

“I’ve Got an International Secret” Uncovering the Mysteries of Drafting Delaware Trusts for Non-US Persons

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Determining Whether a Trust Is Domestic or Foreign

A trust is a domestic trust if:

1. a court within the US is able to exercise primary jurisdiction over the administration of the trust (the Court Test); and
2. one or more US persons have the authority to control all substantial decisions of the trust (the Control Test).

A trust is a foreign trust if it does not meet both the Court Test and the Control Test.

The Control Test

- A trust will satisfy the Control Test if US persons control all “substantial decisions” of the trust. For these purposes, a domestic corporation is a US person regardless of whether its shareholders are US persons.
- Conversely, “ministerial decisions” include decisions about the bookkeeping, the collection of rents and the execution of investment decisions.
- “Control” means having the power to make all of the substantial decisions of the trust, with no other person having a veto power. For this test, it is necessary to consider all persons who have authority to make substantial decisions of the trust and not only fiduciaries (i.e., Investment Advisors, Distribution Advisors, Trustees).
- Trusts often have persons serving as Protectors. The Protector usually has the power to remove and replace the trustee and may have other powers. If the Protector is not a US person, the trust may fail to satisfy the Control Test and therefore be deemed to be a foreign trust.

“Substantial Decisions” Defined

“Substantial decisions” are decisions authorized or required under the trust instrument and applicable law that are not ministerial and include:

1. whether and when to make distributions;
2. the amount of any distributions;
3. the selection of a beneficiary;
4. whether a receipt is allocable to income or principal;
5. whether to terminate the trust;
6. whether to compromise, arbitrate or abandon claims of the trust;
7. whether to sue on behalf of the trust or defend suits against the trust;
8. whether to remove, add or replace a trustee;
9. whether to appoint a successor trustee to succeed a trustee who has died, resigned or otherwise ceased to act as trustee, unless the power to make such a decision is limited insofar as it cannot be exercised in a manner that would change the trust’s residency from foreign to domestic or vice versa; and
10. controlling investment decisions.
11. However, if a US person hires a non-US investment advisor for the trust, the US person will be considered to control investment decisions if the US person can terminate the investment advisor’s engagement at will.

Further Clarifications of Control Test

- Examples in the Regulations illustrate that if a trust has three trustees, two of whom are US persons, the trust will still fail the Control Test if trustee decisions must be unanimous. If the same trust instead provides that the trustees must act by majority vote, the trust satisfies the Control Test.
- Another example in the Regulations clarifies that if only an investment advisor who is a foreign person can make investment decisions, but the US trustees can veto the investment decisions, the Control Test is still not satisfied because the trustees cannot make the investment decisions on their own. If in the same example, the US trustees may accept or veto foreign investment advisor's investment decisions and can make investments independent of the investment advisor, the Control Test is satisfied because the US persons control all substantial decisions of the trust.

Paying Tax in the US

Domestic trust

- Taxed on worldwide income and gains

Foreign trust

- Taxed only on US source income
 - FDAP
 - ECI
 - FIRPTA

Scenario 1

Delaware law foreign grantor trust

Scenario

A foreign grantor wishes to create a trust for the benefit of US family members in a stable and reputable jurisdiction, with protection from forced heirship laws.

Trust Solution

A foreign grantor establishes a foreign grantor trust in Delaware with foreign Private Investment Company (PIC) underneath. The trust structure with PIC would need to be promptly restructured following grantor's death.

US tax consequences

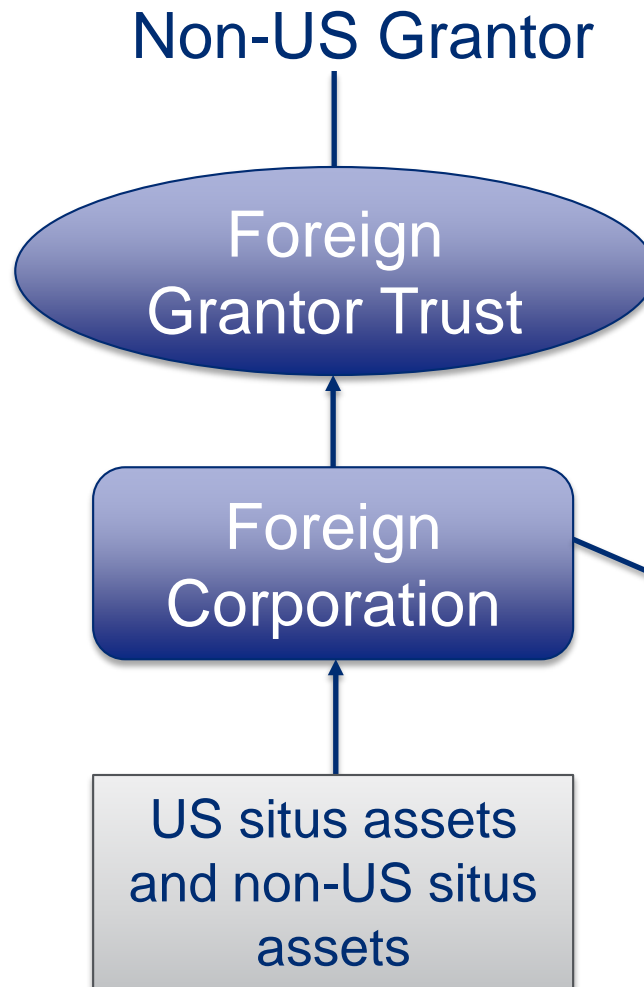
- US income taxes only on US source income
- No US gift, estate or GST taxes

