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ADVISING FAMILIES ACROSS GENERATIONS

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MANAGING TRIVIAL PURSUITS: DOMESTICATION OF FOREIGN TRUSTS

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INTRODUCTION

It is increasingly common for global families to have cross-border circumstances that give rise to a multitude of U.S. income, gift, estate and generation-skipping transfer tax consequences, particularly when trusts are involved.

Overview

I. Brief survey of applicable law.

II. Foreign Trust Domestication

III. Examples

INTRODUCTORY TAX OUTLINE

- **Basic rules of international estate planning:**
  - U.S. persons (based on citizenship or the residency tests) are subject to U.S. income taxation on their worldwide income. (I.R.C. §§ 1, 61).
  - Individuals who are U.S. persons (based on citizenship or domicile) are also subject to gift, estate and generation-skipping transfer taxation on their worldwide assets. (I.R.C. §§ 2001, 2031-2046, 2601).
  - Non-U.S. persons are subject to U.S. income taxation only on their U.S. source income – dividends, interest, rents and income from effectively connected business in the U.S. (bond portfolio interest and capital gains are not source income).
  - Individuals who are non-U.S. persons (non-citizen, non-domiciliaries) are subject to U.S. gift, estate and generation-skipping transfer taxation only on their U.S. situs assets.
  - Trusts, like individuals, can be classified as domestic or foreign.

Foreign Trusts for U.S. Tax Purposes

- Objective Rule – A trust is considered domestic for U.S. tax purposes only if:
  - a U.S. court can exercise primary supervision over its administration (the court test); and
  - the U.S. fiduciaries have the authority to control all substantial decisions relating to the trust (the control test).
- A trust that does not satisfy both tests is a foreign trust for U.S. tax purposes.
  - Trusts can become foreign because of appointment of new trustee.
  - A trust formed in the U.S. could be foreign for U.S. tax purposes
  - Inadvertent loss of U.S. status

Court Test - Treas. Regs. § 301.7701-7(c)

- A court is able to exercise primary supervision over the trust if a U.S. court has authority to render orders or judgments resolving substantially all issues concerning administration of the entire trust.
- A trust that is registered with a U.S. court under the registration provisions of a statute similar to Article VII of the Uniform Probate Code meets the court test. If the parties take steps with a U.S. court that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test even if both a U.S. court and a foreign court have jurisdiction over the trust.
- A trust fails the court test if the trust instrument includes a migration clause but a clause triggering migration of the trust only in the case of foreign invasion or widespread confiscation or nationalization of property is not regarded as a migration clause.

Safe Harbor:

- The trust instrument does not direct that the trust be administered outside of the U.S.
- The trust is actually administered exclusively in the U.S.
- The trust is not subject to an automatic migration provision.

Control Test Treas. Regs. § 301.7701-7(d)

- One or more U.S. persons must have the authority to control all substantial decisions of the trust.
- Substantial decisions 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
  - Whether to sue on behalf of the trust or to defend suits against the trust
  - Whether to remove, add or replace a trustee
  - Investment decisions

Control Test Planning

- Note that, subject to a grace period under the Regulations to correct for “inadvertent” changes, a U.S. trust can become foreign due to a trustee change, or a change in the tax residence of a non-U.S. citizen individual holding a power, since “U.S. persons” does not include individuals who are nonresident aliens as to the United States Reg. § 684-4(c).
- The rule applies to non-fiduciary powers, not only trustee powers – e.g., a power to add a beneficiary such as in a typical power of appointment, or a power to direct investments if not terminable at the will of U.S. persons. But non-fiduciary powers could be held, for example, by a corporation incorporated under U.S. law..
- Examples of powers under the control test:
  - Power to allocate receipts between income/principal is not “substantial” if the distinction is meaningless under the trust.
  - Power to deal with claims may be a convenient means to create foreign status.
  - Power to remove and replace a trustee can lead to surprising result if trustees have mixed US tax status but a trustee targeted for removal cannot in effect cast a vote due to a conflict of interest.

