



WEALTH SUCCESSION PLANNING: SOUTH AFRICANS GOING TO THE USA

Tax on the Move Series

YOUR KEY TO THE TAX COMMUNITY

About The Presenter



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Shaun is an experienced international tax and estate planning advisor. As an admitted attorney in South Africa, he has worked extensively with high-net worth individuals to look after families wealth and structures worldwide.

Shaun is also an International Tax Affiliate of the Chartered Institute of Taxation (CIOT) in the UK with Membership Number: 257196. He also works as an Independent Consultant for a US consulting firm, Asena Advisors and an integral part of the US Advisory Team and advises private clients and family offices on US/AUS International and South African International tax issues.

Specialties: US/AUS/UK/South African International Tax, International Estate and Tax Planning.

U.S. TAXATION OF NON-RESIDENTS (REPRISE)

Income Tax of Non-Residents: Squarely in the Net

- Mainly Taxed in a Net Basis
 - Income that is effectively connected to a U.S. trade or business
 - U.S. real property and U.S. real property companies (rental and gains)
 - Services rendered in the U.S.
- Gross taxation
 - Dividends from U.S. companies
 - Interest on notes from U.S. unlisted companies
 - Royalties from intellectual property associated with U.S. usage

Note: Many of these items may be subject to treaty relief

Income Tax of Non-Residents: Squarely Outside the Net

- Capital gains
 - Most assets other than U.S. trade or / business assets or U.S. real estate
 - Note: U.S. shares are generally free unless of a U.S. real property company
- Portfolio interest
 - Bank interest
 - Interest from listed bonds

Notes on US Income Tax

- U.S. top marginal rates are 37% for individuals (kicking in at a much higher threshold than SA – \$640 000+)
- However, net investment income is subject to a 3.8% additional charge
- Remember social security taxes on wages
- State income taxes
 - May be very high (New York and California)
 - May be very low (Florida and Texas)
 - Only \$10 000 of state income taxes are deductible against federal taxes

Gift & Estate Tax of Non-Residents: U.S. Source

- U.S. assets (including U.S. shares) largely fall into the U.S. Gift & Estate Tax net
- Exclusions
 - U.S. life insurance on a non-resident's life
 - Bank deposits etc. not used in a U.S. business
 - Works of art on loan for exhibition
 - Listed U.S. debt
 - “All property outside the U.S.”

Notes on US Gift & Estate Tax

- The U.S. Gift & Estate Tax rate is 40%
- Domestic residents have high exemption levels for gift and estate taxes
 - \$12.6 million per person
 - Married couples have a portability election
- Foreigners only have \$60 000 exemption on death (no relief from gift tax)

IMPACT OF FOREIGN TRUSTS

US Taxation of SA Trusts & US Beneficiaries

- Where a U.S. Person is a beneficiary of a foreign trust, the U.S. taxation of income from this trust depends on whether the trust is classified as a '*grantor trust*' or '*non-grantor trust*'.

The grantor of a trust is the person (settlor) who provides property or other funds to the trust that forms part of the trust corpus (assets).

- IRC §7701(a)(30)(E), (31) defines a "*foreign trust*" as any trust other than a trust that a **court within the US** is able to exercise primary supervision over the administration of, and over which one or more U.S. persons have the authority to control all **substantial decisions** of the trust.
- SA trusts will generally be classified as "foreign trusts" for U.S. tax purposes.
- To determine whether a foreign trust is a grantor trust for federal tax purposes, IRC §679 will be applied first as this section deals exclusively with foreign trusts and overrides the other grantor trust provisions.

IRC §679

- For IRC §679 to apply, the transferor **must be a U.S. person** at the time of transfer.
- IRC §679(a)(4) states that a **non-resident alien individual who becomes a resident of the United States within five years** after directly or indirectly transferring property to a foreign trust will be treated under §679 (and the reporting requirements of §6048) as if he or she made the transfer on the residency starting date.
- In terms of IRC §679, the SA trust will therefore not be regarded as a grantor trust if the donor/funder transferred assets to the trust more than 5 years prior to becoming a U.S. resident.
- This however does not mean that the trust will not be a grantor trust and could still be classified as a grantor trust in terms of IRC §673-678.

IRC §673 – 678

- If any one of the following factors are present, the grantor may be treated as the owner of the trust and therefore regarded as a grantor trust:
 - a. The grantor retains a reversionary interest in the trust exceeding 5 percent of the trust's value. – **IRC §673**
 - b. The grantor retains the power to affect beneficial enjoyment of the trust income or corpus without the approval or consent of an adverse party. – **IRC §674**
 - c. 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. – **IRC §675**
 - d. The grantor or a non-adverse party has the power to revoke the trust and reinvest the assets in the trust to the grantor. – **IRC §676**
 - e. 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. – **IRC §677**
 - f. 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. – **IRC §678**

Foreign Non-Grantor Trusts

- The income is allocated between a *foreign non-grantor trust* and its beneficiaries through the concept of '*distributable net income*' (**DNI**) and its limitation on the trust's distribution deduction.
- This deduction is calculated depending upon whether the trust is a simple trust or a complex trust.
- A *foreign non-grantor trust* that is not required to distribute all of its income in the current financial year, that distributes accumulated income or principal, or that has a charitable beneficiary is a **complex trust**.

