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Tax Relief Act, reporting requirements and planning for use of foreign trust property

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Background

The Tax Relief, Unemployment Insurance Reauthorisation and Job Creation Act 2010 was signed into law on December 17 2010. The Tax Relief Act changes the estate and gift tax laws that were scheduled to take effect as of January 1 2011. Earlier in 2010, new reporting and tax laws were enacted that will have an impact on Internal Revenue Service (IRS) filings, but for which tax advisers have no new forms or guidance. This update explains the changes and outlines some planning considerations.

The estate and gift tax rules had been proceeding in accordance with provisions implemented under the Tax Relief Reconciliation Act 2001. In 2010 the Hiring Incentives to Restore Employment (HIRE) Act introduced changes to the reporting of foreign financial assets and passive foreign investment companies, as well as instituting a deemed distribution rule for the use of foreign trust property, but it did not address estate and gift taxes or the taxation of beneficiaries of trusts owning passive foreign investment company (PFIC) investments.

Estate and gift tax

At the end of 2009 Congress allowed the repeal of the estate tax for tax year 2010, the replacement of the 'step-up' basis rule with a 'carry-over' basis rule and a reduction in the maximum marginal gift tax rate to 35% on gifts over $1 million (for further details please see "Congress allows estate tax repeal for 2010"). The Tax Relief Act is effective only for tax years 2010, 2011 and 2012. When it expires, the estate and gift tax system reverts to pre-2001 law.

The act provides for:

- a credit sheltering $5 million per person (the basic exclusion amount) and $10 million per couple from gift and estate taxes, indexed for inflation beginning 2012;
- a $5 million exemption from generation-skipping transfer (GST) tax, indexed for inflation beginning 2012; and
- a top tax rate of 35% for estate, gift and GST taxes through 2012.

These changes are effective from January 1 2010, but executors are allowed to make an election for the estates of decedents who died in 2010, and may choose no estate tax and a modified carryover basis. The act also specifies a 0% GST tax rate applicable for 2010 only. For the estates of decedents who die after December 31 2010, the act permits the executor of a deceased spouse's estate to transfer any unused exemption to the surviving spouse.

For gifts made after December 31 2010, estate and gift taxes will be reunified, meaning that an individual may apply the basic exclusion amount to lifetime gifts so that no gift tax is owed until he or she makes taxable gifts in excess of $5 million. Any basic exclusion amount remaining at death will be applied to the estate tax calculation. An individual's basic exclusion amount is reduced by any exemption amount he or she used before 2011. If, for example, taxable gifts of $500,000 have previously been made, the individual's basic exclusion amount in 2011 is $4.5 million.

Foreign bank accounts and financial assets

The IRS released a revised Foreign Bank Account Report (FBAR) Form TD F 90-22.1, which expanded those US persons required to report. The Treasury Department's Financial Crimes Enforcement Network issued proposed regulations regarding the FBAR, which were expected to become effective before the June 30 2010 filing deadline for the 2009 FBAR. The deadline for comments expired on April 27 2010. The IRS has not yet issued a revised Form TD F 90-22.1 and the proposed regulations have not been finalised.

In addition to the FBAR, the HIRE Act requires individual taxpayers to disclose any interest in a "specified foreign financial asset" for any year in which the aggregate value of such assets is greater than $50,000. The new law requires the taxpayer to attach this disclosure to his or her income tax return. Many questions remain open about the extent and form of this new reporting requirement, none of which had been addressed by the end of 2010 (for further details please see "Reporting of offshore investments - proposed regulations and the HIRE Act").

Passive foreign investment companies

The HIRE Act also requires US persons who are shareholders of a PFIC to file an annual report containing such information as the IRS may require. This new law was effective as of March 18 2010 and the IRS released Notice 2010-34, in which it states that it is developing further guidance regarding this new reporting obligation. To date, the IRS has not issued a form for this report or any guidance on what it will entail. Furthermore, there are still no regulations on the interaction between the foreign non-grantor trust accumulation distribution rules and the PFIC excess distribution rules (for further details please see "Need for regulations on taxation of US beneficiaries of foreign trusts owning PFICs").

