

US reporting checklist for foreign trusts

03 January 2019 | Contributed by [Kozusko Harris Duncan](#)

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Introduction

Trusts classified as foreign for US tax purposes, whether established under the law of a US state or of an offshore jurisdiction, must review whether they have any US tax or information reporting filings to make in 2019 with regard to income earned and distributions made in 2018. This article provides trust officers and family advisers with a summary checklist. The Foreign Account Tax Compliance Act (FATCA) also requires foreign trusts to report distributions to US beneficiaries and information on US settlors. Certain information provided to the Internal Revenue Service (IRS) may be shared with other countries pursuant to reciprocal FATCA agreements.

A specific two-part test is used to determine foreign trust status for US tax purposes: the 'court test' and the 'control test'. A trust that satisfies both tests is a US domestic trust; a trust that fails one or both tests is a foreign trust. In addition to being either foreign or domestic, all trusts are either 'grantor trusts' or 'non-grantor trusts' for US tax purposes. The term 'grantor trust' is used to describe a trust in which the settlor (United States or non-United States) is taxed for US income tax purposes as if they still owned the trust property. Non-grantor trusts, on the other hand, are treated as distinct taxable entities that can pass through items of income and deductions to their beneficiaries (for further details please see "[Overview \(March 2018\)](#)").

Foreign trust with US source income

File Form 1040NR by 15 April to report effectively connected income

Taxation of US source income depends on whether that income is:

- 'effectively connected income' treated as attributable to the conduct of a trade or business in the United States; or
- 'passive investment income', such as dividends and interest.

Effectively connected income is taxable at graduated rates on a net basis that allows related deductions to be used to determine the amount subject to tax. If a foreign non-grantor trust or non-US grantor has US effectively connected income, which can be the case when investing in a partnership, Form 1040NR must be filed to report the income and pay any resulting tax. A US tax identification number is needed in order to submit the return.

No return required where US tax withheld

'Passive investment income' (ie, income that is not attributed to a US trade or business activity) is either exempt entirely from US tax under the special exceptions for capital gains and portfolio interest or otherwise subject to a flat 30% withholding on what is called fixed or determinable,

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annual or periodic (FDAP) income. In general, US tax on a foreign trust's taxable FDAP income will be collected by means of the US withholding tax regime.

Withholding tax refers to a 30% flat rate of tax collected at the source by the US payer of dividends, interest, rents and royalties. The withholding tax is collected on a gross basis, without deductions. The rate of withholding can be reduced by any applicable income tax treaty between the United States and the country of residence of the owner of the income. The withholder of the tax files Form 1042 with the US IRS to report the tax withheld. Information reported to the IRS on Form 1042 can be provided to other countries under a reciprocal FATCA agreement.

Certificate of withholding tax and FATCA status

Forms W-8BEN-E and W-8IMY are certificate forms provided to requesting financial institutions and withholding agents. These forms are not filed with the IRS. The W-8 forms include a certification of the foreign trust's withholding tax status, which inform the payer of US source income whether the trust is subject to withholding tax and at what rate. The W-8 forms also include a certification of the foreign trust's FATCA status, which informs the requester as to whether the requester or the foreign trust is responsible for FATCA due diligence and reporting (for further details please see "[Revised Forms W-8 clarify some issues – but not all](#)").

Foreign trust owning US LLC

File a pro forma Form 1120 with Form 5472 attached by 15 April

A limited liability company (LLC) created under the laws of a US state that is wholly owned by a single non-US person, including a foreign trust, is required to report transactions with its non-US owner and related parties to the IRS on Form 5472. Although a single-member LLC is a disregarded entity for US tax purposes, when foreign-owned it is treated as a corporation solely for the purposes of the Form 5472 filing obligation. The LLC must obtain a US tax identification number in order to submit the filing (for further details please see "[Completing and Filing Form 5472 for foreign-owned US LLC](#)").

