Living Trusts for Bona Fide Residents of Puerto Rico – Is Your Living Trust a Foreign Trust for U.S. Tax Purposes?

Individuals who move to Puerto Rico to avail themselves of Act 60 benefits often hold their assets through a living trust. Holding assets through a U.S. living trust may raise complex U.S. tax issues for bona fide residents of Puerto Rico.

This article discusses whether the IRS will treat a U.S. living trust of a bona fide resident of Puerto Rico as a "foreign trust" under U.S. tax principles. Foreign trusts are subject to multiple layers of U.S. tax filing requirements with hefty penalties for failing to comply with those requirements.

Background

Beth is a U.S. citizen who lives in California. Years ago, Beth created a trust in California (the "Living Trust"). She transferred $20 million of her assets into the Living Trust. The primary purpose of creating the Living Trust was to avoid the California probate process. However, she also enjoys the other benefits of the Living Trust which include privacy, asset protection, and estate tax planning.

Beth is both the settlor and the sole trustee of the Living Trust. The trust document provides that Beth reserves the right to revoke or amend the Living Trust at any time during her lifetime. Thus, the Living Trust is a "revocable" trust. The Living Trust does not have an automatic migration provision.[1]

Years after forming the Living Trust, Beth moves to Puerto Rico and becomes a bona fide resident of Puerto Rico. She now administers the Living Trust from her home in Puerto Rico.

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[1] An automatic migration provision specifies that a U.S. court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the U.S.

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The Living Trust Is a Grantor Trust

Code §671[2] provides rules for trusts that are often referred to as "grantor trusts". A grantor of a trust is treated as the owner of all or a portion of the income of a trust.[3] A grantor who is treated as the owner of the entire trust under Code §671 is treated as the owner of all of the income of the trust, and for certain purposes is treated as the owner of the assets of the trust.[4]

A grantor is treated as the owner of a trust if she has the power to revoke the trust.[5] Here, Beth is the sole grantor of the Living Trust, and she has the power to revoke the Living Trust. Therefore, the Living Trust is a grantor trust with respect to Beth, and the income earned by the Living Trust is taxable directly to Beth.

U.S. Tax Filings for U.S. Grantor Trusts

Income of a grantor trust is generally not reported on Form 1041.[6] Instead, the income is generally shown on a separate statement attached to Form 1041.[7] In this case, the grantor trust only files a blank return with a statement that shows the income of the trust that is attributable to the grantor.

As an alternative, the trustee does not need to file any type of return if the entirety of the trust is owned by one grantor, provided that the trustee furnishes certain information to payors, and furnishes to the grantor a statement that:

(1) shows all items of income, deduction, and credit of the trust for the taxable year;
(2) identifies the payor of each item of income;
(3) provides information necessary to take the items into account in computing the grantor's taxable income; and

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2 All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

3 Treas. Reg. §1.671-3(a).

4 Treas. Reg. §1.671-3(a)(1) and Rev. Rul. 85-13.

5 Code §676.

6 Treas. Reg. §1.671-4(a).

7 *Id.*

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(4) informs the grantor that the items of income, deduction, and credit must be included in computing the taxable income and credits of the grantor on the grantor's income tax return.[8]

U.S. Tax Filings for FOREIGN Grantor Trusts

- Trust Owner

Each U.S. person who is treated as the owner of any portion of a foreign trust under the grantor trust rules of Code §§671 through 679 is responsible for ensuring that the trust annually "makes a return * * * which sets forth a full and complete accounting of all trust activities and operations for the year, the name of the U.S. agent for the trust, and such other information as the Secretary may prescribe."[9] This prescribed information is provided by filing Form 3520-A.[10]

- Trust Beneficiary

In addition, any U.S. person who is a beneficiary of a foreign trust and receives a distribution from that foreign trust must file an information return that includes the name of the trust, the aggregate amount of the distribution received from the trust during the taxable year, and such other information as the Secretary may prescribe.[11] This reporting requirement is satisfied when the U.S. beneficiary files Form 3520.[12]

Trusts As Domestic or Foreign

A foreign trust is "any trust other than a trust [that is a] United States person".[13] Stated another way, a foreign trust is any trust that is not a domestic trust.[14]

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8 Treas. Reg. §1.671-4(b)(2)(B).

