

LB&I International Practice Service Process Unit – Audit

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Sub-Chapter	12.2.1.2	Foreign Grantor Trust Determinations	–	–

Unit Name	Foreign Grantor Trust Determination – Part II – Sections 671-678
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Process Overview

Foreign Grantor Trust Determination – Part II – Sections 671-678

Process Description

Having determined that a foreign trust exists by using Practice Unit “Defining the Entity – Foreign Trusts” DCN: FEN/9434.02_01(2013), a determination must be made whether the foreign trust will be treated as a “foreign grantor trust” or a “foreign non-grantor trust” for United States (U.S.) tax purposes.

Although the term "grantor" is generally used to refer to anyone who places property in trust, the term "grantor trust" has a specific technical meaning. Internal Revenue Code (IRC) §§ 671-679 are commonly referred to as the “Grantor Trust Rules.” IRC §§ 671-678 apply to both domestic and foreign trusts. IRC § 679 applies only to foreign trusts and takes precedence over the rules found in IRC §§ 673-678 with respect to a foreign trust. Moreover, the term “U.S. beneficiary” for IRC § 679 purposes is very broad and in most cases of a foreign trust with a U.S. grantor, it is likely that IRC § 679 will apply rather than IRC §§ 671-678. For this reason, ***a determination of whether a foreign trust is treated as a “foreign grantor trust” for U.S. tax purposes should always begin with the Practice Unit “Foreign Trust Determination – Part I – Section 679” DCN FEN/9434.02_02(2013). #***

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Process Overview (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Process Description

Even if the foreign trust is not to be treated as a foreign grantor trust for U.S. income tax purposes under IRC § 679, as discussed in Practice Unit “Foreign Grantor Trust Determination – Part I – Section 679” DCN: FEN/9434.02_02(2013), in rare circumstances, the foreign trust may still be treated as a foreign grantor trust under IRC §§ 673-678. Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the trust income and when they are taxed. If a foreign trust is characterized as a grantor trust under IRC §§ 671–679, the grantor or another person is treated as the owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes under the grantor trust rules, then the U.S. person must report its share of trust income, deductions and credits on its income tax return as if those items were directly received by or paid to that U.S. person.

Any foreign trust not determined to be a grantor trust will be treated as a foreign non-grantor trust for U.S. tax purposes. The taxation of foreign non-grantor trusts will be covered in future units.

Process Overview (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Process Description

The Foreign Grantor Trust Determination is divided into two practice units, with the first unit being Practice Unit “Foreign Trust Determination – Part I – Section 679” DCN: FEN/9434.02_02(2013) . This Practice Unit, “Foreign Grantor Trust Determination – Part II – Section 671-678” discusses the specific powers enumerated in IRC §§ 673-678. The retention of certain specific powers by the grantor, or some other person, converts the trust into a “grantor trust” for U.S. tax purposes. The rules in IRC §§ 671-678 apply to all trusts, whether foreign or domestic. Although generally only U.S. persons can be treated as owners of a foreign trust under IRC §§ 671 through 678, this unit also discusses, under the Other Considerations and Impacts to Audit section, the narrow rules of IRC § 672(f), which specify the circumstances where a foreign person may be treated as the owner of a trust.

Example Circumstances Under Which Process Applies

- Grantor, a U.S. person, creates FT, a foreign trust, and transfers property to FT for the benefit of his non-dependent adult children A, B, and C, none of whom is a U.S. person. Grantor does not have the right to uncompensated use of any trust property, and there are no agreements or understandings that would allow a U.S. person to benefit. A, B, and C each have a 1/3 proportionate share in the trust. FT’s trust instrument provides that no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person and if the trust were terminated, no part of the income or corpus could be paid to or for the benefit of a U.S. person. The trust instrument explicitly provides that it cannot be amended to include any other beneficiaries. Grantor has not retained any rights or interests that could benefit herself as the grantor, but she has retained the power, exercisable in her sole discretion, to dispose of trust income or corpus for the benefit of A, B, and/or C, without the distribution being weighed against each beneficiary’s proportionate share. Because no trust property can be distributed or accumulated for the benefit of a U.S. beneficiary, 679 does not apply. However, because Grantor retained the power to control beneficial enjoyment of the trust corpus for the benefit of A, B, and C, in her sole discretion and without limit, Grantor is treated as owner of the trust under IRC § 674.

Determination of Process Applicability

Foreign Grantor Trust Determination – Part II – Sections 671-678

The grantor trust rules under IRC §§ 671-678 generally prevent a taxpayer who retains certain powers in, or control over, property placed in trust from escaping tax on such property's income when the taxpayer effectively remains the owner of the property placed in trust. The policy behind the grantor trust rules under IRC §§ 671-678 is that the grantor (owner) should be taxed on the income of the trust if the grantor has substantial dominion and control over the property of such trust. In general, the grantor trust rules provide that the person treated as the owner is taxed on the income from a trust (or a portion of the trust) over which the owner retains or acquires substantial dominion and control. If a U.S. person that is the grantor retains any of the powers which are described in IRC §§ 673 -677 or any other U.S. person acquires the power described in IRC § 678, then the foreign trust will be treated as a grantor trust. Due to the broad definition of "U.S. beneficiary" under IRC § 679, if a U.S. grantor retains the powers described in IRC §§ 673, 674, 676, and 677, the grantor will likely be treated as the owner of the trust under IRC § 679 to the extent that the grantor transferred property to the trust for the benefit of U.S. persons. Determining whether a foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. In general, any U.S. person treated as the owner of the trust under the grantor trust rules of IRC §§ 673-678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items are treated as if they had been directly received by or paid to the taxpayer.