Foreign Trust Domestication: Overview

I. Overview

II. Foreign Trust Domestication

  I. Why?

  II. When?

  III. How?

III. Generation Skipping Transfer Tax Considerations

IV. Issue Related to the Rule Against Perpetuities

V. Takeaways

I. Foreign Trust Domestication: Overview

- Traditionally, offshore trusts offered unparalleled asset protection and privacy to the grantor and beneficiaries.
- The unrelenting trend in U.S. jurisdictions to modernize the trust laws, has significantly narrowed the competitive gap with foreign trusts.
- U.S. modernization, combined with the compliance and tax burdens imposed on foreign trusts, have been enough to tip the scales in favor of a domestic trust in many situations.

II. Foreign Trust Domestication: The Why?

- Migrating a foreign trust to the U.S. may be beneficial, especially in cases where the trust has U.S. beneficiaries. Among the benefits:
  - U.S. grantors and beneficiaries can avoid the onerous tax and reporting requirements imposed on foreign trusts
  - U.S. Settlor of a foreign non-grantor trust with U.S. beneficiaries may terminate his responsibility for payment of income taxes under §679.
  - Domestication stops the accumulation of Undistributed Net Income (UNI) under the “throwback” rules.
  - Foreign grantor may be able to take advantage of U.S. trust law without subjecting the trust to U.S. income taxes.
  - A U.S. jurisdiction avoids the negative perceptions associated with offshore trusts.

II. Foreign Trust Domestication: The Why?

- Reporting Requirements imposed on foreign trusts with U.S. grantors and beneficiaries:
  - Form 3520 – Must be filed by a U.S. person, to satisfy the requirements of I.R.C. § 6048(a), upon the occurrence of a reportable event. A reportable event includes:
    - the creation of a foreign trust
    - a transfer of assets to a foreign trust
    - the receipt of a distribution from a foreign trust
  - The penalty for failure to file Form 3520 is the greater of $10,000 or 35% of the value of property transferred to or received from a foreign trust.

II. Foreign Trust Domestication: The Why?

- Form 3520-A – Must be filed by a U.S. owner of a foreign trust, to satisfy the requirements of I.R.C. § 6048(b). The U.S. owner must report:
  - The income generated and the assets held by the trust
  - The U.S. beneficiaries of the trust
  - The U.S. owners of the trust
- The penalty for failure to file Form 3520-A is the greater of $10,000 or 5% of the gross value of the trust.
- Additionally, since the U.S. is not a signatory to CRS, domestication and appointment of only U.S. trustees generally will eliminate any entity-level reporting by the trust associated with CRS.
  - Reporting would also not be required for any U.S. accounts (unlike the trust's CRS jurisdiction accounts).

II. Foreign Trust Domestication: The Why?

- U.S. settlor of a foreign non-grantor trust with U.S. beneficiaries may terminate his responsibility for payment of income taxes under §679.
  – I.R.C. § 679 treats the U.S. settlor of any non-grantor foreign trust that has U.S. beneficiaries as the owner of such trust for income tax purposes.
  – Even a foreign settlor that becomes a U.S. person within 5 years of settling the trust will be treated as a U.S. owner under § 679 upon becoming a U.S. person.
  – If the non-grantor foreign trust is repatriated it will become a domestic non-grantor trust and the trust or its beneficiaries will be responsible for the income tax liability.

II. Foreign Trust Domestication: The Why?

- U.S. beneficiaries may avoid the application of the “throwback” taxes by domesticating a foreign trust.
  - If a foreign trust does not distribute all income currently (its distributable net income or “DNI”) but accumulates it, the DNI becomes undistributed net income (“UNI”).
  - Upon distributions of UNI to U.S. beneficiaries, an unfavorable set of provisions known as the "throwback” rules will apply to the receipt of any UNI.
  - Under the “throwback” rules, a distribution of UNI is taxed to the beneficiaries in a manner roughly approximating the tax situation if it had actually been distributed in the year earned.
  - Any capital gains lose their character once they become UNI, thus all UNI is taxed as ordinary income in the year it was earned, with interest.

