

# GERBER SPECIAL REPORT:

## Wealth Transfer Planning for the Global Family

### Trusts Created by Foreign Persons for U.S. Beneficiaries

We live in an increasingly global society. It is not uncommon for foreign individuals to have family and friends in the United States whom they would like to benefit in their wealth planning – children, grandchildren, nieces, nephews. The question, and the opportunity, for non-U.S. persons who intend to make transfers to U.S. beneficiaries is how to make the transfers in a manner that achieves their goals. The use of a long-term trust located in the United States for the benefit of U.S. beneficiaries is one alternative.

This *Gerber Special Report* provides an overview of considerations related to planning with a trust created in the United States by a non-U.S. person for U.S. beneficiaries. We do not address the use of U.S. trusts created by foreign persons for foreign beneficiaries. Our discussion is an overview; it is not a blueprint for any specific situation. Readers are reminded that individual planning should involve legal and tax advisors familiar with their particular circumstances, considering both U.S. and home country legal and tax implications.

#### OVERVIEW

There are a number of options to consider for the design of a trust by a foreign person who intends to benefit U.S. beneficiaries, depending on the priorities of the settlor. We discuss two approaches – the revocable foreign grantor trust and the irrevocable U.S. domestic non-grantor trust.

First, for clarity, we have a bit of terminology to navigate. We refer to a person who creates a trust as the settlor, and the settlor of a trust who is treated as the owner of the trust under the U.S. income tax rules as the grantor. A person is foreign if they are neither a citizen nor a resident of the United States, although the determination of whether a person is a resident differs depending on the type of tax in question. As to a trust, the residence of a trust is either U.S. domestic or foreign. A trust that is treated as a separate taxpayer for U.S. income tax purposes is referred to as a non-grantor trust. Conversely, a trust with flow-through U.S. income tax treatment is designated as a grantor trust.

## U.S. TAX CONSIDERATIONS

U.S. income, gift, estate and generation-skipping transfer (GST) taxes have a broad reach. U.S. citizens are taxed on worldwide income and assets, as are persons who are U.S. residents, although the technical meaning of a U.S. resident differs for income tax versus gift, estate and GST taxes (collectively, “transfer taxes”). Foreign persons who are neither citizens nor residents of the United States (and, we assume for this discussion, did not formerly expatriate from the United States) are taxed in a much more limited manner. Very broadly speaking for foreign persons, U.S. source income is subject to U.S. income tax and withholding. Similarly, U.S. located assets transferred during life or at death are subject to U.S. transfer taxes. There are exceptions, of course, but that is the general framework.

Just as individuals have an income tax residence, so too do trusts. For U.S. Federal income tax purposes, a trust is a domestic trust if it satisfies each of two separate tests – the court test and the control test. A trust that fails either test is a foreign trust for U.S. Federal income tax purposes, even if the trust is created under and governed by the law of a U.S. state and administered in the U.S. by a U.S. trustee for U.S. beneficiaries.

- **The court test.** A trust meets the court test if a court within the United States is able to exercise primary jurisdiction over the administration of the trust.<sup>2</sup> A trust established under the law of a U.S. state with a U.S. trustee will typically be able to subject itself to the jurisdiction of a U.S. court and will meet the court test.
- **The control test.** Next, we turn to the control test. A trust meets the control test if one or more U.S. persons have the authority to control all substantial decisions of the trust.<sup>3</sup> If a non-U.S. person, whether a trustee, protector, advisor, settlor, or even a beneficiary, has the ability to control, or even to simply veto, a substantial decision, the trust will fail the control test and be classified as a foreign trust for U.S. Federal income tax purposes.

It is important to note that the status of a trust as domestic or foreign can change if there are changes with respect to the persons with control over the trust.

A foreign person ordinarily is not subject to U.S. income tax on her non-U.S. income and not subject to U.S. transfer taxes on transfers of her non-U.S. assets. Similarly, a foreign trust is not subject to U.S. Federal income tax on its non-U.S. source income. This paradigm is the cornerstone of the trust design for a foreign settlor who intends to benefit U.S. beneficiaries. The actual planning and implementation require consideration of the many complexities associated with this basic framework.

