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# U.S. SITUS FOREIGN TRUSTS FOR CROSS BORDER FAMILIES

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# U.S. SITUS FOREIGN TRUSTS

- A U.S. situs foreign trust is a trust that is a foreign trust for U.S. tax purposes but is a domestic trust for state law purposes.
- Can be attractive wealth transmission device for a foreign person who is seeking the protection of the U.S. legal system, particularly for those with U.S. children.

# SCOPE OF DISCUSSION

1. How to create a U.S. situs foreign trust
2. How to the U.S. situs foreign trust should be structured during life of its foreign grantor when the post-death beneficiaries will be U.S. individuals
3. How to administer the U.S. situs foreign trust for the benefit of U.S. beneficiaries after death of foreign grantor

## U.S. SITUS

- A trust is a U.S. situs trust if it is created under the laws of one of the states of the United States and has one or more trustees who are residents of a state within in the United States.

# HOW TO MAKE A U.S. SITUS TRUST A FOREIGN TRUST

- A trust is a foreign trust unless both of these conditions are satisfied:
  - a court or courts within the U.S. must be able to exercise primary supervision over administration of the trust (the “court test”) and
  - one or more U.S. persons have the authority to control all substantial decisions of the trust (the “control test”)

# HOW TO MAKE A U.S. SITUS TRUST A FOREIGN TRUST

- The foreign person who wants a U.S. situs trust will not want to flunk the court test.
- One of her objectives is to seek the protection of courts in the United States

# HOW TO MAKE A U.S. SITUS TRUST A FOREIGN TRUST

- If one person who is not a U.S. person has the power to control one or more substantial decisions of the trust, the trust will be a foreign trust for U.S. tax purposes no matter how many other contacts that trust has with the United States.
- If a foreign person can veto a decision made by U.S. persons, the foreign person is treated as controlling that decision for purposes of the control test.

# HOW TO MAKE A U.S. SITUS TRUST A FOREIGN TRUST- SUBSTANTIAL DECISIONS

- The timing and amount of distributions;
- The selection of beneficiaries;
- The power to determine whether receipts are allocable to income or principal;
- The power to terminate the trust;
- The power to compromise, arbitrate, or abandon claims of the trust and to decide whether to sue on behalf of or defend suits against the trust;



# HOW TO MAKE A U.S. SITUS TRUST A FOREIGN TRUST- SUBSTANTIAL DECISIONS

- The power to remove, add or replace a trustee;
- The power to appoint a successor trustee (even if such power is not accompanied by an unrestricted power to remove a trustee) unless the appointment power is limited in such a way that it cannot be exercised in a manner that would alter the trust's residency; and
- The power to make investment decisions.

# DURING THE LIFE OF THE GRANTOR

- Five objectives

1. Permit income tax-free distributions to U.S. beneficiaries.
2. Avoid the accumulation of undistributed net income (UNI).
3. Avoid possible current taxation of U.S. beneficiaries if trust invests in CFCs or PFICs.
4. Avoid U.S. estate tax at death of grantor.
5. Permit basis adjustment of trust assets at death of grantor.

# GRANTOR TRUST STATUS

- The first 3 goals can be achieved by grantor trust status.
- A grantor trust is a trust that is treated as owned by its grantor under Code §671.
- A grantor trust, whether foreign or domestic, pays no U.S. income tax. Instead, all of the income, deductions, and credits of the trust are taken into account by the grantor in computing the grantor's U.S. income tax.

## GRANTOR TRUST STATUS

- Because the grantor of a grantor trust is treated as having received all trust income,
  - Income distributed to U.S. beneficiaries is excluded from their gross incomes.
  - Undistributed income does not become UNI

# GRANTOR TRUST STATUS

- Because the foreign grantor of a grantor trust is treated as owning all of the trust assets,
  - Shares of foreign corporations are not treated as owned by the trust's U.S. beneficiaries and will not become controlled foreign corporations (CFC's) on account of trust ownership
  - Shares of foreign corporations that are passive foreign investment companies (PFICS) are not treated as owned by the trust's U. S. beneficiaries

# TRANSFERS TO U.S. BENEFICIARIES FROM FOREIGN CORPORATIONS OWNED BY FOREIGN GRANTOR TRUSTS ARE NOT PROTECTED

- Code §672(f)(4) and the regulations under this section requires a U.S. person who receives a distribution other than a transfer for fair value from a foreign corporation that the U.S. person does not have an interest in must include the distribution in gross income as ordinary income.

