An issue of Trust

Understanding the difference between a US trust and a non-US trust

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In this edition of MASECO's '39 Steps to Smart Living in the UK' we focus on a common UK investment scheme structured to help provide UK tax relief, called Enterprise Investment Scheme ("EIS").

There are many different considerations that come into play regarding trusts. Factors that impact the considerations include the type of trust you own, the tax status of the individuals who settle the trust, and the tax status of the individuals who retain an ongoing benefit from the trust. As such, it is often important to review some of the basic rules associated with what makes a trust a US trust as opposed to a non-US 'foreign' trust.

A US trust is one that satisfies two tests:

(1) Court Test – A court within the US has primary rights to administer the trust.

(2) Control Test – at least one 'US person' has the ability to control all substantial decisions related to the trust.

A US person would generally be defined as a US citizen, green card holder, or resident alien under the substantial presence test. Under the regulations, substantial decisions include things like the timing of distributions, the amount of distribution, choosing the beneficiary to receive a distribution, the power to make investment decisions, whether to terminate the trust, whether to pursue a claim on behalf of the trust, amongst other things.

If a trust does not pass one of the two tests noted above, then it is generally considered to be a non-US 'foreign' trust.

In addition to understanding whether a trust is considered to be a US trust or non-US trust, it is also important to determine whether the trust is considered a grantor or non-grantor trust. In general, if the person who settles the trust is alive and retains some sort of interest or trust power, then a trust will be considered a grantor trust. Generally, grantor trusts are taxed at the individual level whereas non-grantor trusts are taxed at the trust level (except to the extent that income and gains are distributed to a beneficiary in the year the income is earned). This difference in taxation can result in varying rates of tax and have broad implications for US individuals who either settle or benefit from a trust so it can be essential to understand.

Depending on the structure of the trust and the tax status of the trustees, beneficiaries and settlors, planning becomes important around the types of assets held within the trust. If individuals are looking to invest the trust assets in any way, it is beneficial to take advice and ensure that the investment strategy is tax-efficient in the jurisdictions that apply to the individual. For US connected individuals, one wants to make sure that any underlying assets held within the trust don't fall foul of the Passive Foreign Investment Company (PFIC) or Controlled Foreign Company (CFC) rules. Equally, for UK connected individuals, one wants to understand how trust assets will be taxed and ensure that the assets held avoid Offshore Income Gains (OIG) treatment to maintain maximum flexibility on the use of the funds in the future. ★

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