

The Foreign Trusts Series (2024-2025)

Episode 2 of 4

Foreign Grantor Trusts

Philip D. W. Hodgen
HodgenLaw PC | Pasadena, California
hodgen.com | internationaltaxlaw.com

International Tax Lunch
January 31, 2025

The Foreign Trust Series (2024-2025)

Date	Episode	Title
November 22, 2024	1	What Kind of Trust is This? Foreign/Domestic, Grantor/Nongrantor, Simple/Complex
January 31, 2025	2	Foreign Grantor Trusts: Taxation, Tax Compliance, and Use Cases
February 28, 2025	3	Foreign Nongrantor Trusts: Taxation, Tax Compliance, and Use Cases
March 28, 2025	4	Foreign Nongrantor Trust Distributions to U.S. Beneficiaries

Table of Contents

1.	Introduction	4
2.	How Do You Know This is a Grantor Trust?	6
3.	When is a Foreign Grantor Trust Useful? An Example.	20
4.	Tax Reporting: U.S. Trust Income Tax Return	28
5.	Tax Reporting (Beneficiary and/or Owner): Form 3520	39
6.	Tax Reporting (Trust or U.S. Owner): Form 3520-A	43
7.	Foreign Retirement Plans as Foreign Grantor Trusts	48
8.	Conclusion	52

1. Introduction

In this episode

- “Grantor” vs. “owner” (hint: “owner” is what matters).
- When is a foreign trust “owned” by a person (and thus a “grantor trust”)?
- When is a foreign grantor trust useful? An example.
- Selected tax reporting requirements for foreign grantor trusts.

2. How Do You Know This is a Grantor Trust?

What we mean when we call a trust a foreign grantor trust

- A “grantor trust” (foreign or domestic) is a trust.
- The trust is “owned” by a grantor.
- Ownership is determined by the rules found in IRC §§671-679.

“Grantor” vs. “owner”

- **Grantor:** A person who creates a trust or makes a gratuitous transfer of property to it. *Reg. §1.671-2(e)(1)*.
- **Owner:** A grantor who made a gratuitous transfer to the trust and also retains certain powers, interests, or meets foreign trust criteria (IRC §§673–677, 679). (IRC §678 also makes a holder of a general power of appointment an “owner”).
- **Key point:** It is status as an “owner” that causes the individual to be taxable on the trust’s income. That’s the word you will see in IRC §671 and in IRC §§673-679, which makes the grantor “own” the trust and therefore “own” the income of the trust.

When is someone a grantor?

- **Creates a trust:** This makes you a grantor. *Reg. §1.671-2(e)(1).*
- **Gratuitous transfers:** Any direct or indirect contribution to a trust without full consideration. *Reg. §1.671-2(e)(1).*
- **Successive transfers:** If a trust transfers assets to another trust gratuitously, the grantor of the first is also grantor of the second. *Reg. §1.671-2(e)(1).*
- **Funding on behalf of another:** Both the person who funds and the intended grantor are treated as grantors. *Reg. §1.671-2(e)(1).*

Grantor but not an owner

- **No gratuitous transfer:** The trust is created but not funded by the grantor. *Reg. §1.671-2(e)(1).*
- **Fully reimbursed contributions:** If you are reimbursed for a gratuitous transfer, you are still a grantor (but will never be an owner). *Reg. §1.671-2(e)(1).*
- **No powers/rights retained:** U.S. grantor does not have powers/rights under IRC §§673-677; did not make a transfer to a foreign trust with U.S. beneficiaries (IRC §679). Foreign grantor does not have powers/rights under IRC §672(f)(2)(A).

U.S. grantor as “owner” of a trust

When is a U.S. grantor also an owner?

- Retained powers or interests
 - Power to control beneficial enjoyment. IRC §674.
 - Certain administrative powers. IRC §675.
 - Power to revoke. IRC §676.
 - Income for benefit of grantor. IRC §677.
- Foreign trust with U.S. beneficiaries
 - IRC §679 deems the U.S. grantor an owner if the trust can have a U.S. beneficiary.

Foreign grantor as owner of a trust

Three situations when a foreign grantor is be an owner of a trust

- A trust will only be a grantor trust if it results in trust income belonging to a U.S. citizen or resident, or to a domestic corporation. *IRC §672(f)(1)*.
- Three exceptions exist to allow foreign persons to be owners of trusts:
 - **Revocable trusts:** the foreign grantor can “revest” trust assets in himself/herself unilaterally (or with a related/subordinate’s consent). *IRC §672(f)(2)(A)(i)*.
 - **Irrevocable trusts:** The foreign grantor (optionally plus the grantor’s spouse) are the sole beneficiaries during the grantor’s lifetime. *IRC §672(f)(2)(A)(ii)*.
 - **Compensatory trusts** (for services rendered). *IRC §672(f)(2)(A)(iii)*. Ignore.

How to figure out the “power to revest” exists (IRC §672(f)(2)(A)(i))?

- Find a clause that gives the Settlor the power to instruct the Trustee to distribute trust assets (income or principal) to the Settlor or anyone. If that clause exists (*whether or not the trust is revocable*) you have “power to revest.”
- Indirect power to cause the trust to return assets to the settlor (e.g., broad power to remove/replace the trustee).
- The Settlor has a power to amend the trust document or revoke the trust.
- Make sure the Settlor can act unilaterally or together with the consent of a related or subordinate party. (“Related or subordinate” is defined at IRC §672(c)).

How do you figure out if the trust deed satisfies IRC §672(f)(2)(A)(ii)?

- Look at the trustee's power to distribute income and capital to beneficiaries. It probably gives the trustee total discretion to distribute anything to any beneficiary. (This is normal).
- The trust must contain a clause that limits distributions during the settlor's lifetime to the settlor (and optionally the settlor's spouse).
- If any other person (including by amendment of the trust or exercise of a power to add or remove beneficiaries) can receive distributions during the settlor's lifetime, the trust does not satisfy IRC §672(f)(2)(A)(ii).