Reporting by non-US financial institutions

The HIRE Act included provisions requiring non-US financial institutions to provide the IRS with sufficient information to identify accounts held by US persons with an average month-end balance of $50,000 or more. Failure to do so will result in a 30% withholding tax on US-source payments to those accounts. Withholding can be avoided if the foreign financial institution enters into a foreign financial institution agreement. No draft agreement has yet been published.

The withholding provisions are effective for payments made after December 31 2012, although obligations outstanding as of March 18 2012 will be exempt. On August 27 2010 the IRS released Notice 2010-60, which describes how such institutions are to comply with the new law. It provides that obligations for the purposes of the exemption do not include instruments treated as equity for US tax purposes or legal agreements that lack a definitive expiration or term (eg, savings deposits, demand deposits or brokerage or custodial accounts).

A foreign financial institution is subject to the act if it is a non-US entity that:

- accepts deposits in the ordinary course of banking or similar business;
- holds financial assets for the account of others as a substantial portion of its business; or
- is engaged in investing or trading in securities, partnership interests or commodities, or interests in the same.

The notice states that a trust company will be considered a foreign financial institution, and that a trust settled and funded by an individual for the sole benefit of his or her children could also be considered a foreign financial institution, although the IRS is considering adopting a less burdensome reporting regime for certain small foreign financial institutions.

Use of foreign trust property

The HIRE Act broadens the tax law to provide that use of foreign trust property after March 18 2010 by a US grantor or US beneficiary - or any US person related to a US grantor or US beneficiary - will be treated as a distribution to the US grantor or beneficiary of the fair market value of the use of the property. 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 the fair market value for the use of the property within a reasonable period of such use (for further details please see "Uncompensated use of foreign trust property: HIRE Act treats as trust distribution").

The IRS has yet to release a revised Form 3520 and no guidance has been issued to address valuation and other issues. However, advisers to international families with existing trusts that own property which is used by US beneficiaries - whether it consists of residences, vacation homes, artwork or jewellery, and wherever it may be located - should consider the following options.

Continue 'as is'
The trustees of a foreign trust may wish to maintain the status quo, allowing both US and non-US beneficiaries to use trust property. If so, the trustee should engage an appraiser to determine the fair market value of the use of each item of property. The appraiser is likely to take into consideration the fact that the property is available solely for use by the beneficiaries, even if they occupy the property for only a few months or days each year. The appraisal should be updated periodically and the trustee should be aware that the IRS can review and challenge appraisals.

The trustee must also consider which beneficiary or beneficiaries should file Form 3520 to report the deemed distribution from a foreign trust. Arguably, only the adult beneficiaries need file, as they bring their minor children with them, but the question of which parent should file, or whether both should file, may depend on how the property is used and whether the adult beneficiaries are always together or make separate trips. The identity of the reporting beneficiary is important because the trustee must provide US beneficiaries with an annual foreign non-grantor trust beneficiary statement, showing the distributable net income (DNI) and undistributed net income (UNI) attributable to the deemed distribution, or a foreign grantor trust beneficiary statement showing that all income is attributable to the settlor. If no beneficiary statement is provided, the US recipient of a foreign trust distribution may be required to treat the entire distribution, whether from income or corpus, as an accumulation distribution for tax purposes, which would be included in gross income and would be subject to interest charges. Generally, amounts distributed to a trust beneficiary are treated first as ordinary income, to the extent of that beneficiary's share of the trust's DNI, then as a distribution of UNI, and finally as a distribution of principal. The HIRE Act does not explicitly address the extent to which the uncompensated use of non-income-producing foreign trust property will result in certain classifications of trust income being attributed to the US beneficiary.

The new law is effective as of March 18 2010, so that even if US beneficiaries will not be using trust property in 2011, there may be a deemed distribution of the fair market value of the use of foreign trust property in 2010 and, thus, a need to value that use and to file Form 3520. 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.