Criteria	Resources	6103 Protected Resources
<p>If any one of the following factors is present, the grantor may be treated as the owner of the trust:</p> <ol style="list-style-type: none"> 1. The grantor retains a reversionary interest in the trust exceeding 5 percent of the trust's value. Generally, if a U.S. grantor retains a reversionary interest in a foreign trust, IRC § 679 will likely also apply and generally trump IRC § 673. 	<ul style="list-style-type: none"> ▪ IRC 673 	

Determination of Process Applicability (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

The grantor trust rules under IRC §§ 671-678 generally prevent a taxpayer who retains certain powers in, or control over, property placed in trust from escaping tax on such property's income when the taxpayer effectively remains the owner of the property placed in trust. The policy behind the grantor trust rules under IRC §§ 671-678 is that the grantor (owner) should be taxed on the income of the trust if the grantor has substantial dominion and control over the property of such trust. In general, the grantor trust rules provide that the person treated as the owner is taxed on the income from a trust (or a portion of the trust) over which the owner retains or acquires substantial dominion and control. If a U.S. person that is the grantor retains any of the powers which are described in IRC §§ 673 -677 or any other U.S. person acquires the power described in IRC § 678, then the foreign trust will be treated as a grantor trust. Due to the broad definition of "U.S. beneficiary" under IRC § 679, if a U.S. grantor retains the powers described in IRC §§ 673, 674, 676, and 677, the grantor will likely be treated as the owner of the trust under IRC § 679 to the extent that the grantor transferred property to the trust for the benefit of U.S. persons. Determining whether a foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. In general, any U.S. person treated as the owner of the trust under the grantor trust rules of IRC §§ 673-678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items are treated as if they had been directly received by or paid to the taxpayer.

Criteria	Resources	6103 Protected Resources
<p>2. The grantor retains the power to affect beneficial enjoyment of the trust income or corpus without the approval or consent of an adverse party. Generally, IRC § 674 will only apply if all of the foreign trust's beneficiaries are not U.S. persons. Otherwise, IRC § 679 will likely apply if the grantor retains the power to affect beneficial enjoyment of the trust.</p>	<ul style="list-style-type: none"> ▪ IRC 674 	

Determination of Process Applicability (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

The grantor trust rules under IRC §§ 671-678 generally prevent a taxpayer who retains certain powers in, or control over, property placed in trust from escaping tax on such property's income when the taxpayer effectively remains the owner of the property placed in trust. The policy behind the grantor trust rules under IRC §§ 671-678 is that the grantor (owner) should be taxed on the income of the trust if the grantor has substantial dominion and control over the property of such trust. In general, the grantor trust rules provide that the person treated as the owner is taxed on the income from a trust (or a portion of the trust) over which the owner retains or acquires substantial dominion and control. If a U.S. person that is the grantor retains any of the powers which are described in IRC §§ 673 -677 or any other U.S. person acquires the power described in IRC § 678, then the foreign trust will be treated as a grantor trust. Due to the broad definition of "U.S. beneficiary" under IRC § 679, if a U.S. grantor retains the powers described in IRC §§ 673, 674, 676, and 677, the grantor will likely be treated as the owner of the trust under IRC § 679 to the extent that the grantor transferred property to the trust for the benefit of U.S. persons. Determining whether a foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. In general, any U.S. person treated as the owner of the trust under the grantor trust rules of IRC §§ 673-678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items are treated as if they had been directly received by or paid to the taxpayer.

Criteria	Resources	6103 Protected Resources
<p>3. The grantor or a non-adverse party can exercise certain administrative powers for the benefit of the grantor without the approval or consent of an adverse party. Generally IRC § 675 will only apply if all of the foreign trust's beneficiaries are not U.S. persons and the grantor cannot exercise these powers for the grantors own benefit. Otherwise, IRC § 679 will likely apply.</p>	<ul style="list-style-type: none"> ▪ IRC 675 	

Determination of Process Applicability (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

The grantor trust rules under IRC §§ 671-678 generally prevent a taxpayer who retains certain powers in, or control over, property placed in trust from escaping tax on such property's income when the taxpayer effectively remains the owner of the property placed in trust. The policy behind the grantor trust rules under IRC §§ 671-678 is that the grantor (owner) should be taxed on the income of the trust if the grantor has substantial dominion and control over the property of such trust. In general, the grantor trust rules provide that the person treated as the owner is taxed on the income from a trust (or a portion of the trust) over which the owner retains or acquires substantial dominion and control. If a U.S. person that is the grantor retains any of the powers which are described in IRC §§ 673 -677 or any other U.S. person acquires the power described in IRC § 678, then the foreign trust will be treated as a grantor trust. Due to the broad definition of "U.S. beneficiary" under IRC § 679, if a U.S. grantor retains the powers described in IRC §§ 673, 674, 676, and 677, the grantor will likely be treated as the owner of the trust under IRC § 679 to the extent that the grantor transferred property to the trust for the benefit of U.S. persons. Determining whether a foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. In general, any U.S. person treated as the owner of the trust under the grantor trust rules of IRC §§ 673-678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items are treated as if they had been directly received by or paid to the taxpayer.

Criteria	Resources	6103 Protected Resources
4. The grantor or a non-adverse party has the power to revoke the trust and reinvest the assets in the trust to the grantor. Generally, if a U.S. grantor retains this power over a foreign trust, IRC § 679 will likely apply and trump IRC § 676.	<ul style="list-style-type: none"> ▪ IRC 676 	

Determination of Process Applicability (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

The grantor trust rules under IRC §§ 671-678 generally prevent a taxpayer who retains certain powers in, or control over, property placed in trust from escaping tax on such property's income when the taxpayer effectively remains the owner of the property placed in trust. The policy behind the grantor trust rules under IRC §§ 671-678 is that the grantor (owner) should be taxed on the income of the trust if the grantor has substantial dominion and control over the property of such trust. In general, the grantor trust rules provide that the person treated as the owner is taxed on the income from a trust (or a portion of the trust) over which the owner retains or acquires substantial dominion and control. If a U.S. person that is the grantor retains any of the powers which are described in IRC §§ 673 -677 or any other U.S. person acquires the power described in IRC § 678, then the foreign trust will be treated as a grantor trust. Due to the broad definition of "U.S. beneficiary" under IRC § 679, if a U.S. grantor retains the powers described in IRC §§ 673, 674, 676, and 677, the grantor will likely be treated as the owner of the trust under IRC § 679 to the extent that the grantor transferred property to the trust for the benefit of U.S. persons. Determining whether a foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. In general, any U.S. person treated as the owner of the trust under the grantor trust rules of IRC §§ 673-678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items are treated as if they had been directly received by or paid to the taxpayer.