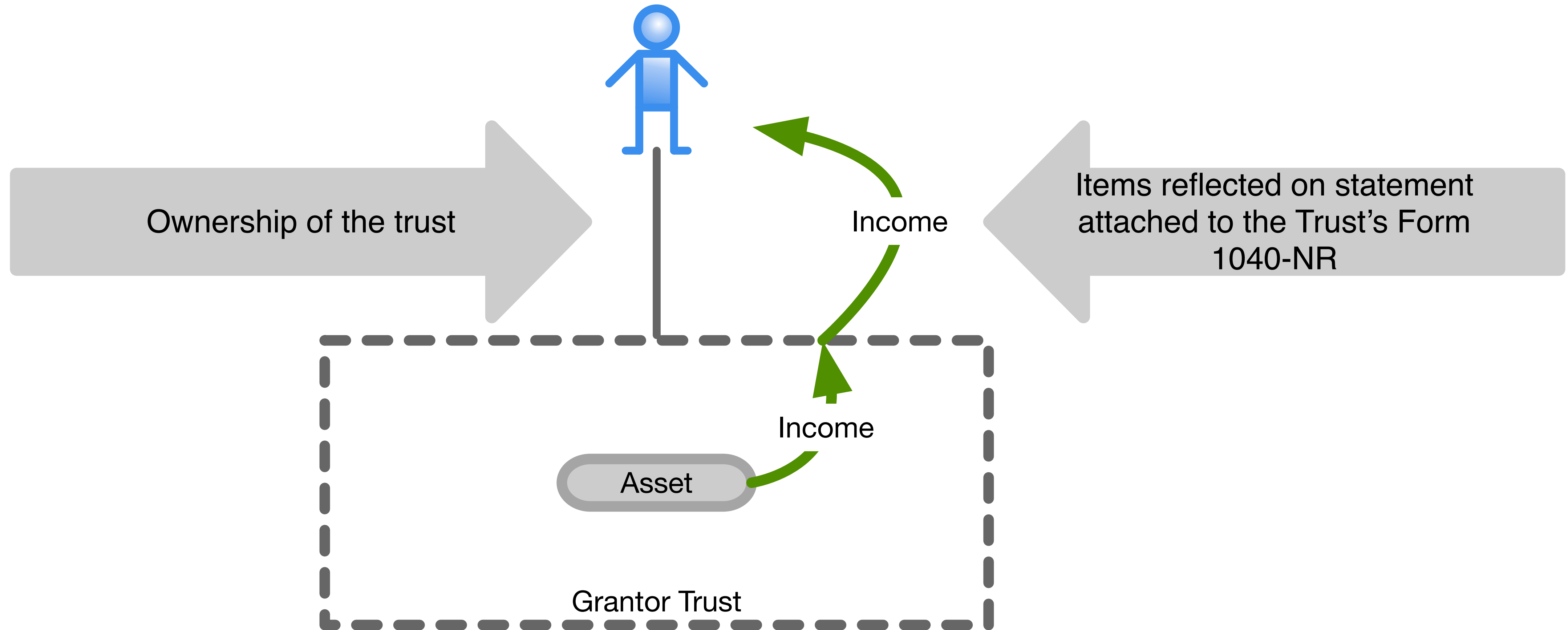
“Owner” of a trust—what does that mean?

- “When a grantor or another person is treated under Subpart E (section 671 and following) as the **owner of any portion of a trust**, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. * * * *”
- *Reg. §1.671-3(a). Emphasis added.*

The grantor is an owner of a portion of the entity, not the assets

- The grantor is the “owner of a portion of the trust” means that the grantor owns the entity, not the assets of the trust directly.
- You will see many places (including IRS publications, court cases, etc.) that say a grantor is owner of the assets of the trust. This is not consistent with the language of the Code and Regulations, even though it will frequently lead you to the correct conclusion.
- Keep this model of “the grantor is the owner of the box” and “the owner of the box gets all of the taxable income goodies from the contents of the box” in mind.

