CROSS-BORDER COMPLEXITIES: WHAT YOU NEED TO KNOW BEFORE YOUR NON-U.S. CLIENT INVESTS IN THE U.S.

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INTRODUCTION

Tax planners outside the U.S. are often asked to develop plans for clients moving to or investing in the U.S. While these plans are effective in the client's country of residence, adverse U.S. tax consequences may arise in ways that are not anticipated.

These problematic situations may include (i) the purchase of U.S. real property using a trust that is tax efficient in the home country but produces suboptimal results from a U.S. tax perspective or (ii) the sudden appearance of a U.S. resident within the family of the foreign client, among other complications. These situations sometimes result in substantial penalties for the client or the family member that is a U.S. tax resident.

The following questions and answers address fact patterns that are commonly are encountered. Some involve use of a trust and others involve gift and estate tax exposures that may be unexpected.

CREATING A TRUST

Question 1: My client and his family are moving from Country A to the U.S. I arranged the formation of a trust to hold certain assets. Will the income within the trust affect the U.S. tax liability of the client or family members?

Yes. The client may face U.S. income tax, estate tax, and gift tax issues in connection with the trust previously formed.

The answer will depend on (i) whether the trust is foreign or domestic for U.S. income tax purposes, (ii) whether the trust is a grantor or nongrantor trust, (iii) whether the trust is revocable or irrevocable, (iv) the tax residence or citizenship of the beneficiaries, (v) the investments held in trust, and (vi) the pattern of trust distributions among beneficiaries in earlier years.

Foreign v. Domestic Trusts

Question 2: The sole trustee of the trust is a Country A national and the trust contains no provision for a protector. All the assets will be in the U.S. Will the trust be considered to be a foreign trust for U.S. income tax purposes?

Yes. Under U.S. tax law, a foreign trust is defined to be any trust that is not a "domestic trust."[1]

For a trust to be a domestic trust, two tests must be met. First, a U.S. court must

[1] Code §7701(a)(31)(B).

exercise primary supervision over the trust's administration (the "court test"). Second, one or more U.S. persons must have the authority to control all substantial decisions affecting the trust (the "control test").[2]

To satisfy the court test, three conditions must be met. First, the trust instrument must not direct that the trust be administered outside the U.S. Second, the trust must actually be administered exclusively in the U.S. Third, the trust indenture cannot contain an automatic migration provision whereby the trust could migrate from the U.S. if a U.S. court attempts to assert jurisdiction over the trust.[3] Interestingly, the third condition is not violated by a provision calling for automatic migration of the trust from the U.S. in the case of foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S.

Regarding the control test, two terms must be defined: "control" and "substantial decisions." Control means having the power, by vote or otherwise, to make a decision regarding the trust, with no other person having the power to veto that decision.[4] To determine whether U.S. persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

If the sole trustee is a Country A national, your client's trust likely does not satisfy the control test.

Question 3: I altered the trust for my Country A clients. Now, a U.S. court has primary supervision over the trust and there are two trustees who must act in unanimity: one is a Country A citizen and resident, and one is an American citizen. Is the trust a U.S. trust?

No. The control test is met only if one or more U.S. persons have the authority to control all substantial decisions.

As previously mentioned, control means having the power, by vote or otherwise, to make a decision regarding the trust, with no other person having the power to veto that decision.[5] If more than one trustee exists and the trustees must act by unanimity, the presence of a non-U.S. person as one trustee will prevent the trust from meeting the control test.[6]

Question 4: What decisions are considered to be substantial decisions for purposes of determining the status of the trust for U.S. tax purposes?

The regulations provide examples of decisions that are considered substantial for purposes of the control test. These include, but are not limited to, the following:

- Whether and when to distribute income or corpus
- The amount of any distributions
- The selection of a beneficiary

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[2] Code §7701(a)(30)(E).

[3] Treas. Reg. §301.7701-7(c)(4)(ii).

[4] Treas. Reg. §301.7701-7(d)(1)(iii).

[5] Treas. Reg. §301.7701-7(d)(1)(iii).

