MASECO ASIA

Investment Guidelines for Foreign Trusts

Background

When foreign trusts are considering appointing investment managers, an understanding of the US tax and legal framework is of paramount importance. Choosing an investment manager who does not understand the investment restrictions and corresponding tax implications of investment decisions can lead to additional taxes, penalties or accounting fees, all of which impact the net return to the investor.

Many feel that the US tax system seems generally hostile to foreign trusts if there is a US person involved. The suspicion is understandable. Trusts interfere with the US government's ability to impose or collect tax, and as a result, the rules and reporting requirements can be onerous. Income may be taxed punitively; the right paperwork must be prepared correctly and filed on time, or sizeable penalties can result. As the IRS note themselves on their website[1]:

> "Although there are legitimate reasons why a U.S. person might create a foreign trust, or have transactions with a foreign trust, they can have tax consequences and result in filing responsibilities as well. Regardless of your motivation, failure to meet these reporting and filing requirements can result in very significant penalties.
>
> Citizens and residents of the United States are taxed on their worldwide income. To help prevent the use of foreign trusts and other offshore entities for tax avoidance or deferral, Congress has enacted several specific provisions in the Internal Revenue Code."

[1] https://www.irs.gov/businesses/international-businesses/foreign-trust-reporting-requirements

FATCA

The suspicion amongst many non-US advisers, banks and trustees of US hostility to foreign trusts was dramatically increased when the HIRE Act was passed in March 2010. A portion of the HIRE Act was devoted to the Foreign Account Tax Compliance Act - FATCA - which was explicitly designed to combat offshore tax evasion by US taxpayers and to recoup federal tax revenues. It not only focuses on reporting by US taxpayers about "certain financial accounts and offshore assets" but also by foreign financial institutions about financial accounts held by US taxpayers, or "foreign entities in which US tax payers hold a substantial ownership interest" – such as foreign trusts. Anxiety about the extra burden of enhanced US reporting requirements and compliance has led many foreign financial institutions to close accounts for US connected clients and to exit this client area altogether.

Nevertheless, many trust companies around the world cannot always take this simple option as they have a large number of clients who are not US persons but one or more of their children or heirs are. Whilst this may not have been the situation when the trust was originally set up, the trust is then exposed to US tax reporting obligations even if under local laws the accounting and record keeping required to fulfill these obligations is unnecessary.

US Tax Classification of Trusts

The US has two separate and distinct views as to the structure of foreign trusts. Either they are considered to be a 'grantor trust' or a 'non-grantor trust'. Determining whether the trust qualifies as a grantor trust or as a non-grantor trust for US federal income tax purposes will have an impact on whether and how the income arising within the trust is reported in the beneficiary or grantor's US Federal income tax return. It will also impact the tax treatment and information reporting obligations that will arise if either party received any trust distributions while they are taxpayers in the US.

Foreign Grantor Trust Taxation

A foreign trust would be considered a grantor trust for US taxation purposes if the trust is considered revocable or if the settlor alone has the right to income and gains whilst they are alive. If this is the case, the trust would be considered a foreign grantor trust and, hence, would be 'looked through' for US taxation purposes during the settlor's life. Any income earned by the trust would be attributed to the settlor/ grantor at his/her marginal tax rates.

Judging whether foreign trusts are considered grantor or non-grantor has to be assessed against the facts and circumstances of each individual case. It is imperative that trustees and settlors alike get professional advice with regards to the trust to ensure that the investments held within are correctly structured.

Investment Implications for Foreign Grantor Trusts

As, the foreign grantor trust is treated by the US as a "look-through" structure, the trustees and their appointed investment manager must take care to invest in US compliant and tax-efficient investment vehicles. At its simplest and crudest, this may mean investing in single stocks and bonds - an approach which then comes with its own attendant issues in terms of sub-optimal diversification. It does, however, avoid making costly mistakes with the US Passive Foreign Investment Company (PFIC) rules which are explored in greater depth below.

Passive Foreign Investment Companies (PFICs) and Foreign Grantor Trusts

In a foreign grantor trust with a US owner or beneficiary, the trustees will need to take care when investing the trusts' assets to ensure that they do not fall foul of the IRS's PFIC rules.