# ACHIEVING GRANTOR TRUST STATUS FOR TRUST WITH FOREIGN GRANTOR

- A trust will be treated as owned by a foreign person only if that person is the grantor of the trust for income tax purposes.
- A person is a grantor of a trust for income tax purposes only to the extent of her gratuitous transfers to the trust either by means of the transfer of her own property to the trust or by the exercise of a general power of appointment over a trust created and funded by someone else.
- A gratuitous transfer by an individual means a transfer other than a transfer made for fair market value .

# ACHIEVING GRANTOR TRUST STATUS FOR TRUST WITH FOREIGN GRANTOR

- Code §672(f) provides that a trust created or funded after September 19, 1995 will not be treated as owned by a non-U.S. person under the grantor trust rules unless:
  - the trust is revocable by its non-U.S. grantor or
  - it may benefit only the grantor or his or her spouse during the grantor's life



# WHEN IS A TRUST REVOCABLE?

- A trust is revocable for this purpose only if the grantor by herself or with the consent of a related or subordinate party who is subservient to the grantor.
- If the grantor becomes incompetent, revocable status will be retained if a guardian or other person has the power to revoke the trust on behalf of the grantor without the consent of any other person.
- The power to revoke must exist for at least 183 days of every taxable year of the trust's existence. If a taxable year is less than 183 days, the trust must be revocable on everyday of that year.
- If the trust ceases to be a revocable trust, a restoration of revocability will not satisfy this requirement for grantor trust status.

# SOLE BENEFIT REQUIREMENT

- A trust that cannot make any distributions to either one or both of the grantor and the grantor's spouse during the lifetime of the grantor will be treated as is exempt from Code § 672(f)(1). If any amount is distributable to another person, even temporarily, it will not satisfy this exemption.
- Satisfying this exception will not, by itself, cause the trust to be a grantor trust. There must be an independent provision that causes the trust to be treated as a grantor trust.
- For example, if distributions of trust income can be made to either the grantor or the grantor's spouse without the consent of an adverse party, the trust should be treated as a grantor trust.

# AVOIDING U.S ESTATE TAX

- The rules governing the inclusion of trust property in the gross estate of its foreign grantor are discussed starting on page 11 of the outline.
- The U.S. situs assets foreign grantors are typically concerned with are shares of U.S. corporations and U.S. real estate.
- U.S. situs assets held directly by a foreign individual at death are subject to U.S. estate tax
- If assets are held in a trust at its foreign grantor's death, and if the grantor has a dispositive power over the trust at death or has retained the right to trust income, the trust property will be subject to U.S. estate tax at his death to the extent the trust was funded with U.S. situs assets or consists of U.S. situs assets at the grantor's death.

# AVOIDING U.S ESTATE TAX

- Foreign individuals who wish to own U.S. situs assets generally transfer ownership to a foreign corporation in order to avoid U.S. estate tax.
- Care must be taken to avoid the IRS's treatment of the corporation as a mere nominee.
  - The shareholder or shareholders should consistently treat the corporation as a separate entity.
  - It should have directors and officers
  - Corporate formalities should be followed before funds are distributed to its shareholders as dividends.

## SECURING BASIS STEP-UP AT DEATH

- Code § 1014(b)(1) and (b)(2) provides a basis equal to the date of death (or alternate valuation date) value of assets held **outright** by a foreign decedent or in a revocable trust if the trust income was payable to or at the direction of the decedent during her life (a **revocable income directed trust**) whether or not the assets were subject to U.S. estate tax.

# DEALING WITH CFC SHARES

- If the decedent or her revocable income directed trust held all of the shares of a foreign corporation at her death (perhaps because she used it to shield her U.S. assets from U.S. estate tax), the trust will become a controlled foreign corporation (a CFC) when the grantor dies, potentially subjecting the U.S. beneficiaries to tax at ordinary income rates on all of the corporations subpart F income , largely passive income, and its global intangible low-taxed income (“GILTI”)
- The U.S. beneficiaries will want the trustee to dispose of the CFC shares as soon as possible after death.
- Because the shares received a date of death basis, there should be little, if any, tax to pay on the gain. Because the sale is likely not to take place immediately, the U.S. beneficiaries will have some inclusion of CFC income. Page 19 of the outline contains an example of how this is calculated.