9 Code §6048(b)(1)(A).

10 See *Rost v. United States*, 44 F.4th 294, 298 (5th Cir. 2022); *Wilson v. United States*, 6 F.4th 432, 434 (2d Cir. 2021).

11 Code §6048(c)(1).

12 Notice 97-34.

13 Code §7701(a)(30)(E), (31)(B); Treas. Reg. §301.7701-7(a)(2).

14 *Id.*

The statute and regulations provide a two-factor test to determine whether a trust is domestic or foreign. A trust is ***domestic*** if:

> (1) "[a] court within the United States is able to exercise primary supervision over the administration of the trust" (the "Court Test") ***and***
>
> (2) "[o]ne or more United States persons have the authority to control all substantial decisions of the trust" (the "Control Test").[15]

If the trust fails to satisfy either the Court Test or the Control Test, the trust will be deemed a foreign trust for federal tax purposes.[16]

Court Test

There are two ways to meet the Court Test. The first is a Safe Harbor. The second is the General Rule.

Safe Harbor

Under the Safe harbor, a trust satisfies the Court Test if the governing document does not direct that the trust be administered outside of the U.S., the trust in fact is administered exclusively in the U.S., and the trust is not subject to an automatic migration provision that would move it outside the U.S. if a U.S. court were to attempt to assert jurisdiction.[17]

"Administration" of a trust means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.[18]

For purposes of the Court Test, the U.S. includes only the 50 States and the District of Columbia.[19] Accordingly, a court within Puerto Rico is not a court within the U.S.[20]

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15 Code §7701(a)(30)(E) and Treas. Reg. §301.7701-7(a).

16 Treas. Reg. §301.7701-7(a)(2).

17 Treas. Reg. §301.7701-7(c)(1), (4)(ii).

18 Treas. Reg. §301.7701-7(c)(3)(v).

19 Code §7701(a)(9), Treas. Reg. §301.7701-7(c)(2).

20 *Id.*

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Beth administers the Living Trust from her home in Puerto Rico. This means that the Living Trust is not administered exclusively in the U.S. Thus, the Living Trust does not meet the Court Test Safe Harbor.

Court Test - General Rule

If the Court Test's Safe Harbor does not apply, the next step is to determine whether the General Rule is met. As described above, the General Rule is met if a court within the U.S. is able to exercise primary supervision over the administration of the trust. The term "is able to exercise" means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust.[21] The term "primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.[22] A court may have primary supervision notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.[23]

The regulations also provide that if both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust meets the Court Test.[24]

If a trust is administered from Puerto Rico, the regulations do not provide clear guidance as to whether a U.S. court would be able to exercise primary supervision over the administration of the trust, or whether a Puerto Rican court would be able to exercise primary supervision over the administration of the trust. Some of the factors that a court might consider in this determination include:

- Where was the trust formed?
- Where does the trustee reside and make decisions related to the trust?
- Where is the trust's real or personal property located?
- Where are the trust's beneficiaries located?

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21 Treas. Reg. §301.7701-7(c)(3)(iii).

22 Treas. Reg. §301.7701-7(c)(3)(iv).

23 *Id.*

24 Treas. Reg. §301.7701-7(c)(4)(i)(D).

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- Do the trust organizing documents indicate which country's laws apply to the trust?
- Do the trust's organizing documents indicate where disputes should be resolved?

The regulations provide that, in the case of a trust other than a testamentary trust, if the fiduciaries and/or beneficiaries take steps with a court within the U.S. that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the Court Test.[25] Thus, if Beth takes steps with a court within the U.S. that cause the administration of the Living Trust to be subject to the primary supervision of a U.S. court, then the Living Trust should meet the Court Test. However, the regulations do not identify which steps Beth needs to take to cause the Living Trust to be subject to the primary supervision of a U.S. court.

In the absence of any guidance regarding the factors a U.S. court or a Puerto Rican court would use to determine whether the court can exercise primary supervision over the administration of the trust, Beth should obtain legal advice from her U.S. tax counsel to determine whether the Living Trust would meet the Court Test.

