

Use of U.S. Trusts in International Tax Planning

Presented by:

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The Climate -- Impact of Current Events on Trust Jurisdictions

- **Stop Tax Haven Abuse**
- **Incorporation Transparency and Law Enforcement Assistance Act**
- **Government Bailouts**
- **Madoff/Stanford Schemes**
- **LGT / UBS**
- **Trustee Liability / Market Losses**

Tax Residence of Trust: Domestic versus Foreign

Tax Residence of trust for US tax purposes does not depend on governing law or place of administration

Domestic trust - for U.S. tax purposes, must meet both tests:

- ***Court Test*** – a U.S. court can exercise primary jurisdiction over the trust, and
- ***Control Test*** – U.S. person or persons control all substantial decisions of the trust

Foreign trust – fail either test, e.g., U.S. law trust where a non-US person controls even one substantial decision – a ***Hybrid Trust***

What are *Substantial Decisions*?

Non-US Person must have one or more of these powers/rights:

- (1) Distributions (*i.e.*, whether to distribute income or principal; timing or amount of distributions; appointment of beneficiaries; allocations between income and principal);**
- (2) Termination of the trust;**
- (3) Trustees (*i.e.*, whether to remove, add, or replace a trustee; and whether to appoint a successor trustee);**
- (4) Investments (including the right to terminate an investment advisor at will; and**
- (5) Claims against or rights of the trust (*i.e.*, whether to compromise, arbitrate, or abandon claims of the trust; and whether to sue on behalf of the trust or to defend suits against the trust);**

Grantor vs. Non-Grantor Status

Compare:

- ***Grantor Trust*** – Transparent Entity, treated as owned by Settlor
- ***Non-Grantor Trust*** – Separate Entity, treated as for benefit of beneficiaries

Foreign Settlor & US Beneficiaries - prefer *grantor* trust so assets/income treated as owned by non-US person

- **must satisfy one of three conditions:**
 - (1) revocable in settlor's sole discretion
 - (2) revocable by settlor with consent of related or subordinate/subservient persons
 - (3) income distributable only to settlor or spouse during lifetimes

Grantor Trust

- **If Foreign Settlor with *grantor* trust, it is transparent, so residence of trust is irrelevant during Settlor's lifetime**
- **Can be effective will/testament alternative for non-tax reasons, such as succession planning, avoiding probate/forced heirship**
- **Once Settlor passes away, trust becomes *non-grantor* trust**
 - **if trust winds up, not relevant**
 - **If trust continues to operate, need to consider consequences of *non-grantor* trust status**

Non-Grantor Trust

- **Separate Entity for US tax purposes**
- **Separate Reporting** - Trust generally is the taxpayer (and files US income tax return)
- **Current Distributions** - Income that is distributed currently is not taxable to trust (whether foreign or domestic)
 - **65 Day rule**

Non-Grantor Trust (continued)

Accumulated Income

- **Domestic Trust**
 - **Worldwide Income Taxation**
 - **No Accumulation Penalty** – no interest charge, trust can utilize preferential capital gain and dividend rates
 - **No Double Taxation** - beneficiaries not taxed again

- **Foreign Trust**
 - **US Source Income Taxation**
 - **Deferred Taxation for Foreign Source Income earned by the Trust**
 - **Accumulation Penalty** – ordinary rates, interest surcharge

Comparison of Accumulated Income: Foreign vs. Domestic Non-Grantor Trusts

	Domestic Trust	Foreign Trust
Trust with US Beneficiaries	Current Taxation of Worldwide Income	Current Taxation of US Source Income Deferred Taxation of Foreign Source Income Accumulation Penalty
Trust with Non-US Beneficiaries	Current Taxation of Worldwide Income	Only US Source Income is Subject to US Tax

So When Does a US Trust Make Sense?

- ***Grantor* trust** – regardless of residence or beneficiaries
- ***Non-grantor Simple Trust*** – regardless of residence of beneficiaries
- **Non-grantor Accumulation Trust for US beneficiaries**
– avoid accumulation penalty
- **Pour-Over trust for US beneficiaries of foreign trust**
- **Other creative uses of domestic *non-grantor* trust**
 - Trust invests in US stocks that pay dividends
 - Treaty shopping – using US tax treaty network for investments in other countries

Pre-Immigration Planning

- **Two different objectives of Pre-Immigration Trusts**
 - Income Tax
 - Transfer Tax (gift, estate, GST)
- **Income Tax – if non-US beneficiaries, prefer non-*grantor* trust**
 - *non-grantor* for income tax purposes – must be established more than five years before settlor becomes US income tax resident
- **Transfer Tax – if will become US estate tax resident, no five year limitation, trust can be established anytime before become US domiciliary**
 - When does one become US domiciliary?
 - Settlor's control and interests in income or corpus must be minimized

Pre-Immigration Income Tax Trust - When to use Domestic

- **Non-Grantor Trust with US Beneficiaries – same analysis: deferral vs. accumulation penalty**
- **Non-Grantor Trust with Non-US Beneficiaries – only if simple trust**
- **Grantor Trust - may want trust for estate tax planning but established within 5 years of US income tax residency**

Temporary “Drop-Off” Trusts

- **No Exit Toll on Domestic *Grantor* Trusts**
- **Exit Toll on Foreign *Grantor* Trusts – with foreign *grantor* trust, built-in gains are subject to US income tax upon:**
 - **Death of Settlor - unless grantor from estate tax perspective, which defeats estate tax insulation objective**
 - **Settlor’s Loss of US Income Tax Residency**
- **May be able to expatriate domestic trust assets subsequently**

Review – Effective Uses of U.S. Trust for Foreign Settlers

- **Hybrid trust – US Trust treated as Foreign**
- ***Grantor* Trusts – because non-US Settlor treated as owner**
- ***Non-Grantor* Simple Trust**
- **Non-Grantor Accumulation Trust for US Beneficiaries – avoid Accumulation Penalty**
- **Pour-over trust for US beneficiaries of foreign trust - upon death to avoid Accumulation Penalty**
- **Pre-Immigration Trusts**
- **Drop-off Trust – avoid Exit Toll**
- **Other creative uses**

Considerations If Structuring Under Proposed Legislation

- Avoiding Entities in Secrecy Jurisdictions
- Avoiding Bank Accounts in Secrecy Jurisdictions
- Avoiding Use of Offshore Account Holders
- Avoiding Beneficial Ownership Disclosure for LLCs



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