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Uncompensated use of foreign trust property: HIRE Act treats as trust distribution

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The Hiring Incentives to Restore Employment (HIRE) Act, which was signed into law on March 18 2010, includes several provisions that change the rules applicable to foreign trusts and their beneficiaries, causing the use of trust property to be treated as a deemed distribution. This results in different rules for foreign trusts compared to US domestic trusts. The act also broadens the grantor trust rules which treat US settlors of foreign trusts as owners of the trust property for income tax purposes. When coupled with the HIRE Act requirement that US individuals disclose "any interest in a foreign entity", the new law signals increased scrutiny of foreign trusts, even when no tax obligation exists. (For a discussion of HIRE Act provisions requiring disclosure of foreign financial assets with an individual taxpayer's income tax return filing, please see "Reporting of offshore investments - proposed regulations and the HIRE Act".)

Background

Loans by foreign trusts treated as distributions

Section 643(i) of the Internal Revenue Code provides that a foreign trust's loan of cash or marketable securities to a US grantor, a US beneficiary or any US person related to a US grantor or a US beneficiary will be treated as a distribution from the foreign trust to such grantor or beneficiary. As a result, a US beneficiary of a foreign trust cannot avoid US tax on the income accumulated in the trust by obtaining a loan from the trust in lieu of a distribution, with the exception of a 'qualified obligation' having a prescribed interest rate and repayment terms (for further details please see "Taxation of offshore trusts and impact of new lower tax rates"). Before the enactment of the HIRE Act, this section did not apply to the loan or use of a trust's tangible or real property by a beneficiary.

US grantor treated as owner of foreign trust with US beneficiary

Although trusts can be taxpayers, Sections 671 to 679 of the Internal Revenue Code contain the so-called 'grantor trust rules', which treat certain trust settlors (and sometimes persons other than the settlor) as the owner of a portion or all of a trust's income, deductions and credits for US tax purposes. A trust where the settlor (or other person) is treated as the owner of the trust assets for US tax purposes is referred to as a 'grantor trust'. The grantor trust rules apply to both foreign and domestic trusts, but in different ways.

Under the grantor trust rules, a US person who transfers property to a foreign trust is generally treated for income tax purposes as the owner of that portion of the trust attributable to the transferred property, even if the trust would not have been a grantor trust had it been domestic. (For a discussion of when a trust is considered foreign for US tax purposes please see "Taxation of offshore trusts and impact of new lower tax rates"). This is the result for any tax year in which any portion of the foreign trust has a US beneficiary. A foreign trust is treated as having a US beneficiary for a tax year unless (i) under the terms of the trust, no part of the trust's income or corpus may be paid or accumulated during the tax year to or for the benefit of a US person, and (ii) if the trust is terminated at any time during the tax year, no part of the income or corpus could be paid to or for the benefit of a US person. The Internal Revenue Service (IRS) regulations under Section 679 of the Internal Revenue Code generally treat a foreign trust as having a US beneficiary if any current, future or contingent beneficiary of the trust is a US person.

Reporting distributions from and transfers to foreign trusts
Section 6048 of the Internal Revenue Code imposes reporting obligations on foreign trusts and persons creating, making transfers to or receiving distributions from such trusts. For example, a US person who transfers property to a foreign trust must report the transfer to the IRS, and a US beneficiary who receives a distribution from a foreign trust must report the distribution. Both reports are made on IRS Form 3520 and failure to file the form in a timely manner results in a penalty generally equal to 35% of the gross value of the transfer or distribution. In addition, if a US person is treated as the owner of any portion of a foreign trust under the grantor trust rules, the US person is responsible for ensuring that the trust files an annual information return on Form 3520-A and provides information to each US person who is treated as the owner of any portion of the trust, or receives (directly or indirectly) any distribution from the trust.

Uncompensated use of property held in foreign trust to be treated as distribution

The HIRE Act broadens Section 643(i) of the Internal Revenue Code to provide that any use of foreign trust property after March 18 2010 by a US grantor, a US beneficiary or any US person related to a US grantor or US beneficiary will be treated as a distribution to such US grantor or US beneficiary of the fair market value of the use of the property. As discussed below, the recipient of the deemed distribution will be required to file Form 3520 to report the distribution from the foreign trust.

This deemed distribution rule will not apply to the extent that the foreign trust is paid fair market value for the use of the property within a reasonable period of time. There is no indication as to what period of time will be considered 'reasonable' and the IRS is likely to provide guidance on this issue.

