

TRUSTS IN CROSS BORDER ESTATE PLANNING

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- Trusts are common vehicles in international estate planning for a number of reasons – asset protection, anonymity, avoidance of forced heirship laws, tax planning considerations.
- What is a trust? A trust is a relationship (generally a written agreement) created at the direction of an individual (the settlor), in which one or more persons (the trustees) hold the individual's property subject to certain duties to use and protect it for the benefit of others (the beneficiaries). In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Treas. Reg. Sec. 301.7701-4(a).
- The U.S. tax laws reveal a bias against the use of trusts – as a means of shifting tax to lower tax bracket individuals or entities, or to avoid U.S. tax altogether.
- Trusts can be characterized as grantor trusts, simple trusts or complex trusts. Trusts can be domestic trusts or foreign trusts; the U.S. tax laws have special definitions for these concepts. Ordinary (non-grantor) trusts are "hybrid" entities – receiving a deduction for distributions to beneficiaries of distributable net income (DNI).
- A trust will be considered domestic if (i) a U.S. court can exercise primary supervision over trust administration (the "court test"), and (ii) U.S. persons control all substantial trust decisions (the "control test"). All other trusts are foreign. Code Sections 7701(a)(30)(E), 7701(a)(31).

Grantor Trusts:

- Grantor trusts are described in Code Sections 671 through 679. These trusts are taxed as if their grantors (or in some cases, their beneficiaries, in the case of a beneficiary controlled trust described in Code Section 678) owned the trust assets personally. Income and deductions of the trust flow directly onto the grantor's (or beneficiary's) income tax return.

U.S. Grantor:

- In the case of a U.S. grantor, a trust will be treated as a grantor trust where the grantor retains specified trust powers or interests, or grants them to persons who are statutorily deemed to be under the grantor's control.
- Such powers and interests include retained reversionary interests, direct or potential beneficial interests in trust income, a power to revoke the trust and recover the trust corpus, certain retained controls over the distribution of trust income or corpus, certain retained administrative powers, the authority to borrow trust funds without adequate interest and security, or actual borrowing of trust funds without adequate interest and security approved by an independent trustee.

In the case of a foreign grantor, a trust will only be treated as a grantor trust in two cases (Code Section 672(f)(2)) –

1. Where the foreign grantor has the power absolutely to revest in the grantor title to the trust property to which such portion is attributable, exercisable solely by the grantor 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, or
 2. The only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.
- Note, however, that if there is a U.S. beneficiary, the U.S. beneficiary will be treated as a grantor if the beneficiary has made (directly or indirectly) transfers of property to the foreign grantor other than in a sale for full and adequate consideration. Code Section 672(f)(5).

U.S. Grantor-Foreign Trust:

- If a U.S. person transfers property (directly or indirectly) to a foreign trust, the trust will be treated as a grantor trust if there is a U.S. beneficiary.
- If a foreign trust first has a U.S. beneficiary after it has been in existence for some time (e.g., because an alien beneficiary becomes a U.S. resident), a U.S. person who transferred property to the trust is taxed for the first year in which the trust has a U.S. beneficiary on (1) income attributable to the transferred property for that year and (2) all undistributed net income, computed as of the end of the preceding taxable year, that is attributable to the transferred property. Code Section 679(b).
- If a U.S. citizen or resident transferred property to a domestic trust that subsequently becomes a foreign trust, the transferor, if then living, is deemed to transfer the portion of the trust that is attributable to the transferred property to a foreign trust. Code Section 679(a)(5). Code Section 684 causes gain to be recognized on transfers to foreign trusts that are not taxed as grantor trusts.
- If a nonresident alien becomes a U.S. resident (i.e., has a residency starting date, as defined under Code Section 7701(b)(2)(A)), within five years after directly or indirectly transferring property to a foreign trust, the transfer will be treated as if it occurred on the residency starting date. If the trust has a U.S. beneficiary, the trust will be a grantor trust.

Foreign Grantor Trusts:

- The income of the trust is taxed to the grantor (i.e., the person who made a gratuitous transfer of assets to the trust). The grantor will not be taxed by the U.S. on foreign sourced income, but certain U.S. sourced investment income and income effectively connected with a U.S. trade or business will be subject to U.S. income or withholding tax.
- Distributions to a U.S. beneficiary by an FGT will generally be treated as non-taxable gifts, but may be subject to U.S. tax reporting requirements (Form 3520). Code Section 6048, Section 6677.
- Note, that in the case of a revocable trust, the foreign grantor trust will generally become a foreign nongrantor trust upon the death of the grantor.

