

Taxation of Foreign Trusts

Comparing U.S. and UK rules.

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The global financial crisis has given the G20 group of nations greater power to put pressure on the, often smaller, international financial centers as well as creating the need for national governments to increase tax revenues by clamping down on areas of perceived tax evasion. On an international level, there have been many new tax information exchange agreements between countries, including with some tax havens and former banking secrecy jurisdictions, as the G20 nations sought to reduce tax evasion by their citizens.

On a national level, a number of governments and revenue authorities have separately conducted disclosure or amnesty programs, designed to collect undisclosed revenues and to close down perceived areas of tax evasion. Following on from the carrot of such voluntary disclosure programs, comes the stick of increased disclosure and compliance requirements for taxpayers with assets held offshore and increased penalties for failure to disclose.

It is in this context that The Foreign Account Tax Compliance Act of 2009 (FATCA) was

introduced into Congress on Oct. 27, 2009. FATCA draws heavily on the provisions of the Stop Tax Haven Abuse Act and is the latest attempt by the U.S. authorities to prevent the avoidance of tax on income from assets held abroad. If enacted, FATCA would impose new rules for taxing certain benefits received from foreign trusts by U.S. persons and would introduce strict new disclosure and compliance obligations which have a significant impact on advisers and their clients.

If enacted, the Foreign Account Tax Compliance Act would impose **new rules** for taxing certain benefits received from foreign trusts by U.S. persons and would introduce strict new **disclosure** and **compliance** obligations.

This article will focus on the taxation of offshore trusts,¹ which have long been considered by revenue authorities as vehicles that may facilitate tax evasion, and on the impact of the changes introduced by FATCA on offshore trusts and persons connected with them. Due to the extraterritorial scope of U.S. taxation, affecting U.S. persons who are not (and in many cases have never been) resident in the United States, this article will also look at how the U.S. rules interact with the rules of another jurisdiction, the United Kingdom.

We focus here on the U.S. and UK laws because these are the two major financial jurisdictions that encourage the formation of foreign trusts, and which now are attempting



to discourage the use of offshore jurisdictions by their taxpayers.

Both the U.S. and the UK have a complex existing regime for imposing tax on offshore trust structures. These have operated for many years and despite the current climate of suspicion surrounding international financial centers where many such structures are based, it remains perfectly legal to establish an offshore trust under both U.S. and UK legislation. Indeed, §§7701(a)(30) and (31) of the Internal Revenue Code continue to allow foreign persons to establish foreign trusts for income tax purposes in the United States, suggesting that the U.S. wants to encourage the creation of trusts that are not subject to U.S. tax.

The focus of both the U.S. and UK legislation is to pursue their domestic taxpayers, most of whom are subject to tax on their worldwide income, who either create foreign trusts or receive benefits from them. This pursuit is not

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just for tax revenues, but is increasingly for information about the structure and its assets.

Taxation of Offshore Trusts

In order to discuss the impact of the proposed changes, it is important to understand the existing legislative structure applying to offshore trusts. Accordingly, there follows a brief summary of the existing U.S. and UK rules applicable to the taxation of offshore trusts.

If a foreign trust is funded by a U.S. person and has a U.S. beneficiary, then the trust will be a foreign grantor trust with the result that the U.S. grantor will be treated as the owner of all items of income and deduction of the trust, and subject to applicable U.S. taxes accordingly.

Foreign non-grantor trusts are subject to different rules. If such a trust distributes an amount up to the amount of the current year's distributable net income (DNI), this is taxable as income in the hands of a U.S. beneficiary who receives it. If the distribution is in excess of its DNI (an "accumulation distribution"), and the trust has undistributed net income² (UNI) from a previous year, then the "throwback" rules apply to this excess amount. The rates of tax and interest imposed under the throwback rules can lead to an effective rate of up to 100 percent of the accumulation distribution received.

Offshore trusts in relation to which a U.S. person has a beneficial interest in more than 50 percent of the trust income or assets must normally file an FBAR of foreign financial account where the aggregate value of the accounts exceeds \$10,000 at any time during the financial year.

The UK also has its own complex set of anti-avoidance rules which apply to ensure that UK resident persons who are connected with, or enjoy benefits from offshore trust structures, are liable to pay tax in the UK. These rules apply differently depending on whether the UK taxpayer is taxed on the remittance basis. Since the Finance Act 2008 changes, it is still possible for a person who is a UK resident, but non-UK domiciled, to claim the remittance basis of taxation subject to paying the £30,000 remittance basis charge where the charge is applicable.³ Taxpayers who are eligible to claim the remittance basis may elect not to do so with the result that they are taxable on a worldwide basis.