Criteria	Resources	6103 Protected Resources
<p>5. The grantor or a non-adverse party has the power to use income (in various ways) for the benefit of the grantor or grantor's spouse. Generally, if a U.S. grantor retains this power over a foreign trust, IRC § 679 will likely apply and trump IRC § 677.</p>	<ul style="list-style-type: none"> ▪ IRC 677 	

Determination of Process Applicability (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

The grantor trust rules under IRC §§ 671-678 generally prevent a taxpayer who retains certain powers in, or control over, property placed in trust from escaping tax on such property's income when the taxpayer effectively remains the owner of the property placed in trust. The policy behind the grantor trust rules under IRC §§ 671-678 is that the grantor (owner) should be taxed on the income of the trust if the grantor has substantial dominion and control over the property of such trust. In general, the grantor trust rules provide that the person treated as the owner is taxed on the income from a trust (or a portion of the trust) over which the owner retains or acquires substantial dominion and control. If a U.S. person that is the grantor retains any of the powers which are described in IRC §§ 673 -677 or any other U.S. person acquires the power described in IRC § 678, then the foreign trust will be treated as a grantor trust. Due to the broad definition of "U.S. beneficiary" under IRC § 679, if a U.S. grantor retains the powers described in IRC §§ 673, 674, 676, and 677, the grantor will likely be treated as the owner of the trust under IRC § 679 to the extent that the grantor transferred property to the trust for the benefit of U.S. persons. Determining whether a foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. In general, any U.S. person treated as the owner of the trust under the grantor trust rules of IRC §§ 673-678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items are treated as if they had been directly received by or paid to the taxpayer.

Criteria	Resources	6103 Protected Resources
<p>6. Unless the grantor is already treated as the trust's owner, a person other than the trust's grantor will be treated as the trust's owner if such person has the sole power to vest corpus or income in themselves. Generally, if a trust has a U.S. grantor and another U.S. person has this power, the U.S. person will be treated as a U.S. beneficiary and the U.S. grantor will be treated as the owner under IRC § 679. Alternatively, if the trust has a foreign grantor and a U.S. person has this power, the U.S. person will be treated as the owner under IRC § 678.</p>	<ul style="list-style-type: none"> ▪ IRC 678 	

Summary of Process Steps

Foreign Grantor Trust Determination – Part II – Sections 671-678

<u>Step 1</u>	Determine if the U.S. grantor retained specific powers over the trust causing the U.S. grantor to be treated as the owner of the trust.
<u>Step 2</u>	If after completing Step 1, the U.S. grantor is determined not to be treated as the owner of the trust, determine if a U.S. person other than the grantor should be treated as the owner of the trust .
<u>Step 3</u>	If the trust is determined, under either Step 1 or Step 2 above, to be a foreign grantor trust with a U.S. owner you must next determine how the income of the foreign grantor trust gets taxed, and how distributions from the foreign grantor trust get taxed.

Step 1

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Revisionary Interest:</p> <ul style="list-style-type: none"> A grantor is considered to be the owner of any portion of a trust in which he or she has a reversionary interest in either the trust's income or corpus. The value of the reversionary interest must exceed 5 percent of the value of the trust (or portion of the trust) at the time property is transferred to it. 	<ul style="list-style-type: none"> IRC 673(a) 	
<ul style="list-style-type: none"> If the value of the reversionary interest cannot be determined with actuarial certainty (i.e., the interest does not revert to the grantor after a fixed period or upon the death of an individual), a special rule is provided for determining the interest's value. Under this special rule, it is assumed that any discretionary powers are exercised in a manner that would maximize the reversionary interest's value. 	<ul style="list-style-type: none"> IRC 673(c) 	
<ul style="list-style-type: none"> A grantor who has a reversionary interest in a trust's corpus that does not fall within the 5 percent rule may still be treated as the owner of the trust's corpus under IRC § 677(a)(2), because income allocable to the corpus may be accumulated for future distributions to the grantor. This power under IRC § 677, relating to the income of a trust for the benefit of the grantor, will be discussed on subsequent slides. 	<ul style="list-style-type: none"> Treas. Reg. 1.673(a)-1(a). Treas. Reg. 1.671-3(b)(2) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Exception to the Reversionary Interest Power:</p> <ul style="list-style-type: none"> ▪ A grantor will not be treated as the trust's owner if the reversionary interest takes effect only upon the death of a lineal descendant (i.e., child, grandchild, great grandchild) under the age of 21. ▪ The lineal descendant must also be a beneficiary of that portion of the trust. ▪ The beneficiary holds the entire present interest, as defined by IRC § 2503(c), in the trust (or trust portion). 	<ul style="list-style-type: none"> ▪ IRC 673(b) ▪ IRC 673(b)(1) ▪ IRC 673(b)(2) 	
<p>Power to Control Beneficial Enjoyment</p> <ul style="list-style-type: none"> ▪ A grantor will be treated as an owner of any portion of a trust if the grantor or an <u>nonadverse party</u> (or both) holds any power to control the beneficial enjoyment of the corpus or income of the trust, exercisable without an <u>adverse party's</u> consent. <p>Note – An “adverse party” is defined as any person (1) who has a substantial beneficial interest in the trust, and (2) would be adversely affected by the exercise or non-exercise of a power which they possess with respect to the trust.</p> <p>An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.</p>	<ul style="list-style-type: none"> ▪ IRC 674(a) ▪ IRC 672(a) ▪ IRC 672(b) ▪ Treas. Reg. 1.672(a)-1(a) ▪ Treas. Reg. 1.672(a)-1(b) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Power to Control Beneficial Enjoyment (continued) An individual with a substantial beneficial interest in a trust is an adverse party only if the exercise or non-exercise of powers would be adverse to the interest of another person in the trust. A beneficiary is generally an adverse party. Provided that a trust has all foreign beneficiaries, a U.S. grantor will be treated as an owner of any portion of a foreign trust if the grantor or a <u>nonadverse party</u> (or both) holds any power to control the beneficial enjoyment of the corpus or income of the trust, exercisable without an <u>adverse party's</u> consent. If the foreign trust has U.S. beneficiaries, the U.S. grantor will likely be treated as the owner of the trust under IRC § 679.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.672(a)-1(b) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Exceptions to Power to Control Beneficial Enjoyment :</p> <p>The following powers held by any person will not cause a grantor to be treated as a trust's owner:</p> <ul style="list-style-type: none"> ▪ A power to apply income in support of a dependent, as described in IRC § 677(b), to the extent that the grantor would not be subject to tax under that section. ▪ A power whose exercise can affect the beneficial enjoyment of income only after the occurrence of some event, such that the grantor is treated as the owner only after the event occurs, unless the power is relinquished. ▪ A power exercisable only by will, except for a power to appoint by will income of the trust that is accumulated for such disposition by the grantor, or may be so accumulated in the discretion of the grantor or a nonadverse party, without the approval or consent of an adverse party. ▪ Power to allocate among charitable beneficiaries. 	<ul style="list-style-type: none"> ▪ IRC 674(b)(1) ▪ IRC 674(b)(2) ▪ IRC 674(b)(3) ▪ IRC 674(b)(4) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Exceptions to Power to Control Beneficial Enjoyment (continued):</p> <ul style="list-style-type: none"> ▪ A power to distribute trust principal (corpus) either 1) to or for a beneficiary, if the power is limited by a reasonably defined standard contained in the trust instrument, or 2) power to distribute corpus to or for any current income beneficiary, provided the distribution of corpus is chargeable against the proportionate share of corpus held in the trust for payment of income to the beneficiary. This exception will not apply if any person has the power to add to the beneficiary or beneficiaries designated to receive the income or corpus unless the addition is to account for subsequently born or adopted children. ▪ Power to withhold income temporarily from a current income beneficiary, provided that any accumulated income must ultimately be paid to the beneficiary from whom the distribution is withheld or to their estate or their appointees. This exception will not apply if any person has the power to add to the beneficiary or beneficiaries designated to receive the income or corpus unless the addition is to account for subsequently born or adopted children. 	<ul style="list-style-type: none"> ▪ IRC 674(b)(5) ▪ IRC 674(b)(6) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Exceptions to Power to Control Beneficial Enjoyment (continued):</p> <ul style="list-style-type: none"> ▪ Power to withhold income or add the income to corpus during the existence of a legal disability of any current income beneficiary or during the period which any income beneficiary is under the age of 21. This exception will not apply if any person has the power to add to the beneficiary or beneficiaries designated to receive the income or corpus unless the addition is to account for subsequently born or adopted children. ▪ Power to allocate receipts and disbursements between income and corpus. ▪ Power of an independent trustee to distribute, apportion, or accumulate income to or for a beneficiary or to pay out corpus to or for a beneficiary (whether or not income beneficiaries). <p>An independent trustee is a trustee who is not related or subordinate to the grantor or the grantor's spouse. If there is more than one trustee, no more than half of them may be related or subordinate to the grantor or the grantor's spouse for this exception to the powers to apply.</p>	<ul style="list-style-type: none"> ▪ IRC 674(b)(7) ▪ IRC 674(b)(8) ▪ IRC 674(c) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Exceptions to Power to Control Beneficial Enjoyment (continued):</p> <p>In addition, in order for this exception to apply, the independent trustee must be able to exercise the power without the consent of another person.</p> <p>This exception will not apply if any person has the power to add to the beneficiary or beneficiaries designated to receive the income or corpus unless the addition is to account for subsequently born or adopted children.</p>		