II. Foreign Trust Domestication: The Why?

- Since the governing law of the trust is not determinative for tax purposes, it is possible to have a foreign trust governed by the laws of a U.S. jurisdiction.
  - This allows the application of flexible trust law (e.g., Delaware)
  - Without the consequences of U.S. income taxation (except for U.S. source income, which all foreign trusts would be responsible for)
- Finally, migrating a trust to the U.S. may eliminate the negative perceptions and even treatment applicable to some offshore jurisdictions.
  - Some offshore jurisdictions have even been added to black lists that expose them to prejudicial treatment by certain countries.
  - Some U.S. jurisdictions have been considered tax havens by foreign countries (e.g., Brazil considers Delaware a tax haven), but it is by no means the prevailing view.

II. Foreign Trust Domestication: The When?

- Consistent with the reasons for migrating a trust to the U.S., a good time to consider migration may be:
  - Upon the death of a foreign grantor if there are U.S. beneficiaries
    - If a trust is migrated before any UNI is accumulated, then the beneficiaries will never have to deal with UNI issues or "throwback" rules.
    - Beneficiaries can also reduce or eliminate the related reporting burdens.
  - When a beneficiary of a foreign non-grantor trust becomes a U.S. person
    - This would similarly avoid the UNI issues.
    - Alternatively, a second domestic trust may be established to receive all DNI and avoid the foreign trust accumulating UNI.

II. Foreign Trust Domestication: The How?

- A foreign trust can be domesticated in the following ways:
  - Replacing the existing trustee with a U. S. trustee (assuming trustee makes all “substantial decisions”) and the place of administration to a U.S. jurisdiction
  - Decanting into a new domestic trust
  - Termination of a trust and recreation of a new trust by original beneficiaries

II. Foreign Trust Domestication: The How?

- Replacing the existing trustee with a U. S. trustee and the place of administration to a U.S. jurisdiction.
  - The simplest way to domesticate a trust is to replace the foreign trustee with a U.S. trustee. Generally, the appointment of a U.S. Trustee would change the place of administration to the trustee's U.S. jurisdiction.
  - Many jurisdictions allow their courts to exercise jurisdiction over trusts administered in their jurisdiction.
  - This would classify the trust as a U.S. trust by both subjecting the trust to the jurisdiction of courts in the U.S. and placing all substantial decisions in the hands of a U.S. person.

II. Foreign Trust Domestication: The How?

- The biggest challenge to this simple method is the language of the trust itself that may include a foreign governing law.
- Under Delaware law, unless expressly provided by the terms of the trust, the laws of the state apply to a trust administered in the state.
- The Delaware Supreme Court recently held that if a trust allowed a change of trustee without geographic limitation, then the appointment of a Delaware trustee will change the place of administration of the trust to Delaware.
    - This applies regardless of a choice of law provision in the trust documents
    - Exception – If the trust expressly provides that a change in trustee does not change the governing law.

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II. Foreign Trust Domestication: The How?

- Termination/divestiture of a trust and recreation of a new trust by original beneficiaries.
  - Terminating or divesting an existing trust and funding a new one is not a method of domesticating a trust, but a method of obtaining the desired result.
  - Although there is precedent for treating a termination followed by a recreation as a mere change in form, there is a chance that the IRS may adopt the split transaction view and impose taxes on the receipt and subsequent disposition of the assets.

III. Generation Skipping Tax Implications

Generation Skipping Tax Implications

– GST tax-exempt trusts may lose their tax-exempt status
  - A generation skipping tax exempt trust is a trust to which the generation skipping tax provisions do not apply because:
    - – it was irrevocable as of September 25, 1985
    - – it was funded by a non-resident alien with non-U.S. situs property
    - – The trust has an inclusion ratio of zero.

– Certain modifications of the trust will result in the loss of the GST tax exempt status.

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III. Generation Skipping Tax Implications

- The IRS takes the position that any change in a trust that "alters the quality, value, or timing of any powers, beneficial interests, rights, or expectancies," will lose it GST tax exempt status.
- The IRS has ruled that a change in the trust situs does not cause a loss of the GST exempt status in cases where it does not also change the governing law of the trust.
- The IRS has not ruled on whether a change in trust situs along with a change in governing law results in the loss of the GST except status.

