TAX 101: FOREIGN SETTLORS, U.S. DOMESTIC TRUSTS, AND U.S. TAXATION

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INTRODUCTION

Trust instruments constitute a common estate planning tool in common law countries. While, planning for future generations within the boundaries of a single jurisdiction constitutes the historical approach, families in today's world do not necessarily live in the same country. When planning for high net worth individuals, present and future international family aspects must be considered. Otherwise, adverse tax consequences may ensue.

This article serves as a primer for the use of trusts in the context of a non-U.S. individual settlor forming a trust that has one or more U.S. beneficiaries on an exclusive or non-exclusive basis. The scenario involves (i) a non-U.S. parent who was never a U.S. citizen or resident for income tax purposes, (ii) a U.S. resident adult child that wishes to acquire a house or a condominium unit in the U.S., and (iii) a trust intended to hold the property for the child.

The U.S. tax consequences of the arrangement must be carefully considered at three points in time. The first point in time is at the funding of the trust: Is there gift tax that may be imposed? The second point in time is during the life of the trust: Is there income tax that may be imposed unexpectedly on the beneficiary, for instance in the case of rent-free use of an apartment? The third point in time is at the conclusion of the settlor's lifetime: Is there estate tax exposure because of retained strings over the trust's assets? This article takes the reader through each step. Throughout, differences are highlighted in the tax treatment of (i) a U.S. individual and a non-U.S. individual, and (ii) a U.S. domestic trust and a foreign trust.

GIFT TAX EXPOSURE ON FORMATION & FUNDING OF THE TRUST

Question 1: Under the rules applicable to U.S. residents and citizens, is a gratuitous transfer of property from a settlor to a trust considered to be a gift?

Yes. Unless, the trust is revocable, a gratuitous transfer of assets, from a settlor to a trust, is ordinarily treated as a gift that is subject to gift tax under the rules applicable to U.S. residents and citizens.[1]

Question 2: When the donor of the gift is a nonresident, non-citizen ("N.R.N.C.") individual, do the same rules apply regarding the taxation of gifts, or is tax imposed on gifts of certain categories of assets?

When the donor of the gift is an N.R.N.C. individual, the scope of gift taxation is

[1] Treas. Reg. § 25.2511-1(c).

reduced. U.S. gift tax is imposed only with regard to real property and tangible personal property[2] having a U.S. situs. In general, gifts of intangible property ("I.P.") made by an N.C.N.R. individual are not subject to U.S. gift tax, even if the transfer is made in the U.S. Examples of I.P. include shares of stock or a debt instrument issued by a corporation.

Question 3: If the N.R.N.C. parent purchases a house in the U.S. and gives the house to a trust for the benefit of the U.S.-resident adult child, will the gift be taxable?

Yes, if the N.R.N.C. parent purchases a house in the U.S. and gives the house to a U.S.-resident adult child, the gift will be taxable. The gift relates to U.S. situs real property.

Question 4: If the N.R.N.C. parent purchases a house in the U.S., transfers the house to a newly created U.S. corporation, and gives the stock of the corporation to a U.S. domestic trust established for the benefit of the U.S.-resident adult child, will the gift of stock be exempt from U.S. gift tax as I.P.?

"A given result at the end of a straight path is not made a different result because it is reached by following a devious path"

No, the transfer likely will not be viewed to be exempt from gift tax even though it is a transfer of shares and shares are considered to be I.P. The transfer of shares is the final step in an integrated plan that begins with the transfer of real property owned by the N.R.N.C. parent. Unless the transfer of the real property to the U.S. corporation is unconnected to the transfer of shares, the substance of the gift is a transfer of real property.

For many years, U.S. courts have applied a court-made rule under which substance must control over form when determining the tax consequences of a particular transaction.[3] To that end, a given result at the end of a straight path is not made a different result because it is reached by following a devious path.[4] Consequently, where a taxpayer has embarked on a series of transactions that are, in substance, a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction.[5]

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2 Code §2511(a)

3 *Gregory v. Helvering*, 293 U.S. 465 (1935). In the case, some of the assets of a corporation, which was owned wholly by the taxpayer, were transferred to a new corporation, which was owned wholly by the taxpayer and created solely for the purpose of receiving and transferring assets to the taxpayer as a liquidating dividend, and after the transfer, the new corporation was dissolved. The transfer was not a "reorganization" within statute, which provides an exemption from tax for gain arising out of a transfer of assets by one corporation to another corporation pursuant to a plan of reorganization. The Court found that the transfer was not made pursuant to a plan of reorganization. Rather, it was made pursuant to a plan having no relation to the business of either corporation.

