BRINGING IT TO UNCLE SAM: SOME ASPECTS OF SUCCESSION FROM FOREIGN INVESTORS TO US BENEFICIARIES

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I. Introduction

We will review not only some of the same income tax issues common to the transfer of foreign corporations (FC) from foreign high net worth individuals ("FOHNWIs" or "NRAs") who die owning FC shares, but also certain aspects which do not necessarily stem from the application of the two "anti-deferral regimes," the Subpart F, controlled foreign corporation ("CFC") rules and the Passive Foreign Investment Company ("PFIC") provisions and in particular certain problems dealing with the form of succession, transfers in trust and the estate tax protection of the US persons (a US tax resident or US citizen) inheriting from the FOHNWI.

II. Income Tax Issues When US beneficiaries Inherit From FOHNWIs

A. Anti-Deferral Regime Issues

1. In order to have a diversified investment portfolio which may include US equities, including preferred shares, US organized diversified mutual funds, US hedge funds and limited partnerships, gold and silver, FOHNWIs will, if properly advised own the account through an FC so as to avoid the US estate tax as all of those investments will be subject to the estate tax if held in his/her individual names. IRC Sec. 2104.

2. Shares of FC non-US situs asset as per Reg. §20.2105-1(f).

3. But what is proper for a FOHNWI is not tax beneficial for the US person. Because of Anti-deferral regimes, Subpart F covering controlled foreign corporations ("CFCs") and the Passive Foreign Investment Company ("PFIC") rules, the FC inherited by one or more US persons either directly or through a trust may be subject to adverse income tax consequences.

4. Generally speaking, given the IRC Sec. 1014(b) step-up for property acquired from a decedent, the US heirs or beneficiaries of the FOHNWI ("US beneficiaries") will not realize any gain in the distribution of the portfolio upon liquidation of the FC or buy back of the FC shares since the latter as it will have the same fair market value as the investment portfolio.

5. In the case where the US beneficiaries are a majority the FC will be a CFC and unless liquidated within 29 days, the portfolio built-in gain may be taxed as foreign personal holding company income which is Subpart F income required to be included in the gross income of the US beneficiaries as ordinary income. IRC Sec. 951.

6. If the US beneficiaries are a minority, the FC owning the portfolio will be a PFIC and given the allowance of the step-up pursuant to IRC Sec. 1291(e), the US beneficiaries will have no gain on the exchange of their shares for the portfolio distribution. Moreover, if the buy-back is effected within a year from the date of the beginning of the US beneficiary holding period, no excess distribution applies under Sec. 1291(b)(2)(B).

7. If for any reason the 29 day period is missed, the US beneficiaries should be advised not to trade the portfolio or make distributions, but instead hold until the end of the tax year and within the next 29 days, liquidate the FC.

8. A tax liquidation of an FC can be effected fairly quickly and easy by "checking-the-box" provided that the FC is an eligible entity. Almost all offshore center corporations, except Panamá and Costa Rica are eligible. In any event, where the FC can't check the box, a liquidation would be effective once the Plan of liquidation has been adopted and the FC shares tendered for cancellation.

9. The built-in gain/appreciated portfolio issue can also be taken care of very efficiently even before the FOHNWI's death if the investment adviser or portfolio manager is aware of the problem and periodically realizes gains on appreciated securities and other portfolio assets, so that there is very little if any appreciation in the portfolio on the date of death.

B. Particular Issues Relating to the Step-Up in Basis of FC Shares

1. IRC Sec. 1014(a) states that the basis of property in the hands of a person acquiring the property from a decedent is generally the fair market value of the property at the time of the decedent's death.

2. It is therefore very important that the US beneficiaries be able to establish that they have received the FC shares as a bequest or inheritance and not as a gift prior to the decedent's death since if the latter the basis would be the adjusted basis in the hands of the donor. IRC Sec. 1015(a).

3. When there is no trust with respect to the shares, it may be difficult to prove, particularly if the shares are bearer shares. These are more rare nowadays particularly in the case of investment accounts at most financial institutions, although still available for Panama corporation.

4. Even in the case of registered shares, there may have been arrangements such as an undated stock power or instrument of share transfer which may indicate a gift rather than a bequest. In this connection, it is important to note that the Regulations under this Section seem to deny the step-up to “gifts in contemplation of death.”Reg.§1.1014-2.

