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Planning ahead

Steven L. Cantor, Hal J. Webb and *Tracey B. Leibowitz* examine the pitfalls to avoid regarding US beneficiaries of foreign trusts

Due to the mobility of wealthy international families, it is not uncommon to encounter either a family member who has moved to the USA while being a beneficiary of a foreign trust or a family member who is already residing in the USA at the time he or she becomes a beneficiary of a foreign trust.

This article seeks to identify some of the pitfalls and provide planning ideas for those advising the settlor, trustee or beneficiary of a trust that has at least one beneficiary who is a US person.

The information contained in this article is predicated upon the following assumptions:

- The trust is a foreign trust, revocable by its sole settlor during his lifetime without the consent of any person;
- the sole settlor of the trust has never been and will never be a citizen, resident or domiciliary of the USA;
- at least one beneficiary of the trust is a US person (as such term is defined in Section 7701(a)(30) of the Internal Revenue Code of 1986, as amended); and
- the entire trust is a grantor trust during the lifetime of the settlor.

Timely tax advice

It is unfortunate that many times neither the settlor nor the trustee seek the appropriate US tax advice until it is too late. In a perfect world, both the settlor and the trustee would obtain independent US tax advice prior to creating the trust if it is known in advance that at least one US person will be



a beneficiary of the trust. If that is not known in advance, then ideally both the settlor and trustee would obtain independent US tax advice at such time that a US person becomes a beneficiary of the trust. It may even be appropriate for the beneficiary to obtain independent US tax advice as well.

While it is no secret that the amount of attorneys' fees incurred to obtain such advice is typically nominal compared to the US tax savings that can be achieved, often US tax advice is not obtained in good time due to the costs involved and the reluctance of the trustee to demand such advice.

Flexibility

It is impossible to predict the future, so why set everything in stone? Many estate planning practitioners prepare trusts that include specific dispositive provisions requiring mandatory distributions (i.e. when the beneficiaries attain a certain age or ages) and do not take into account

any potential for change in the place of residence, citizenship or domicile of any of the beneficiaries. Taking such an approach may result in several unfavorable tax- and non tax-related consequences. Accordingly, in most cases the provisions of the trust instrument should be flexible in order to deal with contingencies and unforeseen events.

US person with powers over the trust

Many trusts provide an individual with various powers over the trust in the capacity as a protector or otherwise. If, for example, a US person is a beneficiary of a trust and has the power to remove and replace the trustee without any restrictions as to the reason or as to who can serve as the new or additional trustee, such power may be treated as a general power of appointment over the assets of the trust with adverse tax consequences (particularly if the trustee can make discretionary distributions). Any power



over a trust should be carefully considered before the trust instrument is executed in order to determine whether there would be any tax consequences in connection with such power if the power holder is or becomes a US person.

Maintaining foreign entities

For various reasons, most trusts hold title to financial assets indirectly through a wholly-owned foreign corporation. Holding title to assets in this manner triggers various US tax issues, particularly if the foreign corporation is ever treated as a passive foreign investment company or controlled foreign corporation.

The remainder of this article addresses some of those tax issues and points out some planning ideas.

Purported gifts from a foreign

corporation: A purported gift is any transfer of property made by a foreign corporation to a person who is not shareholder, except a transfer for fair market value. With certain exceptions, if a US person receives a purported gift directly or indirectly from a foreign corporation (as opposed to a distribution directly from the trust which is the sole shareholder of the foreign corporation), the purported gift must be included in the US person's gross income as if it were a distribution from the foreign corporation. In our experience, the exceptions to the foregoing rule rarely apply and they are therefore outside the scope of this article. Trustees should avoid making purported gifts from a foreign corporation to any US person.

Dividends: If the foreign corporation has retained earnings when the trust becomes

a nongrantor trust (i.e. upon the death of the settlor), then part or all of the retained earnings may be subject to US income tax when they are distributed from the foreign corporation to the trust. To avoid this result, the foreign corporation should regularly declare and pay dividends to the trust. The trust should thereafter re-contribute to the foreign corporation any funds not needed by the trust. Following this procedure regularly should minimize or eliminate the amount of retained earnings within the foreign corporation when the trust becomes a nongrantor trust.

Recognize gains: Upon the death of the settlor, the trust would receive a 'step-up' in its adjusted basis in the shares of the foreign corporation. This 'step-up', however, would apply only to the shares of the foreign corporation and not to the underlying assets of the foreign corporation. If the assets of the foreign corporation have appreciated in value during the lifetime of the settlor, part or all of such appreciation may be subject to US income tax after the death of the settlor. In order to minimize or eliminate such income tax, from time to time during the lifetime of the settlor (i.e. at least semi-annually) the foreign corporation should 'step-up' its adjusted basis in its assets. To do so, the foreign corporation would sell its appreciated assets and then reinvest the proceeds from such a sale; provided, however, that if the same assets will be repurchased immediately after such a sale, they should not be repurchased on the same day they were sold. Before selling any assets, the foreign corporation should consider the domestic and foreign tax and non-tax costs and other issues associated with selling assets and purchasing new assets.

Using a disregarded entity: If a foreign revocable trust directly or indirectly owns assets that are not situated within the USA for US estate tax purposes, it may be prudent for the trust to hold title to those assets through an entity that is disregarded for US tax purposes (such as a single-member domestic limited liability company or a foreign company that has validly 'checked the box' to be treated as a disregarded entity) instead of through a foreign corporation. If, at the time of the death of the settlor, the trust holds title to assets that are not situated within the USA through a disregarded entity, then the adjusted basis of the assets of such disregarded entity would be 'stepped-up' and the disregarded entity would never have any retained earnings (for US tax purposes). In other words, it would not be necessary to regularly recognize gains and regularly pay dividends.

In addition, those assets would not be subject to any US estate tax by reason of the death of the settlor. Certain exceptions may apply, however, such as if the trust was not properly funded.

The foregoing strategies are a small sampling of the vast number of applicable planning opportunities. Resolving issues posed by a US beneficiary of a foreign trust is best achieved by acting preemptively. Sometimes, however, the international estate planning practitioner must make the best of a bad situation for the client to avoid severe penalties and adverse tax consequences.

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