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Taxation of offshore trusts and impact of new lower tax rates

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President Bush enacted the Jobs and Growth Tax Relief Reconciliation Act 2003 into law on May 28 2003. The act accelerates the lower income tax rates that were scheduled to appear in 2006 under the 2001 tax act. Tax professionals and trustees must consider the impact of these lower rates on offshore trusts benefiting families whose members include US citizens or residents. Because of the way in which the United States taxes distributions from foreign trusts, it may be prudent to make distributions to US beneficiaries or US domestic trusts to take advantage of the new lower tax rates.

New Income, Long-Term Capital Gain and Dividend Tax Rates

Income

The act reduces income tax rates to 25%, 28%, 33% and 35%, retroactive to January 1 2003. These new lower rates are in effect until 2010. The top bracket is applied to income over $311,950 and was previously 38.6%

under the 2001 tax act.

Long-term capital gains

The act also reduces the tax rate on long-term capital gains from 20% to 15%. This rate applies to capital gains incurred on or after May 6 2003 and lasts through 2008. The long-term capital gain tax rate is generally available when a capital asset has been held for more than 12 months.

Dividends

The act taxes qualified dividend income as net capital gain at the 15% tax rate, subject to certain holding requirements. The reduced rate is retroactive to January 1 2003 and lasts through 2008. Qualified dividend income includes dividends from domestic corporations, and from foreign corporations incorporated in a US possession or eligible for the benefits of a US income tax treaty, provided the treaty includes an exchange of information provision. Dividends from foreign corporations will also qualify for the reduced rate if the corporation's dividend-paying stock is readily tradable on an established US securities market. The reduced rate is not available for dividends paid by a foreign personal holding company, a foreign investment company or a passive foreign investment company. Payments in lieu of dividends, such as substitute dividends paid on stock loaned from margin accounts, also do not qualify for the reduced rate.

Grantor or Non-Grantor Trust Classification

When analyzing the impact of the new lower tax rates on offshore trusts with US beneficiaries, tax professionals and trustees must first determine whether the trust is classified for US income tax purposes as a grantor trust or a non-grantor trust.

The term 'grantor trust' is used to describe a trust in which the settlor is taxed for US income tax purposes as if he or she still owned the trust property. This result is true even though the settlement is valid and irrevocable under relevant trust law. The settlor of a grantor trust has retained certain rights, benefits or powers over the trust. A complex and technical set of statutory rules replete with exceptions, and exceptions to exceptions, govern the circumstances where the settlor will remain taxable on income from trust property.

Non-grantor trusts, on the other hand, rather than allocating income to the settlor, are treated as taxable entities that can pass through items of income and deductions to the beneficiaries. Income not passed through to the beneficiaries is taxed to the trust itself. This contrasts with the US taxation of partnerships, where the income of a partnership is taxed proportionately to its partners, with no entity-level taxation.

US settlors

The rights and powers that result in a US citizen or resident settlor being taxable on income from the trust include:

- any retained reversionary interest exceeding 5% of trust value;
- the power to control the beneficial enjoyment of trust property;
- the power to revoke the trust;
- certain administrative powers, including power to borrow trust funds and vote stock of closely held companies; and
- any interest in trust income.

The retained powers giving rise to grantor trust status may relate to all or only a portion of the trust. Benefits and rights granted to spouses are treated as held by the settlor. Moreover, a settlor who is a US citizen or resident will be treated as the owner of trust property under the grantor trust rules with respect to any property transferred to a foreign trust which has or may have US beneficiaries, even if the settlor has no retained rights or powers. Even when such a trust is prohibited from making distributions to US persons, transfers of appreciated assets to the trust by a US citizen or resident will be subject to income tax on any unrecognized gain at the time of the transfer.

The grantor trust rules are similar to, but not the same as, rules which determine when a settlor has given up sufficient control for a transfer in trust to be considered complete for gift and estate tax purposes (for further details please see the Overview (March 2003)). Consequently, it is possible for a US citizen or resident to create a trust which is complete for estate and gift tax purposes, but nonetheless is taxable to the settlor for income tax purposes. This mismatch provides numerous tax planning opportunities, as well as pitfalls.

