

TRUSTS – RESIDENCY AND TAXATION



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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 (the “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. §301.7701-4(a).

Domestic Trust

- 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.
- The status of a trust as foreign or domestic will affect the U.S. taxation and reporting requirements of the trust and its beneficiaries.
- A trust is considered **domestic** if
 - a U.S. court is able to exercise primary supervision over trust administration (the "**court test**"), and
 - U.S. persons control all substantial trust decisions (the "**control test**").
- **All other trusts are considered Foreign Trusts.** Code §§7701(a)(30)(E), 7701(a)(31).

Domestic Trust – The Court Test

A trust satisfies the court test under a safe harbor (Reg. §301.7701-7(c)(1)) if

- the trust instrument **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.**

Domestic Trust - The Court Test

- **Administered in the U.S.** means all steps necessary to carry out the duties imposed by the terms of the trust and applicable law including maintaining the records of the trust, filing tax returns, managing and investing trust assets, defending the trust from suits by creditors, and determining the amount and timing of distribution must be performed in the U.S. Treas. Reg. §301.7701-7(c)(3)(v).
- 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**. Treas. Reg. §301.7701-7(c)(4)(i)(D).
- The trust is **subject to automatic migration provision** if the trust document provides that a U.S. court's attempt to assert jurisdiction or otherwise supervise the trust directly or indirectly would cause the trust to migrate from the U.S. Treas. Reg. §301.7701-7(c)(4)(ii).

Domestic Trust – The Court Test

Example:

A U.S. citizen, creates a trust for *A*'s own benefit and the benefit of *A*'s spouse, *B*, a United States citizen. The trust instrument provides that the trust is to be administered in State *Y*, a state within the U.S., by *DC*, a State *Y* corporation. The trust instrument also provides that in the event that a creditor sues the trustee in a U.S. court, the trust will automatically migrate from State *Y* to Country *Z*, a foreign country, so that no U.S. court will have jurisdiction over the trust. A court within the U.S. is not able to exercise primary supervision over the administration of the trust because the United States court's jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction. Therefore, the trust fails to satisfy the court test from the time of its creation and is a foreign trust.

Domestic Trust - The Control Test

A trust satisfies the Control Test if one or more U.S. persons have the authority to control all substantial decisions of the trust. Treas. Reg. §301.7701-7(d)

- **U.S. Person:**

The term U.S. person means a U.S. person within the meaning of Code §7701(a)(30). For example, a domestic corporation is a U.S. person, regardless of whether its shareholders are U.S. persons.

- **Substantial Decisions:**

The term substantial decisions means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions.

Domestic Trust - The Control Test

Substantial decisions (Treas. Reg. §301.7701-7(d)(1)(ii)) include

- whether and when to distribute income or corpus;
- the amount of any distributions;
- the selection of a beneficiary;
- 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 unless decision cannot change the trust's residency; and
- investment decisions (but U.S. control if U.S. person who hires investment advisor can terminate investment advisor's power to make decisions at will).

Domestic Trust – The Control Test

Meaning of Control:

- The term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions.
- 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 trustees.

Domestic Trust – The Control Test

Example (Treas. Reg. §301.7701-7(d)(1)(v) Examples 1 and 2):

Trust is a testamentary trust with three fiduciaries, *A*, *B*, and *C*. *A* and *B* are U.S. citizens, and *C* is a nonresident alien. No persons except the fiduciaries have authority to make any decisions of the trust. The trust instrument provides that no substantial decisions of the trust can be made unless there is unanimity among the fiduciaries. The control test is not satisfied because U.S. persons do not control all the substantial decisions of the trust. No substantial decisions can be made without *C*'s agreement. Assume the same facts, except that the trust instrument provides that all substantial decisions of the trust are to be decided by a majority vote among the fiduciaries. The control test is satisfied because a majority of the fiduciaries are U.S. persons and therefore U.S. persons control all the substantial decisions of the trust.