“Owner of a portion of the trust” does not mean ownership of the assets

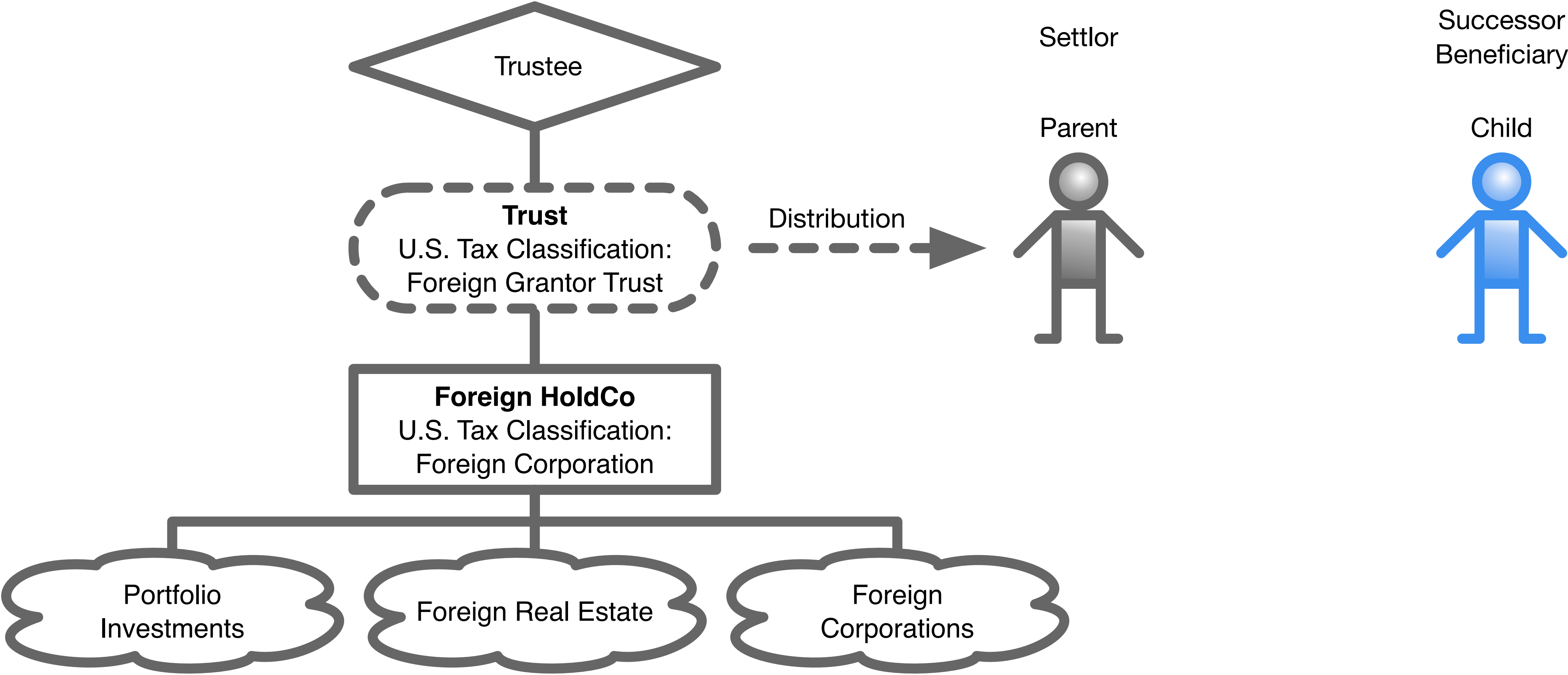


3. When is a Foreign Grantor Trust Useful? An Example.

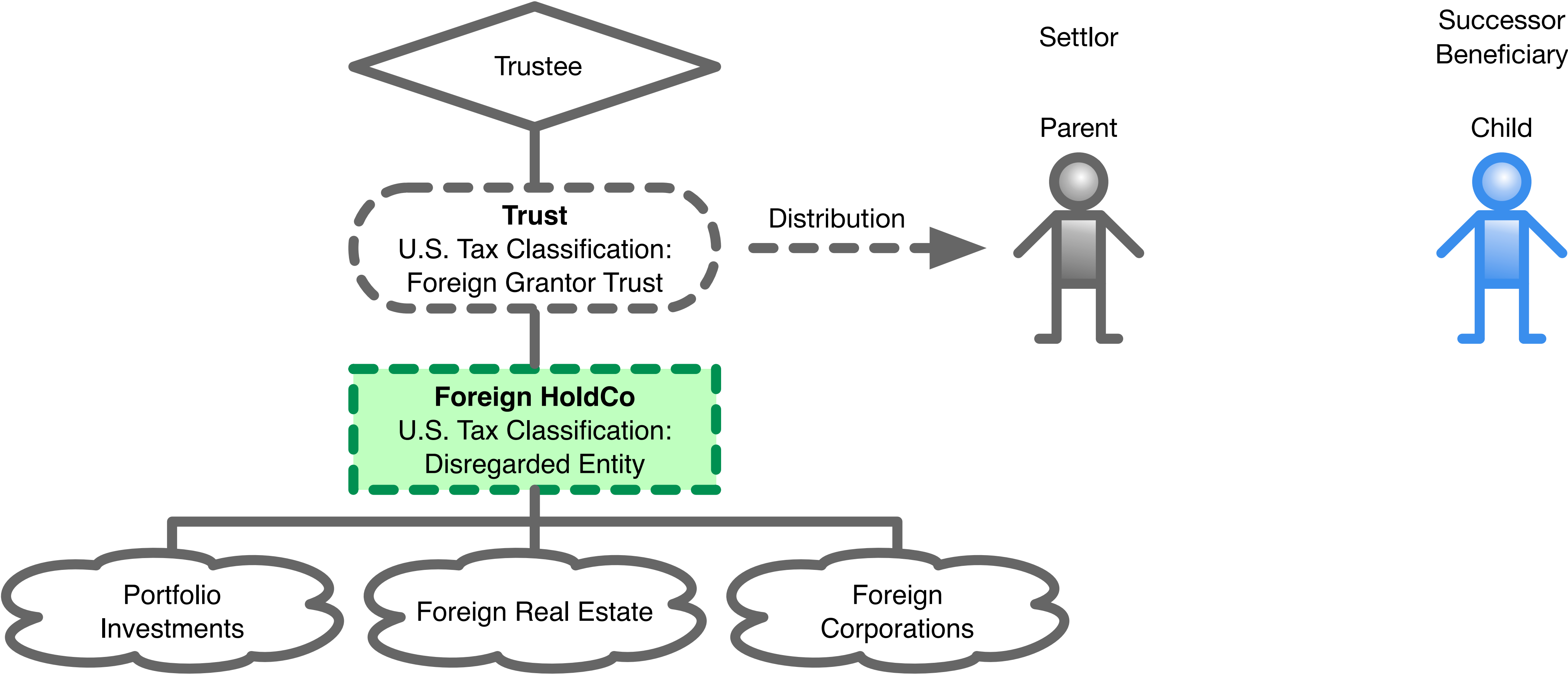
Inbound wealth transfer: foreign parents to U.S.-resident children

- Objectives: transfer foreign situs assets to U.S.-resident children with:
 - Zero U.S. income tax on trust income during the parents' lifetime.
 - All lifetime transfers are received by U.S.-resident children as tax-free gifts.
 - All trust assets inherited by U.S.-resident children receive basis step-up at the parents' death.