[6] Treas. Reg. §301.7701-7(d)(1)(v), ex. 1.

"A grantor trust generally will be disregarded for U.S. income tax purposes and the grantor will be considered the owner of the trust assets and of the trust income."

- 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
- Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from non-U.S. to domestic or vice versa
- Investment decisions

Note that if a U.S. person under Code §7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by a U.S. person if the U.S. person can terminate the investment advisor's power to make investment decisions at will.[7]

Question 5: What decisions are not substantial decisions?

The regulations provide that the following decisions are ministerial and not substantial:

- Bookkeeping
- Collection of rents
- Execution of investment decisions[8]

Grantor v. Nongrantor Trusts

Question 6: My Country A client settled a trust under New York State law. I understand that U.S. tax law provides one type of treatment for trusts referred to as "grantor trusts" and a different type of treatment for trusts referred to as "non-grantor trusts." What is the difference?

A nongrantor trust is treated as the taxpayer and, as such, is taxable on trust income. In comparison, a grantor trust generally will be disregarded for U.S. income tax purposes and the grantor will be considered the owner of the trust assets and of the trust income.

In the case of a nongrantor trust, the trust is taxed on the trust's income but is allowed a deduction for all amounts that are actually distributed during the year and certain amounts that are distributed within the first 65 days of the following taxable year, provided that an election is timely made on the tax return of the trust.[9]

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7 Treas. Reg. §301.7701-7(d)(1)(ii).

8 *Id.*

9 Code §663(b); Treas. Reg. §1.663(b)-2(a).

The includible amount (and the deduction) are limited by distributable net income ("D.N.I.").[10] The beneficiary will include the distribution in his taxable income and the distributed income will have the same character in the hands of the beneficiary as it had in the hands of the trust.[11]

In the case of a grantor trust, the "grantor" (*i.e.*, the person who gratuitously transferred the assets to the trust) is considered the taxpayer.[12] As a result, distributions from a grantor trust are generally treated as gifts from the grantor for substantive income tax purposes. Nonetheless, if the grantor trust is a foreign trust, the beneficiary reports the distribution as a distribution solely for information reporting purposes.[13]

Question 7: I've recommended a tax plan where my Country A client will be transferring assets into a trust. His children and a charity will be the beneficiaries. The trust is irrevocable. Is the trust a grantor trust or a nongrantor trust?

In your client's case, the trust is a nongrantor trust.

For U.S. tax purposes, a trust that has a non-U.S. person as grantor can qualify as a grantor trust in two situations.[14] In the first situation, a non-U.S. person makes a gratuitous transfer of assets to the trust but retains the right to revoke the trust and to be revested absolutely in the title to the property.[15] The right of revocation must be exercisable at his or her sole discretion and without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor. The non-U.S. person must be able to exercise this power on at least 183 days during the taxable year.[16] In the second situation, a non-U.S. person makes a gratuitous transfer of assets to the trust and the only amounts distributable from the trust during the life of the grantor are to the grantor or the grantor's spouse.[17]

Neither exception applies here. The trust is irrevocable and the beneficiaries include persons other than the grantor or the grantor's spouse.

Question 8: I've drafted a trust for my client that is grantor trust from a U.S. tax perspective. My client is the grantor of the trust and is a citizen and resident of Country A. The trust is revocable by my client without the approval or consent of any other person. The trust has now made a distribution to a U.S. beneficiary. Must any information be reported to the I.R.S.?

Yes. The distribution should be reported by the U.S. beneficiary on Part III of Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of*

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[10] Code §661.

[11] Code §§652 or 662.

[12] Code §671. A trust can be a grantor trust for some its income and assets and a foreign nongrantor trust for other assets and income.

[13] 2016 Instructions for Form 3520, p. 13.

[14] Code §672(f).

[15] Code §672(f)(2)(A)(i).

[16] Treas. Reg. §1.672(f)-3(a)(2).

[17] Code §672(f)(2)(A)(ii).