5. If the shares were registered in the name of the decedent and a common law jurisdiction FC is involved, the US beneficiaries may have to go through probate in the particular jurisdiction. This problem is sometimes resolved if the directors of the company are members of the FOHNWI family rather than nominee directors or if the independent directors are willing to accept a “declaration of heirship” from the civil law notary of the decedent’s domicile.

6. In any event, when there is no trust, there will be a period of time that the shares will be owned by the “estate” of the FOHNWI and the US beneficiaries will not be shareholders. However, to be safe, the FC should be liquidated as soon as possible by checking the box. This however will affect the foreign beneficiaries, if they were going to keep the FC. Nevertheless if the US beneficiaries are a majority, liquidation will probably be the safest approach.

III. Trust Distribution Issues

A. FC Shares Held by a Trust

1. Where the FC shares are owned by a trust or private interest foundation, some other problems may arise, particularly if the trust is to continue either as a foreign or domestic trust or if there will be both. We will assume, as is the case with most trusts settled by FOHNWIs to hold shares of an FC that owns an investment portfolio, that the trust is a "grantor" trust, for if by any chance the trust is a "non-grantor" trust, additional problems will arise.

2. The Code classifies trusts variously depending on their particular attributes. Two such classifications are that of "grantor" and "non-grantor" trusts. The former refers to trusts where the grantor or settlor of the trust reserves certain powers which the Code considers the equivalent of having retained ownership of the trust property with the result that all of the income of the trust is deemed as having been received by (whether actually distributed or not) and taxed to the grantor. A non-grantor trust, on the other hand is a taxpayer under our system. If it earns income and does not distribute it to the beneficiaries, the trust, if a domestic trust, pays the tax. But if the non-grantor trust is foreign, it may avoid tax in most portfolio investments and accordingly there are very complex rules which tax income accumulations when later distributed to the US beneficiaries in excess of the trust's fiduciary accounting income.

3. In the case of a grantor who is a foreign person, a trust as to which the grantor has retained (i) all by himself (or with certain "related" or subordinate persons) the power of revocation or (ii) all of the trust income for himself and/or his spouse (to the exclusion of anyone else) for life, is considered a grantor trust. As we said, most trusts settled by FOHNWIs are grantor trusts because (i) the grantor does not want to give up control or he and his spouse want to enjoy the income of the trust during their lifetime and (ii) the status of the trust as a grantor trust avoids the accumulation problem and permits distributions to be made to US beneficiaries tax free as the income is attributed to the grantor. Indeed, in most cases, the accumulation takes place at the FC level and the foreign trust has little if any income during the lifetime of the FOHNWI. However, usually such trusts become irrevocable and thus "non-grantor" trusts upon the death of the grantor and her spouse.

4. Assuming that the trust was a "grantor trust" during the FOHNWI's lifetime, the first question after determining whether we have a CFC or a PFIC and the size of the portfolio's built-in gain, is whether to first liquidate the FC and distribute the portfolio to the US beneficiaries or distribute the shares first. If there are built-in gains in the portfolio, it is very likely that the adjusted basis of the FC shares held by the Trust is much lower, so the question of which to do first will very much depend on whether the Trust, now irrevocable and thus a non-grantor trust, will get the benefit of the Sec. 1014 step-up.

5. Although Section 1014(a) refers to "the basis of property in the hands of **a person** acquiring the property from a decedent" which raises a doubt as to whether a trust itself would have the benefit of the step-up in the shares of the FC owned by the trust, there is language in the Regulations which clearly shows that a trust-if it meets the conditions specified in Sec. 1014(b)(2) or (b)(3) would have the benefit of the step-up pursuant to IRC Sec. 1014(a).

6. One should be careful in trusts with US beneficiaries that the trust not only be revocable and amendable by the grantor, but also that the grantor have the power to direct payments of income to herself or others. What if the trust is revocable by the Grantor but it includes other beneficiaries as discretionary trust beneficiaries? Does such a trust or its US beneficiaries permit a step-up under 1014(b)(2) or (b)(3)? At least RIA Federal Tax Coordinator ¶4109, without citing authority, appears to state that it will have the benefit of the step-up even though the trust does not strictly meet the conditions of Sec.1014(b)(3).