Almost all non-US collective investment vehicles are PFICs for US tax purposes. If a foreign trust has a US owner or beneficiary they will be subject to a punitive tax regime if the trust invests in PFICs. Gains or income from PFICs will be taxed at the top marginal rate of income tax and they will be subject to an additional compounding interest charge.

If care is not taken by the trustees and their appointed investment manager, the worst case is that all gains may be subject to taxes and penalties of up to 100% of the growth in the value of the investment.

A More Considered Approach – Specialist Investment Advice?

It may be that to obtain the best portfolio diversification the trustees and their investment manager could consider the use of US collectives such as US mutual funds or ETFs. If this strategic approach is combined with US custody, then foreign bank account reporting (FBAR) obligations can be avoided together with the considerably lower custody and transaction costs in the US when compared, for example, to Hong Kong, Singapore, the Channel Islands or Switzerland. Nevertheless, care should still be taken with regard to the currency denomination of these investments in respect of the base currency requirements of the trust.

We would suggest that the best way to evaluate these considerations is for trustees to obtain specialist investment advice.

Foreign Non-Grantor Trusts

If the trust is a non-grantor for US federal income tax purposes, it will generally be taxed as a separate entity from the grantor. As the trust is non-resident for US tax purposes – as it is a "foreign" non-grantor trust – it will be subject to US federal income tax only to the extent that it receives US-sourced income, such as dividends paid by US companies. US-sourced dividends will be subject to a withholding tax, the rate depending on the jurisdiction of the trust and whether there is a double taxation agreement between the trust's jurisdiction and the US. Generally, gains from the sales of stocks or securities of publicly traded US companies are not subject to US federal income (or withholding) tax.

Non-US sourced income owned by a foreign non-grantor trust is not subject to US income tax where the income is received by the trust and accumulated or when current or accumulated income is distributed to a non-US person. Non-US sourced income would include dividends received from non-US entities and capital gains realized upon the sale of trust assets.

When distributions are made from foreign non-grantor trusts to a US beneficiary, the US beneficiary is taxed at their marginal rate of income tax to the extent that the distribution is attributable to current calendar year ordinary income owned by the trust (e.g., dividends, interest or gains held for less than one year). If the trust distributes long term capital gains realized in that calendar year the beneficiary will be taxed at their capital gains tax rate (15-20%). There will not be any interest or penalties applied to distributions of income made in the current calendar year.

Often, however, foreign non-grantor trusts do not distribute their income in the calendar year in which it is accumulated, and here is where the problems lie. If income is paid to a US beneficiary in a subsequent calendar year, they will be subject to US income tax at their marginal income tax rates – whether or not the income consists of capital gains – plus an interest charge.

It is imperative that trustees and settlors alike get US tax/legal advice regarding the structure of the trust to ensure that the investments held within are correctly structured.

Investment Implications for Foreign Non-Grantor Trusts

As discussed above, in relation to foreign grantor trusts, care must be taken with regards to PFIC investments as unfavourable taxation under the PFIC rules would also likely result for a foreign non-grantor trust, even if the PFIC gains or income are not actually distributed to the US beneficiary. There are specific rules that apportion ownership of PFICs within trusts to their US beneficiaries. The longer foreign non-grantor trusts hold and trade PFICs, the larger the potential tax charge on the beneficiary when distributions are made.

It is worth noting that for trusts in certain jurisdictions, depending on whether the dividend withholding can be offset against the beneficiary's personal taxes, it may make sense for trustees and their investment managers to consider a range of different options which may include PFICs.

Using an offshore custodian would allow the trust to invest in offshore PFICs with Qualified Electing Fund (QEF)[2] status. The trust would need to file the QEF statement on these positions annually so that the transparency of the PFICs is picked up. The trustees would need to be comfortable doing this annual tax compliance. If this was the case, funds could be managed offshore and the 30% withholding tax could be avoided on the non-US dividends. Nevertheless, an offshore custodian and offshore investments are generally more expensive than a US custodian.

There would also be the cost of filing the FBAR and 8938 form coupled with the uncertainty regarding the quality of the 1042 reporting that is produced by the offshore custodian.

A full analysis of the merits of each of the options for trusts in differing jurisdictions is beyond the scope of this paper, and therefore, we would suggest that trustees obtain specialist tax, legal and investment advice.

2. Taxation method that can be used on a Passive Foreign Investment Company. ("PFIC"). The QEF election allows a PFIC to be treated the same as a US based mutual fund for US tax purposes.

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