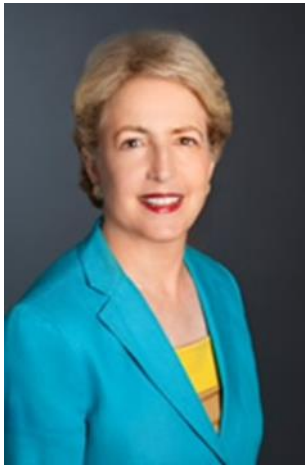
Foreign Non-Grantor Trusts:

- Any foreign trust that does not meet the definition of a foreign grantor trust is a foreign nongrantor trust ("FNGT"), taxed as if it were a nonresident, noncitizen individual who is not present in the U.S. at any time.
- The trust will not be taxed on foreign sourced income, but certain U.S. sourced investment income and income effectively connected with a U.S. trade or business will be subject to U.S. income or withholding tax. Note that the "net investment income tax" does not apply to nonresident aliens, and therefore, does not apply to a foreign non-grantor trust.
- A U.S. beneficiary will be subject to tax on distributions to the beneficiary of "distributable net income" ("DNI) from the FNGT. The character of such DNI distributions will reflect the character of the income as received by the FNGT. A foreign trust is required to include capital gain income in DNI.
- If a FNGT accumulates its income and distributes the accumulation in later years in excess of DNI, the U.S. beneficiary will be subject to the "throwback rules", which generally seek to treat a beneficiary as having received the income in the year in which it was earned by the trust, using a relatively complex formula. (This differs from the treatment of a domestic trust. Capital gains of a domestic trust generally do not enter into the DNI calculation and are usually taxed to the trust. Any distributions by a domestic trust to beneficiaries in excess of DNI will be a non-taxable distribution of capital; thus, any accumulated income and gains of a domestic trust are taxed only to the trust and are not taxed again when distributed to a beneficiary.)

- The beneficiary may be required to pay a “throwback tax” (a “catch up” tax) and an interest charge on the deferral. Furthermore, such throwback distributions will be taxed at ordinary income tax rates.
- Note that the throwback rules will not apply to amounts accumulated when the trust was an FGT.

Planning Suggestions for Nonresident Aliens

- Assuming all assets are non-U.S. situs assets (for estate tax purposes), establish a foreign grantor trust (power to revoke) for the benefit of grantor's beneficiaries (including U.S. beneficiaries). Domesticate or decant the trust upon the death of the foreign grantor to avoid throwback rule.
- Establish a U.S. dynasty trust for the benefit of U.S. beneficiaries and descendants. Assets may include U.S. stocks and securities (not subject to U.S. gift tax).
- Establish a U.S. (domestic) "drop off" trust prior to immigrating to the U.S. (prior to establishing a U.S. domicile). Note that the trust will be a grantor trust under Section 679.



NINA KRAUTHAMER focuses her practice on federal, state and international tax matters involving high net worth individuals, public and private companies and not-for profit organizations. She regularly advises foreign individuals and companies on U.S. tax matters, including planning for investment in U.S. real estate. She reviews complex corporate mergers and acquisitions, and structures partnerships, joint ventures and limited liability companies in both the domestic and cross-border context. Nina's article "New York Estate Tax on Real and Tangible Property – When Intangibles Become Tangible" appeared in the ABA RPTe Ereport (February 2013), published by the ABA Real Property, Trust and Estate Law Section. Another article will appear in the August 2013 Ereport edition concerning foreign trusts with U.S. beneficiaries. She has written a regular International Tax Matters column for the Journal of Taxation of Investments. Nina is a former chair of the Subcommittee on Foreign Investors of the American Bar Association (ABA) Section of Taxation; an ABA Section of Taxation Panel Chair of "The ABC's of FIRPTA Withholding" (May 1985 ABA Tax Section Meeting) and a Panel Participant of "Fundamentals of International Taxation" (June 1999) of the Association of the Bar of the City of New York where she received the highest speaker rating. Nina was an Adjunct Professor in the Baruch College Masters of Taxation Program (1991 – 1995).

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