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Administrative Powers: A grantor will be treated as an owner of any portion of a trust over which the grantor, a nonadverse party, or both, hold certain administrative powers if the power is exercisable without the consent of an adverse party. <u>Specifically:</u></p> <ol style="list-style-type: none"> 1. The grantor, a nonadverse party, or both can deal with the trust funds for less than adequate and full consideration; 2. The grantor, a nonadverse party, or both can borrow, directly or indirectly, from the trust without adequate interest and security; 3. The grantor actually borrows, directly or indirectly, funds from the trust and has not completely repaid the loan, including any interest, before the beginning of the taxable year; or 4. The grantor or any other person not acting in a fiduciary capacity holds a power to vote, direct the vote of, or control the trust's investments in certain closely held stock, or to acquire trust assets by substituting other property of equivalent value. 	<ul style="list-style-type: none"> ▪ IRC 675 ▪ IRC 675(1) ▪ IRC 675(2) ▪ IRC 675(3) ▪ IRC 675(4) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Power to Revoke:</p> <ul style="list-style-type: none"> ▪ A grantor will be treated as an owner of any portion of a trust if the grantor or a nonadverse party holds a power to revoke and revest the assets of the trust without the consent of an adverse party. ▪ The regulations explain that if the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a nonadverse party, or both, the grantor is treated as the owner of that portion of the trust regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. 	<ul style="list-style-type: none"> ▪ IRC 676 ▪ Treas. Reg. 1.676-(a)(1) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
<p>Income for Benefit of Grantor:</p> <p>A grantor will be treated as an owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both:</p> <ul style="list-style-type: none"> ▪ Is or may be distributed to the grantor, the grantor’s spouse, or both; ▪ Is or may be accumulated for later distribution to the grantor, the grantor’s spouse, or both; ▪ Is or may be applied to pay premiums on policies of insurance on the lives of the grantor, the grantor’s spouse, or both; ▪ Is used to discharge the grantor’s legal obligations. <p>Where the trust accumulates current income for future distributions to the grantor, the grantor’s spouse, or both, the grantor is taxed on the income in the year it is accumulated, even though it is not distributed until a later year and even though neither the grantor or the grantor’s spouse have access to the accumulated income.</p>	<ul style="list-style-type: none"> ▪ IRC 677(a)(1) ▪ IRC 677(a)(2) ▪ IRC 677(a)(3) ▪ Treas. Reg. 1.677(a)-1(d) ▪ Treas. Reg. 1.677(a)-1(f) 	

Step 1 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 1: Did the U.S. grantor retain specific powers causing the U.S. grantor to be treated as the owner of the trust?

The policy behind the grantor trust rules under IRC §§ 673-678 is that a grantor should be taxed on the income of the trust if the grantor has retained substantial dominion and control over it. If a U.S. grantor retains any of the powers which are described in IRC §§ 673 -677, then the foreign trust will be treated as a grantor trust under IRC §§ 673-677. Determining whether the foreign trust is a grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed.

Considerations	Resources	6103 Protected Resources
 <p>Decision Point : If the U.S. grantor was not treated as the owner of a foreign trust because he or she did not retain any of the specified powers described in the previous slides, the agent should proceed to <u>Step # 2</u> of this practice unit to determine if the foreign trust (or a portion of that foreign trust) will be classified as a grantor trust because it is treated as owned by another person, not the grantor.</p> <p>However, if the agent determined that the U.S. grantor should be treated as the owner of the foreign trust (or portion of the foreign trust) because the U.S. grantor retained any one of the specified powers discussed in the previous slides (or the agent determined that IRC § 679 applies), the agent should proceed to <u>Step # 3</u> in this practice unit to determine the tax treatment of the trust's income.</p>		

Step 2

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 2: Determine if a U.S. person other than the grantor should be treated as the owner of the trust.