III. Generation Skipping Tax Implications

- The Treasury Regulations have provided for safe harbors that prevent the loss of GST tax exempt status. These safe harbors include:
  - The exercise by a trustee of power to distribute principal to a new trust. Requirements:
    - The distribution must be authorized either by the trust instrument or the governing law in existence at the time the trust became irrevocable.
    - The new trust's terms do not extend the time for vesting of any interest.
  - A modification of the trust that:
    - does not shift the beneficial interest in the trust to a lower generation.
    - The new terms do not extend the time for vesting of any interest.

III. Generation Skipping Tax Implications

– Who is the grantor when a trust is terminated and recreated? Or decanted?
  - The answer will depend on whether the change-of-form view or the split-transaction view is applied to the transaction.
– Change-of-Form View – Under the change-of-form view, there will be no taxable termination, the GST tax exemption will survive and the original grantor will be treated as the grantor of the new trust.
  - In *Buhl v. Kavanagh*, the court adopted the change-of-form view in a case where the taxpayer (beneficiary) and her father (grantor) agreed to terminate a trust and distribute the assets to the taxpayer who would immediately contribute the assets to a new trust with slightly different terms

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III. Generation Skipping Tax Implications

- Split-Transaction View – almost certain that any GST tax exempt attributes of a trust would be lost.
  - The beneficiaries would be treated as recipients of trust assets and the grantors of the new trust
  - This may have both income tax consequences and further transfer tax consequences on the creation of the new trust.
- Under *Buhl v. Kavanagh*, there is precedent for the application of the change-of-form view, but there is no set rule; the courts will look at all the facts and circumstances to determine the nature of a transaction.

III. Generation Skipping Tax Implications

– Delaware Tax Trap

- In Delaware, an interest in property created through the exercise of a power of appointment ("POA") is deemed to be created on the date of exercise of the POA and not on the date of creation of a POA.
- This is an issue where the original POA would be used to create a POA in a second generation, then the second POA would be used to create a POA in the third generation, and so on.
- Since each POA vests on the date of exercise, the rule against perpetuities is never violated and gift and estate tax is never paid.

III. Generation Skipping Tax Implications

- In response to this, the Congress enacted §2041(a)(3) that in effect, causes the inclusion in the gross estate of a decedent, of any property transferred via a POA whose rule vesting is ascertainable without regard to the date of creation of the original POA.
- If a trustee inadvertently springs the Delaware tax trap, it would result in a loss of the GST tax exempt status of a trust and the inclusion of the trust property in the estate of the new power holder.
- The best practice is to include language in the exercise of the POA specifying that the exercise of the POA shall be treated as relating back to the date of the creation of the original power.

IV. Rule Against Perpetuities Implications

- The common law rule against perpetuities (“RAP”) requires any interest in property to vest within 21 years of a life in being.
- Many jurisdictions have extended or eliminated the common law rule, so taking advantage of ever longer perpetuities periods is a large motivator to move to a new jurisdiction.
  - Generally, the RAP of the jurisdiction where real property is located will apply to a trust directly holding such real estate.
  - Some jurisdictions apply shorter RAPs to real estate (e.g., Wyoming 1000 yr. RAP to personal property and 21 yr. RAP for real estate)
- Merely changing the situs of the trust will usually not result in the application of the new jurisdiction’s RAP.

IV. Rule Against Perpetuities Implications

- Practically all jurisdictions treat the RAP as an issue of validity and not administration, so the validity of the trust must be tested at inception under the then applicable RAP.

- Delaware is the exception in that it offers a procedure that result in the application of Delaware's RAP to a trust settled under a shorter RAP.

- Although a trust decanted into a new Delaware trust retains its original RAP, if that trust is further decanted into another Delaware trust, Delaware’s perpetual RAP applies to the second trust.

- <u>May not be an end all solution</u>: This procedure fails the safe harbor provisions and will result in a loss of the GST tax exempt status of a trust.

