

Non-US Trust with US Beneficiaries: Now What?

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Case Study: Representative Family

- ▶ Foreign family with substantial offshore wealth
- ▶ Trust structures in place
- ▶ Trust beneficiary attends university in the US
- ▶ Trust beneficiary falls in love and decides to become a US person
- ▶ Now . . . we have multiple generations of US beneficiaries

Taxation of Trusts: Conduit of Income

- ▶ Trust is taxable in its own right on income, unless it distributes that income to beneficiaries
 - ▶ Distribution by trust gives rise to deduction from trust income
 - ▶ Since beneficiary pays tax (and trust does not), no double taxation

Primary US Tax Issues

- ▶ US Trust taxable on worldwide income
- ▶ Foreign trust = non-US person and taxable on US source dividend income. Most other income (capital gains, interest) is exempt
- ▶ Assets in irrevocable trust are generally excluded from beneficiary's estate unless "self-settled"
- ▶ Generally, no gift tax associated with funding by foreign donor
- ▶ US family members are subject to income tax only when distributed trust income. Non-US family not subject to US tax on distributed income

Sounds like “No Harm No Foul”

- ▶ Foreign trust does not pay US income tax on accumulations of (most) income
- ▶ Beneficiary only taxed upon receipt of a distribution
- ▶ Seems foreign trust must not be bad ...
 - ▶ Deferral of income tax is a very powerful thing

So what's the big problem?

Throwback/Accumulation Distribution Tax

Throwback: When and What?

- ▶ Applies when a **foreign trust** makes an “accumulation distribution” to a United States beneficiary, including another trust, *and* that trust has “undistributed net income” from one or more of its preceding taxable years. Does not apply to domestic trusts (unless were once foreign)
- ▶ An “accumulation distribution” is any distribution to the extent that it exceeds both (a) the trust’s “distributable net income” for that year (reduced by any amount required to be distributed currently) and (b) the trust’s net fiduciary/trust accounting income for the year

Basic Definitional Terms

- ▶ “Distributable Net Income”
 - ▶ Taxable income (US tax concept)
 - ▶ In case of a trust, basically worldwide income, including income from foreign sources, tax exempt income and gains
 - ▶ In case of non-US estate, not including gains or foreign source income
- ▶ “Fiduciary” or “Trust” Accounting Income
 - ▶ Local law concept tied to residence of trust/trustee
 - ▶ Definition varies from jurisdiction to jurisdiction
 - ▶ Usually includes dividends, but – depending – not gains. Should not include “flow-through” income from “checked entities”

Three Conditions to a Taxable Accumulation Distribution

1. Income accumulated in a year;
2. In a later year, a distribution occurs and that distribution exceeds the “income” of the trust in that year; and
3. That distribution of such “excess over income” does not exceed the accumulated income of all years (i.e., otherwise trust corpus)

What Happens?

- ▶ Distribution is taxed as though previously undistributed income had, in fact, been distributed and taxed to the beneficiary in earlier years, except he/she forgot to pay tax
- ▶ US beneficiary must pay tax in the year of receipt plus an interest charge (at the “underpayment rate”) to compensate for the delay in payment of tax from year earned
- ▶ Beneficiary loses benefit of “preferential tax rates” for gains/certain dividends

Come Again?

- ▶ All distributions of “accumulated income” are taxed at
 - ▶ (a) ordinary income rates (40+%+state) and
 - ▶ (b) are subject to an interest charge for failing to pay tax in prior years... OUCH!!!
- ▶ Throwback distribution may thus – depending on facts – be taxed at a rate of 100%

Any Exceptions?

- ▶ Amounts accumulated prior to the beneficiary's 21st birthday (including periods prior to birth)
 - ▶ Such accumulations may thus be distributed to beneficiary w/o tax, but . . .
 - ▶ Amounts are deemed to be distributed first from accumulations commencing in (and after) year of 21st birthday
- ▶ Exception from interest charge (but not tax on distribution at ordinary income rates) for amounts accumulated prior to beneficiary becoming a US person
 - ▶ Thus pre-US status offers some relief

More Exceptions

- ▶ “Specific Gifts” Are Tax-Free:
 - ▶ Specific sums of money or property paid (including to another trust for the benefit of US beneficiary) at direction of trust instrument in no more than 3 installments
 - ▶ Code considers such to be “gifts/bequests” at direction of trust settlor and not “distributions”
- ▶ Distributions not in excess of fiduciary accounting income (and even though greater than DNI) not considered accumulation distribution
 - ▶ Balances local law concepts of “income” with tax-based notion of Distributable Net Income

Any Planning Options?