A person other than the grantor can be treated as the owner of a trust if such person holds power described under IRC § 678. In general, any U.S. person treated as the owner of a foreign trust (or portion of a foreign trust) under IRC § 678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items of income, deduction, and credit are treated as if they had been directly received by or paid to that taxpayer.

Considerations	Resources	6103 Protected Resources
<p>Person other than grantor treated as substantial owner:</p> <ul style="list-style-type: none"> ▪ A person other than a trust's grantor will be treated as the owner of any portion of a trust with respect to which that person has a power, exercisable solely by him- or herself, to vest the corpus or income of the trust in him- or herself. ▪ The person who held such a power described above will also be treated as the owner of the trust even though he or she has partially released or otherwise modified the power so that they no longer can vest the corpus or income in themselves, if they have retained such control over the trust as would have subjected the grantor to be treated as the owner of the trust under IRC §§ 671-677 (described on the previous slides). 	<ul style="list-style-type: none"> ▪ IRC 678(a)(1) ▪ IRC 678(a)(2) 	

Step 2 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 2: Determine if a U.S. person other than the grantor should be treated as the owner of the trust.

A person other than the grantor can be treated as the owner of a trust if such person holds power described under IRC § 678. In general, any U.S. person treated as the owner of a foreign trust (or portion of a foreign trust) under IRC § 678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items of income, deduction, and credit are treated as if they had been directly received by or paid to that taxpayer.

Considerations	Resources	6103 Protected Resources
<p>Exceptions:</p> <ul style="list-style-type: none"> ▪ <i>Grantor treated as Owner.</i> The person other than the grantor will not be treated as the owner of the trust even if such person holds the power described under IRC § 678(a), if the grantor of the trust (or a transferor in the case of IRC § 679) is treated as the owner of the trust under any of the other grantor trust rules, IRC §§ 671-679. ▪ <i>Support Obligation:</i> The person other than the grantor will not be treated as the owner of the trust if they hold the power, <u>in the capacity of trustee or co-trustee</u>, merely to apply the income of the trust for the support or maintenance of a person whom the holder of that power is obligated to support. This exception does not apply to the extent that trust income is actually used to discharge such support obligations. Further, if such support obligations are satisfied from corpus or accumulated income (i.e., other than current income), such amounts are considered to paid or credited under IRC § 661(a) and taxed under IRC § 662. ▪ <i>Renunciation or Disclaimer.</i> If the powers described in IRC § 678(a) are renounced or disclaimed within a reasonable time after the holder of the power first becomes aware of its existence, the holder will not be deemed to be the owner of the trust. 	<ul style="list-style-type: none"> ▪ IRC 678(b) ▪ IRC 678(c) ▪ Treas. Reg. 1.678(c)-1(a) ▪ Treas. Reg. 1.678(c)-1(b) ▪ 678(d) 	

Step 2 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 2: Determine if a U.S. person other than the grantor should be treated as the owner of the trust.

A person other than the grantor can be treated as the owner of a trust if such person holds power described under IRC § 678. In general, any U.S. person treated as the owner of a foreign trust (or portion of a foreign trust) under IRC § 678 will compute his or her taxable income using all of the trust's income, deductions, and credits that are attributable to the trust or a portion of the trust of which that U.S. person is treated as the owner. These items of income, deduction, and credit are treated as if they had been directly received by or paid to that taxpayer.

Considerations	Resources	6103 Protected Resources
 <p>Decision Point : If you determine that a U.S. person, other than the grantor, held the power exercisable solely by him- or herself, to vest the corpus or income of the trust in him- or herself and is therefore treated as the owner of the foreign trust (or portion of the foreign trust) then the agent should proceed to Step #3, in this unit to determine the tax treatment of the trust's income.</p>		

Step 3

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 3: How the income of the foreign grantor trust gets taxed, and how distributions from the foreign grantor trust get taxed?

Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. If a foreign trust is characterized as a grantor trust under the grantor trust rules of IRC §§ 673–678 or IRC § 679, the grantor (or another person in the case of IRC § 678) is treated as owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes, then that person is required to report that person’s share of trust income, deductions and credits as if those items were received by or paid directly to that U.S. person.

Generally, items of income, deduction or credit that are treated as belonging to the owner of the trust are not reported by the trust on a tax return. Instead, those items are reflected on the income tax return of the owner who is taxed on the trust income. However, especially in the case of a trust that is not a wholly-owned grantor trust, information regarding the portion of the trust treated as owned by the U.S. person should be provided in a separate statement attached to the return filed for the trust.

Considerations	Resources	6103 Protected Resources
<p>Trust Income, Deduction and Credits Attributable to Person Treated as Owner of Trust:</p> <p>In short, though the foreign grantor trust may be a separate legal entity for state law or foreign law purposes, it is ignored for U.S. federal income tax purposes. The grantor or another person treated as the owner of any portion of the trust assets must include on the owner’s own income tax return, the items of income, deductions, and credits relating to those assets.</p> <p>Any portion of the trust not treated as a grantor trust is subject to the non-grantor trust rules. Certain U.S. source items of income, deductions, and credits relating to that portion of the foreign trust treated as a non-grantor trust must be reported on the trust’s U.S. federal income tax return (Form 1040NR).</p>	<ul style="list-style-type: none"> ▪ IRC 671 ▪ Treas. Reg. 1.671-3(a) 	

Step 3 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 3: How the income of the foreign grantor trust gets taxed, and how distributions from the foreign grantor trust get taxed?

Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. If a foreign trust is characterized as a grantor trust under the grantor trust rules of IRC §§ 673–678 or IRC § 679, the grantor (or another person in the case of IRC § 678) is treated as owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes, then that person is required to report that person's share of trust income, deductions and credits as if those items were received by or paid directly to that U.S. person.

Generally, items of income, deduction or credit that are treated as belonging to the owner of the trust are not reported by the trust on a tax return. Instead, those items are reflected on the income tax return of the owner who is taxed on the trust income. However, especially in the case of a trust that is not a wholly-owned grantor trust, information regarding the portion of the trust treated as owned by the U.S. person should be provided in a separate statement attached to the return filed for the trust.

