2014 WORLD CONFERENCE:

FOREIGN GRANTOR TRUST

A Foreign Grantor Trust is a Great Solution to Benefit U.S. Persons:

A Look at How This is Done

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Purposes of Foreign Trusts

- Comfort level of settlor
- Broader investment options
- More sophisticated financial management
- More expensive transaction costs
- Asset protection
- Financial privacy

Purposes of Foreign Trusts

- For non-U.S. grantors:
  - To hold inheritances for U.S. children and grandchildren
  - To provide unified ownership in the trust while allowing distributions to vary as directed in applicable instruments or documents
  - To hold U.S. real property and stocks (but beware retained interest rules)

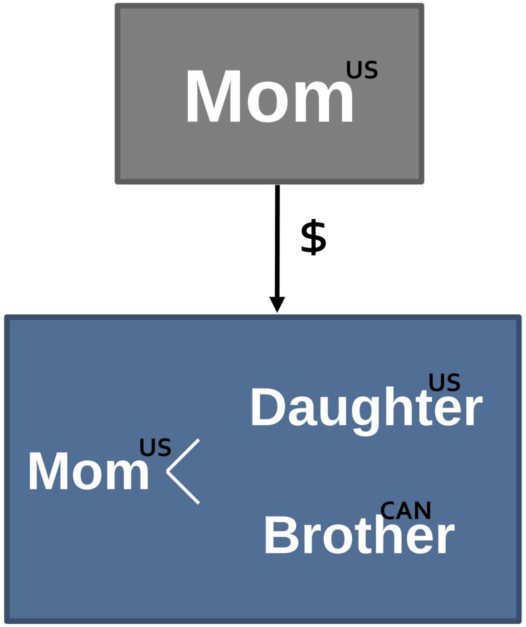
What is a foreign trust for U.S. income tax purposes?

- Trust is foreign if it fails either:
  - The Court Test (Primary Supervision of Administration)
  - The Control Test (U.S. Control over Substantial Decisions)
- If both are met, the trust is domestic even if formed under foreign law.

It is easy to be a foreign trust…

Example:

Mom from Buffalo dies, setting up a trust for daughter, who also lives in Buffalo, with daughter and mom's brother as Trustees. Brother is an expat living in Toronto.



Tax Benefits of Foreign Grantor Trusts

- A U.S. beneficiary is exempt from tax on distributions from a foreign grantor trust.
  - For substantive tax purposes, the distribution is treated as a gift from foreign grantor.
  - For reporting purposes, the distribution retains character.
- To be a grantor trust:
  - Trust must be revocable by foreign grantor.
  - Irrevocable trust in which distributions may be made only to foreign grantor or spouse during grantor's lifetime.
  - Grandfather rule for trusts formed and totally funded prior to September 19, 1995.

Comparison to Distributions from Foreign Non-Grantor Trusts

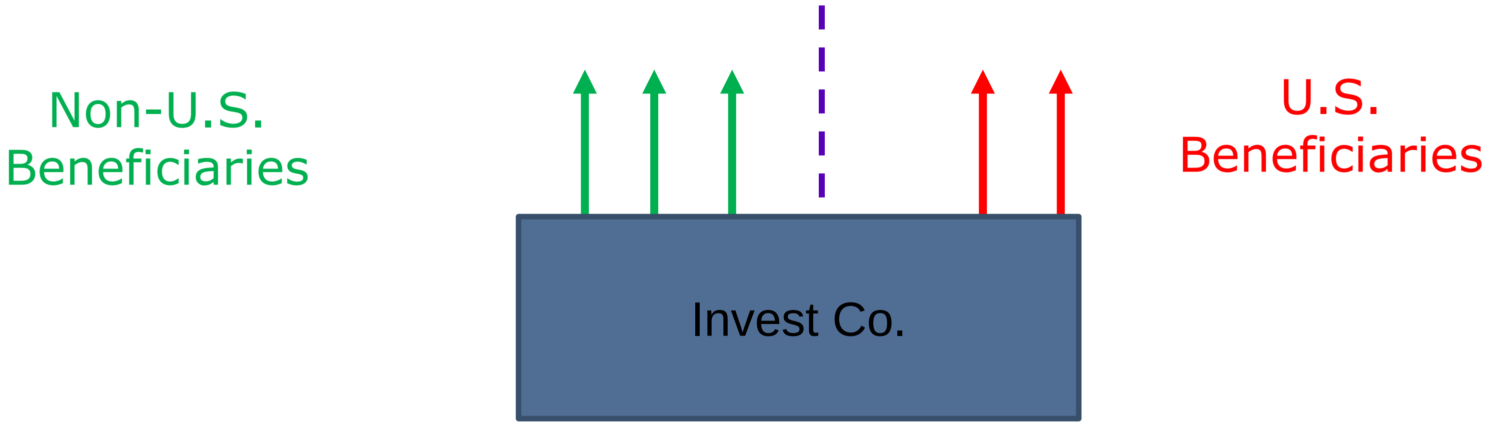
- Rule for distribution of current year’s income of foreign non-grantor trust (“F.N.G.T.”)
- Distributions from prior years’ income of an F.N.G.T. are subject to accumulation distribution rules:
  - Taxed at ordinary income rates (up to 39.6% plus possible net investment income tax of 3.8%); plus
  - Interest is imposed to reflect the benefit of deferral.
- What was capital gains in year earned is taxed as ordinary income when distributed in a later year.
- Interest charge may become punitive.