Foreign trust that made distributions to US beneficiaries

Trustee provides foreign trust beneficiary statement to US beneficiary by 15 March

The trustee of a foreign trust must provide a US beneficiary with either a foreign grantor trust beneficiary statement or a foreign non-grantor trust beneficiary statement. These statements must contain specified items, as detailed in the instructions to Form 3520, including a statement that the trust will permit either the IRS or the US beneficiary to inspect and copy the trust's books and records. This statement is unnecessary if the trust has appointed a US agent. Failure to provide the US beneficiary with a beneficiary statement or include the specified items can cause adverse tax treatment of income items attributable to the beneficiary.

Trustee may also need to file FATCA report

Where the foreign trust has been classified as an investment entity under the FATCA definitions, such as a trustee-documented trust under an intergovernmental agreement (IGA), the trustee must file a FATCA report with details of the US beneficiary's name, address and tax identification number and the amount of the distributions. Trustees under a Model 1 IGA file FATCA reports electronically with the IRS directly. Trustees under a Model 2 IGA file the report through the local reporting portal.

US beneficiary files Form 3520 by 15 April

US persons who receive distributions from a foreign trust, regardless of the amount, must file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. This includes a US trust that receives a distribution from a foreign trust, not just individual beneficiaries. The US beneficiary's use of property held in a foreign trust, such as a holiday home, will be treated as a distribution to the beneficiary of the fair market value of the use of the property. This deemed distribution rule will not apply to the extent that the foreign trust is paid the fair market value for the use of the property within a reasonable period of such use.

US beneficiary may also have 15 April Form 8938 and FBAR (FinCEN 114) filing requirement

A US taxpayer may have to report on Form 8938 an interest in a foreign trust of which the taxpayer

is a beneficiary, provided that the taxpayer knows – or has reason to know – of the interest based on readily accessible information. A US beneficiary who receives a distribution from the trust has knowledge of the interest. The value of a US beneficiary's interest in a foreign trust is the sum of:

- the value of all trust property distributed to the beneficiary during the tax year; and
- the value using specified IRS valuation tables of the beneficiary's right (if any) to receive mandatory trust distributions.

A US person who is the beneficiary of a foreign (or US domestic) trust will be treated as the owner of the trust's foreign financial accounts for foreign bank account report (FBAR) filing purposes if the person has a greater than 50% present beneficial interest in the assets or income of the trust for the calendar year. The FBAR is not an income tax return. It is filed electronically with the Financial Crimes Enforcement Network (FinCEN), a bureau of the US Department of the Treasury that collects and analyses information about financial transactions in order to combat domestic and international money laundering, terrorist financing and other financial crimes. Under the FinCEN regulations, such a beneficiary may avoid FBAR reporting if the trust, trustee or agent of the trust is a US person who files an FBAR disclosing the trust's foreign financial account. This limited exception applies only to US beneficiaries and does not apply to US grantors or US trustees.

Foreign trust whose non-US settlor died owning US situs assets

When a non-US settlor dies, and the trust fund includes US situs assets, the trustee should contact the administrator of the deceased settlor's estate about possible US estate tax. If the trust owns only non-US situs assets, including offshore holding companies that are classified as corporations for US tax purposes, the trust has no US situs assets even if the underlying corporations have investment accounts with US securities. Where the trust itself has an investment account, a review should be made to determine whether the account holds any US situs assets the value of which total more than the \$60,000 exemption amount.

A US estate tax return, Form 706-NA in the case of a non-resident alien decedent, is due nine months following the date of death. The executor is responsible for filing the return, but if no executor, personal representative or administrator is appointed, qualified and acting in the United States, every person in actual or constructive possession of any property of the decedent is considered an executor and must file a return. This can include the trustee of a foreign trust owning US situs assets.