## FOREIGN GRANTOR TRUST

A foreign person may establish a revocable foreign grantor trust in the U.S. funded with non-U.S. situs assets. At the settlor’s death the trust would become irrevocable, be domesticated as a U.S. trust, and continue for the benefit of the U.S. beneficiaries.<sup>4</sup> Because the trust is both a foreign trust and a grantor trust, neither the trust nor the settlor is taxed on non-U.S. source income during the settlor’s lifetime. In addition, unless the trust holds U.S. situs assets at the death of the settlor, no U.S. estate tax would apply

at the death of the settlor. However, the foreign settlor remains subject to any applicable tax rules of her home country.

### **The Foreign Settlor's Lifetime – The Revocable Trust**

The first step is to determine the residence of the trust for U.S. Federal income tax purposes. The foreign settlor retains the power to revoke the trust, which is a substantial decision. The trust, therefore, fails the control test and is considered a foreign trust for U.S. Federal income tax purposes.

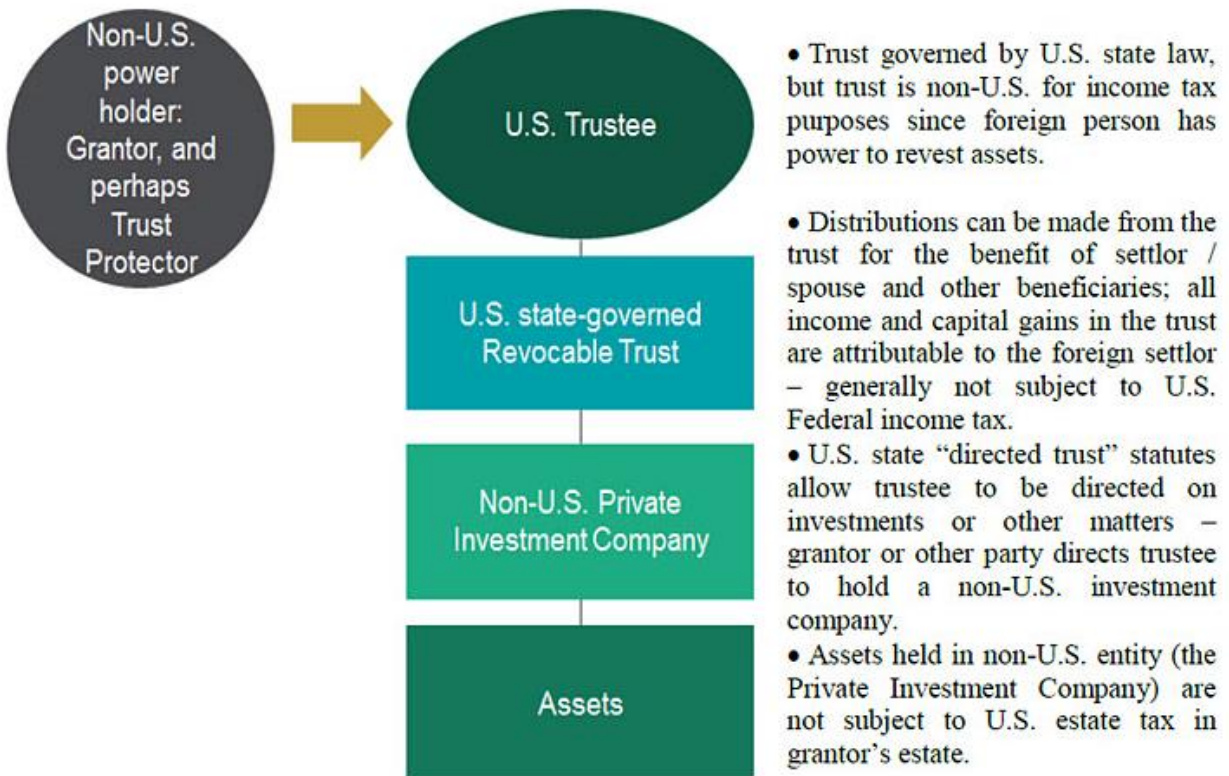
The next step is to determine if the foreign trust is a “grantor trust” the income of which will flow through to the foreign settlor treated as the owner of the trust for U.S. income tax purposes. A foreign settlor is treated as the grantor owner of a trust under the U.S. grantor trust tax rules if either:

