U.S. Trusts With Foreign Beneficiaries: Issues and Observations

There is no perfect solution to the tax issues faced by a U.S. grantor who wishes to establish a U.S. trust for his or her foreign beneficiaries. Nevertheless, there are some general guidelines that can help in structuring these trusts.

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The rules governing foreign trusts, that is to say, trusts that are located and administered outside the United States, are well-defined. Whether "outbound" or "inbound," these trusts are subject to a number of special provisions in the Internal Revenue Code ("the Code") intended to foreclose their use by creative or unscrupulous taxpayers (and their advisors) seeking to avoid U.S. income taxes.¹

Much less well-defined are the rules governing the taxation of U.S. trusts with foreign beneficiaries. What may on its face seem a rather straightforward arrangement, in fact, involves numerous complexities, and can produce unexpected—and quite negative—consequences, particularly tax consequences. Minimization of the tax impact of this arrangement requires careful planning, drafting, and administration. The planner must consider a number of factors, among them the following:

- Whether, for U.S. purposes, the trust's income is taxable to the grantor, the trust, the beneficiaries, or some combination thereof.
- The beneficiaries' income tax status, both in the U.S. and in their country of residence.
- The applicability of wealth transfer taxes, both in the U.S. and in the country of the beneficiaries’ residence.
- The potential impact of a tax treaty with the applicable foreign jurisdiction.
- The need for flexibility in a number of aspects of trust administration, including change in applicable law, the standards for distribution, and allocation of receipts between income and principal.

However, these complexities also present opportunities that, if properly navigated, can yield favorable results.

The problem of mismatched taxpayers: double taxation

Potential grantor trust inefficiencies. Planners often prefer to structure trusts as wholly-owned grantor trusts for U.S. income tax purposes. In simple terms, if the grantor of the trust pays the tax on the trust's income, more of the trust property is preserved for the beneficiaries. Since mid-2004, practitioners have had the certainty that the IRS will not treat the payment of the tax liability by the grantor as an additional gift to the trust. As a result, the use of grantor trusts has become even more attractive. Over time, the benefit of letting the trust grow undiminished by income taxes can be quite substantial.

In the case of a U.S. trust with foreign beneficiaries, the use of a grantor trust may be much less advantageous—at least without

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1. JAMES R. ROBINSON is a partner in the law firm of Arnall Golden Gregory LLP in Atlanta. He is a frequent author and lecturer on estate planning.
careful planning and administration. This is particularly true if the beneficiaries are subject to tax on the trust’s income in their country of domicile (as, presumably, they would be, more often than not). In such a case, the trust’s income may be taxed twice, once in the U.S. and again in the beneficiaries’ domicile, with no offsetting credit for either liability. The reason is that there is a mismatch between the taxpayers in each country. In the United States, it is the grantor who is taxed; in the country of domicile, it is the beneficiaries. If the relevant treaty requires identity between the taxpayers in each jurisdiction for a credit to apply, then the income will be subject to double taxation.

Example. Parent, P, wishes to set up a trust for the benefit of P’s two adult children, A and B. P is a U.S. resident alien; A and B are citizens and domiciliaries of Germany. The trust is to be administered in the United States by a U.S. corporate trustee who has authority to distribute income and principal of the trust to or for the benefit of A and B as the trustee deems necessary for their support, health, and education. Other than what may be paid from the trust, A and B have no U.S.-source income and are not subject to U.S. income tax.

A number of difficult issues arise from this relatively straightforward arrangement. First, in most circumstances, the income of the trust is subject to U.S. income tax. Someone, whether P, the trust, A and B, or some combination of them, will be liable for the tax.3 However, some or all of the trust’s income likely will be subject to tax in Germany as well. Although the parameters, as well as the legality, of the current position of the German fiscal authorities are not entirely clear, there is some indication that those fiscal authorities will attempt to assert that all of the trust’s income, and not just income actually distributed, is taxable directly to A and B.5 In addition, there is some indication that the authorities also might attempt to assert that the distributions from the trust are subject to German gift tax.