U.S. Anti-Deferral Rules

Foreign HoldCo for Investments

Non-U.S. and U.S. Shareholders

When not a C.F.C.



Corporate Anti-Deferral Rules

Passive Foreign Investment Company (“P.F.I.C.”)

- 75% or more passive income or 50% or more passive assets.
- No minimum U.S. shareholder ownership required.
- Attribution through foreign estate or trust.
- Taxed when excess dividend distributions or stock disposed (including non-recognition transactions), at highest U.S. rate (35%), plus interest compounded over holding period.
- Forms 8621, 8938

Corporate Anti-Deferral Rules

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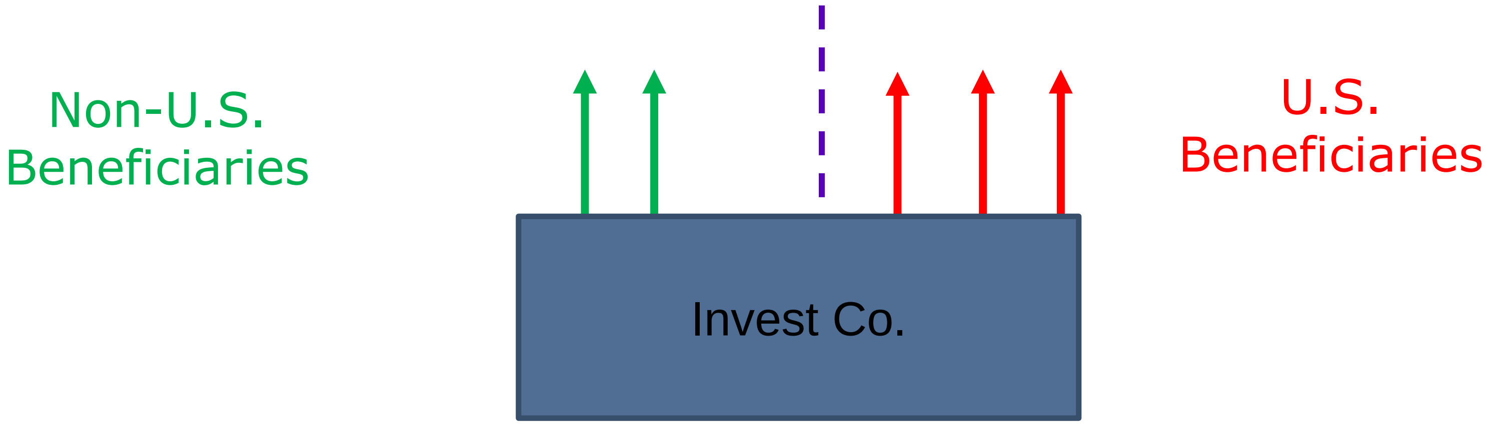
When a C.F.C.