- The grantor has the power to revest title of the trust property in herself exercisable solely by the grantor, either without the approval of another person or with the consent of a related or subordinate party who is subservient to the grantor; or
- Distributions from the trust may only be made during the grantor's lifetime to the grantor or the grantor's spouse.<sup>5</sup>

In a foreign grantor trust the income, deductions and credits against U.S. Federal income tax of the trust are attributed to and flow through to the foreign settlor who is treated as the grantor and owner of the trust. During the settlor's lifetime she would not be subject to U.S. income tax on non-U.S. source income of the trust or on income of the trust otherwise exempted from U.S. Federal income tax.

Any distributions from the foreign grantor trust during the settlor's lifetime to U.S. beneficiaries will be gifts to the beneficiaries, not income. The U.S. beneficiaries will, however, be subject to U.S. tax compliance reporting requirements with respect to distributions from a foreign grantor trust.<sup>6</sup>

## Foreign Grantor Trust: Revocable During Settlor's Lifetime



- Non-U.S. settlor (grantor) establishes a revocable trust governed under U.S. state law.
- Considered non-U.S. for U.S. income tax purposes – because foreign settlor has the power to revest trust assets.

### The Foreign Settlor's Death – The Transition

At the foreign settlor's death the formerly revocable trust will become irrevocable. The U.S. estate tax ordinarily will apply to U.S. situs assets held in the trust at death, but not to non-U.S. situs assets. Shares in non-U.S. corporations held by foreign persons are not subject to U.S. estate tax. Consequently, foreign persons and their revocable foreign grantor trusts commonly hold U.S. investment assets within non-U.S. corporations. These holding entities within a revocable foreign grantor trust, which becomes irrevocable at the settlor's death, are typically restructured following the death of the settlor where assets will remain in trust for U.S. beneficiaries. Complex tax accounting, reporting and compliance rules apply to controlled foreign corporations and passive foreign investment companies held by or for the benefit of U.S. persons.

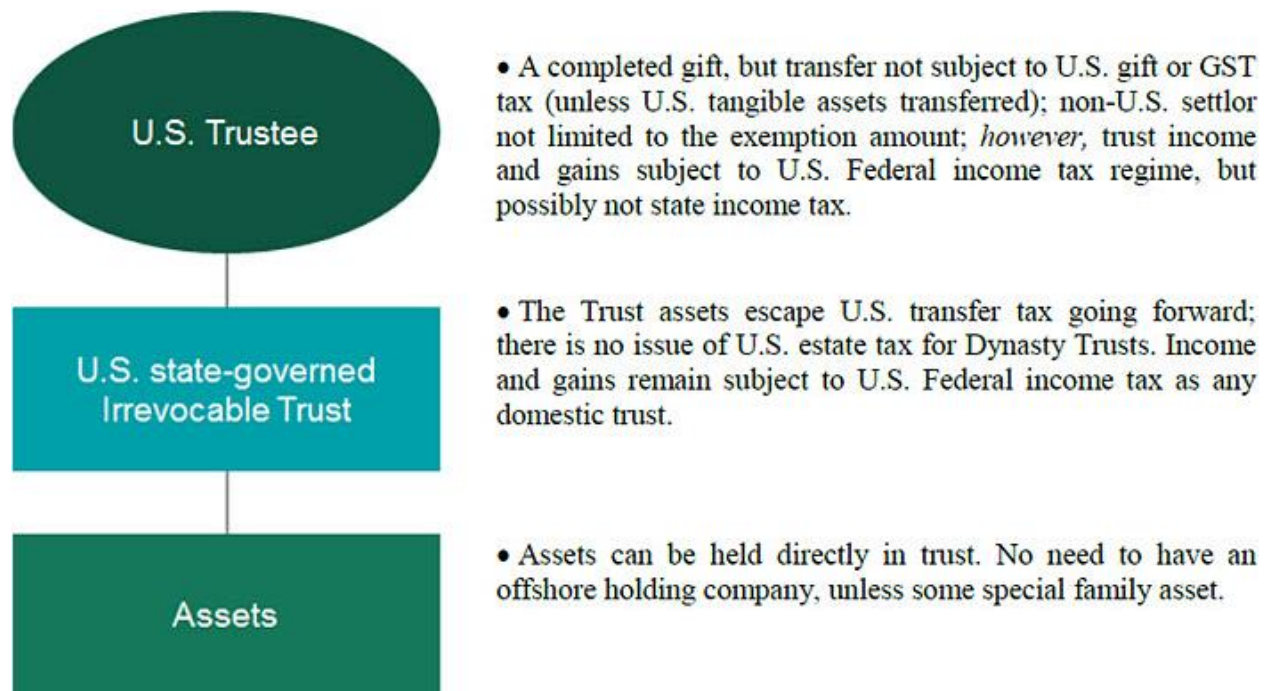
Following the foreign settlor's death the now irrevocable trust becomes a non-grantor trust for U.S. income tax purposes, meaning that it is a separate taxpayer. It will either be a separate U.S. domestic trust taxpayer or a separate foreign trust taxpayer. Where the intention is to benefit U.S. beneficiaries, treatment as a separate U.S. domestic trust taxpayer, rather than as a foreign trust taxpayer, is typically