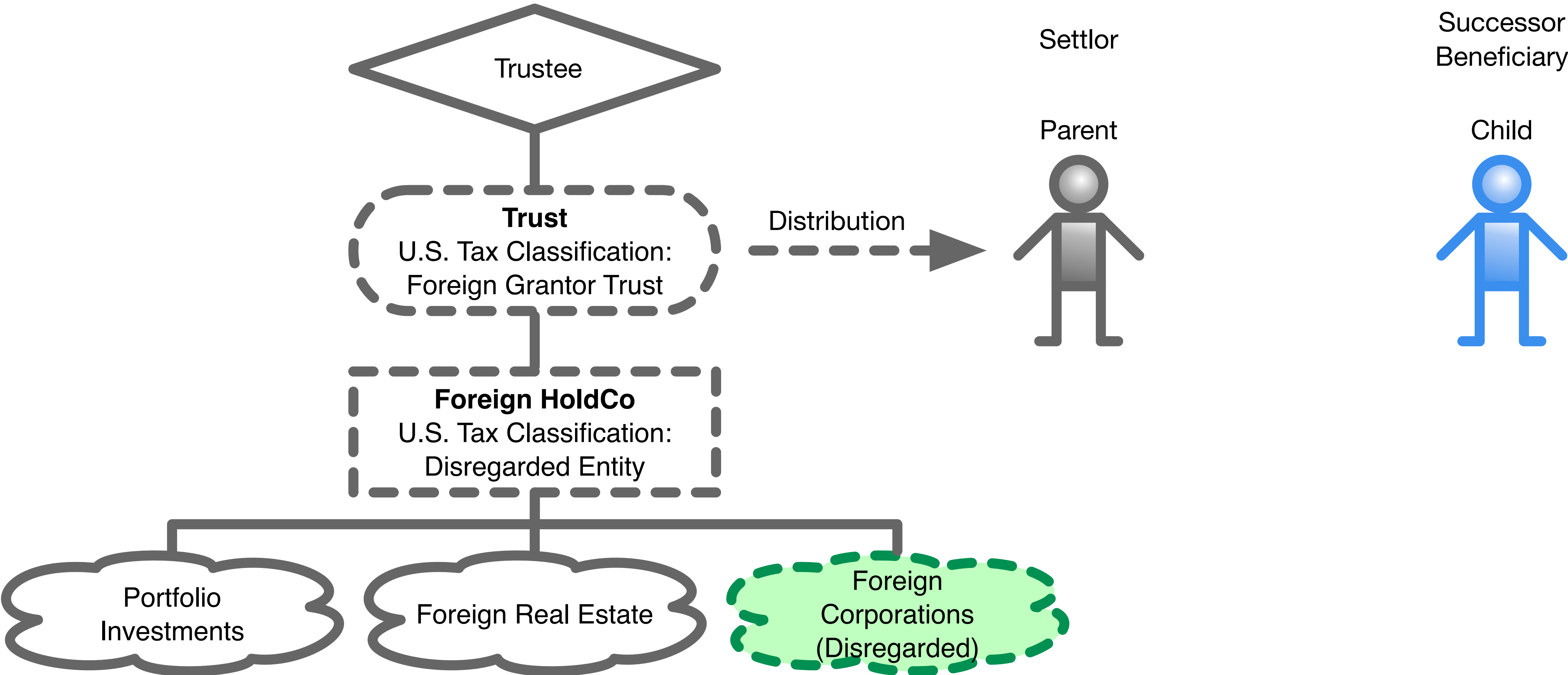
The foreign grantor trust structure



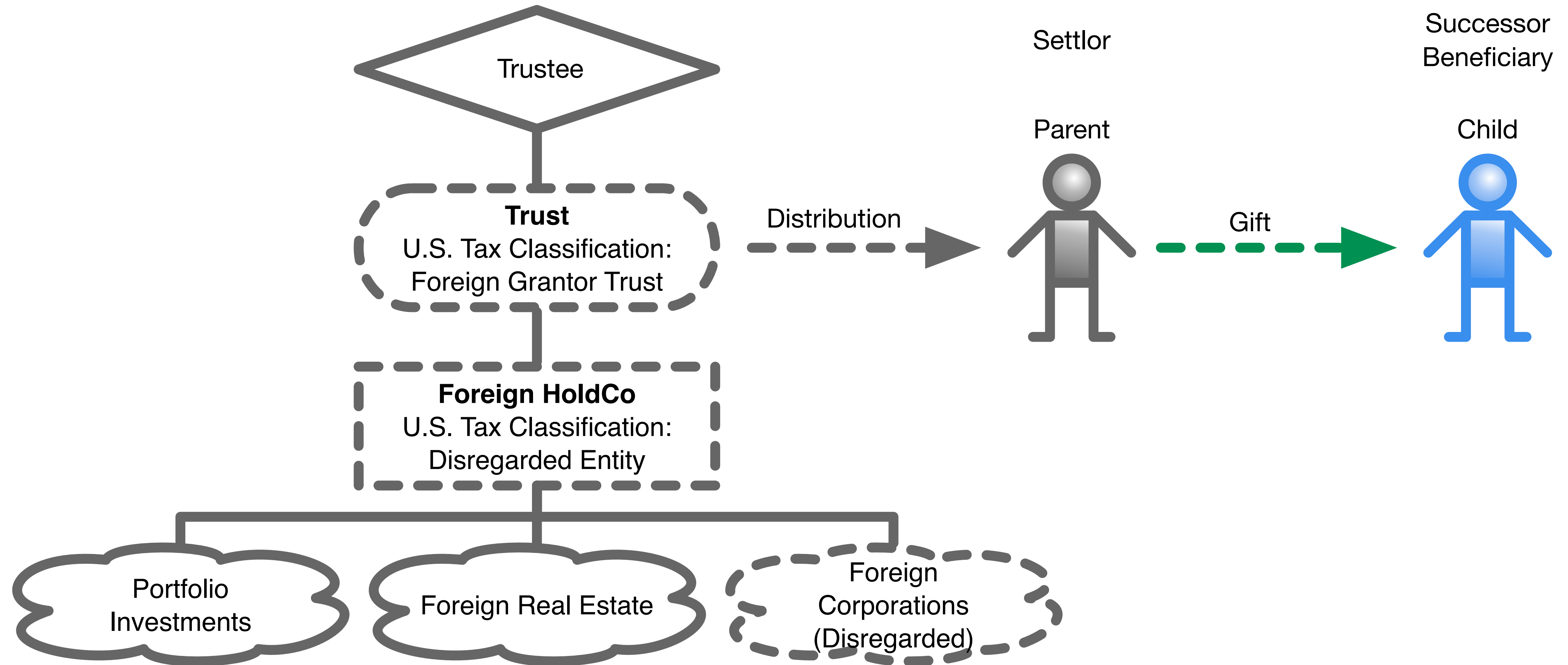
Check-the-box election for the holding company