Certain Foreign Gifts.[18] In addition, a Foreign Nongrantor Trust Beneficiary Statement should be provided to the U.S. beneficiary. In this case, a Foreign Grantor Trust Beneficiary Statement appears to be inappropriate because there is no U.S. person that transferred assets to the trust.

The Foreign Nongrantor Trust Beneficiary Statement must include the following items:

- An explanation of the appropriate U.S. tax treatment of the distribution or sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of the distribution for U.S. tax purposes
- A statement identifying whether any grantor of the trust is a partnership or a foreign corporation
- A statement that the trust will permit either the I.R.S. or the U.S. beneficiary to inspect and copy the trust's permanent books of account, records, and other documents necessary to establish the appropriate treatment of any distribution for U.S. tax purposes
- The first and last day of the tax year of the foreign trust
- A description of property (including cash) distributed to the U.S. beneficiary during the tax year, and the fair market value of the property distributed
- A statement as to whether the foreign trust has appointed a U.S. agent and the name, address, and taxpayer identification number of any such agent

"Once the D.N.I. and U.N.I. is fully distributed, the balance of a distribution may be treated as tax-free capital."

Question 9: My client is a Country A national and has a trust for the benefit of his spouse and children. The trust owns several apartment buildings in Country B that generate rental income. The rents have been retained in the trust. One of my client's children moved to the U.S. several years ago and is now in the process of becoming a U.S. citizen. Can this result in adverse U.S. tax consequences?

Yes. The problem that will adversely affect the U.S. beneficiary relates to the accumulation of income within the trust and its potential distribution at a future point.

If a non-U.S. trust generates and accumulates its D.N.I., the retained D.N.I. is converted into undistributed net income ("U.N.I."). Should the trust ever make a distribution that exceeds D.N.I. for that year, the excess amount will be treated as a distribution made from U.N.I. Distributions from U.N.I. are taxed under a "throwback rule" that allocates the distributed U.N.I. to prior years under a formula.[19] An average increase in taxes allocated to the years covered by the throwback computation and interest charges from deemed late payments of U.S. tax for those years is imposed. In addition, all capital gain items that have not been distributed on a current basis lose their character as capital gains and do not benefit from favorable tax rates for long-term capital gains and qualified dividends. In addition to income tax, net investment income tax of 3.8% may be imposed.

Note that the tax cannot be eliminated by having the trustee treat the distribution as

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[18] See p. 10 of the Instructions for Form 3520 for tax year 2016.

[19] See Code §§665-668.

a capital distribution. All distributions are deemed to consist of (i) income and gains and (ii) D.N.I. and U.N.I. of the trust on a *pro rata* basis.[20] Once the D.N.I. and U.N.I. is fully distributed, the balance of a distribution may be treated as tax-free capital.

U.S. ESTATE & GIFT TAX

Question 10: My Country A client has executed a will, and his estate will be left to his son who is a U.S. person. All property owned by my Country A client is located in Country A. Will the U.S. son be subject to inheritance tax on his receipt of the bequest?

No. The estate tax in the U.S. is imposed on the estate of the decedent. The taxable 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. This limitation in scope affects both assets included in the gross estates and liabilities and costs that reduce the estate. First, U.S. estate tax is generally imposed only with regard to items of U.S.-situs property.[21] Examples of such property include real estate located in the U.S., debt instruments (other than debt having the character of portfolio debt) 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.[22]

As a general rule, indirect ownership of U.S.-situs assets is not sufficient to expose the estate of a nondomiciled, non-citizen individual to U.S. estate tax. Thus, no tax is imposed when a foreign individual owns shares of stock of a foreign corporation that, in turn, owns U.S.-situs property such as shares of stock in a U.S. corporation.

Second, the amount of funeral expenses, administration expenses, claims against the estate, and unpaid mortgages that may be applied to reduce the gross estate in the U.S. is limited to a percentage, which is based on the portion of the worldwide estate that is located in the U.S.[23] A true and accurate accounting must be made in the U.S. estate tax return of the worldwide assets of the decedent. If not made, no portion of the expenses, losses, indebtedness, and taxes may reduce the gross estate.[24]

Here, your client owns property only in Country A. Should the estate be comprised of such property exclusively, the U.S. son will not be subject to U.S. estate tax or income tax upon the receipt.[25] However, the U.S. son is obligated to report the inheritance to the I.R.S. as a form of anti-money laundering compliance. The report is made on Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*. A penalty may be imposed of up to 25% of the amount that goes unreported.