preferred due to complex and often onerous tax rules related to foreign non-grantor trusts with U.S. beneficiaries. Thus, it will be important to review the trust upon the death of the foreign settlor to ensure that the court test and the control test discussed above are met. Any foreign power holders, such as a foreign protector, will need to resign in order for the trust to be considered a U.S. domestic trust.

As a separate U.S. trust taxpayer, the trust will pay U.S. Federal income tax on the worldwide income it realizes and accumulates in the trust. U.S. beneficiaries will pay U.S. income tax on the distributable net income they receive. See the discussion below regarding U.S. state trust income tax considerations.

### Foreign Grantor Trust: Irrevocable After Settlor's Death

- After settlor's (grantor's) death – trust becomes irrevocable and non-grantor trust; beneficiaries are solely U.S. persons.
- Trust becomes subject to U.S. Federal income tax, but may not be subject to state income tax.



### Foreign Grantor Trust – Putting It All Together

With proper trust design and ownership of assets within a foreign grantor trust, it is possible to achieve a number of wealth-planning goals:

- The foreign settlor can create a trust for her benefit during her lifetime and/or for U.S. beneficiaries.
- Any non-U.S. source income is not taxed by the U.S.; any U.S. source income is taxed to the settlor, not the trust.

- Non-U.S. situs trust assets are not subject to U.S. estate tax upon the death of the settlor.
- Upon the death of the settlor, the trust becomes irrevocable and continues for the U.S. family and friends the settlor intends to benefit.
- Although income realized and accumulated in the trust after the settlor's death will become subject to U.S. federal income taxation, depending on the state of residence of the trust, no state income tax may apply.
- The trust may continue for generations as a dynasty trust not subject to future U.S. transfer taxes.

### **IRREVOCABLE U.S. DOMESTIC NON-GRANTOR TRUST**

A foreign person may desire to make a current gift in trust for U.S. beneficiaries. In that case, the trust is designed as an irrevocable U.S. domestic non-grantor trust. The trust is treated as a separate U.S. taxpayer for U.S. income tax purposes, taxed on the worldwide income realized and accumulated in the trust, with the U.S. beneficiaries taxed on any current income distributions.

Transfers to the trust are completed gifts for U.S. gift tax purposes. However, foreign persons are only subject to U.S. gift tax on lifetime gifts of U.S. located tangible personal and real property. Gifts of foreign located property and gifts of U.S. located intangible personal property by foreign persons are not subject to U.S. gift or GST taxes. Therefore, it is possible for a foreign person to transfer unlimited amounts of foreign property and U.S. intangible property during life free of U.S. gift and GST tax. Gifts of U.S. securities are considered intangible. The treatment of U.S. cash and currency as tangible or intangible may be subject to question and should be reviewed carefully with one's legal and tax advisors.