4 *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

5 *Redwing Carriers, Inc. v. Tomlinson*, 399 F. 2d 652, 654 (5th Cir. 1968); *May Broadcasting Co. v. U.S.*, 200 F. 2d 852 (8th Cir. 1953); *Whitney Corporation v. Commr.*, 105 F. 2d 438 (8th Cir. 1939), affirming 38 B.T.A. 224 (1938); *Commr. v. Ashland Oil & R. Co.*, 99 F. 2d 588 (6th Cir. 1938), reversing *sub nom*. *Swiss Oil Corporation v. Commr.*, 32 B.T.A. 777 (1935), *certiorari* denied 306 U.S. 661

One case[6] illustrates how this rule applies when the income tax produces a lesser liability than the gift tax. An N.R.N.C. individual owned real property in Hawaii and wanted to transfer the property to a son. At the time, U.S. law allowed an N.R.N.C. individual to sell real property without incurring U.S. tax on the gain. However, gifts of U.S. real property by an N.R.N.C. individual were subject to U.S. gift tax. Clearly, a gift would produce suboptimal results. Consequently, a gift of funds was made by the N.R.N.C. individual to his son with the expectation that the funds would be used as a down payment to acquire the property in Hawaii. The gift of funds was not subject to U.S. gift tax – foreign currency was used and the transfer took place outside the U.S. A seller's mortgage note was taken back by the N.R.N.C. individual.

At a surface level, the property was transferred by sale and the gain was free of income tax. However, the I.R.S. asserted a deficiency in gift tax and the I.R.S. position was affirmed. The court found that the gift of funds was illusory, as it represented a circular flow of cash. On the other hand, even though payments of the note were forgiven periodically over time, the note was not illusory. The net effect was that the value of the property in excess of the face amount of the note was a gift of U.S. real property. It was subject to gift tax.

Question 5: If an N.R.N.C. individual makes a gift to a U.S. domestic trust by wiring funds to a U.S. bank account for the purpose of acquiring real property, is the wire subject to gift tax in the U.S.?

No, a gift effected by wire transfer to a bank account in the U.S. is a gift of I.P. and not subject to gift tax. Even if the funds in a bank account are viewed to be tangible property, which is at times stated in private letter rulings without support, the same result should apply provided the wire transfer originates from a bank located outside the U.S.

The term "I.P." is not specifically defined in the Code, but the regulations addressing the situs of property expressly define I.P. as including a debt obligation, such as a bank deposit.[7] In broad terms, property is categorized as I.P. when the value of the property is attributable to the property's intangible elements rather than to the property's tangible form.[8] A 1982 private letter ruling acknowledges that bank accounts are not tangible personal property.[9] In particular, the I.R.S. analyzed the gift tax provisions of U.S. law and stated:

> Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift. The gift tax applies, pursuant to section 2511 of the Code, to direct and indirect transfers.

(1939); *Kuper v. Commr.*, 61 T.C. 624 (1974); *Kimbell-Diamond Milling Co. v. Commr.*, 14 T.C. 74 (1950), affirmed *per curiam* 187 F. 2d 718 (5th Cir. 1951), *certiorari* denied 342 U.S. 827 (1951).

6 *Davies v. Commr.*, 40 T.C. 525 (1963).

7 Treas. Reg. §25.2511-3(b)(4).

8 In general, see *Curry v. McCanless*, 307 U.S. 357 (1939). See also I.R.S., *Publication 544 Sales and Other Dispositions of Assets*, (2016) p. 25.

9 P.L.R. 8210055. Note that a private letter ruling may be cited as authority only by the taxpayer to whom it is issued. Nonetheless, it demonstrates the thinking of the national office of the I.R.S. at the time of issue and may be relied on to eliminate penalties.

> In general, section 2501 does not tax the transfer of intangible property by a person who is neither a citizen nor a resident of the United States unless such person is an expatriate who lost his or her citizenship within 10 years of the date of the transfer.
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> Section 25.2511-3(b) of the Gift Tax Regulations defines the term 'intangible property' as 'a property right issued by or enforceable against a resident of the United States or a domestic corporation (public or private), irrespective of where the written evidence of the property is physically located at the time of the transfer.'
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> Debt obligations such as bank deposits or obligations of which the United States is the primary obligor are considered to be intangible property. See section 25.2511-3(b)(4) of the regulations.

