. beneficiaries:
 - Tax-free distributions to U.S. benes
 - But will be advantageous to “domesticate” the trust (or pour over to a U.S. trust) when the settlor passes away due to 3520 reporting obligations and accumulation distribution rules

Foreign Grantor Trusts

- A foreign trust (or a U.S. trust for that matter) settled by a non-U.S. settlor will be a grantor trust only if either or both of the following are true:
 - **Revocability:** The settlor has the power to “revest” the trust assets in himself or herself without the approval or consent of any other person or with the consent of a “related or subordinate party who is subservient to the grantor,” or
 - **The settlor and/or the settlor’s spouse** are the only permitted benes during the settlor’s life

Foreign *Non*-Grantor Trusts

- Subject to limited exceptions, a foreign grantor trust will become a *non*-grantor trust when the settlor passes away or becomes incapacitated





FATCA Compliance

Foreign Account Tax Compliance Act

FATCA

FATCA's Goal

Find U.S. taxpayers



hiding “financial accounts” at



“foreign” financial institutions (FFIs)



Impact on Foreign Trusts

- Most foreign trusts with corporate trustees (even U.S. corporate trustees) will be FFIs
- If the trustee of the foreign trust is a U.S. trust company, the holders of “**financial accounts**” in the trust will be:
 - The **settlor**, but only if the trust is a grantor trust
 - **Mandatory beneficiaries**
 - **Discretionary beneficiaries who receive a distribution** in the year in question
- If any of the above are U.S. Persons, the trustee must file a FATCA report with the IRS

Impact on Foreign Trusts

- Lots of other obligations too:
 - Register with the IRS and get a **GIIN** (Global Intermediary Identification Number) or be “**sponsored**” by an entity with a “sponsor’s” GIIN
 - Conduct detailed and very specific **due diligence** to identify (i) any U.S. settlors of **grantor** trusts, (ii) U.S. discretionary beneficiaries who have received a distribution, and (iii) mandatory beneficiaries

Impact on Foreign Trusts

- File so-called “**FATCA Responsible Officer**” certifications with the IRS:
 - A “**COPA**” (Certification of Pre-Existing Accounts) (a one-time filing)
 - A “**Periodic Certification**” every 3 years
- Adopt mandatory *written* FATCA policies and procedures

Foreign Trust with No U.S. Settlor or Benes

- Good News:
 - No FATCA reporting obligations
- Bad News:
 - All of the other obligations apply, e.g., getting a GIIN, conducting due diligence, making FATCA Responsible Officer certifications, having written FATCA policies and procedures



FBARs and Form 8938

Foreign Bank Account Reports (FinCEN Form 114)

- If a U.S. Person individual or certain U.S. entities owns or has signature authority over one or more **non-U.S. financial accounts** that have a combined total of more than **USD 10,000** in assets *at any point during the year*, they must file an FBAR.
- FBARs are filed with FinCEN, not with the IRS
- Steep penalties for non-filing
- A trust formed under U.S. law *does* have an FBAR filing obligation even if the trust is *not* a U.S. trust (i.e., is a foreign trust) for other purposes
- And the U.S. trustee also has an FBAR filing obligation

IRS Form 8938 (Statement of Specific Foreign Financial Assets)

- A U.S. trustee of a foreign trust does *not* have to file Form 8938—trustees of “Specified Domestic Trusts” do, but foreign trusts are not domestic trusts, let alone “Specified Domestic Trusts”



Grantor and Non-Grantor Trust Status

Grantor Trusts v. Non-Grantor Trusts

- Federal income tax concepts:
 - **Grantor trusts**—flow through entities for U.S. federal income tax purposes, i.e., the settlor is attributed all the income, deductions, etc. of the trust as if the settlor owned the assets outright. Also, beneficiaries are not subject to U.S. income tax on any distributions
 - **Non-grantor trusts**—separate taxable entities. However, distributions from the trust can carry out all or a portion of the trust's income so that the income is taxed to the beneficiaries (and the trust gets a commensurate deduction from its income)