Under Section 643(i)(3) of the Internal Revenue Code, as amended by the HIRE Act, when the use of trust property is taken into account as a distribution to a US person, any subsequent transaction pursuant to which such trust property is returned to the foreign trust will be disregarded. As discussed below, these changes in the law leaves several important questions unanswered.

US beneficiary's use of foreign trust property to cause grantor trust status

The use of trust property by a beneficiary will now also affect whether a foreign trust has a US beneficiary for purposes of the grantor trust rules under Section 679 of the Internal Revenue Code. The HIRE Act revises Section 679 to provide that the use of trust property by, as well as a loan of cash or marketable securities to, a US person will be treated as a payment from the trust to the US person in the amount of the loan or the fair market value of the use of the property. This will cause the US settlor to be treated as the owner of the foreign trust for income tax purposes. Such a loan or use of trust property will not cause the recipient to be treated as a US beneficiary to the extent that the US person repays the loan at a market rate of interest or pays fair market value for the use of the trust property within a reasonable period of time.

The HIRE Act adds several other new provisions to Section 679, which codify the presumption found in the regulations that a foreign trust has US beneficiaries and is thus a grantor trust. The other new provisions provide that:

- amounts accumulated in a foreign trust are treated as being for the benefit of a US person even if the US person's interest in a foreign trust is contingent on a future event;
- if any person has the discretion to make a distribution from a foreign trust to, or for the benefit of, any person (US or otherwise), the trust will be treated as having a US beneficiary unless the terms of the trust specifically identify the class of persons to whom the distributions may be made and none of those persons can be US persons during the tax year;
- if a US transferor is directly or indirectly involved in any agreement or understanding that may result in the trust's income or corpus being paid or accumulated for the benefit of a US person, the agreement or understanding will be treated as a term of the trust; and

- a foreign trust will be presumed to have a US beneficiary unless the US transferor submits IRS requested information demonstrating that no part of the income or trust may be paid or accumulated to or for the benefit of a US person.

Only in rare cases will a foreign trust funded by a US person not now be treated as a grantor trust for US income tax and reporting purposes. The new grantor trust rules contained in the HIRE Act are effective for transfers to a foreign trust after March 18 2010.

Reporting use of foreign trust property

Form 3520
As a result of the HIRE Act, a US beneficiary of a foreign trust who uses trust property will be treated as having received a distribution from the foreign trust, and thus will be required to report that deemed distribution on Form 3520. The instructions to the 2009 Form 3520 released by the IRS before the enactment of the HIRE Act note pending legislation pertaining to the uncompensated use of trust property and treatment as a trust distribution. The IRS will need to release guidance and a revised Form 3520 before the April 15 2011 due date for reporting distributions (and deemed distributions) received in 2010.

Increased penalties for failure to file Form 3520
In addition, the HIRE Act amends the penalty for failure to file Form 3520 to impose a minimum penalty of $10,000, so that the penalty will now be the greater of $10,000 or 35% of the gross reportable amount. The penalty increases by $10,000 for each 30-day period following an IRS notice that the filing is delinquent with a 90-day grace period following such notification before the additional penalties begin accruing. The total penalty assessed for failure to file Form 3520 will not exceed the gross reportable amount. The HIRE Act penalty increase is effective for Forms 3520 required to be filed after December 31 2009 so that taxpayers who failed to file a required Form 3520 with their 2009 income tax return, due on April 15 2010 (unless there were extensions), will be subject to the new penalty structure.

Uncertainty regarding tax consequences of use of trust property

A distribution from a trust (whether domestic or foreign) has potential income tax consequences for the recipient beneficiary. The HIRE Act's characterization of the use of foreign trust property as a distribution imposes a different rule for foreign trusts than for US trusts (where the use of trust property does not give rise to a deemed distribution). Among the issues that require further guidance from the IRS are those related to the proper accounting treatment of any deemed distributions resulting from the use of foreign trust property.

In the case of a loan from a foreign trust, the full amount is treated as a distribution, except to the extent that the loan is a qualified obligation as provided in regulations. Since the loan is of cash or marketable securities, the dollar amount to be reported by the recipient as a distribution is easy to determine. However, in the use situation, appraisers will likely be needed to determine the fair market value of such use.