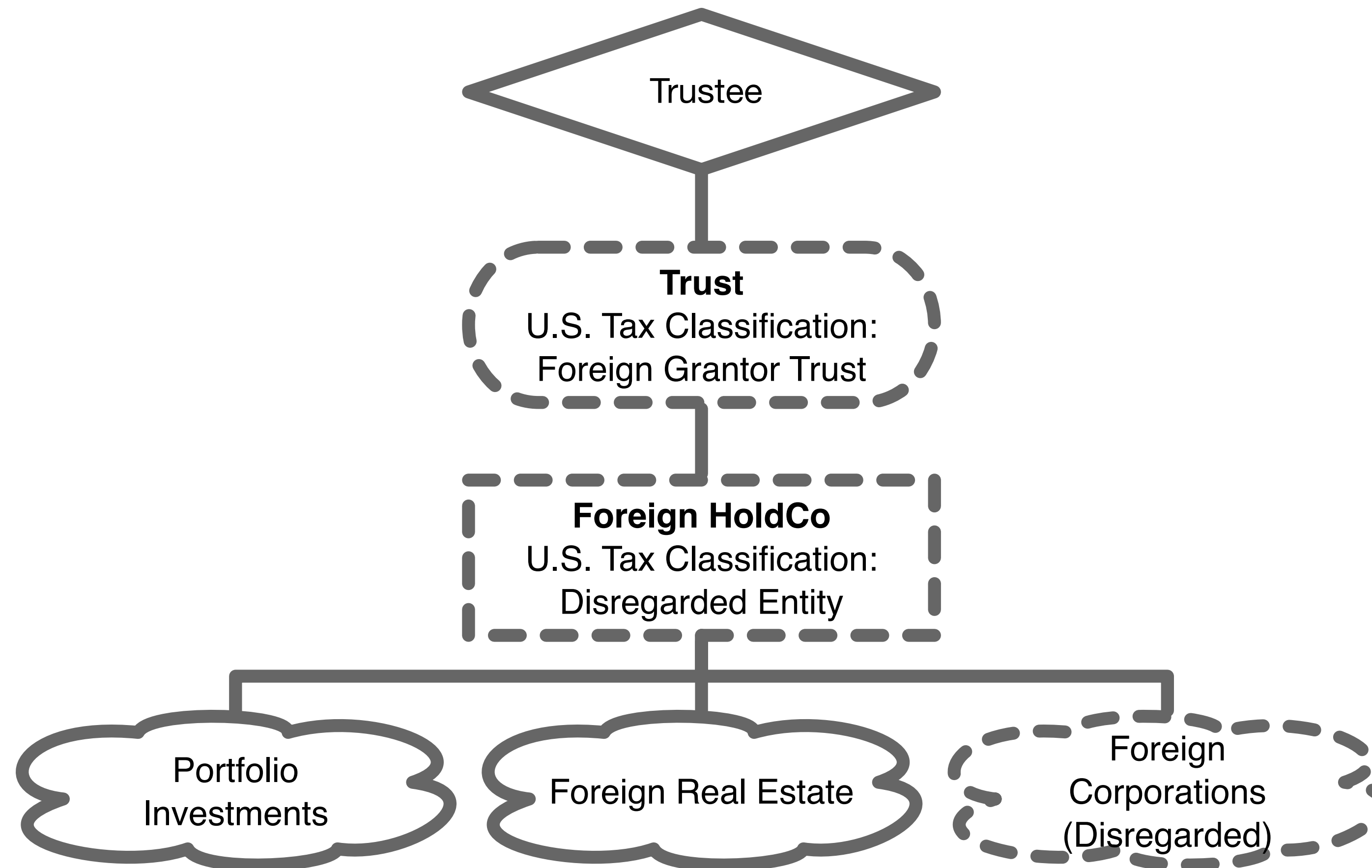
Check-the-box elections to eliminate future CFCs and PFICs



Lifetime distributions are transformed into tax-free gifts to U.S. children



Basis step-up at death

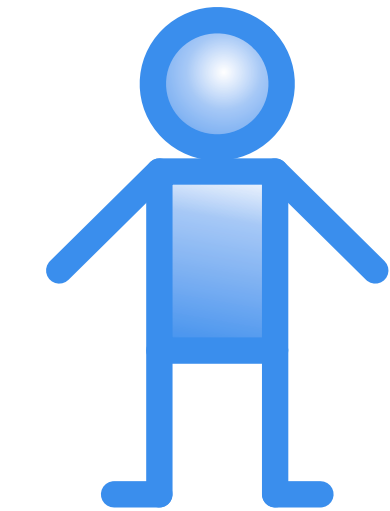
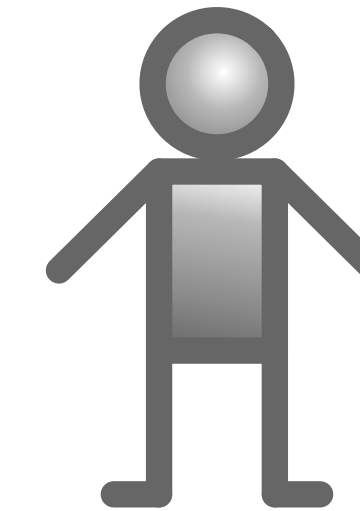