7. In conclusion, it appears that it does not make any difference whether the portfolio is distributed to the trust by first liquidating the FC or that the shares are first distributed to or redeemed from the US beneficiaries. In either case, the US beneficiaries will have no gain in the exchange because either the shares of the FC in the hands of the trust or in their hands will be stepped up to the date of death value of the portfolio.

B. Continuation of Trust for FOHNWI's US Beneficiaries

1.There are many reasons why the FOHNWI and the US Beneficiaries may want to continue the trust. Foremost among them, particularly when the size of the US Beneficiary's share may well result in that share being subject to the US estate tax is to keep the trust fund out of his or her US estate. This can be easily accomplished since the FOHNWI can make the gift of the trust assets free of any gift or estate tax. As we have seen, when the FOHNWI dies the grantor trust becomes irrevocable, the gift complete and the foreign trust as well as any trust created to receive the share of the US beneficiaries will be also be irrevocable and not subject to the US gift, estate or generation skipping tax.

2. Other reasons may be the fact that the US beneficiary is under age or incapacitated or will need professional or investment expertise assistance in managing the trust assets.

3. If the size of the trust share of the US beneficiary is fairly large, consideration should be given to a "dynasty" trust which continues not only for the first generation of US beneficiaries but for remoter descendants as well. However, such dynasty trust may be limited because the perpetuities rule of the foreign trust is limited to a period much shorter than now available in many US jurisdiction such as Delaware and South Dakota which have no rule against perpetuities (or even Florida with 360 years).

4. How the assets settled by the FOHNWI continue in trust for the US beneficiaries present a number of issues depending on how well this succession has been planned. Thus, at the very least the foreign trust should be drafted in such a way that it will permit the trustee to appoint property to trustees in other jurisdictions. In addition, consideration should be given to the creation of a "standby" or receiving trust with a US trustee governed by the laws of one of the states. Alternatively, if all of the beneficiaries are US persons, consideration should be given for the settling a foreign t rust governed by the laws of one of the states which automatically converts into a "domestic" trust upon the FOHNWI's death.

C. Should a Foreign Trust Become US if All or Most Beneficiaries Are US?

1. The problem with a foreign trust for US beneficiaries is that such a trust cannot accumulate income as "undistributed net income" (known as "UNI") without later on imposing a penalty when distributions in excess of fiduciary accounting income are made to the US beneficiaries because of the "throwback rule." This taxes any distribution in excess of accounting income, as opposed to distributable net income or DNI, as an accumulation distribution which results in a significantly higher effective tax because it goes back to the tax that should have been paid in prior years when the income was accumulated and adds interest on such tax. In addition, the character of the income earned is lost and everything is taxed at ordinary income tax rates.

2. Because of the Throwback Rule, particularly when the trust is to serve mostly US beneficiaries of more than one generation, most practitioners suggest that the trust be either converted into a domestic trust or that it be decanted to one or more domestic trusts.

3. Nevertheless, there is no complete consensus on this issue. Some practitioners argue that in certain cases keeping the trust foreign may yield some significant benefits. Indeed, it has been suggested that if the foreign trust is large enough and there are many young beneficiaries, that the power of compounding for a number of years may make sense keeping the trust foreign because there will be more than enough income for future generations and there will be no need to distribute any UNI but only fiduciary accounting income.

4. There are also a number of ways to limit or at least minimize the impact of the "Throwback Rule" by providing for gifts of specific dollar amounts payable in no more than 3 installments under IRC Sec. 663(a)(1), interposing a partnership that does not distribute its profits to the trust so that the income may be accumulated at the level of the entity without generating UNI since the foreign trust can only accumulate what is fiduciary accounting income that it does not distribute.

5. Nevertheless, unless forced to do so by circumstances such as where at the time of the grantor's death the trust has been a non-grantor trust with a significant UNI account, in the majority of cases it is advisable to convert or decant the trust into a domestic trust.