The US recipient of a distribution from a foreign trust is required to treat the entire distribution, whether from income or corpus, as an accumulation distribution for tax purposes, which is includible in the gross income of the recipient and subject to interest charges. A different tax result is permitted if (i) the trust provides the US recipient with a statement regarding the US tax accounting treatment of the distribution, or (ii) the recipient can utilize the default calculation.

Section 643 of the Internal Revenue Code provides that any trust treated as making a distribution as a result of a loan or use of trust property under Section 643 will be subject to US tax accounting rules as a complex trust. These rules, set out in Sections 661 to 663 of the Internal Revenue Code, provide that amounts distributed to a trust beneficiary are treated first as ordinary income to the extent of that beneficiary's share of the trust's current distributable net income, then as a distribution of accumulated or undistributed net income, and finally as a distribution of principal. Each classification has a different tax consequence to the US beneficiary. The HIRE Act does not explicitly address to what extent the uncompensated use of non-income-producing foreign trust property (eg, a holiday home) will result in certain classifications of trust income being attributed to the US beneficiary. Since the taxation of a complex trust does not involve the 'tracing' of trust income to the recipient, perhaps income from other trust property will be deemed distributed to the extent of the fair market value of such use.

This may impact on current trust planning. For example, where a foreign trust has been making regular cash distributions to its non-US beneficiaries equal to the trust's distributable net income in order to avoid undistributed net income, and has permitted its US beneficiaries to use a home owned by the trust, those US beneficiaries may now have taxable income (without having received cash with which to pay the tax) and some portion of the fair market value of the use could be a principal distribution. If the trust has instead been accumulating income, would the use of trust property cause undistributed net income to be attributed to the beneficiary? This could result in the US beneficiary paying steep interest charges.

On the other hand, suppose there is no current income-producing property in the foreign trust, and the beneficiary has been paying maintenance and insurance expenses while using the home rent free. The IRS may treat the payment of those expenses as income to the trust, which will cause the trust to have distributable net income. If the use of the home is then considered a distribution, is that deemed distributable net income attributable to the beneficiary using the home? Will the beneficiary then be reporting (and paying tax on) income with no offsetting expense deduction? Alternatively, will the IRS treat the beneficiary's payment of expenses as a deemed contribution to the foreign trust? Or as undistributed net income without a corresponding deemed distribution to the beneficiary? Each scenario has tax and reporting implications to the US beneficiary. If items of trust distributed and undistributed net income are not allocated to the beneficiary in amounts equal to the value of the use, then the 'deemed distribution' is merely for reporting purposes and is, in essence, a fiction for income tax purposes that is disregarded for accounting purposes.

In the situation where a shareholder uses corporate property, the tax law provides for a deemed dividend to the extent of earnings and profits and a return of capital as to any excess value of the use. If the fair market value of the use of trust property is instead characterized as a distribution of principal (which seems unlikely given that one of the purposes of the legislation is to raise revenues), there is generally no tax consequence (although there is still a reporting obligation). Since the HIRE Act provides that any subsequent return of such property "shall be disregarded for purposes of this title" (meaning Title 26 - the Internal Revenue Code), the beneficiary should not have a reporting obligation or deemed contribution to the trust when he or she gives up the use of the property.

What if the beneficiary pays fair market rent? Will this cause the foreign trust to be treated as conducting a US trade or business (with corresponding deductions for rental expenses), or will the IRS reject this approach and disallow any offsetting expense deductions, thus increasing the distributed or undistributed net income profile of the trust? Will the beneficiary have an obligation to collect the withholding tax on rent paid to the foreign trust?

It is imperative that the IRS issue guidance addressing these issues.

Comment

The United States has moved beyond collecting information only where a tax is to be imposed, and now seeks disclosure of a US taxpayer's interests in foreign trusts, accounts and entities. The HIRE Act creates additional distinctions between the reporting and tax treatment of foreign trusts as compared to their domestic counterparts. Children and grandchildren of international family clients have previously been counselled that the mere use of a home, yacht, artwork or other property owned by a foreign trust would not cause the beneficiary to have any US reporting obligations or tax consequences. That is clearly no longer the case, and offshore trust structures must be reviewed and their US beneficiaries advised to report where applicable. Even US beneficiaries who are not using foreign trust property and who have not received any cash distributions, but are merely members of a discretionary class of beneficiaries of a foreign trust, should consider consulting US tax counsel. The provisions affecting foreign account compliance and foreign trusts are being used as a revenue offset for the HIRE Act, giving the IRS further incentive to audit taxpayers and enforce these new measures.

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