The U.S./German income tax treaty, which also deals with wealth transfer taxation, is quite extensive. In general, the treaty (like many others of its kind) operates to avoid double taxation, and to assign the right to tax to the country having the more significant connection with the taxpayer and the income in question. However, the treaty does not address every instance, and the possibility of double taxation remains, particularly in the case of a trust arrangement.

Suppose, for example, that the trust is a wholly-owned grantor trust for U.S. income tax purposes. On the U.S. side, P, the grantor, is the taxpayer, and will pay U.S. income tax on all the taxable income, both ordinary and capital gain, of the trust. On the German side, A and B, the German resident beneficiaries, also may be subject to tax on the income of the trust, whether or not the income is distributed. There is, therefore, a “mismatch” of taxpayers in the two countries: P is ineligible for a credit against German income tax, which was not paid “by or on behalf of” P, while A and B may not receive credit against German income taxes for U.S. taxes paid by P.

Relief from double taxation under the treaty thus appears to be unavailable, at least without competent authority determination (i.e., a ruling from either the IRS or the German Ministry of Finance). The same result likely applies with regard to gift taxes: P’s initial gift to the trust is subject to U.S. gift taxes, while the German authorities are likely to assert that the distributions from the trust to A and B are subject to German gift tax (in addition to German income tax).

In this instance, the parties might take the position, even without a competent authority ruling, that the income of the trust is taxable in only one jurisdiction. With regard to German residents, U.S.-source income that may be taxed under the terms of the treaty is excluded from the German tax base.6 The German beneficiaries might rely on the language of the treaty itself to take the position that they are not subject to German income tax on the trust’s income. Nevertheless, many clients likely will view this course of action as unacceptably risky, particularly if they wish to avoid excessive involvement with the overseas taxing authorities.7

The U.S. advisor must assume that the taxing authorities in the beneficiaries’ country of domicile—particularly if it is a civil law country that does not recognize the concept of a common-law trust—will view any such arrangement with a certain level of suspicion, and more importantly will assert that the trust is subject to whatever tax liability may conceivably attach (as in the German example just given). While this may not hold true in any given situation, it would be far preferable to structure the trust in such

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3 But see Rev. Rul. 86-76, 1986-1 CB 284, discussed more fully infra.
4 See Pohl, 862-3rd T.M. (BNA), Business Operations in Germany, at XXI-D.
5 See id.
7 For the U.S. reporting requirements on treaty-based return positions, see IRC Section 6114.
a way as to minimize both the risk of double taxation as well as the chances of entanglement with the taxing authorities of the nations involved. Although this may not be possible in every case, there are strategies that can be used, both in drafting and in administering the trust, to accomplish the client’s goals while avoiding an unduly negative, if not disastrous, tax result.

Making trust income taxable to NRAs
One possible solution to the problem of mismatched taxpayers is to structure the terms or administration of the trust so as to make the trust income taxable to the beneficiaries in both jurisdictions. In greatly simplified terms, nonresident aliens (“NRAs”) are subject to U.S. income tax on income “effectively connected” with the conduct of a trade or business in the United States; on “fixed or determinable annual or periodical gains, profits, and income” (“FDAP”); and on U.S.-source capital gains (but only if the NRA is present in the U.S. for at least 183 days during the taxable year). The first category of income is taxed at normal graduated rates; the second and third types are subject to a flat 30% tax, which must be withheld at the source. For purposes of this article, we will assume that the income realized by the trust is investment-type income that would be either FDAP or U.S.-source capital gains.

Under the general rule of IRC Sections 652(b) and 662(b), income has the same character in the hands of the beneficiary as it does in the hands of the trustee. Accordingly, whether a particular item of income is taxable to an NRA beneficiary is determined at the trust level. For example, if a trust receives a dividend that falls under the definition of FDAP, and distributes that dividend to the NRA beneficiary as part of an annual distribution of trust “income,” it is taxable to the beneficiary as FDAP.

FDAP is a very broad category that includes much of the sort of investment income that many trusts are likely to recognize, including “interest, ... dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.” Consequently, to the extent that the trustee distributes items of FDAP to the beneficiaries, those items should be taxable in the hands of the beneficiaries, and as such are subject to 30% tax, which must be withheld at the source.