Question 11: My client proposes to leave all his property in Country A and elsewhere to his daughter, who is in the process of obtaining U.S. citizenship.

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[20] Code §662(a)(2).

[21] Code §2103.

[22] Treas. Reg. §20.2104-1

[23] Code §2106(a).

[24] Treas. Reg. §20.2106-2(a).

[25] Code §6039F.

After his daughter receives the property, will that property be subject to estate tax at the conclusion of the daughter's lifetime?

Yes. All property owned at the time of death by (i) U.S. citizens and (ii) non-U.S. citizen individuals domiciled in the U.S. is subject to U.S. estate tax no matter where located.

The estate may be reduced by funeral and administration expenses, indebtedness, and claims against the estate.[26] In addition, U.S. tax law allows a credit that is the equivalent of a lifetime gift tax and estate tax exemption for individuals. For 2017, the exemption amount is U.S. $5.49 million.[27] Cumulative lifetime taxable gifts are added to the taxable estate to unify the gift and estate tax system.[28]

Married couples may combine the exemptions so that if the first spouse to die owns insubstantial assets, the unused exemption may be claimed at the time of death of the survivor.[29]

If the surviving spouse is a U.S. citizen, a decedent who is a U.S. citizen, or who is domiciled in the U.S., is entitled to an unlimited marital deduction for amounts bequeathed to the spouse.[30] If the surviving spouse is not a U.S. citizen, the deduction is allowed only if the property is transferred to a qualified domestic trust.[31]

If the property is located outside the U.S., a foreign tax credit may be claimed for the amount of any estate, inheritance, legacy, or succession taxes actually paid to another jurisdiction in respect of any property situated within that country and included in the gross estate of the decedent under foreign law.[32]

Here, your client's daughter will be subject to the U.S. estate tax on her worldwide estate at the conclusion of her lifetime. A foreign tax credit may be claimed for any estate tax actually paid to Country A.[33]

Question 12: My client has acquired a condominium in Florida where he intends to spend several months each year. The balance of time will be spent in Country A, in the family home. He is concerned that he will become a resident of the U.S. for estate tax purposes. Is his concern well grounded?

No. The U.S. estate tax rules differ from the U.S. income tax rules. For income tax purposes, residence is based on objective factors such as the number of days present in the U.S. or the issuance of a permanent resident visa. In comparison, residence for estate tax purposes is based on concepts of domicile.

A person acquires a domicile in a place by living there, for even a brief period of time, without the presence of a definite intention to leave. A facts and circumstances test is used to determine domicile. Generally, permanent residents ("green card

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[26] Code §2053(a)

[27] Rev. Proc. 2016-55.

[28] Code §2001(b)(1)(B).

[29] Code §2010(c)(5)(A).

[30] Code §2056

[31] Code §2056(d).

[32] Code §2014.

[33] Code §2014.

holders”) are presumed to be U.S. domiciliaries unless facts show otherwise.

Here, the absence of a permanent resident visa and continued availability of a permanent residence in Country A suggests that your client will not be domiciled in the U.S. This conclusion assumes that contacts in the U.S. are limited to the facts described.

Question 13: My client owns a condominium in New York in his own name. At the conclusion of his lifetime, will U.S. estate tax be imposed on the condominium?

Yes. The condominium is an item of U.S.-situs real property as it is considered to be real property under New York State law. The condominium and all belongings located in it will be included in a U.S. taxable estate.

Question 14: Will the answer change if my client transfers the U.S. property to a discretionary, irrevocable trust for the benefit of himself, his spouse, and his son?

No. In some instances, property not legally owned at the conclusion of lifetime may be included in a taxable estate.