Settlor

Successor
Beneficiary

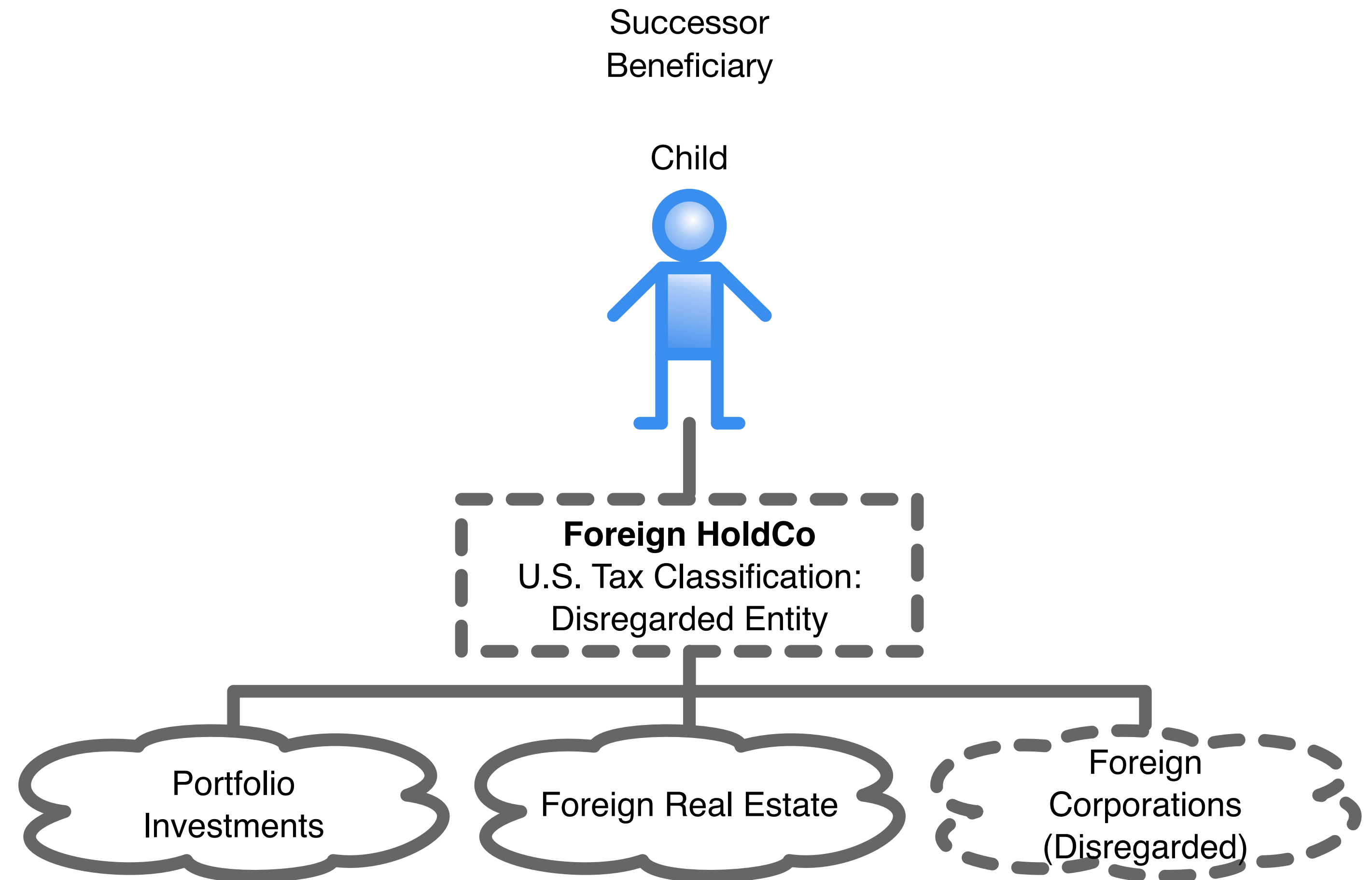
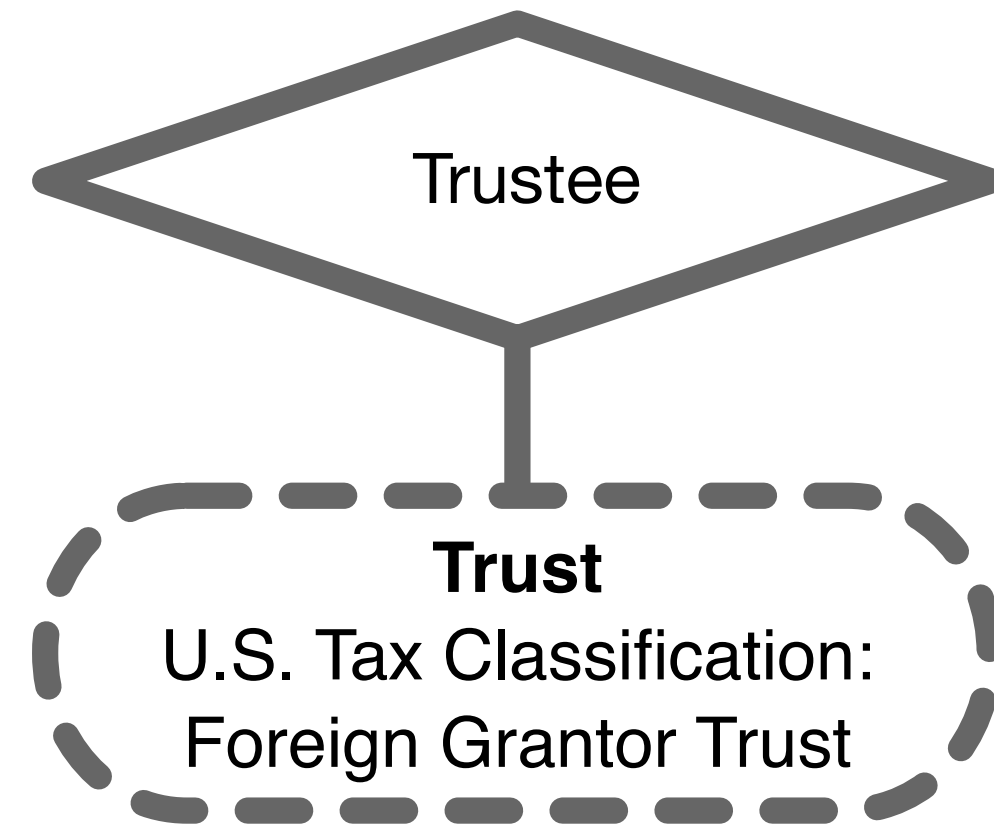
Parent

Child



Basis step-up: IRC §1014(b)(2) or (9).
Inclusion in the gross estate by IRC
§2036(a)(1) (retained life estate) or
IRC §2037 (revocable trust).

End result for U.S. successor beneficiary



4. Tax Reporting: U.S. Trust Income Tax Return

A grantor trust must file an income tax return

- A trust must file an income tax return. IRC §6012(a)(4).
- A grantor trust is a trust.
- Therefore, a grantor trust must file an income tax return.