This basic rule is subject to numerous exceptions under the Code; for example, there are statutory exceptions for U.S. bank debt and “portfolio interest.” In addition, several important treaty exceptions may apply that may narrow the otherwise broad scope of FDAP considerably. The most recent U.S. Model Income Tax Convention (published in November 2006) reserves to the country of residency (broadly defined) the right to tax most kinds of income, specifically including interest and royalties, and imposes a limit (15%) on the rate of tax that may be imposed by the other country on dividends. This approach is largely duplicated in the current actual treaties, including for example the treaty with Germany. Thus, in the example above, most of the types of income likely to be earned by the trust in the U.S. would not be FDAP if earned by the German beneficiaries directly, but would be taxable only by Germany, while some types of income (notably dividends) would be taxable in the U.S. at 15%, rather than the usual 30% rate, with a credit under the treaty against the German tax for U.S. tax paid.

Capital gains are treated similarly. Under the Code, U.S.-source capital gains are taxable to an NRA (again at a 30% rate) only in the unlikely event that he or she is physically present in the United States for 183 days or more during the tax year without being classified for

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tax purposes as a resident alien. If we assume for purposes of our German example that the beneficiaries, A and B, are not physically present in the United States for 183 days or more in any given year, then any capital gains they recognized directly in the U.S. (for example, on the sale of appreciated stock) would not be treated as U.S.-source income and would not be subject to U.S. income tax.

However, the difficulty here is that A and B do not own the property directly. For U.S. purposes, it is the trust that earns the income. Unless the trust’s income “passes through” to the beneficiaries under IRC Section 678 (see below), the trust (or the grantor, by operation of the grantor trust rules) will be the taxpayer for U.S. income tax purposes, and once again we are faced with the problem of mismatched taxpayers. If the trust is a grantor trust, all trust income will be taxable to the grantor. If the trust is not a grantor trust, the trust will pay tax on its income at the trust tax rates, except and to the extent that the income is deductible by the trust under IRC Section 651 or 661.

Example. The trust in the previous example is not a grantor trust for U.S. income tax purposes, and no part of the trust is treated as being owned by the beneficiaries under IRC Section 678. Except to the extent that some special rule applies (e.g., the special rate on “qualified dividend income” under Section 1(h)(11)(B)), the ordinary income of the trust is subject to U.S. income tax at the trust rates, which very quickly reach a top marginal rate of 35%, while the long-term capital gain income of the trust will be subject to the normal capital gains rates (i.e., 15% in most cases). The status of A and B as NRAs is irrelevant for these purposes.

The foregoing presupposes that none of the trust’s income is distributed to A or B. If the trust can deduct amounts distributed to the beneficiaries, the result may change.

The distribution deduction. Under IRC Sections 651 and 661, a trust that distributes income to a beneficiary is entitled to deduct that income from its taxable income, to the extent that such income enters into the trust’s “distributable net income” (“DNI”) for the year. Under IRC Sections 652 and 662, that income is then included in the recipient’s gross income for the year. Although this basic scheme is subject to some exceptions, in general it serves to allocate taxable income to its actual recipient, and to avoid double taxation of that income.

There is explicit authority, both in case law and in IRS rulings, that the distribution deduction is not limited to distributions made to U.S. citizens or residents. Perhaps surprisingly, this is true even if the distribution renders otherwise taxable income non-taxable for U.S. purposes.

Example. During the taxable year, the trust recognizes interest income, which is included in its DNI for the year and which the trust distributes in that year evenly between A and B. The income is excluded from the statutory definition of FDAP under IRC Section 871(h). The income is deductible from the trust’s taxable income for the year under IRC Section 661. Moreover, although under IRC Section 662 the income is includable in A’s and B’s taxable income for the year, because A and B are NRAs and the income is not U.S.-source income, they are not subject to U.S. income tax on the distributions. Therefore, the income is not subject to U.S. income tax.

For this result to obtain, the income must be excluded from the beneficiaries’ U.S. taxable income either under the Code or under the applicable treaty, if any. Thus, for example, dividend income distributed to A and B would be taxable to them for U.S. purposes (and, subject to treaty provisions, also subject to the 30% withholding requirement previously discussed). Moreover, the timing of the distributions is critical. If the trustee does not distribute the income in the same year in which it is recognized (or within 65 days after the end of that year), it will not be deductible.