Foreign Trusts settled by ***U.S.*** Persons

- Very, very difficult for a U.S. person to create a foreign trust that is *not* a grantor trust

Foreign Trusts settled by *Non-U.S.* Persons

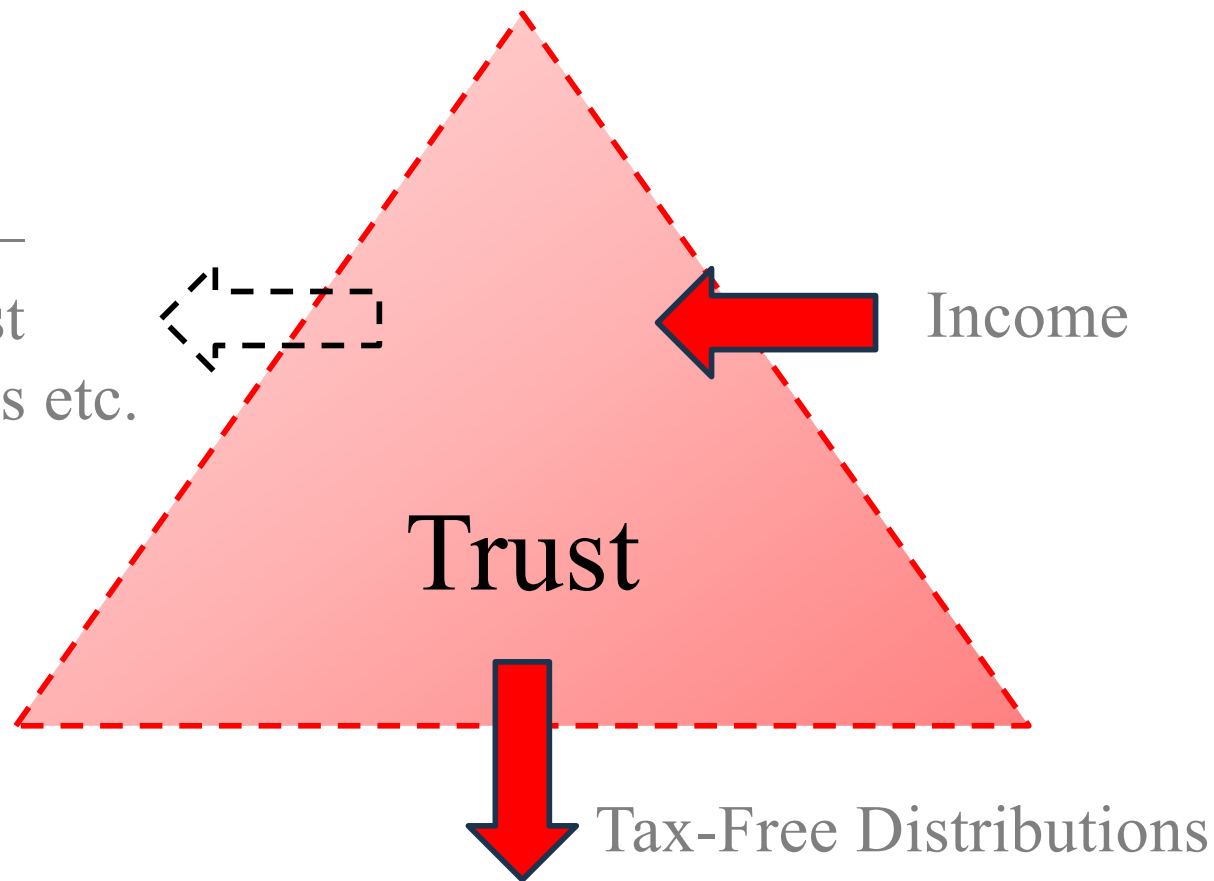
- Only two ways a non-U.S. person can create a trust that is a grantor trust:
 - **Revocability:** The settlor—either without anyone else’s consent or with the consent of a “related or subordinate party who is subservient to the grantor”—has the power to revest the trust assets in the settlor, or
 - **Settlor/settlor spouse:** The only distributions that are permitted to be made during the settlor’s are to the grantor or the grantor’s spouse
- Either way, once the settlor passes away (and also generally when the settlor becomes incapacitated), the trust will become a non-grantor trust

