

Morgan Lewis

Foreign Trusts For US
Family Members: Use of
Section 645 Election

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Case Study – A Representative Family

- Foreign Family with Resident Aliens in the U.S.
- Substantial Off-Shore Wealth
- Primary Goal – To find a tax-effective means of transferring wealth to U.S. family members
 - Long-term solution
 - Minimize or eliminate U.S. and foreign transfer taxes

Usual Solution: The Trust

- Most foreign families desiring to benefit US family members (e.g., children) seek to create structures which make assets available over time.
- Generally, preferred answer (given numerous issues with various alternatives) is a trust – a common law entity where trustee manages assets for the benefit of family members.

Basic Idea

- Non-US Trust established by parents to hold trust assets. May be some “home country” efficiencies, such as reduction of income tax thereon.
- Income accumulates or available to family members (or maybe just parents) during their lifetimes.
- At parents’ death, assets become available for children, including – occasionally family members in the United States.

Current Year Income Distributed

- A distribution of current year income – so-called “distributable net income” – is taxable to the US Beneficiaries.
- Distributable net income (“DNI”) includes all income from whatever source derived, such as interest, dividends, foreign source income and capital gain.
- Distribution of DNI thus “carries out” income and its “character” – e.g., favorable capital gain rates where capital gain realized and distributed.

So What's the Problem?

- Trust better not make a distribution to the US family members of DNI accumulated from a prior year . . .
- Or . . . Throwback Applies!

Throwback Rules: Downright Ugly

- Apply 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.
- IRC Section 665(b) defines an “accumulation distribution” as any distribution of “any other amounts properly paid or credited or required to be distributed” to the beneficiary, to the extent that it exceeds both the trust’s distributable net income for that year (reduced by any amount required to be distributed currently) and the trust’s net accounting income for the year

How Does Throwback Work?

- Trust distributes its “accumulated income” to a United States beneficiary (including another trust). The distribution will be taxed as though the previously undistributed income had, in fact, been distributed and taxed to the beneficiary in earlier years.
- The beneficiary must pay this tax for the year he or she receives the “accumulation distribution,” plus an interest charge to compensate for the delay in payment of tax.

Come Again?

- Confiscatory Regime Designed to Force Distributions from Non-Grantor Foreign Trusts for US Beneficiaries
- All Distributions of “Accumulated Income” are taxed at (a) Ordinary Income Rates and (b) Subject to an Interest Charge for Failing to Pay Tax in Prior Years. . . OUCH!!!



BUT . . . the Throwback Rules
only apply to . . .

FOREIGN *NON-GRANTOR* TRUSTS;

NOT *GRANTOR* TRUSTS

What is a Grantor Trust?

- Generally speaking, a “grantor trust” is a trust that is treated as owned for U.S. income tax purposes by the grantor.
- If the grantor is treated as the owner of a trust, then the trust form is disregarded for U.S. income tax purposes and income, deductions and credits of the trust are attributable to the grantor.

Classic Structure

- Foreign “grantor trust” established by parents to hold trust assets during their lifetimes.
 - Maybe revocable
 - Maybe irrevocable but treated as revocable for US; tax purposes
- Income accumulates tax free during lifetime of parents. At parents’ death, assets become available for US family members.

U.S. Income Tax Advantages of Foreign Grantor Trust Status:

- All income and losses realized and assets owned by the trust are treated as realized and owned directly by the foreign grantor.
- Therefore, income realized by 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 Rules or PFIC regime.

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.
 - Foreign trust beneficiaries are subject to throwback.

Entering Stage Left . . .
The “Section 645 Election”

Section 645 Planning: The Basics

- IRC Section 645 permits a trustee of a “qualified revocable trust” and – if any – the executor of the related estate, to make an election to treat the “qualified revocable trust” as part of the “*estate*” of the decedent
- Election period last no more than 2 years following death
- Qualified revocable trust with foreign settlor may make the election

Section 645 Planning – Making the Election

- To make the election, the trust must be a “qualified revocable trust”
 - A qualified revocable trust is one where the settlor has the power to “revest” property in himself
 - Power to “revest” includes power to revoke, to terminate, to alter or amend, or to appoint the trust property
- In other words, many “grantor trusts” owned by foreign settlors for US tax purposes qualify

Section 645 Planning: What is the Planning About?

- If DNI includes income from all sources (including interest, dividends, non-U.S. source income and capital gains) in the case of a trust

And

- Undistributed or accumulated DNI becomes subject to “throwback” in a later year when the trust distributes it . . .

In the case of an Estate (Including a Trust Electing Section 645 Treatment)

- DNI does NOT include income from non-U.S. sources and capital gains.
- There is simply a different definition of what is included in DNI in the case of an estate *v.* a trust.
- If the DNI of an estate does not include income from sources outside of the US or capital gains, that means that . . .

Benefits of Being Part of Estate

- Non-US source income and capital gains realized by the electing trust (i.e, during the Section 645 period) and distributed to the US Beneficiary can be entirely tax-free in the hands of the US Beneficiary
- Beneficiary is considered to receive “corpus” of the estate of the decedent, rather than DNI

And . . . Maybe Even More Exciting . . .