Pay rent at fair market value for use of foreign trust property

The new law provides that the deemed distribution rule does not apply to the extent that the foreign trust is paid at fair market value for the use of the property within a reasonable period of the use. If the trustee wishes to collect rent from its US beneficiaries, in most cases an appraiser's value of the use will be required to determine fair market rent. Although the rent means no deemed distribution, Form 3520 may still need to be filed. In other situations where there is no deemed distribution (eg, where the foreign trust makes a loan to a US beneficiary in the form of a qualified obligation), an annual reporting requirement applies.

The trustee must also consider the impact of rent payments on the foreign trust's DNI/UNI profile and resulting US tax and reporting obligations. In addition, the US payer of rent will be required to withhold a 30% flat rate of tax. Withholding tax is collected on a gross basis, without deductions, even in a net lease situation. Trustees should explore whether the trust can elect to have the income taxed on a net income basis as being "effectively connected with a US trade or business", without withholding (although the trust may have to file estimated tax returns).

Sell use property to a US trust

The rule that results in a deemed distribution for the use of trust property does not apply to US domestic trusts. The trustee might consider selling the use property to a US trust, so that the deemed distribution issue does not arise in future. A sale would not pull DNI or UNI out of the foreign trust and would replace the value of the property with cash, which can be retained in the foreign trust. There is no Form 3520 filing requirement on a sale. The trustee must keep in mind that withholding tax under the Foreign Investment in Real Property Trust Act is triggered on the sale of US real property by a foreign owner, but that given the decline in the US housing market, there may be little or no gain and a withholding certificate could be obtained to reduce the withholding tax. Another option might be for the relevant US trust to purchase only a partial interest in the real property. This might be an interest as tenants in common with the foreign trust, in a proportion relevant to the manner in which the property is used; alternatively, the foreign trust and the US trust might form a partnership, which defines the right to use real property owned by the partnership on the basis of each partner's economic interest in the partnership.

Distribute use property to a US trust

The trustee might also consider distributing the use property to a US trust. Such a distribution in kind will pull out DNI or UNI, but the trust's distribution deduction and the amount included in the beneficiary's income are both limited to the lesser of the basis of the distributed property or the property's fair market value at the time of distribution. However, distributing property in kind to a new US trust with no other assets would pull out DNI or UNI without funds to pay the resulting tax bill. Some additional planning considerations will surround a distribution to a US grantor trust. Moreover, a qualified US tax accountant should explore whether the default calculation of Form 3520 results in a smaller accumulation distribution.

Change trustee and situs of administration of foreign trust to the United States

In order for a trust to be considered a US domestic trust, it must meet both the control and the court tests (for details please see Taxation of offshore trusts and impact of new lower tax rates). Local counsel for the US trust company should advise on whether the trust document needs alterations or additions to insure that a state court would take primary jurisdiction. The trustee may have powers to make such alterations or additions for this purpose.

IRS private letter rulings conclude that a change of trustee and trust administration to the United States results in the domestication of the trust and a change in its tax status from a non-resident alien to a resident alien. These rulings also state that no taxable gift occurs because no additions were made to the corpus. The domestication of a trust in this manner should not create an accumulation distribution and the interest charge and other accumulation distribution rules should not apply. The exempt status of the foreign trust from GST tax and other favourable tax attributes (eg, no estate tax inclusion) should also be preserved.

UNI in the foreign trust will have an impact on trust distributions after it becomes a US domestic trust. If a trust accumulates income as a foreign trust and, having changed its situs to become a domestic trust, distributes the accumulation, the distribution will be treated as having been made by a foreign trust. The IRS has ruled that beneficiaries of a domesticated non-grantor foreign trust remain subject to the interest charge on distributions allocable to years in which the trust was a foreign trust, regardless of the fact that the trust was a domestic trust when the distributions were made. The use of trust property by beneficiaries of the US trust will not be a deemed distribution under current tax law.

Comment

US tax practitioners and family advisers had their work cut out for them in 2010, wrestling with various changes and new rules. 2011 looks like it will be more of the same. The passage of the Tax Reform Act has provided some certainty. Practitioners can only hope that the issuance of revised forms and IRS guidance will enable them to provide international family clients with answers to their many questions, even if it may be difficult to look beyond the next two years.

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