Using Foreign Grantor Trusts

- Common scenario:
 - Non-U.S. Person settlor
 - One or more U.S. beneficiaries
- Because trust is flow-through, if it earns no U.S.-source income, the settlor won't be subject to U.S. income tax on the trust's income even though he is deemed to own all the assets and income in the trust for U.S. federal income tax purposes, and
- The beneficiaries (including any U.S. beneficiaries) won't be subject to U.S. income tax on any distributions (even of U.S.-source income) because all the income and assets of the trust are treated as owned by the settlor

Foreign *Grantor* Trusts

Non-U.S. Settlor—
“owner” of all trust
income, deductions etc.



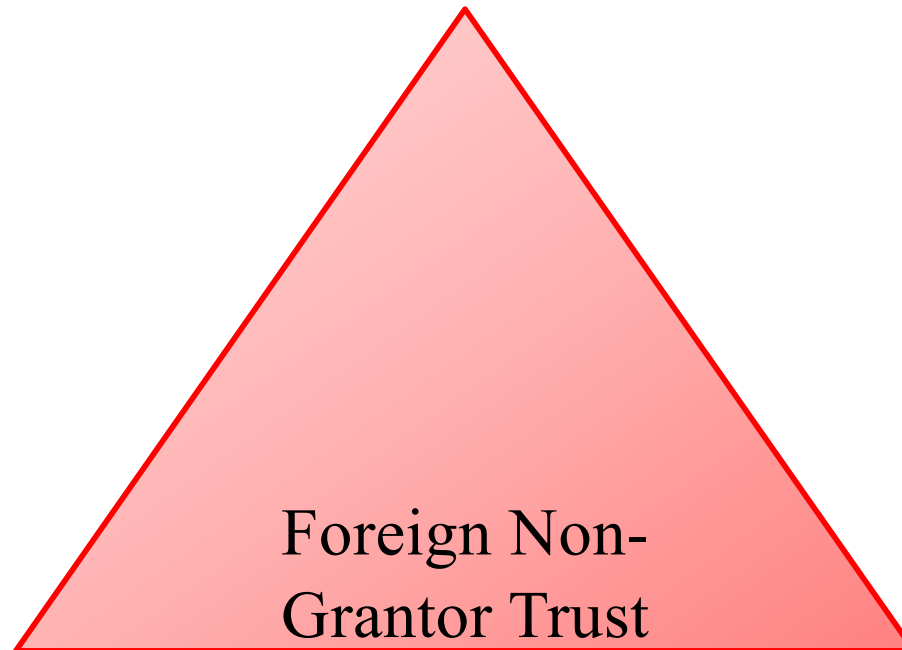
U.S. Beneficiary



Accumulation Distributions

Foreign *Non*-Grantor Trusts

- Subject to limited exceptions, a foreign grantor trust will become a *non*-grantor trust when the settlor passes away or becomes incapacitated