Domestic Trust – Foreign Protector

- Many trusts, particularly foreign trusts, provide for a “Protector.”
- Trusts with a foreign Protector who has unfettered control over substantial decisions like control over termination of the existing Trustee, may cause the trust to become a foreign trust because a non-U.S. person holds a prohibited power.
- Practitioners must be cautious regarding any power over a trust that is held by a non-U.S. person, whether that person is a trustee, a protector, the grantor or a beneficiary.

Domestic Trust – Taxation

- If a trust is a domestic trust, it is treated as a U.S. resident for federal income tax purposes, and will therefore be subject to the U.S. federal tax. State and local tax may also apply.
- U.S. resident trusts are generally subject to U.S. income tax on their **worldwide income**, including the tax on capital gains. This is true regardless of the source of the income, with the result, for example, that a U.S. trust completely invested in non-U.S. bonds and securities may be taxable on all non-U.S. source interest, dividends, and gains from these investments, although the tax may be mitigated, for example, by distributions to beneficiaries.

Grantor Trust – Meaning

- The Grantor is the person who creates a Trust or directly or indirectly makes a “gratuitous transfer” of property to a trust. Treas. Reg. §1.671-2(e)(1).
- For U.S. grantors, a trust will be treated as a grantor trust if the Grantor has
 - 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.

Grantor Trust – How Is It Taxed?

- Grantor trusts are taxed as if their grantors (or in some cases, their beneficiaries, in the case of a beneficiary controlled trust) own the trust assets personally.
- Income and deductions of the trust flow directly onto the grantor's (or beneficiary's) income tax return.
- 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.

Foreign Grantor Trust – Meaning

- In case of a foreign grantor, a trust will be treated as a grantor trust only in either of two cases (Code §672(f)(2)):
 - The foreign grantor reserves the right to revoke the trust solely or with the consent of a related or subordinate party (and reconstitute the trust assets to himself).
 - 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.
- In case of a revocable trust, the foreign grantor trust will generally become a foreign non-grantor trust upon the death of the grantor.
- 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 §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. Code §679.
- 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 (i) income attributable to the transferred property for that year and (ii) all undistributed net income, computed as of the end of the preceding taxable year, that is attributable to the transferred property. Code §679(b).

U.S. Grantor - Foreign Trust

- 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 §679(a)(5). Code §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 §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 Non-Grantor Trust – Meaning & Taxation

- Any foreign trust that does not meet the definition of a foreign grantor trust is a foreign non-grantor 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.
- 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.

Foreign Non-Grantor Trust – Meaning & Taxation

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

Foreign Trust – *Stiftung*

- Main characteristics under foreign law
- Characterization as a trust or corporation for U.S. tax purposes?
- Relevant criteria:
 - Management functions combined with certain “founder’s” rights
 - Permissible activities and current distributions
 - Business purpose or business / holding activities and lack of liability by founder and beneficiaries
- Income tax regulations (Treas. Reg. §301.7701-4(b)) – Business trusts
- *Stiftung* case law in the United States, e.g.:
 - *Estate of Oei Tjong Swan v. Commr.*, 24 T.C. 829 (1955) acq. 1956-2 C.B. 8, affd. In part, revd. In part 247 F.2d 144 (2d Cir. 1957)
 - But compare *MCA Inc. and Universal City Studios, Inc. v. U.S.*, 685 F.2d 1099 (9th Cir. 1982)

Foreign Trust – *Stiftung*

- The dichotomy of treatment has been recognized in a Field Service Advice issued by I.R.S. District Counsel, dated July 1, 1994, and reported unofficially at 1994 FSA LEXIS 792, involving the characterization of a *Stiftung*:

American Courts have considered whether to treat *stiftungs* as corporations or trusts for U.S. tax purposes. Although there is no clear answer to this question, it appears that Courts will treat a *stiftung* as a corporation if it is created primarily for commercial purposes whereas it will be treated as a trust if it is created primarily for the support of beneficiaries. See *Estate of Oei Tjong Swan v. Commr.*, 247 F.2d 144, 147 (2nd Cir. 1957).