For this to occur, the decedent must have transferred property during his or her lifetime but retained sufficient interest or control over the transferred assets for the remainder of his life or for any period not ascertainable without reference to his death. An asset will be included in a taxable estate if the decedent retained the possession or enjoyment of, or the right to the income from, the property.[34] Also included are assets that the decedent transferred during life but with regard to which the decedent had the power to alter, amend, revoke, or terminate the enjoyment of the property through retained powers.[35] This rule applies to a revocable or amendable trust.

Although not specifically asked, it should also be noted that the transfer of the U.S. condominium to the irrevocable trust will give rise to gift tax because a condominium unit generally is viewed to be real property. When determining estate tax, a credit against estate tax due is allowed for previously paid gift tax.[36]

Question 15: My client is a Country A national. He is the sole shareholder of a U.S. company that is valued at $25 million. His only child is his daughter, who has studied in the U.S. and is now in the process of becoming a U.S. citizen. I am concerned about the U.S. estate tax, and so, I advised my client to transfer the shares to a trust for the benefit of his daughter. The father will not have right to income, but he will be the sole trustee of the trust and can vote the stock of the U.S. corporation. Will the assets be included in his estate?

Yes. Although the shares have been given away absolutely, the right to vote stock of a controlled corporation will result in exposure to estate tax.[37] Control is the retention of 20% of the combined voting power of all shares entitled to vote.[38]

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[34] Code §2036(a)(1).

[35] Code §2038.

[36] Code §§2102, and 2012.

[37] Code §2036(b)(1).

[38] Code §§2036(b)(2) and 318.

Question 16: My Country A client's spouse passed away. The spouse's U.S.-situs property was transferred into an irrevocable trust. The trust provides that after the grantor's death, my client was entitled to the trust income and that he could appoint the income and trust assets however he saw fit. I was advised that my client may have a U.S. estate tax exposure. Is this correct?

Yes. If a non-U.S. decedent holds a general power of appointment at the conclusion of her lifetime, the trust's U.S. assets will be included in the decedent's U.S. taxable estate unless an exception applies. A general power of appointment exists if a power is exercisable in favor of the decedent, her estate, her creditors, or the creditors of her estate.[39]

Question 17: My client is a Country A national and purchased a New York City condominium for $10 million. As she is worried about the U.S. estate tax, she wants to transfer the U.S. real property to her daughter, who is also a Country A national and resident and not a U.S. person. Will this transfer be free of tax in the U.S.?

No. U.S. gift tax applies to a noncitizen, non-resident individual who transfers U.S.-situs property that constitutes either real property or tangible personal property.[40] The condominium is real property under New York State law. Hence, the gift is subject to gift tax.

Question 18: My Country A client formed a U.S. corporation to own a condominium. He is concerned that the shares of the U.S. corporation will be subject to U.S. estate tax. He proposes transferring the shares of the U.S. corporation to a Country A corporation in a tax-free transfer covered by Code §351 or Code §368(a)(1)(B). He will own all the shares of the transferee. Will that insulate my client from U.S. estate tax?

No. U.S. law contains anti-inversion rules[41] that prevent shareholders of a U.S. corporation from benefitting when the corporation's assets are directly or indirectly transferred to a foreign corporation that is at least 80%-owned by stockholders of the U.S. corporation. The foreign corporation is treated as a U.S. corporation for all purposes of U.S. tax law. Here, it is proposed that the sole shareholder of the U.S. corporation will become the sole shareholder of the Country A corporation. This is an indirect transfer of assets by the U.S. corporation. Consequently, the Country A corporation is treated as a U.S. corporation, and the U.S. estate tax exposure continues.

Question 19: My Country A client also owns shares of Apple valued at $7 million. Is there an exception for intangible property under the U.S. estate tax as there is for U.S. gift tax?

No. The exception for intangible property under the U.S. gift tax regime does not apply to the U.S. estate tax regime. Your client's Apple shares will be included in his U.S. taxable estate at the conclusion of his life.

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[39] Code §2041(b).

[40] Code §2511(a).

[41] Code §7874.

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