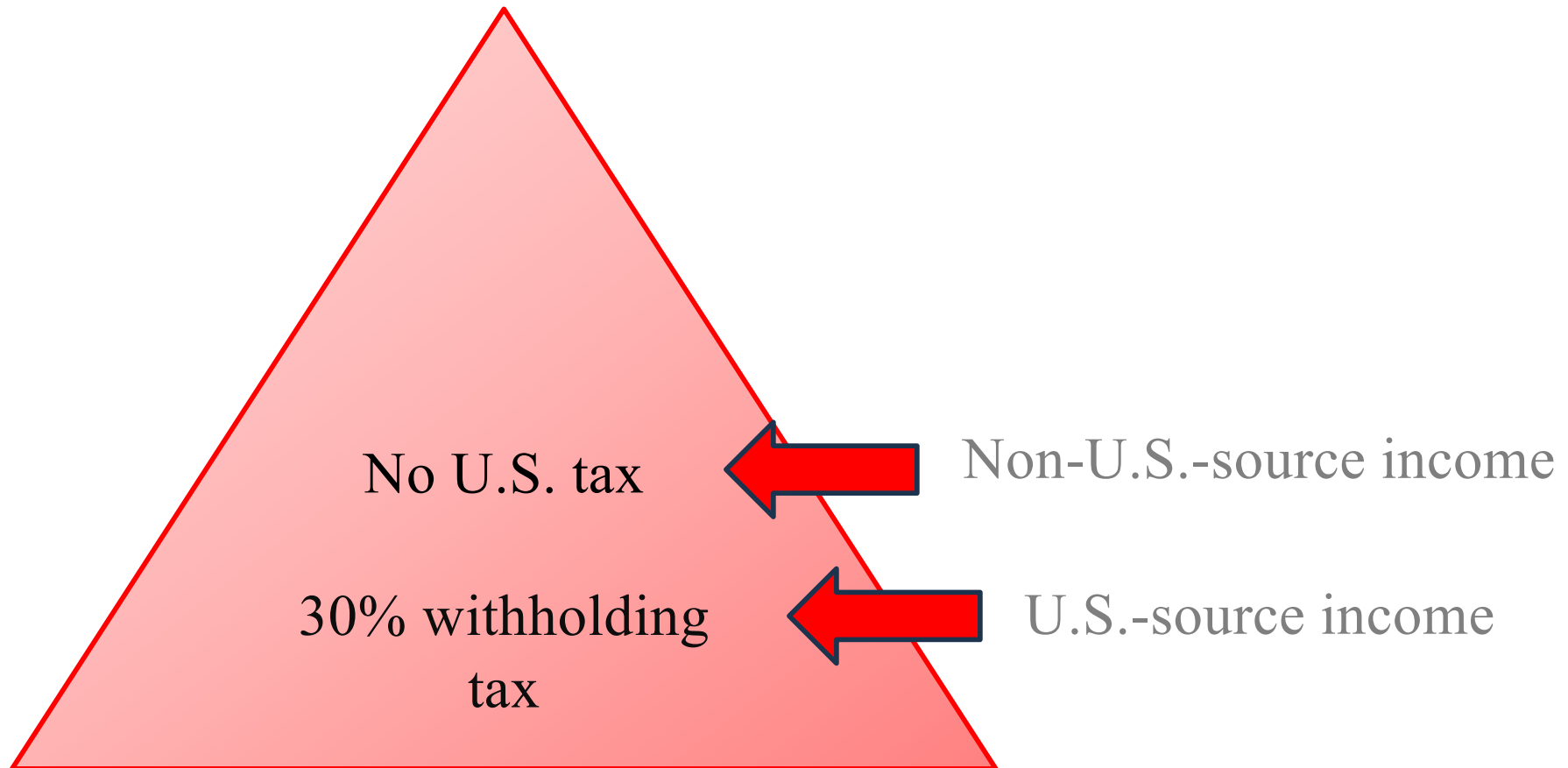


Income taxation—Big Picture (simplified)

- Foreign *non*-grantor trusts are generally taxed similarly to non-U.S.-person individuals
- Just like non-U.S.-person individuals, foreign trusts:
 - are *not* subject to U.S. income tax on non-U.S.-source income
 - *are* subject to U.S. income tax on “U.S.-source income”, which includes, for example, dividends on U.S. shares (tax withheld at source), income effectively connected with a U.S. trade or business, etc.
- If the trust does not earn any U.S.-source income, it will not pay any U.S. income tax

Income taxation—Big Picture (simplified)