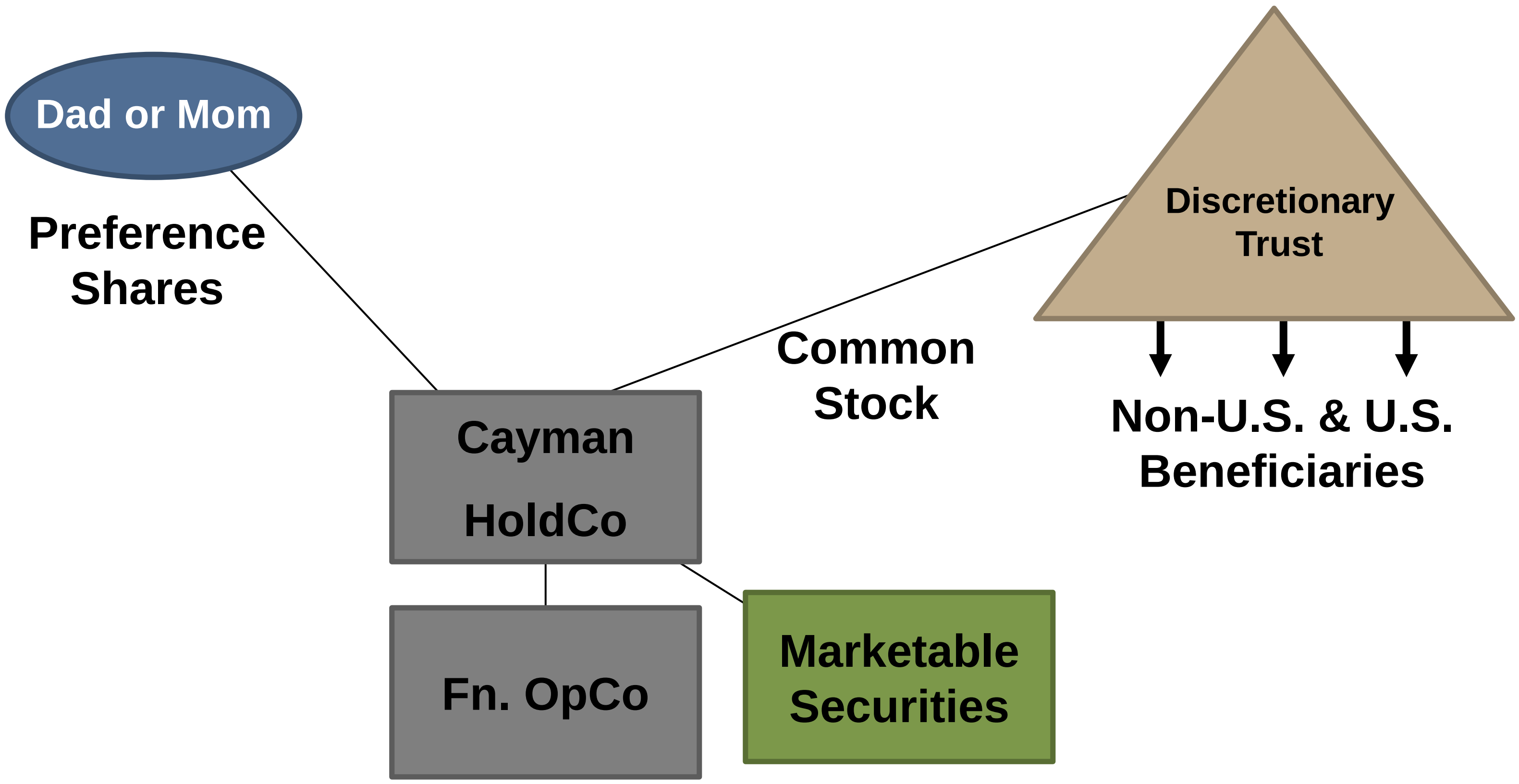
Corporate Anti-Deferral Rules

Controlled Foreign Corporation ("C.F.C.")

- More than 50% by vote or value owned by U.S. shareholders with at least 10% voting power.
- Attribution through foreign estate or trust (and other chains of ownership).
- "Subpart F" income (generally, passive income) taxed currently to U.S. owners (10%+) as a dividend (creating "phantom" income).
- Rental or royalty income may be passive or active.
- Forms 5471, 8938

Common Canadian Structures Exposing U.S. Taxpayers to Anti-Deferral Rules

Typical Cross Border Structure



P.F.I.C./C.F.C. Attribution to U.S. Beneficiaries

- If F.G.T., attribution solely to grantor.
- If F.N.G.T., attribution to U.S. beneficiaries.
  - Facts and circumstances:
    - History of distributions if discretionary
    - If no distribution history …?
  - Possibility of phantom income where no cash ever received.
  - Protective Q.E.F.
- Not synchronized with F.N.G.T. accumulation rules.

Traps

- Indirect distributions through other beneficiaries may be treated as direct distributions from trust.
- Indirect contributions through other persons cause individual to be treated as grantor.
- Rent-free use of apartment owned by foreign F.N.G.T.
- Loans from F.N.G.T.
- Status of trust becomes foreign trust inadvertently.
- The grantor of an irrevocable trust dies, terminating grantor trust status affects status of foreign entities.
- A U.S. tax resident other than a citizen relinquishes U.S. residence and a grantor trust becomes a non-grantor trust, forcing recognition of gain.

Traps

Complex reporting requirements for U.S. grantor or beneficiary (whether F.N.G.T. or F.G.T.):

- 35% penalty to beneficiary for failure to comply with reporting obligation (Form 3520).
- All distributions deemed to be accumulation distributions unless proven otherwise.
- 5% penalty to grantor for failure to comply with reporting obligation (Form 3520-A).

Traps

- F.B.A.R. Reporting:
  - Severe penalties for failure to report, if threshold interest exists for beneficiary.
  - Range from $10K to $100K to 50% of highest value each year.
- Form 8938 Reporting:
  - $10K penalty for failure to report.
  - Tolling of the statute of limitations for all issues in a tax return if Form 8938 is not filed.

Planning Opportunities

- Grantor trust owns portfolio of foreign assets and U.S. persons receive income.
- Pre-immigration planning for assets owned by existing trust.
- Through a partnership, F.N.G.T. owns an interest in operating U.S. rental property.

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