DYNASTY IN THE DETAILS – U.S. ESTATE PLANNING CONSIDERATIONS FOR GLOBAL FAMILIES

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INTRODUCTION

In the United States, creating "dynasty trusts" has become common planning tool for many estate planners. A dynasty trust is a trust that may continue for generations under applicable law. It has a myriad of benefits for strategic income, estate and gift tax planning, creditor protection and ensuring family inheritance.

All too often, a person will create a dynasty trust thinking that he or she has set up the best possible estate plan to protect the family legacy through generations. But what happens when an heir such as a child decides to move to a different country? Or the succession of trustees includes a noncitizen, nonresident of the U.S. (an "N.R.N.C. individual")? These seemingly trivial details could unintentionally cause severe tax and other planning consequences in the U.S. and abroad.[1]

This article will explore various considerations for clients, advisors and fiduciaries when creating and administering U.S. dynasty trusts – a dynasty is in the details. It should not be set up and then forgotten.

ILLUSTRATIVE FACT PATTERN

The following typical fact pattern illustrates the continual care required by a trust and estate attorney who advises on the formation or maintenance of a dynasty trust.

Daniel and Jane Clark are prospective clients who meet with a trust and estate attorney for the first time. They wish to have the new lawyer review and update their estate planning documents.

- Daniel and Jane are married, U.S. citizens, residing in New York and have two adult children, Emily and John, each of whom are U.S. citizens. Emily is married with one child, and John is married with three children.
- The Clarks provide copies of two trust agreements – the Emily Clark Family Trust and the John Clark Family Trust – created by Jane ten years previously for the benefit of each child.
- The trust agreements provide that each trust is (i) irrevocable, (ii) for the benefit of the relevant child during the beneficiary's lifetime, and (iii) is to continue in further trust for the life of such child's children, and then (iv) is to continue to future generations.

[1] The same issues arise if a U.S. resident trustee becomes an N.R.N.C. individual. See, for example, Nina Krauthamer and Galia Antebi, "Domestic Trust – Does Yours Satisfy the Court Test," *Insights* Vol. 8 No. 5, p. 38 (2021).

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- Each Clark Family Trust has only one trustee, who is a U.S. citizen, and no other fiduciaries are named. There are no trust protectors, distribution advisors, or investment advisors.
- Jane has the power granted to her in the trust agreement to remove and replace trustees.
- The trust agreements state that the laws of the State of New York apply in all matters of construction and interpretation.

In short, aside from the absence of replacement trustees and various advisers serving certain functions, each trust is a classic dynasty trust.

The Clarks understand that the dynasty trusts are irrevocable, but they want to make a few changes based upon Jane's limited retained powers in the trust agreements. They also want to learn how these trusts will be affected by new developments within their family.

TAX DEFINITION OF A U.S. DOMESTIC TRUST

The Clark Family Trusts are solely administered in the U.S. and the terms of the trust agreements provide that the laws of the State of New York apply in all matters of construction and interpretation. The Clark Family Trusts currently appoint only U.S. persons with decision-making authority. There is no indication that the courts of a foreign country would have any jurisdiction over any matters relating to the trusts in the event a child were to move to a foreign country.

As of its formation and through the review, each trust is a U.S. domestic trust for U.S. Federal taxation purposes. This means that the ordinary rules regarding the taxation of income and gains that appear in Subparts A , B, and C of Part I of Subchapter J of the Internal Revenue Code ("Code") – apply, beginning with Code §641 and continuing to Code §664) apply. In very broad terms, a domestic trust reports distributable net income ("D.N.I."), deducts distributions to beneficiaries and amounts required to be distributed beneficiaries, and pays tax on the balance. Beneficiaries receiving distributions from D.N.I. or required to receive distributions report those amounts as if they received a *pro rata* amount of the classes of income that comprise D.N.I. In certain limited instances, a fixed amount can be distributed to a beneficiary, and the distribution is treated as a gift from the settlor. Once a U.S. domestic trust incurs U.S. tax on retained D.N.I., no further tax is imposed on the beneficiary when the accumulated income is ultimately distributed.

A trust is a "domestic" trust if it passes each of the Court Test and the Control Test.[2] Generally speaking, a trust satisfies the Court Test if a court within the U.S. can exercise primary supervision over the trust administration.[3] A trust satisfies the Control Test if one or more U.S. persons as defined in Code §7701(a)(30) control all substantial decisions of the trust.[4] Substantial decisions include, but are not limited to, the following decisions:

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[2] Code §7701(a)(30)(E); see also Treas. Reg. §301.7701-7(a)(1).

[3] Code §7701(a)(30)(E)(i).

[4] Code §7701(a)(30)(E)(ii).