- Foreign non-grantor trust—assume no distributions

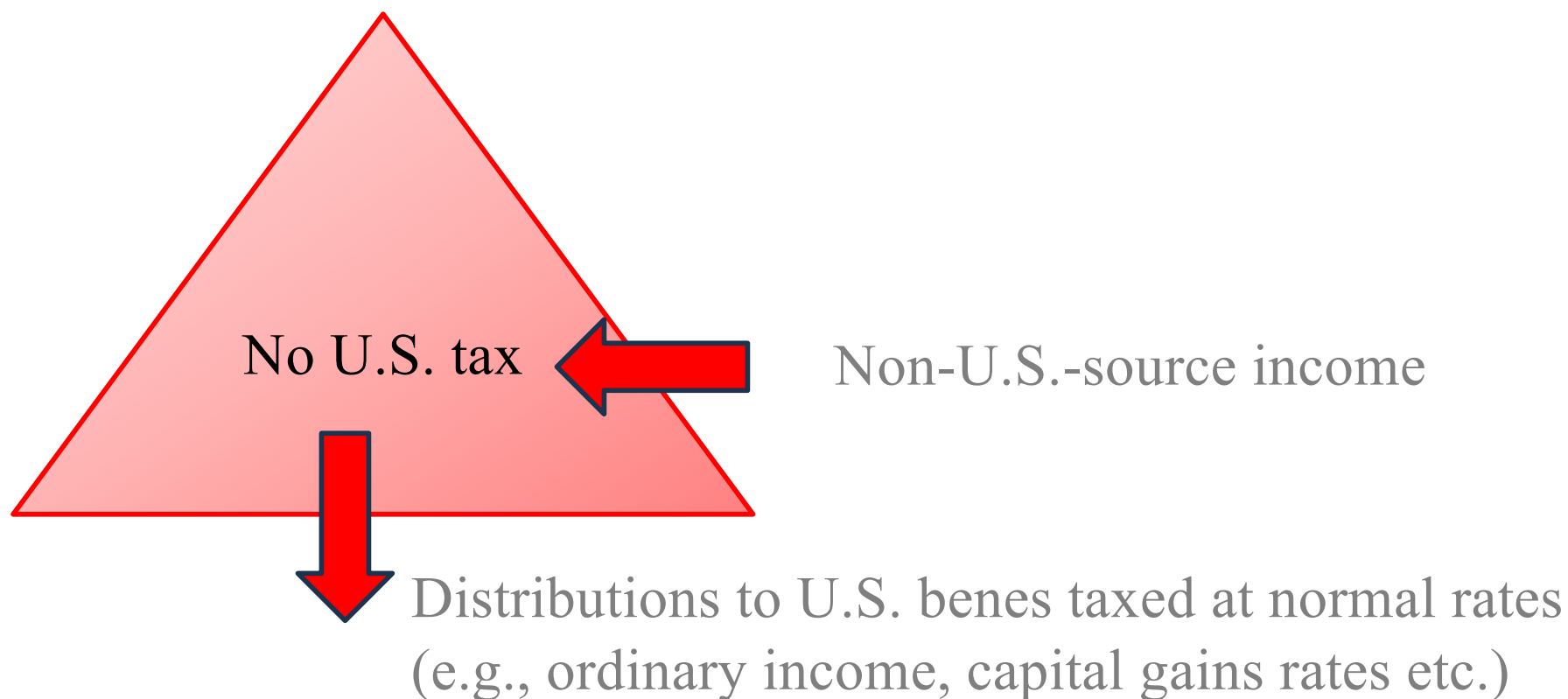


Income taxation—Big Picture (simplified)

- U.S. beneficiaries aren't taxed on any trust income unless and until they receive a distribution
- Non-U.S.-source income *not* distributed to beneficiaries in the year earned (i.e., accumulated in the trust) is not taxed to the trust—resulting in tax deferral until distributed