Foreign trust with US grantor

Trustee files Form 3520-A by 15 March

A US person who is treated as an owner of any portion of a foreign trust under the US grantor trust rules must ensure that the foreign trust files Form 3520-A, Annual Information Return of Foreign Trust with a US Owner. Form 3520-A provides information about the foreign trust and its US grantor. If the foreign trust fails to file Form 3520-A, the US grantor, and not the foreign trust, is subject to penalties. The trustee must also provide the grantor with a Foreign Grantor Trust Owner Statement, the form of which is contained in Form 3520-A.

Trustee may also need to file annual FATCA report

Where the foreign trust with a US grantor has been classified as an investment entity under the FATCA definitions, the trustee must file an annual FATCA report with the US grantor's name, address and tax identification number. FATCA reports are filed electronically either with the IRS directly by trustees under a Model 2 IGA or through the local portal by trustees under a Model 1 IGA. If the foreign trust is classified not as an investment entity, but rather as a passive non-financial foreign entity (NFFE), the financial institutions where the trust has accounts will have been provided with the grantor's details and will file the FATCA report (for further details please see "[Practical FATCA and CRS compliance for family structures](#)").

US grantor files Form 3520 by 15 April

A US person who is treated as an owner of any portion of a foreign trust under the US grantor trust rules must file Form 3520 annually, along with the Foreign Grantor Trust Owner Statement. The US grantor will include all income earned in the trust on the grantor's personal US income tax return, Form 1040. In addition, Form 1040 must include a completed Schedule B, Part III, Foreign

Accounts and Trusts, to report information regarding the foreign grantor trust.

US grantor may have multiple other 15 April filing requirements

FBAR

A US grantor with financial interests in foreign bank accounts, securities accounts and other financial accounts must file a foreign bank account report (FBAR). This is the case even when those accounts are in the name of the foreign grantor trust and it is the trustee who has signature authority over the account. If the foreign trust holds investments only with US banks and custodians, the FBAR is not required.

Form 8938

Separate from the FBAR filing requirement, a US grantor must file Form 8938 annually to disclose any interest in a 'specified foreign financial asset'. This includes an ownership interest in a foreign trust as grantor under the US grantor trust rules. Form 8938 asks for detailed identifying information on each specified foreign financial asset being reported and its maximum value during the tax year.

Form 5471 and Form 8621

US persons owning, directly or through a trust, more than 10% of a foreign corporation must file Form 5471 with their income tax return. US persons investing, directly or through a trust, in a passive foreign investment company (PFIC) must file Form 8621 upon the disposition of stock, the receipt of a distribution or the making of certain elections. There is an annual PFIC reporting requirement as well, also on Form 8621.

Foreign trust with US trustee

Trustee files FBAR to report foreign accounts by 15 April

A trust subject to the laws of a US state and administered by a US trust company can still be classified as foreign if it fails the 'control test' under the US tax rules. As such, it will be taxed as a foreign trust and subject to FATCA compliance just like an offshore foreign trust. However, for purposes of the FBAR, the definition of 'US person' is different. As mentioned above, the FBAR is not a tax return, but rather an electronic filing required by the Bank Secrecy Act. US persons must file the FBAR to report a financial interest in or signature authority over a foreign financial account to FinCEN. The FinCEN rules define a 'US person' as, among other things, an entity, including a corporation, partnership, trust or limited liability company created, organised or formed under the laws of the United States, any state, the District of Columbia, the territories and insular possessions of the United States or the American Indian tribes. Onshore foreign trusts that hold investments with US banks and custodial institutions will generally not have to file an FBAR.

Comment

It is important for trustees of foreign trusts to make note early in the year of which US filings will be required and the respective deadlines. If a trustee will not be able to meet the reporting due date, a request for extension should be filed prior to the due date. Form 4868 is used to request an automatic six-month extension to file Form 1040NR. A request for an extension of time to file Form 3520-A or Form 1120 with Form 5472 attached can be made by filing Form 7004. FinCEN will grant filers failing to meet the FBAR annual due date of April 15 an automatic extension to October 15 each year, and an extension request is not required. All IRS forms and explanatory materials may be found at www.irs.gov.

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