Considerations	Resources	6103 Protected Resources
<p>Trust Income, Deduction and Credits Attributable to Person Treated as Owner of Trust (continued):</p> <p>Capital Gains:</p> <ul style="list-style-type: none"> ▪ Under U.S. tax law, domestic non-grantor trusts that receive capital gains generally treat such capital gains as additions to the corpus of the trust (unless the trust instrument indicates otherwise). In the case of foreign non-grantor trusts, capital gains are treated as the income of the trust and not as part of the corpus. Nevertheless, in the case of a foreign or domestic grantor trust with a U.S. owner, capital gains are treated as if they had been realized directly by the U.S. person treated as the owner of the trust and must be included as such on the U.S. owner's income tax return. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.671-3(a)(1) 	

Step 3 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 3: How the income of the foreign grantor trust gets taxed, and how distributions from the foreign grantor trust get taxed?

Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. If a foreign trust is characterized as a grantor trust under the grantor trust rules of IRC §§ 673–678 or IRC § 679, the grantor (or another person in the case of IRC § 678) is treated as owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes, then that person is required to report that person's share of trust income, deductions and credits as if those items were received by or paid directly to that U.S. person.

Generally, items of income, deduction or credit that are treated as belonging to the owner of the trust are not reported by the trust on a tax return. Instead, those items are reflected on the income tax return of the owner who is taxed on the trust income. However, especially in the case of a trust that is not a wholly-owned grantor trust, information regarding the portion of the trust treated as owned by the U.S. person should be provided in a separate statement attached to the return filed for the trust.

Considerations	Resources	6103 Protected Resources
<p>Tax Treatment of Distributions from a foreign grantor trust:</p> <p>When any portion of a trust is treated as a grantor trust, the income related to that portion is taxed to the person(s) treated as the owner(s) as if the owner had earned the income directly. If a trust is treated as a wholly-owned grantor trust, then the owner is deemed to own all the assets of the trust and must take into account all items of trust income, deductions and credits. To the extent that a person is treated as the owner of the trust or a portion of a trust, he is treated as the owner of the trust assets (or portion thereof). Distributions of trust assets from the trust (or portion of the trust) treated as owned by a U.S. person or any transactions between the trust and the owner are not taxable for U.S. federal income tax purposes.</p>	<ul style="list-style-type: none"> ▪ Rev. Rul. 85-13, 1985-1 C.B. 184 	

Step 3 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 3: How the income of the foreign grantor trust gets taxed, and how distributions from the foreign grantor trust get taxed?

Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. If a foreign trust is characterized as a grantor trust under the grantor trust rules of IRC §§ 673–678 or IRC § 679, the grantor (or another person in the case of IRC § 678) is treated as owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes, then that person is required to report that person's share of trust income, deductions and credits as if those items were received by or paid directly to that U.S. person.

Generally, items of income, deduction or credit that are treated as belonging to the owner of the trust are not reported by the trust on a tax return. Instead, those items are reflected on the income tax return of the owner who is taxed on the trust income. However, especially in the case of a trust that is not a wholly-owned grantor trust, information regarding the portion of the trust treated as owned by the U.S. person should be provided in a separate statement attached to the return filed for the trust.

Considerations	Resources	6103 Protected Resources
<p>Tax Treatment of Distributions from a foreign grantor trust: (continued)</p> <p>Note that the income distribution deduction provided in IRC §§ 651 (simple trusts) and 661 (complex trusts) applies only to non-grantor trusts. Distributions from the portions of a foreign trust considered owned by a U.S. person (or a foreign person in the case where IRC § 672(f) does not prevent IRC §§ 673-677 from applying) are treated as made by the owner and are not deductible by the trust under IRC §§ 651 or 661.</p>	<ul style="list-style-type: none"> ▪ IRC 643 ▪ IRC 671 	

Step 3 (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Step 3: How the income of the foreign grantor trust gets taxed, and how distributions from the foreign grantor trust get taxed?

Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the income of the trust and when they are taxed. If a foreign trust is characterized as a grantor trust under the grantor trust rules of IRC §§ 673–678 or IRC § 679, the grantor (or another person in the case of IRC § 678) is treated as owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes, then that person is required to report that person's share of trust income, deductions and credits as if those items were received by or paid directly to that U.S. person.

Generally, items of income, deduction or credit that are treated as belonging to the owner of the trust are not reported by the trust on a tax return. Instead, those items are reflected on the income tax return of the owner who is taxed on the trust income. However, especially in the case of a trust that is not a wholly-owned grantor trust, information regarding the portion of the trust treated as owned by the U.S. person should be provided in a separate statement attached to the return filed for the trust.

Considerations	Resources	6103 Protected Resources
<p>Distributions from a grantor trust to someone other than the owner:</p> <p>Distributions to a beneficiary from the portions of a foreign trust considered owned by a U.S. person are not includible in the income of the beneficiary under IRC §§ 652 or 662.</p> <p>However, a distribution from a grantor trust to a beneficiary may give rise to gift tax liability to the grantor/owner of the trust depending on the powers retained by the grantor and whether the distribution resulted in a completed gift.</p> <p> CONSULTATION: Consult with your local counsel for Estate and Gift Tax.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.671-2(b) ▪ IRC 2511 ▪ Treas. Reg. 25.2511-2(b) 	

Other Considerations / Impact to Audit

Foreign Grantor Trust Determination – Part II – Sections 671-678	
Considerations	Resources
<p>Generally, No Foreign Person Treated as Owner of Foreign Trust</p> <p>The grantor trust rules under IRC §§ 671-678 do not generally apply to treat a foreign person as the owner of a foreign (or domestic) trust.</p> <p>Under IRC § 672(f) the grantor trust rules generally apply only to the extent their effect is to cause items to be included in the income of a U.S. citizen or resident or a domestic corporation. Therefore, a nonresident alien grantor or a foreign corporation is generally not treated as owner of the trust, regardless of the interests and rights retained by the foreign grantor.</p> <p>A trust with a foreign settlor will generally be considered a non-grantor trust.</p>	<ul style="list-style-type: none"> ▪ IRC 672(f)(1) ▪ Treas. Reg. 1.672(f)-1(a)
<p>Exceptions where a foreign owner will be recognized:</p> <p>There are however limited circumstances under which a foreign person will be treated as the owner of a trust under the grantor trust rules. The broad rule of IRC § 672(f) is modified by four exceptions that sometimes treat a foreign grantor as owner of all or a portion of a trust. A foreign grantor will be recognized as the owner of certain revocable and irrevocable trusts (or portion of the trusts) where any one of the following applies:</p> <p>1) <i>Absolute power to revest.</i> The foreign grantor has the power of revocation (a power to “revest” title “absolutely” in the grantor) that is exercisable by the grantor alone, without the approval or consent of any other person, or is exercisable by the grantor with the consent of a related or subordinate party who is subservient to the grantor.</p>	<ul style="list-style-type: none"> ▪ IRC 672(f)(2)(A)(1)(i) ▪ Treas. Reg. 1.672(f)-3(a)