V. Takeaways

- The domestication of a foreign trust may be in the best interest of U.S. beneficiaries that would otherwise be subject of onerous reporting requirements and punitive tax regimes
- Although various methods exist to migrate a trust to the U.S., extreme care must be taken to avoid incurring unfavorable tax consequences
- Special care should be taken to ensure that a valuable GST tax exemption is preserved after any transaction designed to migrate a trust
- Migrating a trust is not generally a realistic option if the goal is to obtain a new rule against perpetuities

Modern Cross-border Scenarios: The Foreign Non-grantor Trust

- Scenario 1: The Foreign Non-Grantor Trust
  - Many years ago, grandparents in Europe established a foreign grantor trust for their lifetimes, with the ultimate benefit passing to their grandchildren.
  - Grandchildren are U.S. citizens and residents. The surviving grandparent recently died and the grandchildren will now receive distributions from the foreign trust.
    - How will a distribution from a foreign trust to a U.S. beneficiary be taxed?
    - Would a U.S. domestic trust result in a better outcome?

Dealing With a Foreign Trust with U.S. Beneficiaries

- When the non-U.S. grantor of a foreign trust dies leaving U.S. family members as beneficiaries, the trust becomes a foreign non-grantor trust. A foreign non-grantor trust is subject to the "throwback rules."
  - Distributions from the foreign trust may include UNI that is subject to income tax and an interest charge based on a dollar-weighted number of years of accumulation.
  - Capital gains and qualified dividends included in UNI will be treated as ordinary income and taxed at ordinary income tax rates.
  - U.S. persons who receive distributions from foreign trusts are subject to additional reporting obligations, with substantial penalties for noncompliance.

Options for a Foreign Non-grantor Trust With U.S. Beneficiaries

- The family should consider deploying one of several options to avoid the unfavorable U.S. income tax consequences of UNI:
  - Domesticating the foreign non-grantor trust into a U.S. domestic trust if it is possible to do so before it accumulates UNI.
  - Establishing a separate mirror trust in the U.S. to receive annual distributions of DNI, thereby preventing the accumulation of UNI in the foreign trust.
  - Have the U.S. beneficiary elect the “default method” under which all distributions are ordinary income but avoid the interest charge if they remain less than 125% of the 3-year average of distributions to the beneficiary.

Modern Cross-border Scenarios: The Foreign “U.S.” Trust

- Scenario 2: The Foreign “U.S.” Trust
  - Patriarch is the life income beneficiary of an irrevocable Guernsey trust established by his father some years ago. At patriarch's death, his children – all of whom are U.S. citizens -- will become successor beneficiaries under the trust deed.
  - Patriarch wants to anticipate the U.S. income tax consequences that will occur following his death. He also wants to keep the trust “silent” until his children are sufficiently mature.
  - Can a Delaware trust offer greater flexibility?
  - What are the U.S. income tax consequences with a foreign U.S. trust?

Moving a Foreign Trust to the U.S. For Significant Modifications

- There may be circumstances in which a client wants to change the design of his or her trust to address a particular need, but the laws of the current offshore jurisdiction do not readily facilitate the proposed change.
  - The client wants to appoint investment advisors or distribution advisors for the trust, without any involvement of the trustee in investment or distribution decisions.
  - The client would like to defer informing the beneficiaries of the existence of the trust or client anticipates a potential challenge to the terms of the trust.
  - The client has concerns about his family's personal security and does not want to subject the trust and its underlying entities to asset and income reporting under the Common Reporting Standard. (The U.S. is not a signatory to CRS and has no obligation to report client financial data to participating countries.)
- In these and other circumstances, a Delaware trust may be the answer.

Moving a Foreign Trust to the U.S. Without U.S. Income Tax

- Non-U.S. clients can maintain a trust with a U.S. trustee, governed by U.S. state law, but ensure that the trust is treated as a foreign trust for U.S. income tax purposes. By giving a non-U.S. person authority over any substantial decisions involving a trust, the trust will fail the "control" test and qualify as a foreign trust.
- Only U.S. source income will be subject to U.S. income tax. Generally speaking, U.S. source income includes interest (but not portfolio interest from U.S. bills, notes and bonds), dividends from U.S. corporations, and proceeds and rents from U.S. properties. Capital gains on intangible U.S. assets are not source income.
- The point of the foreign "domestic" trust is to have the advantages of U.S. trust law without subjecting the trust to U.S. income and transfer taxes.

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Thank you!

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