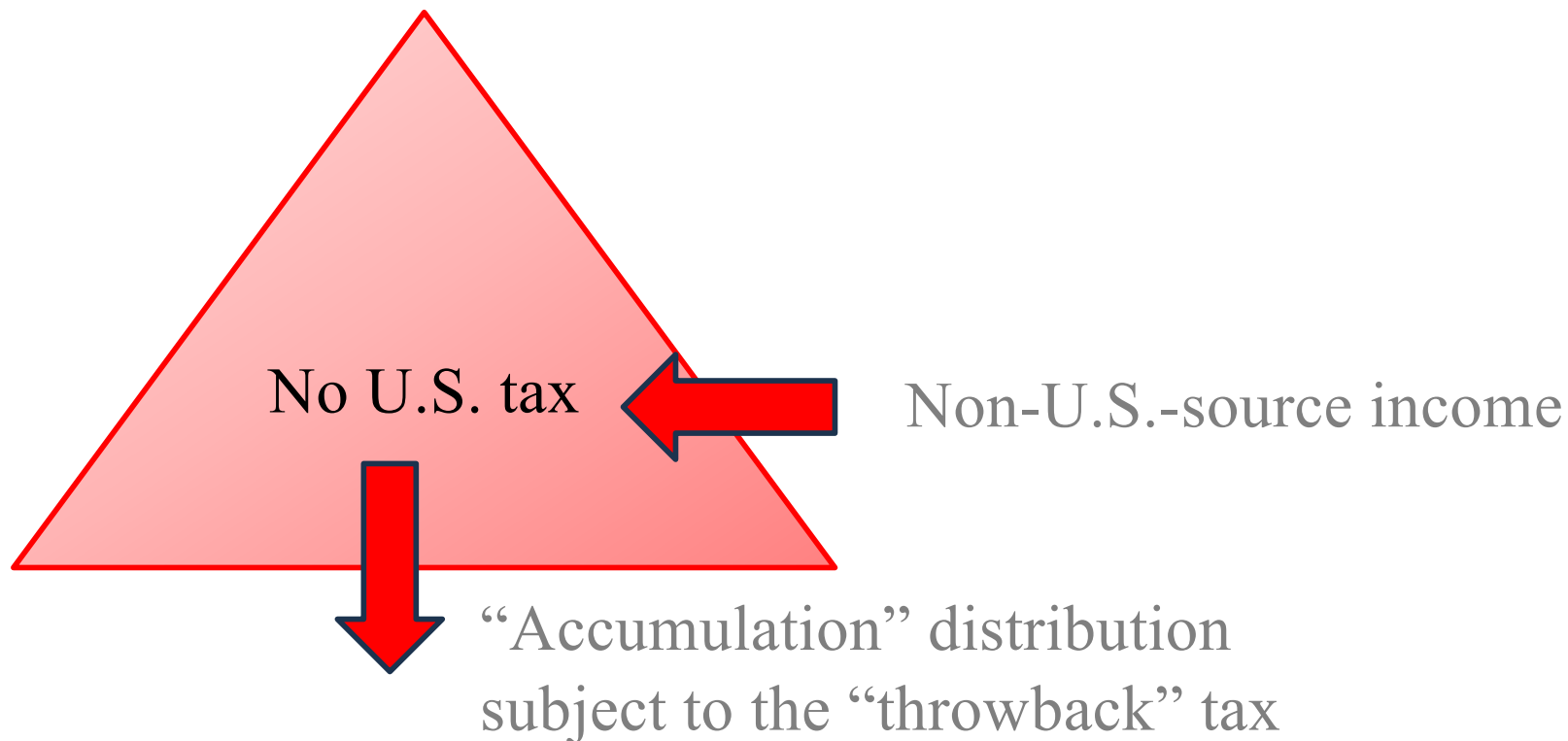
Income taxation—Big Picture (simplified)

- Foreign non-grantor trust—now assume trust distributes its income in the year the trust earns the income



Income taxation—Big Picture (simplified)

- Foreign non-grantor trust—now assume trust accumulates its income and distributes it in a **subsequent** year



Throwback Tax on Accumulation Distributions (simplified)

- All prior years' income taxed at ordinary rates, regardless of its original character (e.g., lose capital gains tax rates)
- Taxed at bene's **highest** marginal rate *for the year the income **was earned***
- Punitive interest charge—very complicated calculation, but goes back to the year earned and is compounded daily! May be up to—but not more than—100% the total distribution 🤔
- In addition to filing Form 3520, bene may use Form 4970 to calculate the tax:

Form **4970**
Department of the Treasury
Internal Revenue Service

Tax on Accumulation Distribution of Trusts

Attach to beneficiary's tax return.
Go to www.irs.gov/Form4970 for the latest information.