- Since capital gains and non-U.S. source income are not included in DNI, such income, if accumulated, should not be included in determining UNI.
- Effect –Throwback Rules rendered inapplicable during Section 645 period, if foreign “estate” can generate only non-U.S. source income and capital gains during such period.

Section 645 Election: Useful Tool

Section 645 Planning: Basis Step-Up Benefits

- Upon the decedent's death, step-up in the basis of trust assets may not be available under other more traditional methods (i.e., IRC § 1014)
- Provided the trust is a “qualified revocable trust”, the trust may refresh trust asset basis (i.e., buy/sell) during the Section 645 period
- For U.S. tax purposes, the basis will be adjusted to purchase price (i.e., fair market value)
- Provided assets held only provide capital gain (including U.S.) and other non-U.S. source income, such churning should occur free from U.S. tax

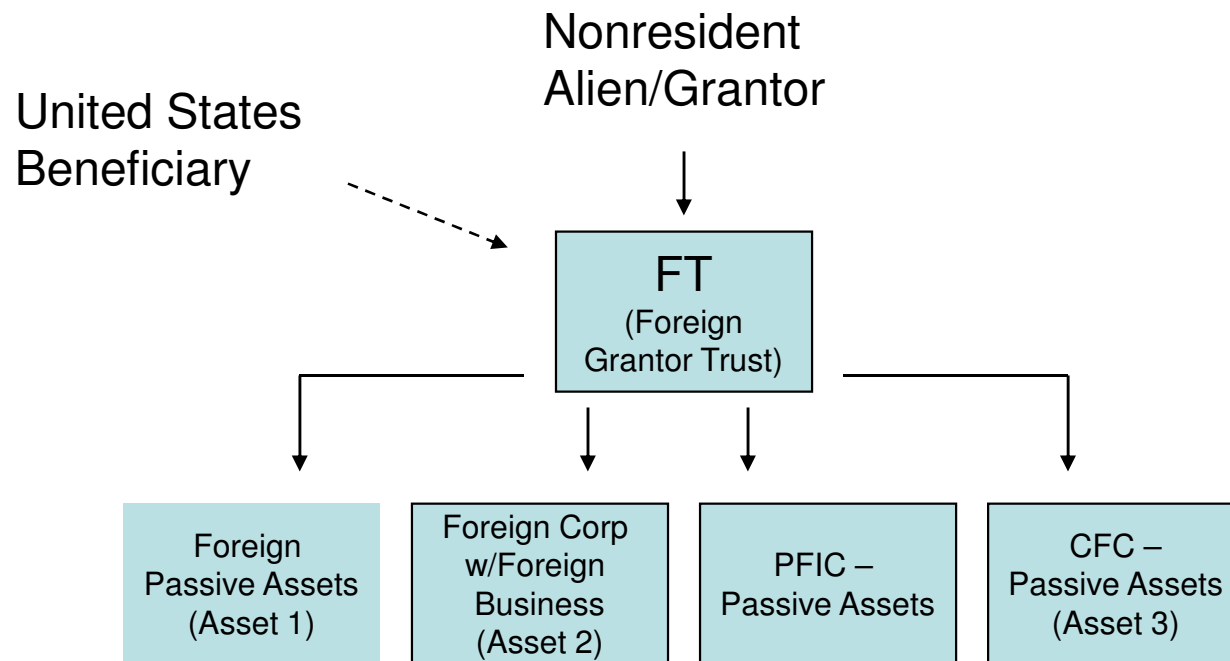
Section 645 Planning: “Checking-the-Box”

- Section 645 basis step-up can apply in conjunction with so-called “check-the box” planning
- Upon decedent’s death, CTB elections can be made for any corporation owned by the trust
- CTB election is treated as taxable disposition of corporate assets, which produces an adjusted basis in the underlying assets equal to fair market value
- Provided assets held by corporation only provide capital gain (including U.S.) and other non-U.S. source income, such churning should occur free from U.S. tax

Section 645 Basis-Step Up: Illustration

- Assumed Facts:
 - Non-U.S. person (FP) settles foreign trust (FT) f/b/o U.S. person
 - FT provides FP with power to “revest”, thus it is a “qualified revocable trust” and owns:
 - *Non-U.S. real estate (Asset 1)*
 - *Non-U.S. corporation owning a non-passive non-U.S. business (Asset 2)*
 - *A so-called “passive foreign investment company” (PFIC)*
 - *A so-called “controlled foreign corporation” (CFC) which holds only shares of stock in a publicly traded U.S. corporation (Asset 3)*
 - Each of Asset 1, Asset 2, Asset 3, PFIC and CFC have a basis of zero and fair market value of \$100