This private letter ruling revisited a position in an earlier ruling,[10] expressly finding that the earlier ruling was incorrect. The prior ruling held that Treasury bills are tangible personal property and subject to gift tax if held in the U.S. at the time of the gift. Both rulings held that a gift made by check drawn on a foreign bank is a gift of non-U.S. property, even if it is payable by a U.S. bank.

"The I.R.S. views cash as tangible property. . . . It has expressed a view that bank account balances funded by cash are tangible property, notwithstanding the plain meaning of the regulations."

The I.R.S. views cash as tangible property. As previously mentioned, it has expressed a view that bank account balances funded by cash are tangible property, notwithstanding the plain meaning of the regulations. However, there should be no gift tax, even if the I.R.S. were to assert that view, when the bank account of the N.R.N.C. individual is maintained with a bank located outside the U.S. In a 2003 private letter ruling[11] involving generation skipping tax ("G.S.T."),[12] the issue involved, *inter alia*, a division of rights in the trust and whether the division was subject to G.S.T. The conclusion was dependent on whether the original funding of the trust was subject to gift tax. In concluding that the original funding was not subject to gift tax, the private letter ruling applied the following rationale for concluding that G.S.T. was not due under the circumstances:

> When Trust was established on D1, and when A initially funded Trust, A was a citizen of Country 1 and a permanent resident of Country 2. Consequently, for purposes of the GST tax, A was a nonresident alien, not a citizen of the United States. Trust was funded with cash transferred directly from A's accounts in Country 2 to Trust. Thus, although A, a nonresident alien, transferred cash, which is tangible personal property for purposes of §2501(a)(2), the funds were not physically situated within the United States prior to the transfer. Therefore, pursuant to §25.2511-3(b)(1), the transfer of cash was not a transfer that was subject to the gift tax under §2501(a). Consequently, generation-skipping transfers from Trust, to the extent attributable to A's transfer of cash to Trust, will not be subject to the GST tax.

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[10] P.L.R. 8138103.

[11] P.L.R. 200340015.

[12] Under Code §2601, G.S.T. applies when a transfer from one generation (*e.g.*, parent) skips the next generation (*e.g.*, child) and is received by a lower generation (*e.g.*, grandchild).

While treating a transfer from a bank balance as tangible property appears to be inconsistent with the status of the account balance as I.P. and is inconsistent with an earlier private letter ruling treating cash as I.P.,[13] the wire transfer is not subject to gift tax if the transferor's account is maintained with a bank located outside the U.S.

Whichever approach is taken, a wire transfer of funds maintained in a foreign bank is not subject to tax under Code §2501, under the circumstances presented.

Question 6: If an N.R.N.C. individual makes a gift to a U.S. domestic trust, must the gift be reported to the I.R.S.?

Subject to two exceptions, a gift by an N.R.N.C. individual to a U.S. domestic trust must be reported to the I.R.S. Reporting is made on Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*. Failure to report the gift exposes the trust to a penalty equal to 5% of the amount of such foreign gift(s) for each month for which the failure to report continues (not exceeding a total of 25%).[14] However, no penalty is imposed if the trust can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

The reporting obligation is subject to two exceptions:

- The first applies to a gift from an N.R.N.C. individual to a trust, where the N.R.N.C. individual is treated as the owner of the trust under the U.S. grantor trust rules discussed below. In this set of circumstances, no transfer is deemed to have occurred for income tax purposes and the N.R.N.C. individual is treated as the owner of the property legally transferred to the grantor trust.
- The second applies to all gifts received from an N.R.N.C. individual during the year, where the total amount does not exceed $100,000 during that period. For this purpose, an aggregation rule applies so that gifts from the N.R.N.C. individual include gifts from other foreign persons that are related to the N.R.N.C. individual. The penalty applies if the trustee knows (or has reason to know) that the other persons are related to each other. For this purpose, related persons include family members such as brothers and sisters, half-brothers and half-sisters, spouses, parents, grandparents, great grandparents, children, grandchildren, and spouses of any of the persons mentioned above. It may also include a corporation in which the N.R.N.C. owns, directly or indirectly, more than 50%, in value, of the outstanding stock.

Question 7: If an N.R.N.C. individual arranges for a foreign corporation or a partnership to make a gift to a U.S. domestic trust acting on his or her instruction, is the transfer subject to gift tax under the same rules applicable to the N.R.N.C. individual?