A foreign grantor trust must file a U.S. income tax return

- Unless an alternate method is authorized in Reg. §1.671-4(b), all grantor trusts must file Form 1041 with an attached statement that reports the items of income, deduction, and credit allocable to the grantor. *Reg. §1.671-4(a)*.
- The alternate methods in Reg. §1.671-4(b) are not permitted for foreign trusts, trusts with foreign assets, or trusts with foreign grantors. *Reg. §1.671-4(b)(6)(ii), (v), (vi)*. One of those will without question apply to the foreign grantor trust.
- Therefore, a foreign grantor trust files an income tax return using the method described in Reg. §1.671-4(a), not the alternate methods in Reg. §1.671-4(b).

Treat a foreign grantor trust as a nonresident alien individual

- For purposes of computing its U.S. taxable income, a foreign trust is treated as a nonresident alien who never sets foot in the United States. IRC §641(b).
- A foreign grantor trust is a foreign trust.
- Therefore, for purposes of computing its taxable income, a foreign grantor trust is treated as a nonresident alien who never sets foot in the United States.

Foreign trusts file Form 1040-NR, not Form 1041

- The IRS tells the trustee of a foreign trust to file Form 1040-NR instead of Form 1041. *Instructions for Form 1041 (2024)*, page 5.
- A foreign grantor trust is a foreign trust.
- Therefore, the trustee of a foreign grantor trust will file Form 1040-NR instead of Form 1041 for its U.S. income tax return.
- (This makes sense in light of IRC §641(b)'s admonition to treat a foreign trust as a nonresident alien who is never present in the United States).

A foreign grantor trust must file a U.S. income tax return . . . *sometimes*

- A nonresident alien (and thus a foreign grantor trust) files Form 1040-NR if:
 - Engaged in trade or business in the United States, even if effectively connected income is zero. *Reg. §1.6012-1(b)(1)(i)*.
 - Has any kind of U.S. source taxable income. *Reg. §1.6012-1(b)(1)(i)*.
 - The “\$600 minimum gross income” requirement of IRC §6012(a)(4) for trust tax returns does not apply. *Reg. §1.6012-1(b)(1)(i)*.
- Filing exception: the trust is not engaged in business in the United States, **and** tax liability is fully satisfied by withholding at source. Exceptions to this filing exception exist. *Reg. §1.6012-1(b)(2)(i)*.

Conclusion: when to file Form 1040-NR for a foreign grantor trust

- If the foreign grantor trust is **engaged in a U.S. trade or business**, even if the amount of income from that activity is zero.
- E.g., a foreign grantor trust owns rental real estate in the United States—especially if the net election is made, or in the year of sale for any trust-owned U.S. real estate—because of IRC §897.
- If the foreign grantor trust has IRC §871(a) FDAP income and **withholding is less than the actual tax liability** (30% or lower treaty tax rate).
- Use Form 1040-NR. Attach the statement required by Reg. §1.671-4(a) allocating items of income, deduction, and expense to the grantor.

Foreign grantor trust Form 1040-NR: filing deadline

- Filing deadline:
 - Foreign trust with an “office” (what is this?) in the United States: 15th day of the 4th month after close of the trust’s tax year (i.e., April 15).
 - Foreign trust with no “office” in the United States: 15th day of the 6th month after close of the trust’s tax year. (i.e., June 15).
- *Instructions for Form 1040-NR (2024)*, page 11.

Foreign grantor trust: accounting period

- A trust's accounting period must be the calendar year. *IRC §644(a), Reg. §1.441-1(b)(2)(F).*
- Compare this to the possibility of a fiscal year for a nonresident alien if:
 - The individual has not previously filed a U.S. tax return on a calendar year basis, and
 - Uses the same fiscal year as used for home country purposes.
 - *Reg. §301.7701(b)-6(a).*

Overlap of Form 1040-NR and Form 3520-A

Form 1040-NR and Form 3520-A may be required

- Form 3520-A satisfies the filing obligation imposed by IRC §6048(b).
- Form 1040-NR satisfies the filing obligation imposed by IRC §6012(a)(4).
- Where this will happen:
 - The foreign grantor trust has a U.S. owner (triggering a Form 3520-A filing), and
 - The foreign grantor trust has U.S. source income or is engaged in business activity (triggering a Form 1040-NR filing).

5. Tax Reporting (Beneficiary and/or Owner): Form 3520

Events that trigger a Form 3520 filing requirement

- Creation of a foreign trust by a U.S. person. *IRC §6048(a)(3)(A)(i).*
- Transfer of money or property to a foreign trust by a U.S. person. *IRC §6048(a)(3)(A)(ii); Form 3520, Part I.*
- Death of a U.S. citizen or resident if the decedent was the owner of a foreign grantor trust or any portion of the foreign trust was included in the decedent's gross estate. *IRC §6048(a)(3)(A)(iii); Form 3520, page 1, line 4f.*
- Receipt of trust distributions by a U.S. person. *IRC §6048(c)(1). Form 3520, Part III.*

Form 3520 required every year for a U.S. owner of a foreign trust

- Every U.S. owner of a foreign grantor trust must file Form 3520 every year.
- See *Instructions for Form 3520 (December 2023)*, page 9.

Part II—U.S. Owner of a Foreign Trust

Complete Part II if you are considered the owner of any assets of a foreign trust under the rules of sections 671 through 679 during the tax year. You are required to enter an EIN for such foreign trust on line 2b on page 1 of the form.

Note. Complete Part II even if there have been no transactions involving the trust during the tax year. You may also need to complete Part III if you receive a distribution from the foreign trust. See the instructions for Part III.

Filing deadline for Form 3520

- Filing deadline: April 15. *Prop. Reg. 1.6048-3(a)(2)(i)*.
- Filing deadline for U.S. persons living outside the United States: June 15. *Prop. Reg. 1.6048-3(a)(2)(ii)*.
- Extension: to October 15. *Prop. Reg. 1.6048-3(a)(2)(i)*. Note that the extension is to “the 15th day of the 10th month following the close of the grantor or transferor’s tax year” so it will always be October 15, whether the filer lives in or outside the United States. Your Form 1040 extension is your Form 3520 extension.
- Special rules for a decedent’s estate. *Prop. Reg. 1.6048-3(a)(2)(iii)*.