# DEALING WITH CFC SHARES

- It may not be practical to sell the CFC shares for their full value.
- Liquidation of the corporation is an alternative.
  - Actual liquidation
    - Corporation distributes all of its assets to its shareholders
  - Deemed liquidation
    - Corporation (if not a per se corporation) under the regulations makes an election by filing Form 8832 to be treated as a partnership if there is more than one shareholder or a discarded entity if there is only one shareholder, a check-the-box election.

# CONSEQUENCES OF DEEMED LIQUIDATION OF CFC

When a corporation has a deemed liquidation it is deemed to have transferred all of its assets to its shareholders. The distribution causes a deemed recognition of all of the unrealized gain in its assets.

If the deemed liquidation is treated as occurring after the death of the foreign individual, this income will be subpart F income and a pro rata portion of it will be taxable to the U.S. beneficiaries of the foreign individual's estate or of her revocable income directed trust. There's an example on page 20 of the outline that shows how to calculate the pro rata portion. The longer the corporation remains a CFC, the greater the portion that will be taxed to the U.S. beneficiaries.



# CONSEQUENCES OF DEEMED LIQUIDATION OF CFC

- The election can be made retroactive to a date before the foreign decedent's death. In that case, the corporation will never become a CFC, and no part of the deemed gain will be taxed to the U.S. beneficiaries.
- If the corporation held U.S. situs assets, a check-the-box election effective before death could cause those assets to be subject to U.S. estate tax.

# DEALING WITH SHARES OF PFICS

- If the estate of a foreign decedent or her revocable income directed trust sells its shares of a PFIC, a pro rata share of any gain realized may be taxed to the U.S. beneficiaries of the estate or trust. Any gain realized will be treated as an excess distribution within the meaning of Code § 1291(a)(2), taxed as ordinary income, and subject to an interest charge under Code § 1291(c) if the sale occurs in a year after the year of the decedent's death.
- If the estate sells the PFIC shares within the year of the decedent's death, the consequences to the U.S. beneficiaries is unclear but it is likely that there will be no interest charge.

# SECURING A BASIS STEP UP AT DEATH

- If the trust is **irrevocable** during the decedent's life but is a grantor trust because no distributions were permitted to be made during the decedent's life to any person other than the decedent and the decedent's spouse, its assets will likely not be entitled to the Code § 1014 basis step up.
- If this is the case, a basis step up can be arranged for by transferring all of the trust's assets prior to the grantor's death to a foreign corporation that is not a per se corporation. After the decedent's death, retroactive check-the-box election can be made to cause a deemed gain recognition on the death before the grantor's death. This will cause a increase in the basis of all corporate assets to their value on the date before the date of the decedent's death.

# HOW IS THE TRUST TAXED AFTER THE GRANTOR'S DEATH?

- The trust will be a foreign nongrantor trust (a FNGT).
- A FNGT is taxed like a nonresident alien (an NRA) individual only on US source income,
- A FNGT must keep track of worldwide income to calculate DNI, which measures the amount of income that is taxed when a distribution is made to a US beneficiary,
- A FNGT is allowed a deduction for distributions made to US beneficiaries and charities in a manner similar to US nongrantor trusts, but there are important differences.

# GROSS INCOME OF THE FNGT

Only the U.S. source income of a FNGT is subject to U.S. tax.

U.S. source income is

1. income effectively connected with a U.S. trade or business (ECI),
2. income from the disposition of U.S. real property interests, which is treated as effectively connected income (FIRPTA), and
3. fixed, determinable, annual or periodic income (FDAP) from U.S. sources such as interest, dividends, rents and annuities and the like (other than interest excluded under §871(h) and (i).

## TREATMENT OF INCOME FROM PASS-THROUGHS

- Income from partnerships and other pass through entities in which a foreign trust has an interest is treated as effectively connected income to the extent the partnership has a U.S. business or gains from the disposition of U.S. real estate.

# FDAP INCOME

- FDAP income includes all income from U.S. sources that is included in gross income under §61 other than
  1. Gains derived from the sale of property other than (a) gains from the sale or disposal of timber, coal, or domestic iron ore with a retained economic interest or (b) gains subject to the 30% tax under §871(a)(1)(D) or §881(a)(4), relating to contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property. Treas. Reg. § 1.1441-2.

# FDAP INCOME

2. Interest paid on U.S. bank deposits.
3. Interest (including original interest discount) paid on certain obligations issued by U.S. persons after July 18, 1984 (the “portfolio debt” exception).

FDAP income is subject to U.S. income tax at a 30% rate.