No, if a U.S. person receives, directly or indirectly, a purported gift from a foreign corporation, the purported gift or bequest must be included in income as if it were a distribution from the foreign corporation.[15] If the foreign corporation is a passive

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[13] P.L.R. 8120030.

[14] Code §6049F.

[15] Code §672(f).

foreign investment company ("P.F.I.C."), the P.F.I.C. rules of Code §1291 apply.[16] If the purported gift is made by a foreign partnership, the gift is treated as ordinary income.[17] No P.F.I.C. treatment applies when the purported gift comes from a partnership.

Under an exception in the income tax regulations, the recharacterization provisions do not apply to gratuitous transfers by foreign corporations or partnerships if the N.R.N.C. individual who beneficially owns the corporation or partnership reported the purported gift as a dividend and as a gift to the trust for purposes of the tax laws of the N.R.N.C. individual's country of residence. This suggests that better tax treatment may exist in the U.S. if the N.R.N.C. individual who owns the foreign corporation, or partnership, is resident in a jurisdiction that does not impose tax on unremitted income.

INCOME TAX EXPOSURE ON INCOME AND GAINS DERIVED BY A TRUST

Question 8: Are all trusts categorized in a similar way under U.S. tax law for the purpose of computing the tax of the trust, the grantor, and the beneficiaries?

No. The U.S. tax treatment applicable to trusts, their grantors, and their beneficiaries is dependent on the characterization of the trust as either a grantor trust or a nongrantor trust.

Question 9: How is a grantor trust taxed under U.S. tax law?

In general, if a trust is a grantor trust, neither the trust nor the U.S. beneficiaries are subject to tax on either (i) the realization of the income by the trust or (ii) the distribution of income to the beneficiaries. Instead, the income of the trust is considered to be the income of the person who settled the trust (other than a nominee grantor) and who made a gratuitous transfer of assets to the trust. For U.S. tax purposes, that person is referred to as the "grantor" of the trust, and the grantor is the taxpayer with regard to the income of the grantor trust, whether or not that income is taxed. If a distribution is made by a grantor trust to a U.S. beneficiary other than the grantor, the trust distribution is treated, in general, as a gift from the grantor to the beneficiary. Such gifts are not considered to be taxable income of the beneficiary, although reporting obligations exist for the beneficiary.

Question 10: What circumstances will cause a trust to be a grantor trust for U.S. income tax purposes?

In general, a trust is treated as a grantor trust when the person who funds the trust (*i.e.*, the grantor) retains one or more of the following interests in the trust:

- The grantor has a reversionary interest in either the corpus or the income therefrom and, as of the inception of that portion of the trust, the value of the interest exceeds 5% of the value thereof.[18]

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16 Treas. Reg. §1.672(f)-4(a)(2).

17 Treas. Reg. §1.672(f)-4(a)(1).

18 Code §673.

- The grantor has the power to control beneficial enjoyment of the income or corpus.[19]
- The grantor retains certain administrative powers, including the right to substitute property in the trust and the right to borrow from the trust on an interest-free basis.[20]
- The grantor has a power to revoke the trust so that all property reverts to the grantor.[21]
- The income of the trust is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the life of the grantor, or the grantor's spouse.[22]

Question 11: Are the circumstances the same for a trust being treated as a grantor trust, when the person funding the trust is an N.R.N.C. individual?

No, the circumstances for a trust to be treated as a grantor trust are not the same when the person funding the trust is an N.R.N.C. individual. A trust will be viewed to be a grantor trust with an N.R.N.C. individual as grantor only in two circumstances:

- The foreign settlor, alone or without the approval of any person having an adverse interest, has the power to revoke the trust and be revested absolutely in the trust assets.[23] This power must exist for a total of 183 days or more during the trust's taxable year.[24]
- During the settlor's lifetime, the trust can make distributions to the settlor or the settlor's spouse, only.[25]

The higher threshold in the context of a foreign settlor is designed to prevent a double non-taxation scenario, where the assets of an irrevocable trust produce foreign income that is neither taxed in the U.S. nor in the country of residence of the settlor. This could exist if grantor trust status flowed from the retention of a minor administrative power, such as (i) the right to substitute assets of equal value or to control investment policy over the trust assets or (ii) the power to appoint additional beneficiaries or to remove beneficiaries.[26]

Question 12: How are a nongrantor U.S. domestic trust and its beneficiaries taxed?