OMB No. 1545-0192

2023
Attachment
Sequence No. **178**



IRS Forms 3520 and 3520-A

Detailed Foreign Trust Reporting Rules

- Proposed Regulations issued 8 May 2024 (Reg 124850-08):
 - Transactions With Foreign Trusts and Information Reporting on Transactions With Foreign Trusts and Large Foreign Gifts

U.S. Settlers of Foreign Trusts

- Must file IRS Form 3520 annually:

Form 3520 (Rev. December 2023) Department of the Treasury Internal Revenue Service	Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts Go to www.irs.gov/Form3520 for instructions and the latest information.	OMB No. 1545-0159
Note: All information must be in English. Show all amounts in U.S. dollars. File a separate Form 3520 for each foreign trust.		
For calendar year 20 , or tax year beginning , 20 , ending , 20		
A Check appropriate boxes: <input type="checkbox"/> Initial return <input type="checkbox"/> Final return <input type="checkbox"/> Amended return		
B Check box that applies to person filing return: <input type="checkbox"/> Individual <input type="checkbox"/> Partnership <input type="checkbox"/> Corporation <input type="checkbox"/> Trust <input type="checkbox"/> Executor		
C Check if any excepted specified foreign financial assets are reported on this form. See instructions <input type="checkbox"/>		
Check all applicable boxes. See applicable instructions.		
<input type="checkbox"/> You are (a) a U.S. transferor who, directly or indirectly, transferred money or other property during the current tax year to a foreign trust; (b) a U.S. person who (1) during the current tax year, transferred property (including cash) to a related foreign trust (or a person related to the trust) in exchange for an obligation, or (2) holds a qualified obligation from the trust that is currently outstanding; or (c) the executor of the estate of a U.S. decedent and (1) the decedent made a transfer to a foreign trust by reason of death, (2) the decedent was treated as the owner of any portion of a foreign trust immediately prior to death, or (3) the decedent's estate included any portion of the assets of a foreign trust. Complete all applicable identifying information requested below and Part I of the form.		
<input type="checkbox"/> You are a U.S. owner of all or any portion of a foreign trust at any time during the tax year. Complete all applicable identifying information requested below and Part II of the form.		
<input type="checkbox"/> You are (a) a U.S. person (including a U.S. owner) or an executor of the estate of a U.S. person who, during the current tax year, received, directly or indirectly, a distribution from a foreign trust; (b) a U.S. person who is a U.S. owner or beneficiary of a foreign trust and in the current tax year, you or a U.S. person related to you received (1) a loan of cash or marketable securities, directly or indirectly, from such foreign trust, or (2) the uncompensated use of trust property; or (c) a U.S. person who is a U.S. owner or beneficiary of a foreign trust and in the current tax year such foreign trust holds an outstanding qualified obligation of yours or a U.S. person related to you. Complete all applicable identifying information requested below and Part III of the form.		
<input type="checkbox"/> You are a U.S. person who, during the current tax year, received certain gifts or bequests from a foreign person. Complete all applicable identifying information requested below and Part IV of the form.		
1a Name of U.S. person(s) with respect to whom this Form 3520 is being filed (see instructions)		b Taxpayer identification number (TIN)
c Number, street, and room or suite no. If a P.O. box, see instructions.		d Spouse's TIN
e City or town	f State or province	g ZIP or foreign postal code
h Country		
i If you are filing with your spouse a current-year joint income tax return and a joint Form 3520, check this box <input type="checkbox"/>		
j If an automatic 2-month extension applies for the U.S. person's tax return, check this box and attach statement. See instructions <input type="checkbox"/>		



G&TCA

GATCA & Trusts Compliance Associates LLC

www.gatcaandtrusts.com

U.S. Settlers of Foreign Trusts

- Plus, if the trust is a grantor trust, *the foreign trust* must file IRS Form 3520-A annually:

Form **3520-A**
(Rev. December 2023)
Department of the Treasury
Internal Revenue Service

**Annual Information Return of Foreign
Trust With a U.S. Owner**
(Under section 6048(b))
Go to www.irs.gov/Form3520A for instructions and the latest information.