Due to the discretionary powers, in general, given to trustees in terms of the Trust Deed of a SA trust, majority of SA trusts (discretionary inter vivos trusts) will be complex trusts.

Foreign Non-Grantor Trusts

- The DNI of a trust is generally equal to its taxable income, computed without the deduction for distributions to beneficiaries and the personal exemption, and increased by any tax-exempt interest (net of allocable expenses).
- Thus, income that is ordinarily exempt from tax by the provisions of the Treaty must be considered in computing the DNI of a foreign trust.
- The beneficiary of a *foreign non-grantor trust* is taxed on the trust's current income to the extent that the income either is distributed or is required to be distributed under the governing instrument.

Foreign Non-Grantor Trusts

- A distribution which is more than the SA trust's DNI is treated either as a non-taxable distribution of principal or a distribution of income accumulated from prior years taxable income under the *'throwback rule.'*
- It is however possible that the beneficiary's unpaid present entitlement (**which is either on loan account or recorded as 'vested distributions not yet paid'**) that is referenced in the financials of the SA trust has created a separate grantor trust.
- Pursuant to IRC §679, the beneficiary would be obligated to report a proportionate share of the income of the entire trust based on the value of his/her unpaid present entitlement when divided by the corpus of the entire trust. This would require the beneficiary to **file a separate form 3520-A** for that entitlement.
- Under §667(d), the beneficiary is permitted to claim a **foreign tax credit** for the taxes deemed distributed if she elects the provisions of the foreign tax credit (except for franking credits because these are not taxes paid on the beneficiary's behalf). For taxes paid on the beneficiary's behalf, can elect the benefits of the foreign tax credit opt claims a deduction for the taxes deemed paid.

US Compliance Requirements

- A non-grantor U.S. person (U.S. beneficiary) who receives a distribution, directly or indirectly, from a foreign trust is **required to file form 3520**, reporting the distribution.
- A *'distribution from a foreign trust'* includes:
 - property from a foreign trust, whether or not the trust is deemed to be owned by another U.S. person;
 - the receipt of trust corpus and the receipt of a gift or bequest that is described in §663(a); and
 - a direct or indirect loan of cash or marketable securities to a U.S. grantor or U.S. beneficiary by a foreign trust.
- IRC §6048(c)(2) states that any distribution of income or principal from a foreign trust to a U.S. beneficiary is treated as an accumulation distribution includible in the gross income of the distributee unless adequate records are provided to the Secretary to determine the proper treatment of the distribution.

US Compliance Requirements

- If the beneficiary cannot obtain such a statement from the trustees, the beneficiary can avoid accumulation distribution treatment by providing certain information regarding actual distributions from the SA trust for the prior three years (the '*default rule*').
- The beneficiary can treat 125% of the average of the trust distributions received in the prior three years as a distribution of current income, with only the excess amount treated as an accumulation distribution.
- If the beneficiary uses this default treatment, it will not affect calculations by the SA trust, such as calculating the DNI.
- A beneficiary who fails to report a distribution received is subject to a penalty of the greater of \$10,000 or 35% of the '*gross reportable amount*' for the failure to file a timely form 3520 or the failure to include all required information on a timely filed return.

Foreign Non-Grantor Trust

Beneficiary Statement

- The penalties under §6677 are not imposed if the failure to file is shown to be due to reasonable cause and not due to willful neglect. But the US Treasury will not be denied for imposition of a foreign civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information.
- Without a proper submission by the beneficiary, the distributions from the SA trust, will be taxable to him/her under §665–§668, together with the interest charge.
- The beneficiary can avoid the accumulation distribution treatment by obtaining from the SA trustees either:
 - A *'Foreign Grantor Trust Beneficiary Statement'*, Form 3520-A, page 4 showing that the trust is taxable as a grantor trust owned by a US person;
 - OR
 - A *'Foreign Non-Grantor Trust Beneficiary Statement'*, showing the proper income tax consequences of the distributions to her.

Foreign Non-Grantor Trust

Beneficiary Statement

- The *Foreign Non-Grantor Trust Beneficiary Statement* is not part of any return and must be prepared independently but must be attached to the beneficiary's form 3520.
- A *Foreign Non-Grantor Trust Beneficiary Statement* must contain the following information in substantially the following format:
 - a) the first and last day of the tax year to which the statement applies;
 - b) a description of the property (including cash) distributed or deemed distributed to the U.S. person during the year and the fair market value of the distributed property;
 - c) a statement as to whether the foreign trust has appointed a U.S. agent and, if one is appointed, the name, address, and taxpayer identification number of the agent
 - d) an explanation of the appropriate U.S. tax treatment of the distribution or deemed distribution and sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of the distribution or deemed distribution for U.S. tax purposes;
 - e) a statement identifying whether any grantor of the trust was a partnership or foreign corporation, with an explanation of all relevant facts; and
 - f) a statement that, upon request, the trust will permit either the IRS or the U.S. beneficiary to inspect and copy the trust's permanent books of account, records, and such other documents that are necessary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes.



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