A nongrantor trust is generally taxed like an individual. Taxable income is computed much the same way as for an individual, but with certain modifications.[27] One

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19 Code §674

20 Code §675.

21 Code §676.

22 Code §677.

23 Code §672(f)(2)(A)(i); Treas. Reg. §1.671(f)-3(a)(1).

24 Treas. Reg. §1.671(f)-3(a)(2).

25 Code §672(f)(2)(A)(ii); Treas. Reg. §1.671(f)-3(b).

26 An example appears in Rev. Rul. 69-70.

27 Code §641(b).

significant modification is that a nongrantor trust is entitled to deduct distributions paid from current year's income or required to be paid from such income to a beneficiary.[28] Distributions that are deductible for the trust generally are includible in the gross income of the beneficiaries.[29] The current year's income that is includible in the income of a beneficiary has the same character for the beneficiary as it had in the hands of the trust.[30] Thus, if the item is considered to be foreign-source income for the trust, it is foreign-source income for the beneficiary; if it is characterized as long term capital gain for the trust, it is similarly characterized for the beneficiary. In this manner, nongrantor trusts that distribute income on a current basis are treated as conduits between the trust and the beneficiary.

"When a nongrantor trust provides that the trustee may distribute income or capital, the trust is entitled to a deduction for the amount distributed, even if the distribution is allocable to capital for trust law purposes."

For U.S. income tax purposes, the amount that is deductible for the nongrantor trust and includible in the income of the beneficiaries generally is limited by the distributable net income ("D.N.I.") of the trust for the taxable year. D.N.I. generally means the taxable income of the trust, computed with adjustments.

Question 13: If a trustee designates a distribution as being made from capital, will that designation be respected for U.S. income tax purposes when the recipient is a U.S. resident or citizen?

No. The designation by the trustee is generally not given effect for income tax purposes. No matter how it is identified by the trustee, for U.S. income tax purposes, all distributions made to all beneficiaries are deemed to consist on a *pro rata* basis of all income and gains of the trust.

When a nongrantor trust provides that the trustee may distribute income or capital, the trust is entitled to a deduction for the amount distributed, even if the distribution is allocable to capital for trust law purposes. The deduction is limited to the trust's D.N.I. for the year. The recipient includes the amount received in income. As mentioned above, this amount has the same character as at the level of the trust. All distributions are deemed to come on a *pro rata* basis from all D.N.I. Thus, if the amount of the distribution exceeds D.N.I., the amount of the distribution included in income by the beneficiary is determined on a *pro rata* basis computed with reference to all amounts distributed during the year.[31]

To illustrate, assume a trust has D.N.I. of $100. It distributes $100 of income to certain beneficiaries and $300 of capital to other beneficiaries pursuant to the exercise of a discretionary grant to the trustee. If, pursuant to the exercise of the trustee's discretion, a U.S. beneficiary receives a $100 capital distribution, and foreign beneficiaries receive $100 of income distributions and $200 of capital distributions, the U.S. beneficiary is considered to have received $25 of income and $75 of capital for income tax purposes. That is because the $400 of capital and income is considered to be distributed *pro rata* to the recipients of all distributions during the year. The distribution to the U.S. beneficiary represents 25% of all amounts of income and capital distributed by the trust during the year. Consequently, 25% of the "capital distribution" is taxable for the U.S. recipient as income.

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28 See Code §651(a) for current inclusion trusts; and Code §661(a) for other trusts.

29 See Code §652(a) for current inclusion trusts; and Code §662(a) for other trusts

30 Code §§652(b) and 662(b).

31 Code §662(a)(2).

Question 14: If a U.S. domestic trust accumulates income that is distributed in subsequent years, will beneficiaries be subject to U.S. income tax when the accumulated income is distributed in a later year?

No. As a general rule, when a U.S. domestic trust accumulates income that is ultimately distributed in a later year, the beneficiaries will not be subject to U.S. income tax when the accumulated income is distributed.[32]

Question 15: If a non-grantor trust, other than a U.S. domestic trust, accumulates income that is distributed in subsequent years, will U.S. beneficiaries be subject to U.S. income tax when the accumulated income is distributed in a later year?