D. Conversion or Decanting

1. A foreign trust may be converted to a domestic trust by changing the trustee and the primary court having jurisdiction over the trust. Alternatively,"decanting" involves "the payment of part or all of the principal of an irrevocable trust (the "Distributing Trust") to another irrevocable trust (the "Receiving Trust" for the benefit of one or more of the beneficiaries of the Distributing Trust." See New York State Bar Association Tax Section, Report on Notice 2011-101; Request for Comments Regarding the Income, Gift, Estate and Generation-Skipping Transfer Tax Consequences of Trust Decanting, April 26, 2012, at p. (referred to hereafter as the "NYSBA Report")

2. Conversion is usually possible if all or most all of the beneficiaries are US and the trust instrument is not significantly different than the original, although if the trust instrument has broad amendment provisions, an English trust deed can be amended substantially to conform to the laws of the state of the new chosen law and jurisdiction.

3. In the conversion to a domestic trust, care must be taken to make sure that no foreign person, such as a Protector or Protector committee, has authority to, either direct or consent to a substantial decision of the trust so that despite the change of Trustee and primary court jurisdiction the trust may continue to be a foreign trust since the "control" test of IRC Sec. 7701(a)(30) requiring that **all substantial decisions** of the trust be authorized by US persons has not been met. In order to convert it into a domestic trust one needs to insure that all substantial trust decisions be controlled by of US persons.

4. On the other hand, if there are a minority of US beneficiaries, the more practical approach is to “decant” the shares of the US beneficiaries into a domestic trust. Most foreign trusts settled in the English offshore jurisdictions contain provisions expressly conferring upon the Trustee broad powers to appoint trust property to a trust of which one of the trust beneficiaries is also a trust beneficiary. In fact, there are not many limitations as to the provisions such Receiving Trust may contain, provided that the Rule Against Perpetuities of the foreign Trust jurisdiction is not violated. Thus, the new trust must contain a provision which limits the perpetuities period to that of the Distributing Trust.

5. If the grantor has properly planned the succession, an unfunded standby trust may have been created in one of the US states. This applies to both common law trusts and foundations. We have drafted provisions for foundation regulations and letter of wishes that specifically require the foundation council to consult with US tax counsel and the US beneficiaries to determine whether their share should be distributed outright to a standby trust or if no trust is then in effect for the trustee or foundation to settle a trust following the grantor/founder’s intent to benefit the US beneficiary and her descendants.

E. US Income and Transfer Tax Issues on Decanting

1. The IRS has at times viewed decanting as triggering a distribution to the beneficiary of the Receiving Trust which may carry DNI and to that extent taxable to the Receiving Trust and the US beneficiary, if the Receiving Trust is viewed as a separate and different trust rather than a continuation of the Distributing Trust. The NYSBA Report on trust decanting has recommended that the Receiving Trust be viewed as a continuation of the Distributing Trust so as to avoid not only a distribution which in some cases may result in adverse tax consequences to the US beneficiary of the Receiving Trust.

2. Another problem, stemming from various Private Letter Rulings cited in the NYSBA Report is the treatment of the decanting as an exchange of property for other property that differs materially in kind which requires the Distributing Trust and the Receiving Trust beneficiary to recognize gain under IRC Sec. 1001. Those PLR's suggested that there may be gain recognition if the beneficiary's new interest in the Receiving Trust is "materially different" from the interest he had in the Distributing Trust. The NYSBA Report recommends that since decanting really does not involve an "exchange" by the beneficiary of the Receiving Trust who was also a beneficiary of the Distributing Trust, that there should be no tax consequences to the beneficiary in such a case.

3. Nevertheless, the cited Report stated that they recognized that if decanting could not be achieved without the consent of the beneficiary "and the beneficiary's interests in the Receiving Trust differ materially from that of the Distributing Trust, then **gain may be recognized by the beneficiary who affirmatively consented to the change."**

4. In most foreign trusts, the beneficiary need not consent for the Trustee to exercise its power to appoint trust property to another trust, so this does not present a problem in most cases. Moreover, since most well-advised grantors will have the benefit of tailoring the standby domestic trust so as to avoid adverse US tax problems for the US beneficiary, it is doubtful that the decanting of a foreign trust would result in recognition of gain to the US beneficiary.

IV. Conclusion

As you have heard from two speakers there can be fairly tricky tax and trust issues on the receipt of an inheritance from a FOHNWI by a US beneficiary. And while many international tax practitioners and international advisers are aware of possible pitfalls, the vast majority of FOHNWI's, their US children and financial advisors are not cognizant of these problems. Therefore, we strongly recommend that in addition to helping in the creation of the structures to hold their investments and their management, these pesky transition complications be explained to those concerned.