Section 678. Under IRC Section 678, it is possible to make all income of a trust taxable to the trust beneficiary or beneficiaries, even if the income is not distributed. The basic rule of Section 678 is that a beneficiary will be considered the owner of any part of the trust with respect to which the beneficiary has the power “exercisable solely by himself” to vest the corpus of the income therefrom in himself or herself. In other words, if a beneficiary may withdraw some part of the trust principal (as with a Crummey power of withdrawal or other inter vivos general power of appointment), he or she will be considered the owner of that part of the trust for income tax purposes, and will be taxable directly on the income attributable to that portion, whether or not the income is distributed.

Achieving this “pseudo”-grantor trust status is not as straightforward as it might seem at first blush. Giving a beneficiary an unlimited

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16 For example, specific gifts of property or money not distributable in more than three installments are not deductible. See IRC Section 661(a). In the current context, a much more important question is whether certain kinds of income—e.g., capital gain—are included in DNI in the first place. See Wares, “Deciphering DNI in a Unitrust World,” 146 Tr. & Est. (Mar. 2007).
17 See Isidro Martin-Montis Trust, 75 TC 381 (1980); see also Rev. Rul. 86-76, supra note 3.
18 See Isidro Martin-Montis Trust, supra note 17.
19 See IRC Section 662(b).
power of withdrawal over the entire trust corpus (or, as in the example, giving each beneficiary such a power over half of the corpus, or over his or her separate share) runs directly counter to one of the nearly universal reasons for establishing a trust in the first place—that is, not giving the beneficiaries direct access to and control over the property. Making the beneficiary the sole trustee over his or her share of the trust (remember, the power must be exercisable “solely” by the beneficiary) may work, provided that the trustee’s discretion is broad enough—and it may have to be so broad as to render the trust meaningless, although Section 678 treatment as to ordinary income may be available if the child/trustee has a mandatory income interest. However, a mandatory income interest would make the trust’s income taxable to the beneficiary in any event, and so applying Section 678 appears to be redundant.

In short, while in theory Section 678 might be a means to make all income of the trust, whether distributed or not, “pass through” to the beneficiaries as a pseudograntor trust, and therefore achieve identity of taxpayers in both jurisdictions, it is likely to be of little practical help, except in fairly unusual circumstances. With regard at least to trust income, a similar result can be achieved by distributing all trust income to the beneficiaries (whether under a mandatory income provision or by the exercise of the trustee’s discretion). This treatment might not be limited to ordinary income; remember that what is deductible by the trust under IRC Section 651 or 661 is DNI, which may under certain circumstances include capital gains.

Planning observations

Perhaps not surprisingly, there is no perfect solution to the tax issues faced by the U.S. grantor who wishes to establish a U.S. trust for his or her foreign beneficiaries. Each of the options so far discussed—grantor trust, nongrantor trust, pseudograntor trust—involve trade-offs that may be unacceptable in any given case, and therefore careful consideration of the individual client’s goals, as well as the applicable laws, is essential. Nevertheless, there are a few general guidelines that can help in structuring these trusts to avoid the worst results.

First, the initial inquiry should be whether it is preferable, or even possible, to structure the trust as a foreign trust for U.S. purposes, or, for an existing trust, to change the trust to a foreign trust. As noted at the beginning of this article, the rules governing foreign trusts are well-defined. Moreover, if the trust has no U.S. beneficiaries, IRC Section 679 does not apply, and the trust may not be subject to U.S. income taxation at all, whether to the grantor or to the beneficiaries.

Certainly, a drafter considering the issues presented here should build in the possibility that the trust may be administered in another country; all other things being equal, a choice of law and situs provision that permits the trustee to change both the governing law and the place of administration, including to another country, should be the preferred approach. In a given situation, establishing the trust offshore from the outset may be the most sensible alternative. At the same time, though, there may be good reason for establishing the trust in the U.S.; for example, the choice of fiduciary and accessibility (and accountability) to U.S. courts may be as important as, or even more important than, the tax consequences. Furthermore, establishing or moving the trust outside the U.S. will not solve the issues presented by the law of the country of the beneficiaries’ domicile, particularly as in the German example) if that country does not recognize the concept of a trust as a separate entity.