6. Tax Reporting (Trust or U.S. Owner): Form 3520-A

Facts that trigger a Form 3520-A filing requirement

- A foreign trust exists and has a United States person as the owner of any portion of that trust under the foreign grantor trust rules of IRC §§671-679. *IRC §6048(b)(1), Prop. Reg. §1.6048-3(a).*

Technically, the trustee files Form 3520-A, but . . .

- The U.S. grantor is responsible for ensuring that the trustee of a foreign grantor trust files Form 3520-A. *Prop. Reg. §1.6048-3(a)(1)(i)*.
- A foreign trustee of a foreign grantor trust is beyond the reach of a U.S. court's subpoena, so the IRS has no power to threaten the trustee.
- As a result, the burden (and penalty risk for failure to file) is imposed on the U.S. grantor—who is well within reach of the U.S. judicial system.
- So, if the trustee does not file Form 3520-A, the U.S. owner of the trust must file a “substitute Form 3520-A.” *Prop. Reg. §1.6048-3(a)(2)*.

Filing deadline for Form 3520-A

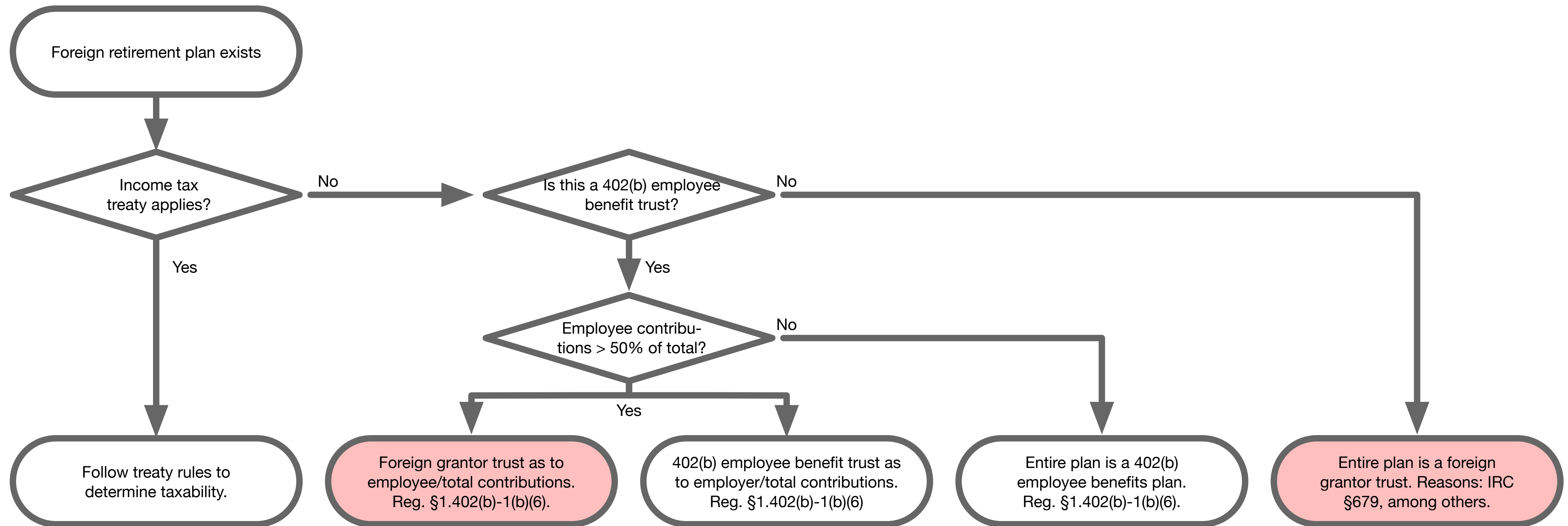
- Filing deadline: March 15. *Prop. Reg. §1.6048-3(a)(1)*.
- Extension allowed: six months to September 15. *Prop. Reg. §1.6048-3(a)(1)(i)*. Use Form 7004. (Note that an extension of time to file Form 1040 does not extend the time to file Form 3520-A).

Filing procedure and deadlines for a substitute Form 3520-A

- Responsibility is placed on the U.S. owner of the foreign trust:
- Prepare Form 3520, Part II. *Prop. Reg. §1.6048-3(a)(2)(i)*.
- Complete Form 3520-A and related statements, attach everything to Form 3520, and file by the owner's Form 3520 filing deadline. *Prop. Reg. §1.6048-3(a)(2)(ii)*.
- Deliver a Foreign Grantor Trust Beneficiary Statement to a U.S. beneficiary of the foreign trust (per Form 3520-A instructions) by the owner's Form 3520 filing deadline. *Prop. Reg. §1.6048-3(a)(2)(ii)*.

7. Foreign Retirement Plans as Foreign Grantor Trusts

How to figure out whether a retirement plan is a foreign grantor trust



Reporting requirements: retirement plans as foreign grantor trusts

- Form 3520 required.
- Form 3520-A required.
- Exception: neither required for Canadian RRSPs and RRIFs. Rev. Proc. 2014-55, §5.01.

Reporting requirements: retirement plans as employee benefit trusts

- Form 3520 (for contributions, distributions) not required. *IRC §6048(a)(3)(B)(iii)(I)*.
- Form 3520-A not required. An employee benefit trust is not a grantor trust. *IRC §402(b)(3)*.

8. Conclusion

Foreign grantor trusts: summary

- Foreign grantor trusts are frequently unavoidable (retirement plans, trusts created by U.S. persons).
- Income taxation operates as a straight pass-through to the grantor who is the owner of the trust.
- The big problem is Form 3520 and Form 3520-A, and specifically filing these forms before the deadlines. The penalties are horrific for late-filing: 35% of unreported contributions, 35% of unreported distributions (Form 3520), and 5% per year of the trust's value (Form 3520-A).

Thank you!

Philip D. W. Hodgen

HodgenLaw PC

150 E. Colorado Blvd., Suite 211

Pasadena, California 91105

www.hodgen.com

w: +1 626 689 0060

phil@hodgen.com

This is not legal advice and I am not your lawyer. Do not rely on this presentation—do your own research to verify that the information is correct and that it applies to you.

Newsletter sign-up: internationaltaxlaw.com.

Join a community of international tax professionals: pro.internationaltaxlaw.com.