- Office of Chief Counsel Advice Memorandum AM2009-012, 10/16/2009

Estate and Gift Tax Rules

- A U.S. resident for estate and gift tax purposes is a person who is “domiciled” in the U.S. at the time of death or at the time of the gift (the “**subjective test**”).
- A person acquires domicile in a place by **living there**, for even a brief period of time, with **no definite present intention to leave**. Treas. Reg. §20.0-1(b)(1).
- An individual can be a resident for income-tax purposes and not for transfer-tax purposes and vice-versa.
- The highest rate is 40%. Exclusions/exemptions apply.

Gift Tax on Nonresident Alien

- Nonresident aliens are taxed **only** on gifts of
 - U.S.-situs tangible property, and
 - U.S.-situs real estate.
- Gifts of stock of U.S. corporations are **not** subject to tax, since intangible property.
- Gifts of U.S. partnership/L.L.C. interests **may not** be subject to tax, but this result is less clear in certain cases.

Gift Tax on Nonresident Alien

- For 2017, annual exclusion amounts available to nonresident aliens are as follows:
 - **Gifts to Non-U.S. Citizens:**
 - \$149,000 for gifts to spouse
 - Annual exclusion of \$14,000 for gifts to non-spouse
 - **Gifts to U.S. Citizens:**
 - Unlimited marital deduction for gifts to spouse
 - Annual exclusion of \$14,000 for gifts to non-spouse
- All gifts above annual exclusion to non-spouses or to non-citizen spouses are taxable.

Estate Tax on Non-U.S. Domiciliary

- U.S. domiciliary is taxed on the value of **worldwide assets** at death in the same manner as U.S. citizens.
- Non-U.S. domiciliary is taxed only on the value of **U.S.-situs assets**, including:
 - U.S. real property
 - Tangible personal property located in the U.S.
 - Debt obligations of U.S. persons, unless portfolio exemption applies
 - Stock in U.S. corporations (whether or not publicly traded)
 - Uncertain treatment of partnership interests

Estate Tax Exemption and Deduction

- There is an unlimited marital deduction if assets left to a spouse who is a U.S. citizen (*i.e.*, an unlimited amount of assets can pass to the spouse without being subject to U.S. estate tax).
- In all other cases, the following applies:
 - For bequests by U.S. citizens and U.S. residents to persons other a U.S. citizen spouse a \$5.49 million exemption applies (for 2017; indexed).
 - An exemption of \$60,000 is available against the value of assets includable in the U.S. taxable estate of an individual who was not U.S. domiciled.
- A Qualified Domestic Trust must be used to defer estate tax if surviving spouse is a non-U.S. citizen.
- Nonrecourse debt on U.S. property results in only net value included in U.S. estate.

Proposed Estate and Gift Tax Provisions

Topic	Current Law	House Tax Bill	Senate Document
Gift Tax	<p>Top gift tax rate of 40%</p> <p>Annual exclusion amount: 2017: \$14,000 2018: \$15,000</p>	<p>For gifts made after December 31, 2023: Top rate of 35%</p>	No changes
Estate Tax	<p>Top tax rate of 40%</p>	<p>Beginning after 2023: Repeal of estate tax while maintaining a beneficiary's stepped-up basis in estate property.</p> <p><u>Exception in case of a Qualified Domestic Trust (QDOT)</u> Estate Tax shall continue to be imposed if:</p> <ul style="list-style-type: none"> • The decedent dies on or before December 31, 2023, and • Distributions are made within 10-year period beginning on such date. <p>No estate tax on distributions after expiry of the 10-year period.</p>	No changes

Proposed Estate and Gift Tax Provisions

Topic	Current Law	House Tax Bill	Senate Document
Generation Skipping Transfer Tax (GST)	Top tax rate of 40%	Beginning after 2023: Repeal of the GST while maintaining a beneficiary's stepped-up basis in estate property	No changes
Basic Exclusion Amount	For 2017: \$5.49 million For 2018: \$5.6 million	For tax years beginning 2017: Exemption doubled	For tax years beginning 2018: Exemption doubled
Stepped-up Basis in case of an Inherited Property	Yes	Yes	Yes

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