Plenty of Options

Pre-Death Planning/Drafting

- ▶ Grantor Trust Planning
- ▶ Specific Gifts/Bequests
- ▶ Use of IRC Section 645 Election

Post-Death Planning/Options

- ▶ Extending Grantor Trust Status
- ▶ Simple Power of Deferral: Domestication of DNI
- ▶ Distributions of Property Other than Cash
- ▶ Use of the “Default Rule” in Calculating Accumulation Distributions
- ▶ Manage Distributions Not in Excess of Accounting Income

Planning During Settlor's Lifetime

Foreign Grantor Trust Planning

- ▶ All income and losses realized and assets owned by the trust are treated as realized and owned directly by the grantor
- ▶ Therefore, income realized by non-US trust/grantor is subject to U.S. income tax only on U.S. source income –mostly only dividend income
- ▶ “Distributions” to family members are deemed “gifts” and are tax free. Not subject to Throwback

When is Non-US Trust a Grantor Trust?

- ▶ Section 672(f)(2) – A foreign grantor will be treated as the owner of a trust if:
 - ▶ the power to *revest absolutely in the grantor* title to trust property... is exercisable solely by the grantor without the approval or consent of any other person or with *the consent of a “related or subordinate party”* (within the meaning of Section 672(c))
- ▶ Section 672(f)(1) – Irrevocable and solely for benefit of grantor and/or spouse during grantor’s lifetime



Unfortunately, all good things come to an end . . .

- ▶ Grantor trust status “terminates” at the death of the grantor.
- ▶ At that point, the trust “springs into existence” and the normal rules of trust accounting apply:
 - ▶ Trust is taxable owner of income and assets.
 - ▶ Distributions are taxable to the beneficiary.
 - ▶ US trust beneficiaries become subject to throwback.

Specific Gifts/Bequests

- ▶ IRC Section 663(a):
 - ▶ A distribution from a trust is not taxable to the beneficiary if distribution is: (1) “properly paid or credited as a gift...of a specific sum of money...,” and (2) “paid or credited all at once or in not more than 3 installments.”
- ▶ Treas. Reg. 1.665(b)-1A(c)(1): “A gift described in Section 663(a)(1) is not an accumulation distribution.”
- ▶ Where non-grantor trust provides for such, throwback avoided entirely on qualifying payments



Election under IRC Sec. 645

- ▶ Permits trustee of “qualified revocable trust” and – if any – executor of related estate to make election to treat the “qualified revocable trust” as part of “estate” of decedent
- ▶ Applicable to non-US trusts as well as domestic trusts
- ▶ Status continues for at least 2 years (maybe more)



Distinctions in Definitions: Key to 645 Benefit

- ▶ DNI defined differently for non-US trusts and non-US estates
 - ▶ Capital gains and foreign source income excluded from DNI of non-US estates
- ▶ If non-US trust considered part of settlor's estate, gains and foreign source income not included in DNI and thus cannot become UNI
- ▶ If not DNI, not taxable when distributed
- ▶ If not UNI, no throwback thereon



645 Election: Two Main Benefits

- ▶ Basis-step up for trust assets at death, and thereafter through churning of trust assets during Section 645 election period – if done right – free from US tax
- ▶ DNI does not include gains or non-US source income
- ▶ Throwback rules inapplicable to accumulated non-DNI during period
 - ▶ Thus avoid US source income during period



Drafting Trust for Election

- ▶ To make the election, the trust must be “qualified revocable trust”
- ▶ A “qualified revocable trust” is one where settlor has power to “revest” property in himself – essentially grantor trust requirement
- ▶ Power to “revest” includes power to revoke, to terminate, to alter or amend, or to appoint trust property in favor of settlor