Non-US settlors

If the settlor is a non-resident alien, the trust is considered a grantor trust only if: (i) a power to revest (eg, revoke) absolutely title to trust property in the settlor exists which is exercisable solely by the settlor without the consent of any other person, or with the consent of a related or subordinate party subservient to the settlor; or (ii) the only amounts distributable (whether income or corpus) during the lifetime of the settlor are distributable to the settlor or the spouse of the settlor.

If neither of these criteria is satisfied, a trust with a non-resident alien settlor is taxed as a non-grantor trust rather than a grantor trust.

US Settlors of Grantor Trusts Benefit from Lower Tax Rates

A US citizen or resident settlor who is treated as the owner of a trust under the grantor trust rules is generally subject to income tax on the trust's worldwide net annual income and capital gains. This is the case regardless of whether the grantor trust is foreign or domestic. Such income and capital gains will be taxed at the new lower tax rates when reported on the US settlor's income tax return.

A non-resident alien settlor of a grantor trust, on the other hand, is subject to US income tax only on the trust's income and gain from US sources. Again, this is the result regardless of whether the grantor trust is foreign or domestic. Generally, tax on US-source income is withheld at the source at the rate of 30% or lower treaty rate.

Non-Grantor Trusts - Foreign or Domestic?

Whether a trust is foreign or domestic affects the income tax liability of a non-grantor trust. A US domestic non-grantor trust, like a US citizen or resident individual, is generally subject to US federal income tax on worldwide income and gains derived from all sources. Such a domestic non-grantor trust will be entitled to the new lower tax rates. A domestic trust is also ordinarily allowed the same deductions as US citizens or residents, even if it has non-resident alien beneficiaries.

A foreign non-grantor trust, on the other hand, like a non-resident alien individual, is generally subject to tax only on income and gains derived from US sources. Such tax is generally withheld at the source at a rate of 30% or lower treaty rate. Foreign trusts are allowed only those deductions available to non-resident alien taxpayers.

The status of a trust as foreign or domestic also dictates reporting obligations of US settlors and beneficiaries, regardless of whether the trust is a grantor trust or non-grantor trust for income tax purposes. Transfers to and distributions from foreign trusts are subject to special reporting requirements (for further details please see "Reporting Deadlines Draw Near").

In 1996 the US legislature adopted a specific two-part test to determine foreign trust status for US tax purposes - the 'court test' and the 'control test'. A trust that satisfies both tests is a domestic trust; a trust that fails one or both tests is a foreign trust.

Court test
A trust satisfies the court test if a US court is able to exercise primary supervision over the administration of the trust. A court is able to exercise primary supervision over a trust if that court has or would have the authority under applicable law to render orders or judgments resolving substantially all issues regarding the administration of the entire trust. The administration of a trust is the carrying out of duties imposed on a transfer by the terms of the trust instrument and applicable law, including maintaining books and records, filing tax returns, defending the trust from suits by creditors, and determining the amount and timing of distributions. If both a US court and a foreign court are able to exercise primary jurisdiction over the administration of a trust, that trust will satisfy the court test.

Control test
A trust satisfies the control test if US persons control all substantial decisions of the trust. Substantial decisions include:

- whether and when to distribute income and corpus;

- the amount of any distributions;
- the selection of a beneficiary;
- the power to make investment decisions;
- 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; and
- whether to remove, add or replace a trustee.

'Control' means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto substantial decisions. Accordingly, if a trust has two trustees that must agree on all trust decisions, one of which is a US person and the other foreign, the trust will be taxed as a foreign trust, regardless of its place of administration. Ministerial decisions that are not considered substantial include bookkeeping, the collection of rents and the execution of investment decisions.

A trust will automatically fail the court test if the trust instrument provides that an attempt by a US court to assert jurisdiction over the trust will cause the trust to migrate from the United States. A trust will also automatically fail the control test if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust no longer to be controlled by US persons.

A trust that fails either the court test or the control test will be treated as a foreign trust for US federal income tax purposes, yet that status does not prevent the trust from having a US situs and being administered in the United States. Under these circumstances, however, care must be taken to ensure that the trust is not considered a local trust for state income tax purposes.

Distribution Deduction and DNI Calculation

The reason the new tax rates may affect distributions to US beneficiaries from non-grantor trusts is because non-grantor trusts pass through items of income and deductions to the beneficiaries for US tax purposes by means of a distribution deduction and distributable net income (DNI) calculation. Income not passed through to the beneficiaries is taxed to the trust itself. The calculation of DNI is somewhat modified for a foreign non-grantor trust.