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Considerations	Resources
<p>Exceptions where a foreign owner will be recognized (continued):</p> <p>2) <i>Grantor and spouse are only permitted distributees.</i> During the foreign grantor's lifetime, distributions of corpus or income may be made only to the grantor or the grantor's spouse.</p> <p>3) <i>Compensatory trusts.</i> If distributions from a trust or a portion of a trust are taxable as compensation for services rendered.</p> <p>Special Rule for CFCs and PFICs <i>Trusts owned by Controlled Foreign Corporations (CFCs) and Passive Foreign Investment Companies (PFICs).</i> If the owner of any portion of a trust is a CFC or PFIC, then the CFC or PFIC will be treated as a domestic corporation for purposes of the grantor trust rules.</p>	<ul style="list-style-type: none"> ▪ IRC 672(f)(2)(A)(1)(ii) ▪ Treas. Reg. 1.672(f)-3(b) ▪ IRC 672(f)(2)(B) ▪ Treas. Reg. 1.672(f)-3(c) ▪ IRC 672(f)(3) ▪ Treas. Reg. 1.672(f)-2(a)
<p> DECISION POINT: Determine if the trust meets one of the exceptions under the Code to be considered a grantor trust with a foreign grantor (or if owned by a CFC or PFIC it will be treated as having a U.S. grantor). If you do have a foreign person treated as the owner of the trust, the foreign owner is taxed as any non-resident for U.S. tax purposes. If you have a CFC or a PFIC treated as the grantor then the income will be taken into account directly or through the CFC or PFIC. Although, a U.S. beneficiary of the foreign grantor trust would not be taxed on any distributions from the trust, the U.S. beneficiary would nevertheless be required to file information returns (i.e., Form 3520) with respect to any distributions from the foreign trust (or the uncompensated use of foreign trust property) – see the Practice Unit “Failure to File the Form 3520-3520-A Penalties” DCN: FEN/9434.02_05(2013) .</p>	<ul style="list-style-type: none"> ▪ IRC 6048 ▪ Practice Unit “Failure to File the Form 3520-3520-A Penalties” DCN FEN/9434.02_05(2013).

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678	
Considerations	Resources
<p>U.S. Beneficiary May be Treated as Owner of the Foreign Trust under the Grantor Trust Rules:</p> <p>If a foreign person would be treated as owner of any portion of a trust (if IRC § 672(f) did not exist) and such trust has a U.S. beneficiary, the U.S. beneficiary is treated as the owner of such trust to the extent that U.S. beneficiary directly or indirectly transferred property (for less than full and adequate consideration) to the foreign grantor. If the beneficiary establishes to the IRS's satisfaction that the transfer to the foreign grantor was "wholly unrelated to any transactions involving the trust," then the U.S. beneficiary will not be treated as the owner of the foreign trust.</p> <p>This rule only applies if the transfer of property from the U.S. beneficiary to the foreign grantor was gratuitous (a transfer for an amount less than fair market value). In addition, this rule will not apply to the extent the transfer was excluded from taxable gifts by IRC § 2503(b), the annual gift tax exclusion.</p>	<ul style="list-style-type: none"> ▪ IRC 672(f)(5) ▪ Treas. Reg. 1.672(f)-5(a)(1) ▪ Treas. Reg. 1.671-2(e)(2)
<p> DECISION POINT: If you determine that no U.S. person is considered the grantor of a foreign trust after referring to Practice Unit "Foreign Trust Determination – Part I – Section 679" DCN: FEN/9434.02_02(2013) and this practice unit then the trust will be considered either a foreign non-grantor trust or as a foreign grantor trust with a foreign grantor.</p>	<ul style="list-style-type: none"> ▪ Practice Unit "Taxation of Beneficiary of a Foreign Non-Grantor Trust" In process as of 04/15

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Considerations	Resources
<p>Other Tax Issues of foreign grantor trusts:</p> <p>Transactions between Trust and Owner:</p> <p>The assets and income of a foreign grantor trust are treated as owned by the person treated as the owner under the grantor trust rules rather than the trust itself. As the owner of a wholly-owned trust is treated as the owner of all trust income, deductions and credits, the owner is also treated as the owner of all the assets of the trust. As a result, transactions directly between the grantor and the trust are disregarded for U.S. federal income tax purposes. Thus, self-dealing transactions cannot create either income or deductions for the grantor or the trust.</p> <p>Transactions between Trust and Related Party to Owner:</p> <p>Transactions between the trust and parties related to the grantor are treated as if they were directly between the grantor and the related party. In such situations, reallocations under IRC § 482 may be necessary in certain circumstances.</p> <p>Attribution Rule Considerations:</p> <p>The Internal Revenue Code provides that stock owned directly or indirectly by a grantor trust is constructively owned by any person treated as an owner of the trust.</p>	<ul style="list-style-type: none">▪ Rev. Rul. 85-13, 1985-1 C.B. 184 ▪ IRC 318(a)(2)(B)(ii)

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678	
Considerations	Resources
<p>Other Tax Issues of foreign grantor trusts (continued):</p> <p>Foreign Trust Attribution Rules for Determination of CFC Status</p> <p>Under IRC § 958(a)(2) and Treas. Reg. 1.958-1(b), persons treated as owners of a foreign grantor trust that owns CFC stock are considered to own a proportionate amount of the stock owned by the trust for purposes of subpart F. As a result, a U.S. person treated as the owner of CFC stock under this attribution rule may have an IRC § 951 inclusion with respect to the CFC owned by the trust.</p> <p>Disposition of CFC Stock Owned by Foreign Trust:</p> <p>In general, in the case of a U.S. person that is treated as owning at least 10 percent of the stock of a CFC owned by a foreign grantor trust, gain recognized on the sale or exchange of CFC stock by the trust would be included in the gross income of the U.S. person as a dividend to the extent of earnings and profits attributable to the stock that have not previously been included in gross income under IRC § 951.</p> <p>Miscellaneous Schedule A Expenses – Trust Administration Expenses</p> <p>When a trust is treated as a grantor trust, expenses of administering the trust become a miscellaneous deduction to the grantor, subject to the 2-percent floor imposed by IRC § 67(a).</p>	<ul style="list-style-type: none"> ▪ IRC 958(a)(2) ▪ IRC 1248 ▪ Susan L. Bay v. Commissioner, TCM 1998-411; 76 TCM 866

