
TREASURY DEPARTMENT

PREEMPTIVE ACTION REQUIRED

The Foreign Trust and Its Consequences

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Of all the tax traps likely to ensnare immigrants as they transition to the U.S. tax system, foreign trusts top the list as the least expected and the most costly. All too often, the foreign trust problem is only recognized when the immigrant files his or her first U.S. resident tax return, but by then, it is usually a matter of dealing with consequences rather than avoiding the problem.

An immigrant is required to file a regular tax return (Form 1040) for the year in which he or she becomes tax resident in the United States. (Department of the Treasury, Internal Revenue Service, U.S. Tax Guide for Aliens (Feb. 7, 2012), at 44). The foreign trust problem is not generally obvious before filing a regular tax return, even if the immigrant has filed non-resident returns (Form 1040NR) in previous years. In many cases, the tax classification of the foreign trust changes the day the immigrant becomes a U.S. tax resident. Foreign trust classification can arise when the immigrant becomes a U.S. tax resident under the substantial physical presence test or under the green-card test.

Once immigrants become U.S. tax residents, they are generally taxed (sometimes with "penalty interest") on distributions received from foreign trusts. But the real surprise awaiting tax resident immigrants is that they may be taxed on the income received by the foreign trust rather than on the income they receive from the foreign trust. As a result, immigrants may be taxed on trust income even if they do not receive a distribution or any other payment from the foreign trust. This nightmare— tax without income—occurs because the immigrant is regarded as "owning" the assets of the foreign trust. An individual is regarded as "owning" trust assets for U.S. tax purposes where he or she is the grantor of the trust, and trust income can be used for his or her benefit or he or she retains certain powers over the trust.1 The problem is exacerbated if the immigrant is unable to secure payment from the foreign trust to offset tax liability on trust income.

Anti-deferral Measures: Excessive and Harsh

The tax rules for foreign trusts are extreme both by design and effect, even by the standards of the Internal Revenue Code (IRC). These harsh measures are meted out to foreign trusts because they were perceived (and are still perceived) as a means by which taxpayers can avoid or at least defer their U.S. taxes. To prevent taxpayers from diverting income to a foreign trust that they would otherwise earn, the IRC was amended to include a string of "anti-deferral" measures aimed specifically at foreign trusts.2

As a result of these anti-deferral measures, in many cases, individuals are taxed on income earned by foreign trusts even if payment is not received by the individuals themselves. In other cases, individuals are taxed only on the distributions they receive from foreign trusts, but then "penalty interest" is imposed on the tax payable. The result is that the overall tax burden may be far heavier than if the income had been earned by the individuals directly.

It may be understandable that anti-deferral measures were enacted to prevent existing U.S. taxpayers from diverting their income to foreign trusts as a means to avoid U.S. tax. However, it comes as an unwelcome surprise that these same anti-deferral rules apply to foreign trusts with immigrant beneficiaries. Immigrants are often surprised that

the U.S. tax system can reach foreign trusts that have had no previous connection with the United States.
The anti-deferral rules are intended to prevent all U.S. taxpayers (including immigrants once they become tax resident) from securing tax benefits through all foreign trusts (including those trusts that had no connection with the United States before the individual's immigration).

The Treasury Regulations make it clear that the foreign trust rules are intended to apply to individuals who subsequently become tax resident in the United States. IRC §679(a)(4) specifically applies to a "foreign grantor who later becomes a United States person"; Treas. Reg. 1.679-5 specifically applies to "Pre-immigration trusts"; and Treas. Reg.1.679-5(c) Example 1 specifically applies to: "Nonresident alien (who) becomes resident alien." In the latter example, the nonresident alien becomes subject to the provisions of IRC §679 once he or she becomes tax resident in the United States.
Immigrants are not only subject to the same foreign trust tax rules as U.S. citizens, but they actually face additional tax rules aimed at "pre-immigration" trusts. The pre-immigration trust rules are aimed at preventing U.S. tax benefits from foreign trusts formed by immigrants before immigrating to the United States.

Spotting What Is or Isn't a Foreign Trust

A related problem is that it may not always be obvious that a foreign entity is a trust. This is unlikely to arise where the foreign entity is, by type and purpose, a trust (for example, a family trust). Foreign trusts can be insidious, however, especially where the foreign entity has some trust-like qualities, yet may be used in the foreign country as a vehicle for commercial purposes. For example, depending on the facts, a Liechtenstein stiftung is typically

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recognized by the IRS as a trust for U.S. tax purposes, while the agency typically does not recognize a Liechtenstein anstalt as a trust. In other cases, while the foreign entity is a trust, in the foreign country, it may be used as a vehicle for investment or retirement plans, and more commonly known by another name, such as a super fund (common in Australia), or provident fund (often used in countries that are members or former members of the British Commonwealth).

Under certain circumstances, payments from these funds received by immigrants who are tax resident in the United States may be regarded as distributions from a foreign trust and subject to the anti-deferral rules discussed above.
The U.S. tax reporting requirements for foreign trusts also are onerous. While most people entering the U.S. tax system expect trust distributions they receive to be reportable, few realize that any payments they make to a foreign trust are generally reportable. Generally, Form 3520 must be filed for distributions from, and transfers to, foreign trusts. Perhaps more surprising, those tax resident immigrants regarded as owning the assets of a foreign trust are required to file annual tax information returns for the foreign trust, even though they may neither have received distributions from the trust nor had any other transactions with the trust during that year. Generally, Form 3520A must be filed for a foreign trust regarded as owned by U.S. tax residents.

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How does an immigrant avoid the unfair extremes of the IRC aimed at foreign trusts? The answer lies in timing. As the saying goes, "Forewarned is forearmed." Therefore, immigrants with foreign trust relationships need to know before they become U.S. tax residents, and preferably before they leave their foreign country, of the tax issues they will encounter once they become tax resident in the United States. In most cases, early preemptive action can avert what will otherwise result in costly tax and penalty impositions.

The reach of U.S. tax rules to foreign trusts is surprisingly broad, considerably broader than under the tax rules of other countries. Immigrants to the United States need to be forewarned that foreign trust relationships are often heavily taxed in this country, and that they may face heavy penalties for non-compliance.

Perhaps even more importantly, immigrants should be aware that most, if not all, of these negative consequences can be avoided if the appropriate preemptive action is taken before they become U.S. tax resident and, ideally, before they leave their home country.

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1 IRC §677(a) provides that "The grantor shall be treated as the owner of any portion of a trust … whose income … is … or … may be … distributed to the grantor…." The grantor is also treated as the owner of a trust where he has a reversionary interest in trust corpus or income (IRC §673(a)), where he has the power of trust corpus or income disposition (IRC §674(a)), where he has any of a number of "administrative powers" in respect of a trust (IRC §675(1)–(4)), or where he has the power to revoke the trust (IRC §676(a)).

2 IRC §679 ("Foreign Trusts having one or more United States Beneficiaries") was introduced into the Internal Revenue Code by the Tax Reform Act of 1976, then amended by the Small Business Job Protection Act of 1996. The 1976 "Blue Book" of the Joint Committee on Taxation (Volume 5, page 17) commented as follows on the foreign trust tax provisions to be enacted in the Tax Reform Act of 1976: "The rules of present law permit U.S. persons to establish foreign trusts in which funds can be accumulated free of U.S. tax. … it is contended that it is unfair to permit a grantor by using a foreign trust to provide a tax-free accumulation of income while the income remains in the trust."