Reporting

- Trust may need to report foreign assets on an FBAR
- US beneficiaries to report distributions in excess of \$100,000 in any given calendar year on Form 3520 following receipt of Foreign Grantor Trust Beneficiary statement from the trustee
- Possible CRS reporting for the PIC

Optimal Foreign Grantor Trust Structure

- ❖ No U.S income tax liability (except if US source income)
- ❖ No estate tax on death of non-US grantor or on death of US beneficiary if assets continue in trust
- ❖ No GST tax if trust continues in perpetuity



US Beneficiaries

- ❖ Distributions to US beneficiaries during grantor's lifetime are treated as gifts and not taxed by the US, but must be reported on Form 3520 if in excess of \$100,000 in a given calendar year

Scenario 2

Delaware law foreign non-grantor trust

Scenario

A foreign grantor wishes to create a trust for the benefit of foreign family members in a safe, stable and reputable jurisdiction, with protection from forced heirship laws and privacy

Trust Solution

A foreign grantor establishes an irrevocable foreign non-grantor trust in Delaware without a PIC

US tax consequences

- US income taxes only on US source income
- If structured appropriately, no US gift, estate or GST taxes
 - Grantor has no powers or beneficial interests in the trust – trust can invest in US and non-US situs assets
 - Grantor retains beneficial interests of powers over the trust within the meaning of IRC Sections 2035 through 2038 – trust can invest only in non-US situs assets (see IRC Section 2104(b))

Reporting

- Trust may need to report foreign assets on an FBAR
- No CRS reporting for the trust itself, but possibly for foreign alternative investments held in the trust

Scenario 3

Delaware law US non-grantor trust to hold US real estate

Scenario

A foreign settlor wishes to buy US real property for his US child.

Trust Solution

A foreign settlor creates Delaware law US non-grantor trust. The trust would hold 100% interest in a Delaware LLC that in turn would hold US real property.

US tax consequences

- So long as gift of cash is made from an offshore account, no US gift taxes
- No US estate or GST taxes on settlor's death
- US capital gains tax on sale of real estate and US income tax on any rental income
- No FIRPTA withholding on sale.
- Rent-free use of the real property by US beneficiaries does not constitute imputed rental income

Reporting

- Trustee files Form 3520 for gifts made to the LLC/trust in excess of \$100,000 in any given calendar year

State Law Considerations

- Under current Delaware law, the Rule Against Perpetuities has been repealed for irrevocable trusts holding non-real estate assets such as marketable securities or cash. However, the statute limits duration where a trust holds real estate to 110 years from when trust acquires the real property. Trust must distribute real estate as though trust terminates 110 years after acquisition. See Del. Code Ann. Title 25 §503(a).
- Practical solution is to convert any real estate to be held by a trust into intangible property by placing ownership into an LLC 100% owned by trust. Per Del. Code Ann. Title 25 §503(c), real estate for purposes of the statute does not include a trust owned interest in a limited liability company that in turn owns real estate.

Scenario 4

Delaware law pre-immigration trust

Scenario

A foreign settlor intends to immigrate to the US with spouse and children.

Trust Solution

A foreign settlor creates a Delaware law irrevocable asset protection trust with an independent trustee for the benefit of self, spouse and children. Settlor retains sufficient funds in personal name to support her and her family's living expenses so as to avoid any pattern of distributions to the settlor.

US tax consequences

- While the settlor is a non-US person, the trust pays US income tax only on US-source income as a foreign non-grantor trust.
- When the settlor becomes a US person, the grantor pays all income tax on the grantor trust.
- No gift, estate and GST taxes on the trust or the transfer to the settlor and family members.

Reporting

- While the trust is a foreign non-grantor trust, Trust may need to report foreign assets on an FBAR
- When the trust becomes a US grantor trust, to the extent the trust holds interests in foreign corporations or partnerships, information reporting requirements apply
- Possible CRS reporting for trust assets

Final Caveats – Expanded Need for Due Diligence

- With the advent of the Common Reporting Standard (CRS) in which the US does not participate, the US is viewed by some international organizations as a “leading tax and secrecy haven for rich foreigners.”
- Per *Pasquantino v. United States*, 544 U.S. 349 (2005), facilitation of foreign tax evasion occurring in the US can be prosecuted in the US.
- *Pasquantino* holds that the common law revenue rule whereby US courts traditionally have refused to assist foreign governments in collecting taxes in the US does not protect US based taxpayers (or their advisors) where activities in the US result in the evasion of foreign taxes or the concealment or aiding of such activity.
- The major takeaway here is that a lawyer or other professional who advises a client in connection with an inbound transaction where foreign taxes have been evaded or non-taxed funds are being brought into the US might be considered as aiding and abetting conduct deemed to be fraudulent and could thus be subject to criminal prosecution in the US even though the US Treasury does not suffer any loss.

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