Distribution deduction

A unique aspect of trust taxation is the method by which double taxation of trust income and capital gains is avoided. Non-grantor trusts are taxed like individuals but allowed a deduction from taxable income for distributions made to beneficiaries, and beneficiaries pay tax on income so distributed. If the trustee retains trust income, the trust pays tax on the income based upon rates which are independent of the beneficiaries. In this way, income earned by the non-grantor trust is taxable either to the trust or to the beneficiaries in proportion to any distributions received by them.

A foreign non-grantor trust is also subject to the distribution deduction method designed to avoid double taxation in domestic trusts. The trust will be regarded for income tax purposes as a conduit, to the extent that the trust distributes (or is deemed to distribute) amounts to the beneficiaries. The tax treatment will flow through to the beneficiary, and the beneficiary will be taxed in roughly the same manner as if the beneficiary had earned that distributed income directly.

Distributable net income

To accomplish the pass-through tax nature of a non-grantor trust, DNI is calculated to measure the amount of income a trust can deduct because of distributions to beneficiaries and that is to be reported by such beneficiaries as income. It also stipulates the character of the distributed income for purposes of the trust's distribution deduction and the beneficiary's income.

The calculation of DNI is a matter of specific and technical rules in the US Internal Revenue Code. For most US domestic trusts, DNI will be equal to taxable income determined without the distribution deduction or the personal exemption, less net capital gains, plus tax-exempt income reduced by expenses (and any charitable deduction) allocated to such income.

Since the concept of DNI provides that distributed amounts will retain their tax character in the hands of the beneficiary, taxation to the beneficiary may be avoided where it would not have occurred in the absence of the trust. Thus, while a US citizen or resident beneficiary is subject to US tax on all items of distributed income, a non-resident alien beneficiary is subject to US tax only on items of distributed income and gain derived from US sources. The collection of such tax is accomplished through the US withholding regime.

In addition, non-resident alien beneficiaries of a domestic non-grantor trust benefit from deductions otherwise unavailable to non-resident alien individuals. This is because taxation of income distributions by a trust to its beneficiaries is limited by the trust's DNI, which in turn relates to taxable income. In effect, deductions are taken into account automatically and the beneficiaries are taxed on net rather than gross income.

Capital gains included in DNI of foreign non-grantor trust
In the case of a foreign non-grantor trust, DNI includes capital gains, as well as foreign-source income and income otherwise exempt by treaty. This does not lead to taxation of these income items to the foreign trust, but instead preserves the taxability of income items distributed to the beneficiaries.

The inclusion of capital gains in the calculation of a foreign trust's DNI results in the beneficiaries being liable for tax on distributed gains. This is in contrast to the case of a domestic trust, where the domestic trust is generally liable for such tax. The beneficiaries can therefore benefit from the new 15% rate on distributed long-term capital gains. Any capital gain accumulated in a foreign trust will lose its tax character as such and, to the extent distributed in a later year, be taxed to the beneficiaries as ordinary income.

Undistributed Net Income

When a trust does not distribute all of its available income to the beneficiaries, but instead accumulates ordinary income or realized capital gains, such accumulations are characterized as undistributed net income (UNI). The calculation of UNI no longer affects the taxation of domestic trusts which are themselves subject to US tax on recognized capital gains and undistributed income. UNI can have a big impact, however, on foreign non-grantor trusts which generally escape US tax on undistributed income (with the exception of income from US sources).

Accumulation distributions

If UNI is present in a foreign non-grantor trust, and the trust makes a distribution in a subsequent year which is greater than the greater of the current year's DNI or income (as defined by the Internal Revenue Code), such excess is considered an accumulation distribution and the beneficiary is subject to the throwback rules. These rules no longer apply to distributions from domestic trusts.

Under the throwback rules, an accumulation distribution is treated as a distribution of UNI from prior years of the trust and is included in the income of the beneficiary. The beneficiary's tax rate, the amount of the accumulation distribution and the tax years of the beneficiary to which the tax is applied are all determined by a complex formula set out in the Internal Revenue Code.