The "settlor-charging" regime applies where the settlor, being a person who has provided funds to the offshore trust, is a UK resident for tax purposes. Briefly, and subject to some

limited exemptions and deductions, the settlor charging rules apply to treat all income arising to the trust structure as the settlor's income. Where the settlor is taxable on a worldwide basis, he must declare all trust income and pay tax on it in the UK. If he claims the remittance basis, the settlor is taxable on any UK source income and on any foreign income remitted to the UK. Remittance now has a wide meaning. Capital gains arising within the offshore trust structure are treated as the settlor's gains for UK tax purposes only if the settlor is a UK resident and domiciled under general law principles.

The "beneficiary charging" regime applies in the UK where trust income and gains have not been subject to the settlor charging rules. Trust income not used to meet costs or distributed to beneficiaries is accumulated in the trust to create a pool of "relevant income." Trust gains that are not distributed are carried forward. Any distributions to, or benefits enjoyed by, a UK resident beneficiary are matched first against available relevant

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income and, once the relevant income has been exhausted, against stockpiled gains in the trust structure. Gains distributed after the year they are realized are subject to a supplemental charge to taxation.

Under UK rules, taxable benefits provided to beneficiaries include loans and occupation or use of trust property rent-free. The value of the benefit is equal to its market value (either the market rate of interest or the free-market rental value of the property in question) and this value is then matched against available relevant income and/or trust gains. Where the beneficiary is eligible to claim the remittance basis and does so, and the benefit is not received or enjoyed in the UK, no charge to tax will arise.

Proposals in FATCA

FATCA contains a number of new measures that would affect offshore trusts and persons connected with them, including professional advisers.

FATCA proposes to create reporting and disclosure obligations for a variety of persons, not simply grantors or beneficiaries of a foreign trust. These include:

- Under the rules applying to "foreign financial institutions," bankers and investment managers of an offshore trust where a U.S. person is treated as an owner of any portion of the trust;
- Certain investment entities, including hedge funds and private equity funds where they have an investor which is an offshore trust with a substantial U.S. owner;
- Trustees or directors of a company within an offshore trust structure who are within the definition of "non-financial foreign entity"; and
- "Material advisers" who will be required to file a return of any "foreign entity transaction" which is likely to include in particular the establishment of or transfer of property into an offshore trust—a material adviser could include trustees, lawyers, accountants or other professional advisers including non-U.S. persons and entities and advisers who do not operate within the U.S..

Failure to comply with the reporting regimes applicable to foreign financial institutions and non-financial foreign entities would give rise to a withholding tax of 30 percent on any withholdable payments of U.S.-source income made to such entities. Any person required to deduct and withhold the new withholding tax imposed by FATCA would be personally liable for the tax that is to be withheld. A failure by a material adviser to make a report without a reasonable cause would give rise to a minimum penalty of \$10,000.

It is clear therefore that FATCA creates significant new compliance obligations and risks that could potentially apply to a variety of persons connected with offshore trusts including the trustees, lawyers, investment advisers, bankers and other professional advisers as well as U.S. grantors and beneficiaries. This in turn will increase the administrative and compliance costs associated with providing these services. It is currently envisaged that the effective date for the new provisions will be Dec. 31, 2010.

FATCA seeks to bring more offshore trusts within the grantor trust provisions described above by broadening the circumstances in which a foreign trust is treated as having a U.S. beneficiary. At present if, under the terms of a trust, any part of the income of the trust may be accumulated for the benefit of a U.S. person in a taxable year then the trust will be treated as having a U.S. beneficiary for this purpose.

Under the proposed rules, this would apply even where the person's interest is contingent on a future event. In the case of discretionary trusts, where the trustee has discretion to make a distribution to or for the benefit of any person, the trust is treated as having a U.S. beneficiary unless the terms of the trust specifically identify the class of persons to whom such distributions may be made and none of those persons is a U.S. person during the relevant taxable year. Where a U.S. person transfers property to an offshore trust and there is an agreement or understanding, whether or not written, that may result in the income or capital of the trust being paid or accumulated to or for the benefit of a U.S. person, then this shall be treated as an express term of the trust.

These provisions will apply to existing trusts from the date of enactment of FATCA with the result that a number of foreign trusts which had not previously been within the grantor trust rules would be caught going forward unless steps were taken in advance to ensure none of the above provisions was applicable.