OMB No. 1545-0159

- If the foreign trust doesn't file the 3520-A, the U.S. settlor must file a substitute Form 3520-A with his or her 3520

U.S. *Settlors* of Foreign Trusts

- The 3520-A includes a Foreign Grantor Trust **Owner** Statement that the foreign trust must attach to the 3520-A and must also give a copy to the U.S. settlor
- Plus the 3520-A includes a Foreign Grantor Trust **Beneficiary** Statement that the foreign trust attach to the 3520-A and must also give to each U.S. beneficiary who received a distribution in the relevant year
- If the foreign trust doesn't file the 3520-A, the U.S. settlor must file a substitute Form 3520-A (including the Foreign Grantor Trust **Owner** Statement and any Foreign Grantor Trust **Beneficiary** Statement) and must give a copy of the Foreign Grantor Trust **Beneficiary** Statement to each U.S. beneficiary who received a distribution in the relevant year

U.S. *Beneficiaries* of Foreign Trusts

- Must file IRS Form 3520 each year they (or a U.S. person related to them) directly or indirectly:
 - received a distribution from a foreign trust
 - received a loan of cash or marketable securities, directly or indirectly, from the foreign trust
 - received uncompensated use of trust property, or
 - had a loan in the form of “qualified obligation” that they had made to the trust that is still outstanding
 - must attach to their 3520 a Foreign **Grantor** Trust Beneficiary Statement or a Foreign **Non-Grantor** Trust Beneficiary Statement (as applicable), which the trust (or in the trust’s absence, the settlor) should have given to the beneficiary



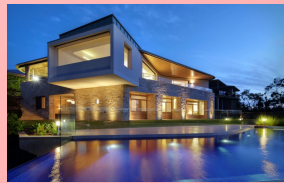
Basis Step Up

The Issue

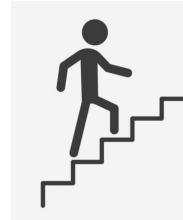


Settlor

SHARES



Assets with a
low basis



to fair market value at
date of death to shelter
unrealised pre-death
gains from tax on future sale

Required Trust Deed Provisions

- Revocable trusts where settlor has power to direct the payment of trust's income, or
- Trust's income is payable to at the direction of the settlor *plus* settlor can change the enjoyment of the income via a power to alter, amend, or terminate the trust
- **Note:** Either provision can cause **estate tax inclusion** therefore be wary of using with trusts that hold U.S. assets that are subject to estate tax in a non-U.S. Person's estate (non-U.S. Persons have only USD 60,000 estate tax exemption or, optionally, they can have the U.S.-person exemption multiplied by a fraction where the numerator is U.S. assets and the denominator is worldwide assets (including U.S. assets))

Questions





G&TCA

GATCA & Trusts Compliance Associates LLC



Peter Cotorceanu LL.B.(Hons), J.D., LL.M. (Tax), TEP

Attorney-at-Law (U.S.A.)

Barrister and Solicitor (New Zealand)

Founder & CEO

peter.cotorceanu@gatcaandtrusts.com

www.gatcaandtrusts.com

Disclaimer

This Presentation is intended solely for information purposes. The views contained in this Presentation may be altered at any time. Although GATCA & Trusts Compliance Associates LLC (G&TCA) have taken all reasonable care to ensure that the information contained in this presentation is accurate at the time of publication, the details in this presentation do not represent decision-making aids for legal, tax, or other matters. Before taking any action, you should consider the suitability of the action to your particular circumstances and discuss with your professional advisers as necessary the specific risks as well as the tax, legal, regulatory, and other implications.

Copyright

© 2024. All rights reserved.