Control Test

As described above, the Control Test is met if one or more U.S. persons have the authority to control all substantial decisions of the trust. Beth is a U.S. citizen; therefore, Beth is a U.S. person.[26] Beth has the authority to control all substantial decisions of the Living Trust. Consequently, the Living Trust should meet the Control Test.

Status of the Living Trust as a Foreign Trust

Because it meets the Control Test, the status of the Living Trust as a foreign trust will ultimately depend on whether it meets the Court Test. Beth will need her U.S. tax counsel to consider her facts and circumstances and make a determination on the Living Trust's status.

25 Treas. Reg. §301.7701-7(c)(4)(i)(C).

26 Code §7701(a)(30)(A).

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Potential Penalties ***If*** a Foreign Trust

If the Living Trust is a foreign trust, failure to timely file Form 3520, or to fully disclose all required information, results in a penalty equal to the greater of $10,000 or 35% of the gross reportable amount.[27] The "gross reportable amount" is "the gross value of the property involved in the event (determined as of the date of the event)."[28]

One "event" that requires disclosure on Form 3520 is the transfer of money or property to a foreign trust by a U.S. person.[29] A domestic trust that becomes a foreign trust is deemed to have made a transfer of all its assets to a foreign trust.[30]

While Beth lived in the U.S., the Living Trust was a domestic trust. If moving to Puerto Rico and administering the trust from Puerto Rico caused the Living Trust to become a foreign trust, Beth would need to disclose the deemed transfer of assets from the Living Trust as a domestic trust to the Living Trust as a foreign trust. If the value of the property on that date was $20 million, the penalty to Beth for failing to file Form 3520 would be $7 million (35% x $20,000,000).

A U.S. person who receives a distribution from a foreign trust generally must report the receipt of that distribution on Form 3520.[31] Failure to report the receipt of the distribution on Form 3520 results in a 35% penalty on the gross amount of the distribution.[32] Thus, if the Living Trust is a foreign trust and Beth removes assets from the Living Trust, failure to report those distributions on Form 3520 could result in significant penalties.

Failure to file Form 3520-A results in a penalty equal to the greater of $10,000 or 5% of the gross reportable amount."[33] The "gross reportable amount" is "the gross value of the portion of the trust's assets at the close of the year treated as owned by the U.S. person."[34]

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[27] Code §6677(a).

[28] Code §6677(c).

[29] Code §6048(a)(3)(A)(ii).

[30] Notice 97-34, §III. B.

[31] Code §6048(c).

[32] Code §6677(a).

[33] Code §6677(a)-(b).

[34] Code §6677(c)(2).

If the Living Trust was a foreign trust and if the value of the Living Trust's assets at the end of each year was $20 million, the penalty to Beth for failing to file Form 3520-A would be $1 million (5% x $20,000,000) each year.

Summary

It is important for Beth to determine whether her move to Puerto Rico may cause the Living Trust to become a foreign trust. If the Living Trust were to become a foreign trust, she would be subject to Form 3520 and Form 3520-A reporting requirements, with very substantial penalties for failing to file those forms. Failing to file these returns would also keep the statute of limitations open indefinitely on the IRS's ability to examine the returns and assess penalties.

About Tom Duffy, C.P.A., P.A. & P.C.

Tom Duffy C.P.A., P.A. & P.C. is a Greater Chicago-based firm that specializes in international taxation with a particular focus on U.S. possessions. In addition, the firm is one of the few CPA firms in the country that specializes in representing residents of Puerto Rico during IRS examinations, specifically those taxpayers granted tax incentives under Puerto Rico's Act 60 (formerly Act 20/22).

Our foreign clients rely on our knowledge and expertise in complying with their U.S. tax obligations. Tom Duffy has over fifteen years of experience in international tax planning and associated U.S. tax return preparation. The firm services clients in the United States, its possessions, and throughout the world. Tom Duffy is a member in good standing with the American Institute of CPAs and the Puerto Rico Society of CPAs. He is licensed to practice in Florida, Illinois, and Puerto Rico.

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