For new trusts created after enactment of FATCA's provisions, there will be a presumption that a foreign trust to which a U.S. person has transferred property shall have a U.S. beneficiary unless the transferor furnishes such information as the Treasury Department may require to satisfy itself that there is no U.S. beneficiary in the taxable year.

The provision of FATCA that is likely to have the greatest impact on foreign trusts is the introduction of a charging provision for use of a foreign trust's property by the U.S. grantor, a U.S. beneficiary or any U.S. person related to such grantor or beneficiary. From the date of enactment, any such use will be treated as a distribution from the trust to the U.S. grantor or U.S. beneficiary. The amount of the distribution will be equal to the fair market value of the use. In the case of trust-owned personal or real property, the value will therefore be the market rent. These rules will apply to the occupation of trust property (or use of trust personal property such as paintings or furniture) anywhere in the world by a U.S. person who may be resident in another jurisdiction for tax purposes. As this is a relatively common situation, the example below illustrates the impact of the new rules.

A BVI discretionary trust structure established 10 years ago by Michael (who

was not a U.S. person and is now deceased) owns a property in London. Michael's son, Bob is a U.S. person. Bob is currently a UK resident but non-UK domiciled for general law purposes. He occupies the London property rent-free with his family. The trust also owns a portfolio of investments which, over the years, has produced income and realized gains; the trustees have accumulated the surplus income and gains.

Under the UK rules, Bob has been treated under the beneficiary charging provisions as receiving a benefit from the trust. The value of the benefit is equal to the equivalent of the market rent for occupying the property. Since the trust contains accumulated income and gains, Bob has been paying tax each year on the benefit received. As the benefit is enjoyed in the UK, Bob cannot claim the remittance basis in relation to the benefit.

Although he is a U.S. person, Bob has not been subject to any U.S. tax on the benefit represented by his occupation of the London property under the existing rules. Under the new rules, however, Bob will be treated for U.S. tax purposes as receiving a distribution from a foreign trust. This distribution is likely to be treated as carrying out UNI to the extent that the distribution is an accumulation distribution and a tax charge will arise in the United States. Under the throwback rules, and as there is significant historic income in the trust, the effective rate of tax payable could be punitive.

Subject to any credit allowed under the U.S./UK Double Tax Convention, Bob now potentially has significant tax charges in both the UK and the U.S. which he will need to fund unless one of the following alternatives can be implemented:

- Bob pays the full market rent for his use of the property—this takes him out of the UK beneficiary charging rules and the U.S. charging provisions; however, he still needs to fund the rent; additionally, the rent paid will be taxable in the hands of the trustees as UK source rental income;

- Prior to the enactment of FATCA, the trustees take steps to resettle the property onto a new structure which holds only the property and does not have any income-producing assets or historic income and gains. Bob could occupy the property without a charge to tax because there is no relevant income or UNI to match against the benefit he receives. This planning would be problematic; however, it is likely that the trust will want to

sell the London property at a time when Bob continues to be a UK resident. Furthermore, as the trust would have no income stream, there could be problems with funding ongoing expenses.

- Prior to enactment, the trustees could consider distributing the property to Bob absolutely. This may incur a charge under the UK and U.S. beneficiary charging provisions depending on the levels of stockpiled income and gains and UNI, and is likely to incur transaction costs. Going forward, however, there is no ongoing charge for Bob to occupy his home. If it is his main home, reliefs will apply for UK capital gains tax, and the inheritance tax consequences of having the property in his estate can be dealt with by appropriate estate planning.

FATCA's proposed taxation of the value of use of trust property is very similar to existing UK law, and both the U.S. and UK are increasing reporting requirements in an effort to subject all offshore income to tax. The regimes are increasingly similar, and taxpayers, subject to tax in both jurisdictions, must be aware of both tax regimes.

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1. In this article, "offshore trust" means, in relation to the U.S. rules, a trust that is a foreign trust under §7701(a)(31) of the Code and, in relation to the UK rules, a trust that is not resident in the UK for tax purposes. The rules relating to onshore trusts in both jurisdictions are beyond the scope of this article and accordingly "offshore trust" will refer to trusts that are offshore under the rules of both jurisdictions.

2. In the case of foreign non-grantor trusts, UNI includes capital gains realized by the trust.

3. Broadly speaking, a person is within the scope of the remittance basis charge where they are age 18 or over, have unremitted foreign income or gains of £2,000 or more and where they have been resident in the UK for tax purposes in seven out of the nine tax years immediately preceding the tax year in question.