Yes. For U.S. beneficiaries receiving an accumulation distribution from a foreign trust, the tax rules are significantly more complex. U.S. tax law considers the beneficiaries to have "deferred" income in a foreign trust because income is earned in one year at the level of the trust, but the U.S. beneficiaries do not receive that income until it is distributed in a later year. This time gap is often referred to as a "deferral period." U.S. tax law provides that the beneficiaries must re-compute their tax for each of the years in the deferral period,[33] and the re-computation generally results in additional tax in each intervening year. That additional tax is deemed to be paid late, and it is subject to an interest charge payable to the Federal government.[34] The actual computation is significantly more complex than the foregoing description and a full description is beyond the scope of this article.

Question 16: What tests are applied for a non-grantor trust to be considered a U.S. domestic trust?

Generally, a trust is considered a U.S. domestic trust if it is subject to primary supervision by a U.S. court and all substantial decisions are made by U.S. persons.[35] Neither the residence of the trustee nor the law under which the trust is formed, by itself, controls the status of a trust as a domestic trust or a foreign trust. Consequently, a trust formed in New York can be viewed to be a foreign trust if either the court test or the control test is not met.

A trust meets the court test if a court within the U.S. is able to exercise primary supervision over its administration. Treasury regulations contain a safe harbor.[36] A trust is a domestic trust if it meets the following criteria:

- The trust instrument does not direct that the trust be administered outside the U.S.
- The trust in fact is administered exclusively in the U.S.
- The trust is not subject to an automatic migration provision, *i.e.*, a provision that provides that a U.S. court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the

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32 Code §665(c).

33 Code §666.

34 Code §668.

35 Treas. Reg. §301.7701-7(a).

36 Treas. Reg. §301.7701-7(c)(1).

trust to migrate from the U.S. (but not if it applies only in the case of foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S.).[37]

The control test requires that one or more U.S. persons (*e.g.*, a U.S. citizen, U.S. resident, or U.S. corporation)[38] have authority to control all substantial decisions of the trust.[39] The term "substantial decisions" means all decisions other than ministerial decisions (*e.g.*, bookkeeping, collection of rents, and the execution of investment decisions made by others[40]) that any person, whether acting in a fiduciary capacity or not, is authorized or required to make under the terms of the trust instrument or applicable law. These include decisions regarding

- whether and when to distribute income or principal;
- the amount of any distributions;
- the selection of a beneficiary;
- the power to make investment decisions;
- whether a receipt is allocable to income or principal;
- whether to terminate the trust;
- whether to compromise, arbitrate, or abandon claims of the trust;
- whether to sue on behalf of the trust or to defend suits against the trust;
- whether to remove, add, or replace a trustee; and
- whether to appoint a successor trustee or trustees.[41]

If either the court test or the control test is not met, a trust is considered a foreign trust.[42] The application of both tests depends on the terms of the trust instrument and applicable law.[43] The tests are applied daily, and a trust is a U.S. domestic trust on each day that it meets both tests.

Question 17: For U.S. income tax purposes, must a U.S. domestic nongrantor trust charge rent to a beneficiary in connection with the occupancy of aa residence in the U.S.?

No. A beneficiary that is allowed to reside in a residence owned by a U.S. domestic nongrantor trust on a rent-free basis does not have imputed income.[44] One U.S.

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37 Treas. Reg. §301.7701-7(c)(4).

38 Code §7701(a)(30).

39 Treas. Reg. §301.7701-7(d)(1)(ii).

40 *Id.*

41 Treas. Reg. §301.7701-7(d)(1)(ii).

42 Code §§7701(a)(30)(E) and 7701(a)(31)(B).

43 Treas. Reg. §301.7701-7(b).

44 *H.B. Plant v. Commr.*, 30 B.T.A.133 (1934), affd. 76 F.2d 8 (2d Cir. 1935), and *Alfred I. duPont Testamentary Trust v. Commr.*, 66 T.C. 1976, affd. 574 F.2d 1332 (5th Cir. 1978).

Supreme Court case[45] characterized this as an issue not to be pursued by the I.R.S.:

> It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters.

Question 18: Would the answer differ if a nongrantor trust other than a U.S. domestic trust were to own the residence?

If the nongrantor trust is not a U.S. domestic trust (a "foreign trust"), the answer could be different. Code §643(i) provides, in pertinent part, that if a foreign trust directly or indirectly permits any U.S. person who is a beneficiary (or a person related to a beneficiary) to use the property without paying fair market compensation, the fair market value of the use of such property is to be treated as a distribution by the trust to the beneficiary. Under this rule, rent-free use of a residence (or below-market rent charged for the residence) could be treated as taxable income if and to the extent the foreign trust has D.N.I. In the context of this discussion, D.N.I. would likely arise from net income and gains from investments. It follows that if the foreign trust has neither D.N.I. for the current year nor undistributed net income ("U.N.I.") for past years, no tax can be imposed in connection with the deemed distribution. There is, however, a distribution from a foreign trust. That distribution must be reported by the U.S. beneficiary on Form 3520 with sufficient back-up information to demonstrate the absence of D.N.I. and U.N.I.