Planning After Settlor's Lifetime

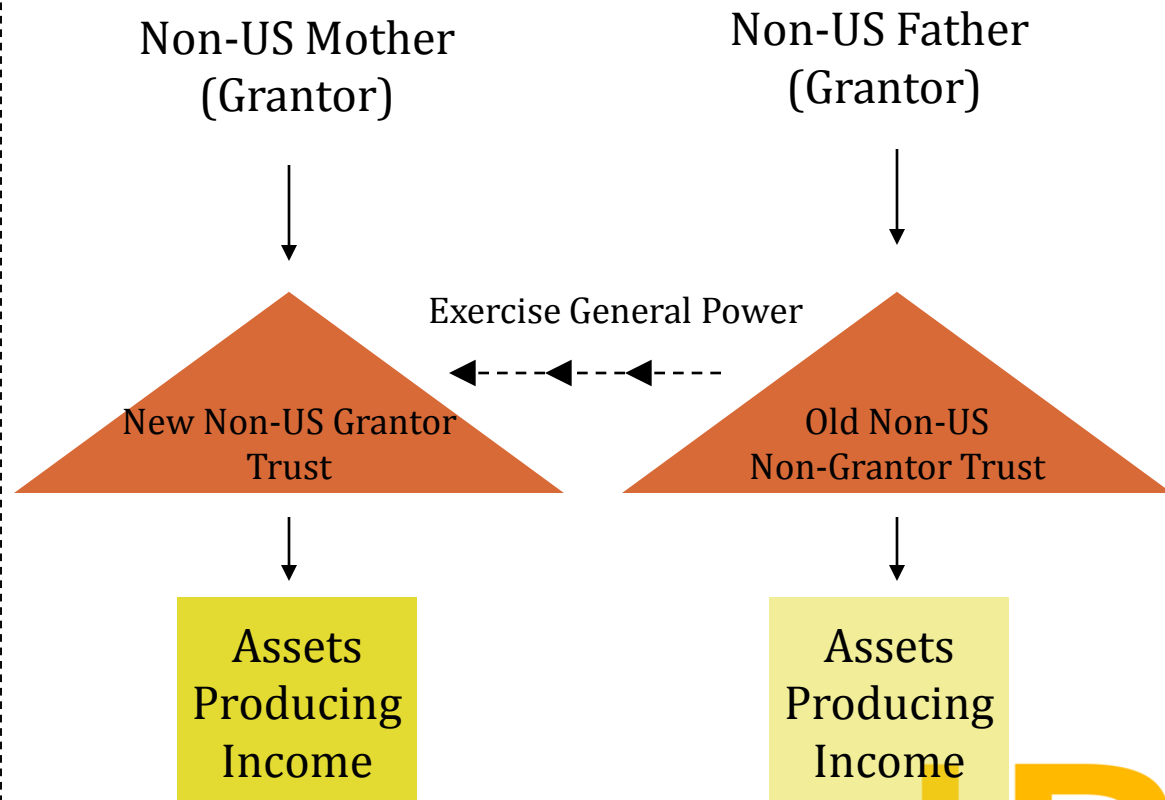
Can We Extend Grantor Trust Status?

- ▶ If somehow can “extend” grantor trust status of a now non-grantor trust, . . . US beneficiaries enjoy even greater benefit
- ▶ Where multiple beneficiaries include other non-US persons may identify one to “re-settle” new grantor trust
- ▶ Key to process are **both** (a) right provisions + becoming “grantor”
- ▶ “Grantor” includes person exercising general power of appointment in favor of new trust



Extend Grantor Status (Exercise General Power of Appointment)

1. **Establish New non-US Trust to Receive Appointed Assets**
Trustee grants power of appointment to non-US beneficiary
2. Non-US Beneficiary exercises power in favor of new non-US “revocable” trust with family beneficiaries, including US persons
3. Assets transfer from old trust to new trust
4. New trust enjoys same benefits as appointing trust had prior to death of grantor



Keeping Offshore? Throwback Tax Sounds Ugly, But . . .

Deferral is a very powerful thing.