- 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 as a trustee, subject to certain limitations
- Investment decisions made, including the unfettered authority of a U.S. persons to terminate a foreign investment adviser[5]

A trust that fails one test or the other is a foreign trust for U.S. Federal income tax purposes even if formed under the laws of state of the U.S.[6] An unintentional foreign trust can cause adverse tax consequences for both the grantor (*i.e.*, the creator of the trust) and the beneficiaries. These include the throwback rules with respect to accumulation distributions[7] (the details of which are outside the scope of this article). Such a trust may also be subject to additional reporting requirements that carry penalties for noncompliance.[8]

For now, based on the above, the Clark Family Trusts appear to pass both the Court Test and the Control Test and would be considered U.S. domestic trusts.

ADDITIONAL FACTS

Jane advises that she is considering changing the trustee.

- The current trustee of the John Clark Family Trust is a U.S. person who is a family friend.
- There have been several disagreements with the trustee.
- Jane holds the power granted to her in the trust agreement to remove and replace trustees.
- She would like to name another family friend to serve as a replacement trustee. The individual is not a U.S. person.

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5 Treas. Reg. §301.7701-7(d)(1)(ii).

6 Code §7701(a)(31)(B). There are a few safe harbors and relief provisions to retain domestic trust status, see Treas. Reg. §301.7701-7(c), and Treas. Reg. §301.7701-7(d)(2).

7 Code §§665-668.

8 Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) and Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner).

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NEW TRUSTEES/NEW PLACE OF RESIDENCE

As noted above, carefully selecting the trustees, trust protectors, distribution advisors, investment advisors, and their successors are key considerations in satisfying the Control Test. Continually satisfying this test over the life of the trust can prove difficult, especially when administering dynasty trusts that are expected to be in existence for many years.

Dynasty trusts often give the grantor, beneficiaries, or some other person the power to remove and replace trustees. This power is typically accompanied by cautionary language under which the holder's power to remove and replace a trustee is limited, requiring the replacement trustee to be independent and not "related" or "subordinate" to the person exercising such power. It is crucial to adhere to these rules for various U.S. taxation purposes that are outside the scope of this article.[9]

In addition, it is crucial for a replacement trustee to be a U.S. person at all times relevant. If (i) the replacement trustee is not a U.S. person and (ii) the replacement trustee has the ability to control any substantial decision listed above, the trust will fail the Control Test and will be deemed to become a foreign trust.

The same logic applies when dealing with the holder of any of the following powers granted in a dynasty trust regarding fiduciaries:

- The power to designate new fiduciaries other than trustees, such as trust protectors, investment advisors, and distribution advisors.
- The power to name a successor fiduciary in the event of vacancy.
- The power to designate additional fiduciaries.
- The of a beneficiary to become a co-trustee at a certain age when the beneficiary holding that power is not a U.S. person when the power is exercised.

If the holder of any of these powers is not a U.S. person, the trust runs the risk of failing the Control Test, meaning that it would become a foreign trust. This change of status brings Code §684 into play.

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[9] A trust can be considered to be a "grantor trust" – meaning a person that settles or makes gratuitous transfers to the trust – where (i) a related or subordinate person (Code §672(c)) is trustee that controls beneficial enjoyment over the trust's assets or income (Code §674) or (ii) the grantor borrows from the trust and a related or subordinate person subservient to the grantor is the trustee (Code §675(3)). With regard to the imposition of estate tax, ordinarily property transferred during life is not subject to estate tax. But if the transferor retained rights to appoint persons who could possess the property or enjoy its income, the property is includible in the individual's taxable estate at the time of death (Code §2036). The same result exists if the transferor appoints a third person to make the decision, provided the third person can be removed by the transferor. This latter rule does not apply where the incumbent holder is an independent person and the transferor's power is limited so that only a successor independent person and be appointed. Rev. Rul. 95-58. The same result is reached under Code §2038 regarding revocable transfers, where the holder of the power is an independent person who can be replaced by the transferor only with a successor independent person.

Code §684 provides rules that apply to transfers by U.S. persons of appreciated property to a foreign trust. Typically, the transaction must be reported on Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) and inherent gain on each appreciated asset must be recognized.

Somewhat different rules apply when a U.S. domestic trust becomes a foreign trust, sometimes referred to as a migration of the trust for tax purposes. Code §684 addresses the tax treatment of the migration in one of two ways, depending on whether the grantor of the trust is a U.S. person and whether the trust has U.S. beneficiaries.