ESTATE TAX CONSEQUENCES FOR A FOREIGN SETTLOR

Question 19: If a U.S. domestic nongrantor trust were to hold the U.S. residence at the conclusion of the settlor's lifetime, will U.S. estate tax be due on the value of the property at that time?

Subject to certain exceptions discussed below, estate tax should not be due because the settlor will not own the property at the time of death. The estate of an individual decedent who is neither a citizen nor a resident of the U.S. is computed generally by taking into account only items connected with the U.S. that are owned at the time of death.[46] U.S. estate tax is generally imposed only with regard to items of U.S. situs property. As discussed above, in connection with gift tax in the context of an N.R.N.C. individual, examples of U.S. situs property include real estate located in the U.S., debt instruments and shares of stock issued by U.S. companies, and personal property located in the U.S. at the time of the decedent's death. The exception for I.P. under the gift tax regime generally does not apply to estate tax.

Question 20: In what circumstances can property, not actually owned by an N.R.N.C. individual, be included in his or her taxable estate in the U.S.?

There are several circumstances in which U.S. situs property may be included in the gross estate of an N.R.N.C. individual even though the property is owned by another.

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45 *Dickman v. Commr.*, 465 U.S. 330 (1984).

46 Code §2103.

Lifetime Transfers Subject to Retained Right to Enjoy the Income or Appoint Persons Who Will Enjoy the Income

U.S. situs property may be included in a U.S. taxable estate of an N.R.N.C. individual where the individual gave away property during lifetime but (i) continued to have a right to the income from the property or (ii) retained the right, either alone or in conjunction with any person, to designate the persons who can possess or enjoy the property or the income. Code §2036(b) causes shares of stock to be included in a taxable estate if the decedent transfers the stock but retains control over how the shares are voted. It does so by deeming such retention of the voting rights a retention of the enjoyment of the transferred property.

"A right to income generally would not exist if the trust agreement provides for a true exercise of discretion by an independent trustee."

Where either right exists, property transferred during life will be included in the decedent's estate unless the property was disposed of in return for adequate consideration in money or money's worth. A transfer by gift is not considered to be a transfer in return for adequate consideration in money or money's worth.

It is important to note that having a right to income is different from receiving income as a result of the exercise of discretion by an independent party. A right to income generally would not exist if the trust agreement provides for a true exercise of discretion by an independent trustee.[47] Consequently, if a trust is established for the benefit of all the family members of the settlor, including the settlor, it will not cause the trust assets to be included in the settlor's estate, so long as the trustee is independent and has the authority to determine who among the beneficiaries will benefit from the trust's income and gains.

While the foregoing rule is favorable, cases in the U.S. provide a clear warning that abuses will not be tolerated. A decedent will be viewed to have retained the right over income even though the trust agreement provides for the appearance of discretion in the trustee. U.S. courts have concluded that the presence of certain arrangements will cause the settlor to have the right to income or the power over income in the following circumstances:

- *Hidden Retention*: Where there is an agreement or understanding that the transferor would receive the income, the property will be included in the settlor's estate.[48] Even though the instrument of transfer might not give the transferor an interest, right, or power, a retention of that type of interest, right, or power may still be held to exist under a methodology that looks beyond the terms of the trust to extrinsic facts, such as the transferor's domination of the trustee or a "side agreement" with the trustee. Such an agreement may sometimes be inferred from the fact that the transferor actually received all or most of the income.

- *Creditor Invasion*: Where, under the law of creditors' rights, the settlor's creditors can reach the trust income to pay the settlor's debts, the settlor has been deemed to have the right over the income.[49] The settlor may spend borrowed money and refuse to make payments to creditors. If the creditors

47 *Commr. v. Irving Trust Co.*, 147 F.2d 946 (2d Cir. 1945); *Sherman v. Commr.*, 9 T.C. 594 (1947).

48 Treas. Reg. §20.2036-1(a)(1)(ii).

49 See in general, Rev. Rul. 77-378, 1977-2 C.B. 348.

can look to the trust for payment, the settlor is viewed to have an interest over the income of the trust.