The U.S. recipient trust or beneficiary receiving a gift from a foreign person typically has U.S. tax compliance reporting obligations independent of any tax or reporting obligations of the donor.<sup>7</sup>

Where there is a completed gift into an irrevocable trust, the assets are no longer in the settlor's estate, and therefore, not subject to U.S. estate taxes upon the death of the settlor. The settlor remains subject to any applicable home country tax rules.

#### **Irrevocable U.S. Domestic Non-Grantor Trust Created by Non-U.S. Settlor**

- Settlor creates an irrevocable U.S. domestic trust for the benefit of U.S. persons.
- Generally, the transfer of assets is not subject to U.S. gift or GST taxes.
- Trust is subject to U.S. Federal income tax, but possibly not state income tax.

#### **Irrevocable U.S. Domestic Non-Grantor Trust – Putting It All Together**

With proper gift and trust design, it is possible for a foreign person to achieve a number of wealth-planning goals with an irrevocable U.S. domestic non-grantor trust –

- Unlimited lifetime transfers of foreign assets and intangible U.S. assets for the benefit of U.S. beneficiaries may be made free of U.S. gift and GST taxes.

- Assets for the ultimate benefit of U.S. beneficiaries may be removed from the estate of the foreign settlor and from the reach of U.S. estate and GST taxes at death.
- The trust may be a dynasty trust which avoids U.S. transfer taxes for future generations.
- While the trust will be subject to U.S. Federal income tax, it may be established in a state free of state income tax.

### CHOOSING A U.S. STATE TO CREATE THE TRUST

In creating either a revocable foreign grantor trust or an irrevocable U.S. domestic non-grantor trust in the U.S., there are choices to be made regarding the selection of –

- The laws of the U.S. state under which the trust will be established and governed;
- The U.S. trustee; and
- The U.S. state where the trust will be administered.

The choice of state law, trustee and place of administration will have implications on the state income taxation of the trust and the governance of the trust. By way of example –

- Florida, Nevada and Texas have no state income tax.
- Delaware state income tax is limited and does not apply to trusts with no Delaware resident beneficiaries or Delaware state source income.
- Certain states have what is commonly referred to as “directed trust statutes” which provide for expanded flexibility in the division of the powers and responsibilities of the administration of a trust. Representative states with directed trust statutes include Delaware, Florida, Illinois and Nevada.
- State law may or may not permit a trust to continue for an extended period, in perpetuity.
- State law may or may not permit “confidential trusts,” limiting the circumstances in which a beneficiary is entitled to statements of account and other information regarding a trust.

These examples are representative; they are not exhaustive. The choice of state law and location of a trust within the fifty states of the U.S. is material and the choices are not limited to the residence of the settlor, trustee or beneficiary. Trusts are often established in the U.S. by foreign settlors for beneficiaries who reside throughout the United States and around the globe.

### CONCLUSION: PITFALLS AND OPPORTUNITIES

**There is an abundance of planning opportunities for foreign persons desiring to benefit U.S. beneficiaries. Trusts play an important role in that planning. However, the planning is complex.**

**The consideration of the alternatives for planning in individual circumstances requires consultation with one’s legal and tax advisors.**

**LEGAL, INVESTMENT AND TAX NOTICE:** This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal or tax advice from their own counsel.

**OTHER IMPORTANT INFORMATION:** Opinions expressed and information contained herein are current only as of the date appearing in this material and are subject to change without notice.

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<sup>2</sup>IRC § 7701(a)(30)(E)(i).

<sup>3</sup>IRC § 7701(a)(30)(E)(ii).

<sup>4</sup>See for example PLR 200243031.

<sup>5</sup> IRC § 672(f)(2)(A).

<sup>6</sup>Extensive tax compliance reporting requirements pertain to distributions from a foreign trust (grantor and non-grantor) to a U.S. beneficiary. IRC § 6048(c). See IRS Forms 3520 and 3520A.

<sup>7</sup> Id.