- If there are U.S. beneficiaries and a U.S. grantor, the trust is treated as a grantor trust and the U.S. grantor becomes subject to tax on the income and gains under Code §679. Under that provision, a U.S. person who directly or indirectly transfers property to a foreign trust having one or more U.S. persons as beneficiaries is treated as the owner of the portion of the trust attributable to the transferred property.
  - If at some point in the future, the trust ceases to be treated as a grantor trust in whole or in part, the change in status causes the U.S. grantor to be treated as having transferred the underlying assets of the grantor trust to a foreign nongrantor trust. Gain must be recognized immediately before (but on the same date that) the trust is no longer treated as owned by the U.S. grantor.[10] Only gain on the assets that are no longer treated as being owned by the U.S. grantor is deemed recognized.
  - If the U.S. grantor dies, gain on all assets in the portion of the trust that is a grantor trust is recognized. Recognition is deemed to occur immediately before the grantor's death.
- If at the time of migration of the trust, the facts are such that there are no U.S. beneficiaries or no U.S. grantor, Code §679 ceases to be applicable. The general rule of Code §684 applies. The trust recognizes gain as a result of the migration for tax purposes.[11]

"Somewhat different rules apply when a U.S. domestic trust becomes a foreign trust, sometimes referred to as a migration of the trust for tax purposes."

When looking at the Clark Family Trusts, the trustee is the only person with the authority to make substantial decisions. Consequently, to keep the John Clark Family Trust a domestic trust, and to avoid triggering the application of Code §§684 and 679 to Jane, the non-U.S. family friend should not be appointed as the new trustee. Only U.S. persons should hold the power to make decisions or to hold the power to replace a foreign financial adviser. The following language should be included with regard to the trustee and the persons holding the power to make substantial decisions:

> Notwithstanding any other provision of this agreement to the contrary, for so long as each trust hereunder is a domestic trust for U.S. taxation purposes, each trustee of such trust shall be a "United States person" as defined in Section 7701(a)(30) of the Internal Revenue Code, as amended, and the trustees shall utilize the powers under this agreement to ensure that all trustees of such trust are United States persons at all times relevant.

[10] Treas. Reg. §1.684-2(e).

[11] Treas. Reg. §1.684-4(a).

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FURTHER CHANGE IN FACTS

Daniel and Jane advise the following anticipated changes of facts:

- Their daughter, Emily, is planning on moving to "Country X" where her husband is to be stationed by his employer.
- Emily, her husband, and her son look forward to a new adventure.
- While the change is not intended to be permanent, it will last for several years.

NEW TAX RESIDENCE = ADDITIONAL SET OF TAX RULES

When creating and administering dynasty trusts, it is important to know where the beneficiaries are domiciled currently and of equal importance where they may establish a new domicile. This is also important for grantors and fiduciaries of the trust. While a beneficiary may seek to find a new life in another country, the trust may not be a good travel companion.

Every country has its own laws concerning estate succession, and not all countries recognize trusts to have the same legal effect as in the U.S. For those countries that do recognize trusts, distributions from a U.S. trust can be taxed both at the level of the trust and at the level of the beneficiary. Additionally, the relocation of a beneficiary may trigger trust reporting requirements in the new country. If the beneficiary decides to expatriate, additional tax and other implications could occur both in the U.S. and in the new country.

The beneficiary and any future beneficiary should be mindful of how the move affects inheritance rules in the new location and how the move affects the family's estate plan. In principle, this is a consideration that should be addressed before a move. Often, however, family estate planning is put on the back burner.

Here are some problems that arise in practice:

- What if the beneficiary decides to renounce U.S. citizenship?
- Will the expectancy precede the renunciation of citizenship?
- What if the beneficiary is expected to become a co-trustee of the dynasty after renunciation occurs?

It is recommended that these and other expectations should be addressed before the beneficiary leaves the U.S. It is extremely important to have the dynasty trust reviewed by competent advisors in both the U.S. and the new country to determine the best strategy. In some circumstances, it may be beneficial to change the beneficiary's interest in the trust through a process known as decanting. If the relocating person is a remainderman of a dynasty trust of which he or she currently has no present interest, decanting the trust to change the person's remainder interest to an outright distribution may be an option that provides benefits in the new jurisdiction of residence.

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It may be recommended to reclassify the dynasty trust to a foreign trust. A properly structured dynasty trust may contain the following language to provide such flexibility.

> The trustees may change the situs of any trust under this Agreement, and to the extent necessary or appropriate, move trust assets to a state or country other than the one in which the trust is then administered if the trustees shall determine it to be in the best interest of the trust or the beneficiaries. The trustees may elect that the law of such other jurisdiction shall govern the trust to the extent necessary or appropriate under the circumstances. Notwithstanding the foregoing, the trustees shall first consult with a tax adviser prior to the change of situs of any trust hereunder in order to ensure no adverse tax consequences would result from the change of situs under Section 684 of the Internal Revenue Code, as amended, or otherwise.

FINAL CHANGES IN FACTS

As the meeting with Daniel and Jane draws to a close, Daniel directs the discussion towards his mother.