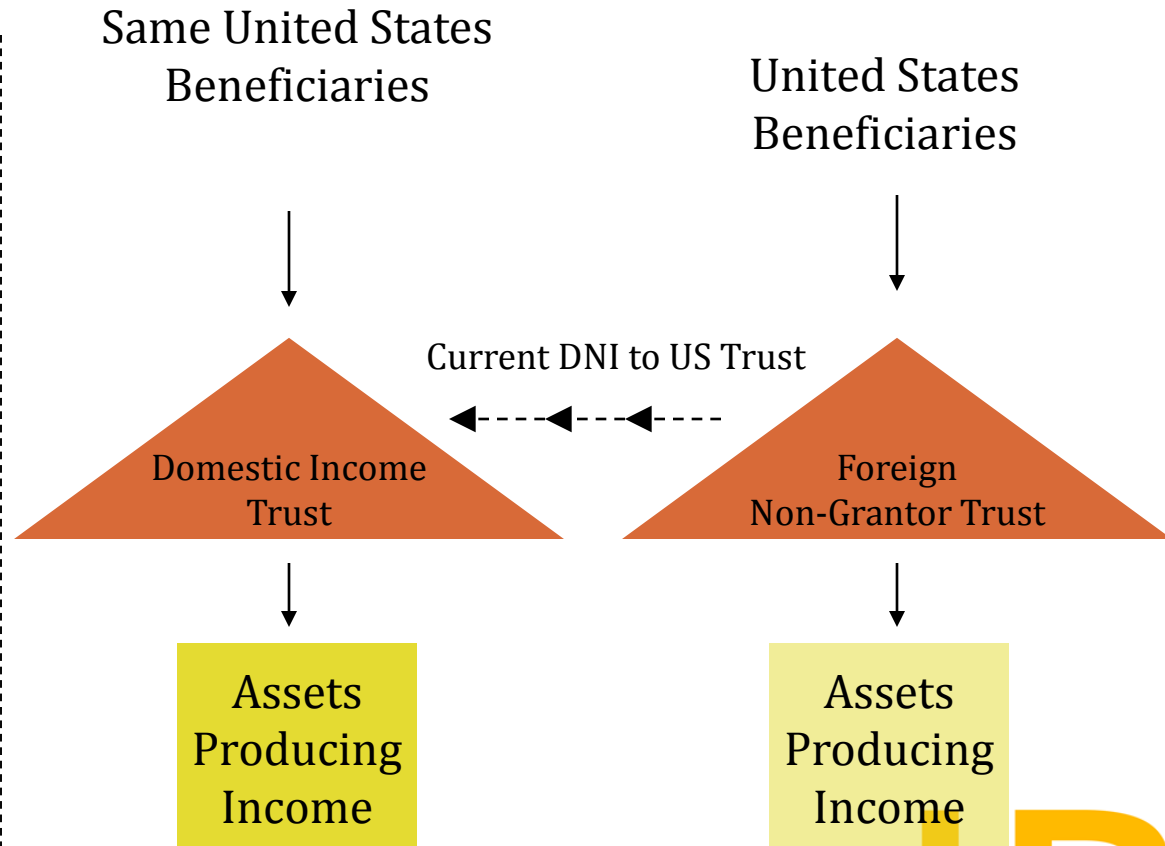
Trust as Endowment: Maximize Use of Deferral

- ▶ Non-US source income not subject to US tax until distributed onshore
 - ▶ Throw-back applicable to amounts distributed in excess of Distributable Net Income (DNI) or Fiduciary Accounting Income (FAI) for year of distribution
- ▶ Turn Foreign Trust into Accumulation Vehicle
 - ▶ Fact that Foreign Trust not subject to US tax until distribution permits (a) tax-free build-up offshore and (b) distributions in later years from substantially larger base
 - ▶ Reasonably certain to produce greater after-tax net wealth.

Domesticate DNI

Establish U.S. Trust to Receive Endowment Income:

1. Foreign Trustee establishes and funds a new U.S. Trust with the income of the FNGT
2. Transferring income annually should not trigger the “Throw-Back” Regime when less than or equal to DNI of Foreign Trust
3. Deferral in FNGT builds “base” upon which DNI may be paid
4. Net Accumulated Wealth Greater



Distributions of Property Other than Cash

- ▶ Absent Trustee's election, when trust distributes property other than cash to beneficiary, value of "distribution" – including UNI – is lesser of
 - ▶ Trust basis in the property distributed or
 - ▶ Fair value of that property
- ▶ If trust distributes asset = \$1M value, but with \$1000 basis, US beneficiary has income = historic basis of \$1000 and not \$1M
- ▶ Election increases DNI to trust as trustee deemed to have sold asset for FMV

“Default” Rule for Calculating Accumulation Distribution

- ▶ No distribution subject to throwback if does not exceed product of (a) average of last three years actual distributions multiplied by (b) 1.25
- ▶ Elective “default rule” (made by beneficiary) to account for difficulty to determine historic UNI – esp. for long-term trusts. Once elected, method permanent
- ▶ Regular distributions may thus increase by 25% annually w/o triggering throwback



Managing Distributions not in Excess of Accounting Income

- ▶ Throwback requires distribution in excess of *both* DNI *and* accounting income (i.e., as calculated by fiduciary) (“FAI”)
- ▶ Again, definitions matter
 - ▶ DNI = all income (including exempt)
 - ▶ FAI = local law determined. Likely not until receipt
- ▶ If can increase FAI in any year, distributions not in excess are not subject to throwback



Managing FAI

1. Flow-through status means trust calculates DNI annually by reference to asset income, not distributions
2. Trustee accounts for FAI of trust under local law
3. No “income” to trust until local law until distribution to trust, permitting deferral until receipt
4. If accumulate for years and distribute cash to trust in later year, trust FAI “swells” to equal distribution
5. Follow-on distribution to USB taxed solely to extent of DNI (no amount in excess of FAI)
6. No UNI, no tax on excess over DNI, but less than FAI