# TAXATION OF U.S. BENEFICIARIES

- U.S. beneficiaries of FNGTs are taxed on distributions from current income and from accumulated income. Distributions from accumulated income are taxed at ordinary income rates and are subject to punitive interest charges.
- If distributions to U.S. beneficiaries never exceed the greater of distributable net income and trust accounting income in any year, accumulated income from non-U.S. sources will never be subject to U.S. income tax. This will enable principal to grow income tax-free, providing an ever increasing pool of capital to provide greater distributions to future generations.

# EXAMPLE

- Suppose, for example, that a non-U.S. grantor with one U.S. child establishes a trust with no termination date in a jurisdiction that does not impose an income tax. At the time of his death, the trust is funded with \$100 million. Its terms provide for an annual distribution of 2% to his sons. The balance of the trust's income and appreciation is accumulated. If the trust is invested in assets that earn income not subject to U.S. income tax, if it earns income and appreciation of 7%, and if the child lives 40 years after the death of his parent, the child's annual income will have grown to \$13 million per year and the trust fund now available for the grantor's grandchildren will have grown to about \$704 million.

# HOW U.S. BENEFICIARIES OF FNGTS ARE TAXED

1. U.S. income tax on distributions.
2. U.S. income tax on certain loans.
3. U.S. income tax on certain gifts received from other trust beneficiaries
4. U.S. income tax on income earned by controlled foreign corporations and passive foreign investment companies whose shares are owned by the trust.

# HOW U.S. BENEFICIARIES OF FNGTS ARE TAXED

- A U.S. beneficiary of a FNGT is taxed on the lesser of the amount of cash or the basis of property other than cash received from her trust in a particular year and (2) her distribution's share of the taxable portion of the trust's distributable net income or DNI for the year but may also be taxed on her share of the FNGT's accumulated income if the amount of her distributions exceeds her share of the greater of DNI and trust accounting income.

# DNI

- The DNI of a FNGT is its taxable income including capital gain income.
- The character of a beneficiary's share of income is generally the same as her pro rata share of the character of the trust's income included in DNI.

## FOUR PRINCIPLES THAT CAN PROTECT A U.S. BENEFICIARY FROM TAX ON DISTRIBUTION FROM A FNGT

1. §662 provides that a beneficiary who is required to receive distributions of trust accounting income will include in her gross income the lesser of the income or the trust's DNI. Amounts that are properly paid to another beneficiary but are not required to be paid are taxable to the beneficiary only if the trust's DNI exceeds the trust accounting income

## FOUR PRINCIPLES THAT CAN PROTECT A U.S. BENEFICIARY FROM TAX ON DISTRIBUTION FROM A FNGT

2. §663(b) provides that an amount required to be paid to a beneficiary as a gift of a specific sum of money or of specific property and which is actually paid to her all at once or in no more than three installments is not treated as a distribution and is not included in the gross income of the U.S. beneficiary.

## FOUR PRINCIPLES THAT CAN PROTECT A U.S. BENEFICIARY FROM TAX ON DISTRIBUTION FROM A FNGT

3. §643(e) provides that the amount of any distribution to a beneficiary of property other than cash (other than a required distribution of trust income) is the lesser of the trust's basis in the property or its value at the time of distribution unless the trustee makes an election to recognize gain on the distribution.



# FOUR PRINCIPLES THAT CAN PROTECT A U.S. BENEFICIARY FROM TAX ON DISTRIBUTION FROM A FNGT

- 4. A distribution that exceeds the trust's DNI for the year but not its trust accounting income for the year will not be taxed to the U.S. beneficiary to the extent of the excess of trust accounting income over DNI.
- Example : FNGT has DNI of \$100,000. It received a \$200,000 cash distribution from an LLC in which it was a member. The distribution was not a liquidating distribution. Under SDCL §55-13A-501 the distribution is trust accounting income. FNGT distributed \$200,000 to its U.S. beneficiary B. Bi includes only \$100,000 in her gross income.

# DISTRIBUTIONS OF ACCUMULATED INCOME

- U.S. beneficiaries are subject to tax on accumulation distributions from NGTs to the extent of the NGTs undistributed net income (UNI). §666.
- A NGTs UNI for any taxable year is the amount by which its DNI for the year exceeds the sum of the amounts distributed to beneficiaries plus the amount of taxes imposed on the undistributed income. §665(a).
- It is sometimes possible to prevent the accumulation of income in a FNGT by regularly distributing all of its DNI to other foreign trusts with somewhat different beneficiaries.