- *Settlor as Trustee*: Where the settlor is the trustee of the discretionary trust, the settlor has retained sufficient power over the income to cause the property to be included in his or her estate.[50] A settlor of a trust has reserved a power in him- or herself, if the trust instrument confers that power on the trustee and also designates the settlor as trustee. Retention also exists in a case where the settlor names another as trustee, if the settlor has the power to remove the trustee from office and name him- or herself as successor trustee.

- *Discretion Limited by Enforceable Standard*: Where the trustee's discretion is limited by a standard that can be enforced by the settlor-beneficiary, the settlor is considered to have retained rights over the income. He can go to court to force the trustee to exercise discretion in favor of the settlor.[51]

Revocable Trusts and Trusts Over Which the Decedent Controls Enjoyment by Others

The taxable estate of an individual will include any interest in property transferred during life if enjoyment of the interest is subject, at the date of death, to change through the decedent's exercise of a power to alter, amend, revoke, or terminate.[52] At its simplest and most straightforward form, one example is a revocable trust whose assets may revert to the grantor by written notification to the trustee.

However, this provision also reaches non-beneficial powers. These include powers that affect the beneficiaries of a trust even if the power cannot be exercised in the donor's favor. Examples include a power to change the proportionate interests of a trust's remainder beneficiaries, the power to remove beneficiaries, and the power to add beneficiaries. These powers could subject an N.R.N.C. individual's U.S. situs property to estate tax, even if the settlor must act in conjunction with another person. Of course, if these powers are held solely by persons other than the decedent, property owned by a U.S. domestic nongrantor trust will not be subject to U.S. estate tax.

Question 21: If the U.S. domestic trust is a U.S. grantor trust for income tax purposes, will an N.R.N.C. grantor be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime?

Yes. If the U.S. domestic trust is a U.S. grantor trust for income tax purposes, an N.R.N.C. grantor will be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime. As mentioned previously, for the U.S. domestic trust to be a grantor trust for income tax purposes, the trust must be either revocable so that the property reverts to the settlor at the discretion of the settlor during the settlor's lifetime or the settlor and spouse are the only persons entitled to distributions during the settlor's lifetime. Each of these powers will cause the settlor to be subject to U.S. estate tax.

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50 *U.S. v. O'Malley*, 383 U.S. 627 (1966).

51 *Boardman Est. v. Commr.*, 20 T.C. 871 (1953).

52 Code §2038(a)(1).

Question 22: If the U.S. domestic trust is not a U.S. grantor trust for income tax purposes, could an N.R.N.C. settlor be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime?

Yes. Even if the U.S. domestic trust is not a U.S. grantor trust for income tax purposes, an N.R.N.C. settlor could be subject to U.S. estate tax with regard to the real property owned by the trust at the conclusion of the grantor's lifetime. If the N.R.N.C. individual retains rights identified in either Code §§2036 or 2038, estate tax exposure can exist if the settlor retains powers over the enjoyment of the U.S. real property. To illustrate, a U.S. domestic trust may not be revocable and may provide that distributions can be made to persons other than the settlor and spouse during the settlor's lifetime. A U.S. domestic trust with those provisions is not a grantor trust. Nonetheless, the settlor might demand the retention of a power to appoint or remove beneficiaries or to defer the time when a beneficiary may become entitled to a share. Other settlors may wish to retain the right to receive the capital transferred to the trust, leaving the appreciation to the beneficiaries. To achieve the goal without clearly running afoul of Code §2038, the settlor lends to the trust on noncommercial terms. If the debt is not true debt, the settlor is not a lender. If not a lender, the settlor's relationship with the trust is unclear, at best.

CONCLUSION

An N.R.N.C. grantor of a U.S. domestic trust formed and funded to acquire assets held for the benefit of an adult child must carefully consider how income, gift, and estate taxes may be imposed at various times during the life of a trust. This includes the formation of the trust, the generation of income within the trust, and the demise of the settlor. Depending on the terms of the trust and the assets owned by the settlor and transferred to the trust, income tax, gift tax, and estate tax consequences must be considered, and the conclusions regarding income tax may not be consistent with the conclusions regarding gift and estate taxes. Merely because the settlor is not subject to gift tax on the formation of the trust or income tax during the lifetime of the trust, does not mean that estate tax will not be imposed at the conclusion of the settlor's life.