Second, structuring the trust as a wholly-owned grantor trust for U.S. income tax purposes would be clearly preferred in one, probably unusual, situation: where the beneficiaries are not subject to income tax in their country of domicile. In that case, the trust income would be taxable to the grantor in the United States, and the grantor could pay the tax liability out of other funds, leaving the trust assets undiminished, without concern that the beneficiaries would be taxed on the same income, possibly without an offsetting credit for the U.S. liability, or a similar credit being available to the grantor for U.S. purposes. Barring that set of facts, and barring also a definitive pronouncement from the country of domicile (e.g., an unambiguous statute or agency regulation, or a ruling from the nation’s highest court), the client and his or her advisors are faced with either applying for a competent authority ruling, or taking a position based on the applicable laws and treaties and hoping for the best result. Many clients may find either course of action unacceptable.

Third, structuring the trust as a nongrantor trust (i.e., a trust that is a separate taxpayer and not a...
grantor trust or pseudo-grantor IRC Section 678 trust) involves many of the same risks. Again, in most circumstances there will be a mismatch between taxpayers in each jurisdiction, at least with regard to undistributed income, and therefore the same risk of double taxation exists. On the other hand, if income that enters into the trust’s DNI for the year and is actually distributed in the year in which it was recognized (or within 65 days thereafter), it will be deductible by the trust and includable in the beneficiaries’ U.S. income. In many (if not most) circumstances, that income will not be taxable to the NRA beneficiaries for U.S. purposes because it is not U.S.-source income, under either the Code or the applicable treaty.

Remember, also, that the country of domicile may take the position that all of the trust’s income, not just the income actually distributed, is taxable to the beneficiaries. The practitioner must take this into account. In this regard, consultation with local counsel in the foreign country is indispensable, in order to determine the likelihood of such a result occurring.

Fourth, if the trust is structured as a pseudo-grantor trust under IRC Section 678, there is complete identity between the taxpayers in each jurisdiction. Assuming that there is an applicable treaty or other authority that provides relief from double taxation, the income of the trust would not be subject to double taxation. However, achieving complete IRC Section 678 treatment for a trust is challenging at best, particularly without vitiating some or all of the purposes of setting up a trust in the first place.

Fifth, achieving the best result requires not only careful planning and drafting, but careful administra-

tration as well. Certainly, taxes, and their impact on financial performance, typically are among the considerations a prudent fiduciary must take into account. This concern is magnified when the trust has foreign beneficiaries. As discussed above, many types of income recognized by a trust will not be taxable in the U.S.—if the income enters into the trust’s DNI and is distributed to the beneficiaries. However, taxes rarely are the only consideration, and in many cases there will be substantial reasons not to distribute income to the beneficiaries. The fiduciary therefore must take into account not only the tax impact of particular investments, but also the intent of the grantor as expressed in the document, the personal circumstances of the beneficiaries, the advisability of making or declining to make distribution (assuming that doing so is within its discretion), the feasibility of allocating some or all capital gain to income, and the impact of all of these considerations—and the fiduciary’s decisions with regard to each of them—on the overall result.

Conclusions
Perhaps the best conclusion one can draw is that in this context, perhaps above all others, flexibility is not only desirable, but necessary. To the extent consistent with the client’s objectives, the drafter is well-advised to consider drafting for maximum ability to adapt to changing circumstances, and to consider including the following:

• Having the ability to toggle in and out of grantor trust status, as circumstances (e.g., the beneficiaries’ tax status) warrant.
• Giving the trustee discretion over distributions of income and principal, perhaps with guidance as to the preferred way to achieve the goal of minimizing the tax impact of the trust’s performance to both the grantor and the beneficiaries, consistent with the grantor’s intent.
• Drafting for flexibility in allocations to income and principal, consistent with both the law of the trust situs and the requirements of the Internal Revenue Code.
• Including an ability in the fiduciary to change situs and applicable law, including to a location outside of the United States, if the objectives of the trust cannot be achieved.

Again, though, there is no substitute for careful consideration of how best to achieve the client’s goals in the circumstances, which almost inevitably will be more complex than a typical domestic situation.