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Considerations	Resources
<p>Other Tax Issues of foreign grantor trusts (continued):</p> <p>Foreign Tax Credit: Issues can arise in the context of a foreign grantor trust where the foreign trust receives foreign income, and the foreign country taxes such foreign income in the hands of the trust itself. Under U.S. federal income tax rules, the foreign trust is treated as a foreign grantor trust and all of the income is taxable in the hands of the U.S. owner. In addition, the foreign taxes paid to the foreign country(ies) will be attributed to the U.S. grantor owner. IRC § 671. The U.S. grantor owner may elect either to deduct or to claim a foreign tax credit for the foreign taxes paid or accrued. IRC § 901(a) and (b)(5). Keep in mind that when a foreign tax credit is involved, the source of each item of income must be determined for purposes of computing the foreign tax credit limitation of IRC § 904. IRC §§ 861-865.</p>	<ul style="list-style-type: none">▪ IRC 671▪ Treas. Reg. 1.671-4▪ IRC 901▪ IRC 904▪ Treas. Reg. 1.901-2(f)(2)(i)

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678	
Considerations	Resources
Other Tax Issues of foreign grantor trusts (continued):	
<p>Foreign Tax Credit – Treaty Issues:</p> <p> TREATY IMPLICATIONS: In addition, any relevant Income Tax Treaties should be consulted to determine the proper tax treatment when the trust is a taxable entity in the foreign country and a grantor trust for U.S. tax purposes. Issues may arise regarding determining the person who is deriving the income, the person who is the beneficial owner, as well as the source, timing and character of income.</p>	<ul style="list-style-type: none"> ▪ Article 1(6) of the U.S. Model Treaty (2006)
<p> CONSULTATION: Consult the Treaties IPN on these issues.</p>	

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Considerations	Resources
<p>Other Tax Issues of foreign grantor trusts (continued):</p> <p>Foreign grantor trust ceases to be a foreign grantor trust:</p> <p>A person treated as the owner of a foreign trust (or a portion of a foreign trust) may cease to be considered the owner because of the loss or renunciation of the power(s) that caused such person to be treated as an owner. If a person treated as an owner of a foreign trust ceases to be treated as the owner of such trust, that person is deemed to have disposed of his or her share of trust property. The gain recognition provisions of IRC § 684 apply as if the person treated as the owner had transferred all the trust's property of which he or she was treated as the owner to a foreign non-grantor trust.</p> <p>If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the owner of that portion of the grantor trust to the foreign trust. The transfer would subject the owner/transferor to tax on the appreciation in the property transferred as long as the U.S. person is not treated as the owner of the second transferee trust under any of the grantor trust rules of IRC §§ 671-679.</p> <p>Gain recognition on the transfer of property by a U.S. person to a foreign trust does not apply to the extent that any person is treated as the owner of such trust under the grantor trust rules.</p>	<ul style="list-style-type: none"> ▪ IRC 684 ▪ Treas. Reg. 1.684-2(e) ▪ Treas. Reg. 1.684-2(d) ▪ IRC 684(b)

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678

Considerations	Resources
<p>Other Tax Issues of foreign grantor trusts (continued):</p> <p>Request Books and Records of Foreign Trust (continued):</p> <p>A foreign trust owned by a U.S. person must generally designate a U.S. person as its “limited agent solely for purposes of” (1) responding to IRS requests to examine records or produce testimony “related to the proper treatment of amounts required to be taken into account under” the grantor trust rules and (2) receiving an IRS summons for such records and testimony.</p> <p>If such a grantor trust fails to make a valid designation of a U.S. agent, the IRS may determine the amounts to be included in the owner’s income under the grantor trust rules.</p>	<ul style="list-style-type: none">▪ IRC 6048(b)(2) ▪ Practice Unit “Failure to File the Form 3520 and 3520-A Penalties” DCN: FEN/9434.02_05(2013) ▪ IRC 6048(b)(2)(A)

Other Considerations / Impact to Audit (cont'd)

Foreign Grantor Trust Determination – Part II – Sections 671-678	
Considerations	Resources
<p>Multiple Owners: When a foreign grantor trust has multiple owners, each owner must include in computing his tax liability those items of income, deduction and credits attributable to or included in the portion of the trust such owner is treated as owning.</p>	<ul style="list-style-type: none">▪ IRC 671▪ Treas. Reg. 1.671-3(a)(2)▪ Treas. Reg. 1.671-4
<p> CONSULTATION: Consult with your local counsel on the proper allocation of income if you have a situation where you believe you have multiple owners of the same foreign trust.</p>	

Training and Additional Resources

Chapter 12.2.1 Taxability of Income from Grantor Trust		
Type of Resource	Description(s) and/or Instructions for Accessing	References
Podcasts / Videos	CPE 2011 – Day 1 – Foreign Corporations and Pass-Through	
Other Training Materials	Revenue Agent Foreign Trust and Other Offshore Entity Training (Catalog Number 20347E) – <i>WARNING this text was last updated in April 2009 so some information may be outdated</i>	

Glossary of Terms and Acronyms

Acronym	Definition
FE	Foreign Entities
IRC	Internal Revenue Code
IPS	International Practice Service
Treas. Reg.	Treasury Regulations
U.S.	United States

Index of Related Issues

Issue	Associated UIL(s)	References
Defining the Entity – Foreign Trust	FEN/9434.02_01(2013)	
Foreign Grantor Trust Determination – Part I – Sections 679	FEN/9434.02_02(2013)	
Failure to File Form 3520/3520-A – Penalties	FEN/9434.02_05(2013)	
Taxation of Foreign Non-Grantor Trusts	To be developed	
Taxation of Beneficiary of a Foreign Non-Grantor Trust	In process as of 04/15	
Check-The-Box Rules for Foreign Entities	To be developed	