- Daniel's mother is an N.R.N.C. individual with regard to the U.S.
- She would like to provide for her grandchildren in the U.S. and their descendants.

U.S. citizens and U.S. residents for income tax purposes are taxed on their worldwide income and gains. However, the term "resident" has a somewhat different meaning for estate, gift, and generation-skipping transfer ("G.S.T.")[12] tax purposes.

For income tax purposes, the term "resident" is defined in Code §7701(b). Broadly speaking, a noncitizen individual is considered to be a resident for income tax purposes if either of two tests are met. One is the green card test, under which an individual holding permanent resident visa is considered to be a U.S. income tax resident. The other is the substantial presence test, under which an individual is considered to be a U.S. income tax resident if he or she is present in the U.S. for a targeted number of days over a three-year period.

For estate tax purposes, a noncitizen individual is considered to be a resident of the U.S. by reference to domicile. Thus, the relevant estate tax regulations[13] provide as follows:

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[12] In very broad terms, G.S.T. is a tax that is imposed when property passes from a donor or decedent to a family member that is two or more generations removed from the donor or decedent. The goal is to prevent wealthy families from saving on overall inheritance taxes by means of providing first generation heirs or recipients with a life estate or a trust interest. G.S.T. is imposed when property passes to remaindermen, heirs, or trust beneficiaries below the first generation. See Code §§2601 to 2664.

[13] Treas. Reg. §20.0-1(b)(1).

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Estates Of Citizens Or Residents. —

> Subchapter A of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a citizen or a resident of the United States at the time of his death. A "resident" decedent is a decedent who, at the time of his death, had his domicile in the United States. The term "United States", as used in the estate tax regulations, includes only the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to their admission as States. See section 7701(a)(9). A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. * * *

In comparison to most European countries, the U.S. imposes estate, gift, and G.S.T. taxes on the N.R.N.C. individual making the gift or the estate of the nonresident decedent. With the exception of U.S. citizens and residents receiving a gift or bequest from a "covered individual" – *i.e.*, an expatriate who was taxed under Code §877A[14] – the taxpayer is not the U.S. individual who receives the gift or inheritance. In addition, only U.S. situs tangible personal property[15] and U.S. real estate[16] are subject to gift tax. Thus, for example shares of stock or debt instruments are not subject to gift tax. They are, however, subject to estate tax as long as the property is situated in the U.S.

"It is important to note that the N.R.N.C. individual that establishes the dynasty trust may be subject to applicable tax rules and reporting requirements in the home country."

For an N.R.N.C. individual who wishes to provide a gift or bequest to a U.S. beneficiary, a U.S. domestic dynasty trust can be an attractive option. Typically, a dynasty trust is established by an N.R.N.C. individual for the benefit of a U.S. individual. It can be structured as an irrevocable "nongrantor" trust. This means that the trust is considered a separate U.S. taxpayer for U.S. Federal income tax purposes, taxed on worldwide income accumulated and realized in the trust. The property gifted to the dynasty trust consists of property that does not attract gift tax for an N.R.N.C. individual. In addition, if established during the lifetime of the N.R.N.C. individual with assets that do not attract gift tax, G.S.T. is not imposed as succeeding generations become beneficiaries.[17]

It is important to note that the N.R.N.C. individual that establishes the dynasty trust may be subject to applicable tax rules and reporting requirements in the home country. Additionally, the recipient dynasty trust (or any beneficiary receiving a gift from a non-U.S. person) has reporting obligations in the U.S. which are separate from that of the grantor. For example, Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) must be filed for each year in which the dynasty trust receives a gratuitous transfer from the N.R.N.C. individual

[14] Code §2801.

[15] Code §2501(a)(2) eliminates U.S. gift tax on items of U.S. situs intangible property.

[16] Code §2511(a).

[17] Code §2663(2); Treas. Reg. §26.2663-2(b).

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CONCLUSION

Several takeaways regarding cross border trust and estate planning:

- Always be mindful of where the grantor, fiduciaries, and beneficiaries reside currently, and if possible to project, where they may reside in the future.
- Make sure current and future beneficiaries are aware of their interests in dynasty trusts. Even if family relations suggest otherwise, some degree of communication is helpful.
- Do pre-immigration planning – consult with U.S. and foreign advisors as to the treatment of the dynasty trust before immigrating.
- N.R.N.C. individuals should consider gifting of intangible personal property to U.S. persons rather than tangible. Investment grade bonds of U.S. issuers are preferred; jewelry kept in a vault in the U.S. is problematic.
- Check in with advisors during any major life event: birth, marriage, divorce, death, retirement, impending relocation. These are the times to review the planning currently in place and discuss ways to remain in compliance.

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