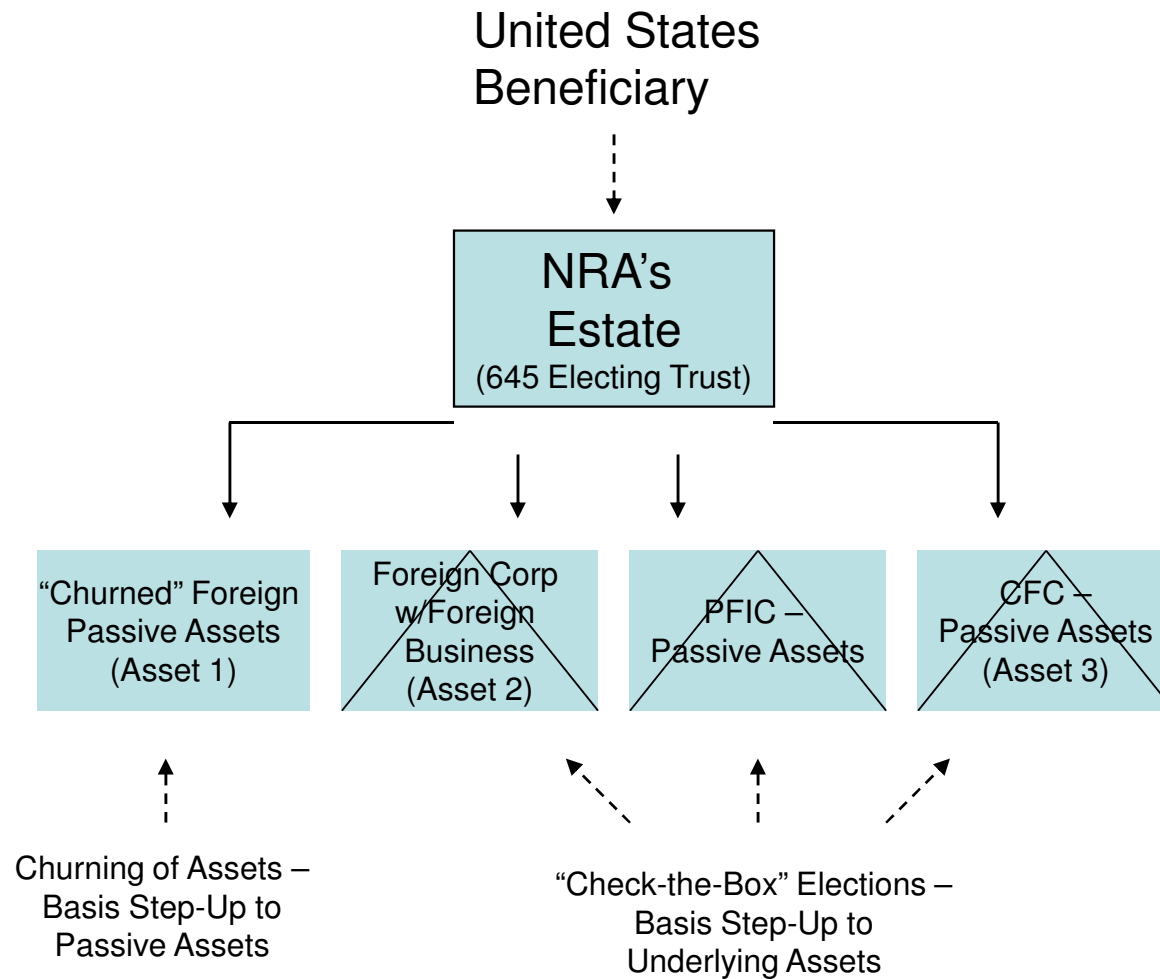
Section 645 Basis-Step Up: Illustration – During Life of Settlor



Section 645 Basis-Step Up: Illustration – Cont'd

- Settlor dies and trustee makes a Section 645 election
- Thereafter, trustee of FT:
 - Sells Asset 1 for \$100 at any time during Section 645 period
 - Makes a CTB election for Asset 2 at any time during Section 645 period
 - Makes a CTB election for PFIC before the end of the tax year which includes decedent's death
 - Makes a CTB election for CFC within 30 days of death, churns Asset 3 just prior to the end of the Section 645 period

After Death of Grantor



Section 645 Basis-Step Up: Illustration – Results

- Asset 1: FT will receive \$100 to reinvest, and new asset will have a cost basis (i.e., \$100)
- Asset 2: CTB election will cause a deemed sale of underlying assets – basis stepped up to FMV (underlying assets can be refreshed before end of Section 645 period)
- PFIC: CTB election (must be made before end of year of death) will cause a deemed sale of underlying assets -- basis stepped up to FMV (underlying assets can be refreshed before end of Section 645 period)
- CFC: CTB election (must be made within 30 days of death) will cause a deemed sale of underlying assets -- basis stepped up to FMV (underlying assets (i.e., Asset 3) can be refreshed before end of Section 645 period)

Section 645 Election and PFIC Rules

- Unfortunately, Section 645 election does not protect against PFIC treatment commencing in year following Grantor's death
- Sales/dispositions of PFICs occurring in year after Grantor's death are subject to adverse PFIC taxation
- So . . . The Election is not a “cure-all”.

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together