## DISTRIBUTIONS OF ACCUMULATED INCOME

- A FNGT's accumulation distribution for any year is the amount by which its distributions during the year, exceed the greater of (1) its DNI for the year or (2) its trust accounting income for the year. §665(b). If the distribution does not exceed trust accounting income, it will not be an accumulation distribution no matter the size of the trust's UNI.

# DISTRIBUTIONS OF ACCUMULATED INCOME

- The basic function of the tax on accumulation distributions (the “throwback tax”) is to tax the trust beneficiary when she eventually receives a distribution of income at the tax rate that would have applied to her if she had received it in the year the trust received the income. The accumulation tax imposed on the beneficiary is reduced by the U.S. tax paid by the trust. In the case of a foreign trust, that tax may have been zero.
- In the case of distributions from FNGTs, §668 imposes an interest charge on the throwback tax, calculated at the applicable §6621 rate for underpayments of tax, compounded daily.

# THE THROWBACK TAX

- There are two methods of calculating the throwback tax
  1. The exact method and
  2. The default method.

# WHO CAN USE THE EXACT METHOD

- A U.S. beneficiary of a FNGT may use the exact method of calculating the throwback tax only if the beneficiary received a FNGT beneficiary statement from the foreign trust with respect to the distribution.
- If the beneficiary did not receive a FNGT statement from the foreign trust with respect to the distribution, she must report the distribution using the default method of calculating the tax and interest.

# THE DEFAULT METHOD

- If the beneficiary did receive a FNGT statement, she may, but is not required to, use the default method.
- If she elects to use the default method, she must continue to use it until the final year of the trust.
- The election by one beneficiary of a FNGT to use the default method will not prevent other beneficiaries from using the exact method.

# THE DEFAULT METHOD

Step #1- Beneficiary calculates total amount of distributions received from FNGT during prior 3 years.

Step #2 – Multiply step #1 amount by 125%

Step #3 – Divide step # 2 amount by 3.

- The amount of the beneficiary's distribution in excess of step #3 amount is an accumulation distribution. Beneficiary is taxed on distribution at ordinary income rates.
- The number of years for purposes of calculating interest § 668 will be one-half of the number of years the trust has been in existence as a foreign non-grantor trust.



# THE DEFAULT METHOD

- Example:
- FNGT was created and funded on January 1, 2013.
- FNGT makes no distributions to B, a U.S. person until 2017.
- In 2017, 2018 and 2019, FNGT makes distributions of \$1,000,000 to B. FNGT's DNI in each year was \$1,000,000
- FNGT makes a \$1,250,000 distribution to B in 2020 when its DNI and TAI is only \$100,000.  
\$1,000,000 multiplied by 1.25% and divided by 3 = \$1,250,000
- Therefore no part of the 2020 distribution is an accumulation distribution.

# THE DEFAULT METHOD

- When it is desirable to terminate a FNGT with significant accumulated income, the default method can be used with careful planning to drain all of a FNGT's UNI before its termination without subjecting any distributions to an interest charge.

# DEEMED DISTRIBUTIONS: LENDING RULES §643(I)

- a) § 643(i) treats a loan from a FNGT to a U.S. beneficiary or U.S. grantor or a U.S. person related to a U.S. beneficiary or grantor as a distribution to the U.S. beneficiary or grantor unless the loan is a “qualified obligation.”
- b) A “qualified obligation” is one that is (i) in writing; (ii) has a maturity date of 5 years or less; (iii) all payments are denominated in U.S. dollars; (iv) the yield to maturity is between 100% and 130% of the AFR; (v) the taxpayer extends the SOL to 3 years after the loan is paid; and (vi) the loan is reported on Form 3520.

## DEEMED DISTRIBUTIONS: LENDING RULES §643(I)

- c) Section 643(i) treats the use of foreign trust property as a deemed distribution that will carry out DNI and UNI except to the extent fair value is paid.
- d) Section 643(i) applies only to foreign trusts and only where the borrower or user of property is a U.S. person who is a grantor, beneficiary or a person related to a grantor or a beneficiary.

# CONCLUSIONS

# CONCLUDING THOUGHTS

- Dealing with foreign nongrantor trusts for U.S. beneficiaries can be challenging. In addition to the issues we've been focusing on for the past hour, there are a number of reporting obligations accompanied by significant penalties if not complied with in a timely manner.
- Nevertheless, careful administration of a foreign nongrantor trust in a state like South Dakota that permits perpetual trusts can reap substantial financial rewards for multiple future generations of beneficiaries.