Interest charge

In addition to the tax on such an accumulation distribution, the beneficiary of a foreign non-grantor trust is also subject to an interest charge. For UNI derived from tax years beginning after December 31 1995, the interest charge is computed in the same manner as interest applicable to underpayments of tax. For UNI derived from previous tax years, the interest charge is 6% simple interest.

Alternative Minimum Tax Trustees and their tax advisers should also be aware that some of the act's tax savings may be mitigated for US beneficiaries who are subject to the alternative minimum tax. This is basically a flat 28% tax on income calculated without the benefit of such things as personal exemptions and itemized deductions for state and local taxes. If a beneficiary's regular tax is lower than his or her alternative minimum tax, the beneficiary pays that regular tax plus the difference between the regular tax and the alternative minimum tax. Since the act accelerates the 2001 act's lower rates, it may also accelerate a beneficiary's exposure to the alternative minimum tax. That said, the 15% rate on long-term capital gains and qualified dividends also applies for alternative minimum tax purposes.

Taking Advantage of the New Lower Tax Rates

Tax professionals and trustees must consider the impact of the lower US tax rates on offshore trusts that have US citizen or US resident beneficiaries (please see the Overview (March 2003) for a discussion of when an individual is resident in the US for income tax purposes). Determining whether the foreign trust is a grantor or non-grantor trust for US tax purposes is crucial. In addition, the asset mix and timing of distributions from foreign non-grantor trusts with US beneficiaries are important fiduciary considerations.

A US settlor of a foreign grantor trust will generally remain subject to US tax on the income, dividends and capital gains earned in the trust until his or her death. A US settlor will benefit from the new lower tax rates, regardless of whether distributions are made to US or non-US beneficiaries. A non-US settlor will still have tax withheld on US-source income at the 30% or lower treaty rate, also regardless of any distributions made from the trust.

In the case of foreign non-grantor trusts, because of the way in which the United States taxes distributions from such trusts, it may be prudent for trustees to reconsider the asset mix and distributions to US beneficiaries or US domestic trusts to take advantage of the new lower tax rates. The most immediate consideration is whether to distribute US dividend income to US beneficiaries in the year received, if the trust is not already making distributions of DNI. This is because the items that comprise DNI retain their tax character as dividends, interest, capital gain and so on in the hands of the beneficiary, but items that comprise UNI do not. Thus, the US beneficiary will pay only 15% tax on qualified dividends distributed in the year earned, but accumulated dividends paid in a later year will be taxed as ordinary income. Since trustees cannot designate which income items were distributed, it is important to consult competent US tax counsel when calculating tax consequences to US beneficiaries.

A second consideration is whether trust investments should be evaluated for US tax savings. For example, the trustees of a foreign non-grantor trust may want to sell some dividend-paying foreign stocks that have been held for more than one year and buy US stocks with a portion of the proceeds. As a result, US beneficiaries who receive distributions of DNI will pay 15% rather than 20% tax on capital gains distributed in the year incurred, and will pay 15% rather than the higher ordinary income tax rate on qualified dividends distributed in the year received.

An analysis of the benefits of the lower dividend tax rate must consider withholding on the payment of such dividends to the foreign trust. Dividend payments to the foreign trust by a US corporation will still be subject to the 30% withholding tax. The beneficiary reports as income the amount actually received grossed up by the tax withheld. A credit is then available to the beneficiary for the tax previously withheld and any excess tax withheld is to be refunded. For example, suppose the foreign trust received $100 of dividend income from a US corporation from which $30 was withheld for tax purposes. The trust distributes $70 to the beneficiary, who must include $100 on his or her US tax return. The beneficiary's $15 tax on the qualified dividend distribution is offset by the tax previously withheld and a refund of $15 due the beneficiary. There may be opportunities to simplify the withholding consequences, which should be discussed with a qualified US tax practitioner.

It is important for trustees and their tax advisers to remember that the act's provisions are temporary, and whether future Congresses will allow the rates to increase is unknown. It may therefore be prudent for trustees of foreign non-grantor trusts to take advantage of the lower rates by making substantial distributions now, with careful planning to insure that the distributions are subject to the new lower rates. For example, the trustees might consider selling assets held for more than one year and distributing the proceeds to a US domestic trust which will be taxed at the 15% long-term capital gains tax rate. The domestic trust can then continue to provide creditor protection while taking advantage of the new lower tax rates for the benefit of its US beneficiaries.

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