

# Risk! – Administering Trusts with Non-U.S. Components and Foreign Reporting

Dina Kapur Sanna, Day Pitney LLP

John S. Harrison, The Bryn Mawr Trust Company of Delaware

Elizabeth M. Luk, J.P. Morgan Trust Company of Delaware



# Advantages of Delaware Laws

- Directed Trusts
- Perpetual Trusts
- Robust Asset Protection Laws
- Responsive Legislature and Specialized Chancery Court
- Availability of Common Law Trusts for Individuals in Civil Law Countries
- United States Jurisdiction

# U.S. Trusts v. Foreign Trusts

## (Post-1996, Trust Residency Rules)

- Trust Residence Has Significant Tax Implications for Both Settlor/Grantor and Beneficiaries
- Two-Part Test for Trust Residence:
  - Court Test
  - Control Test

# U.S. Trusts v. Foreign Trusts (cont'd)

- Planning for Foreign Status or Accidentally Defaulting to Foreign Status
  - A Substantial Decision in Hands of Nonresident Settlor, Nonresident Protector or Nonresident Co-Trustee
  - Having a Majority Non-U.S. Distribution Committee or Investment Committee
  - Twelve-Month Grace Period to Cure Unintended Change in Status

# U.S. Tax Consequences of Trust Residence and Grantor Trust Status to the Delaware (Foreign) Trust, Grantor and U.S. Beneficiaries

- Foreign Grantor Trust with Foreign Grantor and U.S. Beneficiaries
  - U.S. Income Tax Treatment of Grantor Trusts
    - Income Flows Up to Grantor/Settlor
    - Trust Income Not Taxable to Trust or Beneficiaries During Grantor's Lifetime
    - Trust May Be Structured to Provide Basis Step-Up at Grantor's Death

# U.S. Tax Consequences of Trust Residence and Grantor Trust Status to the Delaware (Foreign) Trust, Grantor and U.S. Beneficiaries (cont'd)

- Post-1996 Limitations on Nonresident Treated as “Owner” and Exceptions
- Use of Foreign Corporation to Avoid Estate Tax
- U.S. Tax and Reporting Requirements of Foreign Corporation, U.S. Beneficiaries and Delaware Trustee (not Trust)

# U.S. Tax Consequences of Trust Residence and Grantor Trust Status to the Delaware (Foreign) Trust, Grantor and U.S. Beneficiaries (cont'd)

- Foreign Nongrantor Trust with Foreign Grantor and U.S. Beneficiaries
  - Accumulation Distribution Rules – Determining a Foreign Trust's Distributable Net Income (DNI) and Undistributed Net Income (UNI)

# U.S. Tax Consequences of Trust Residence and Grantor Trust Status to the Delaware (Foreign) Trust, Grantor and U.S. Beneficiaries (cont'd)

- How Trust and Beneficiaries Are Taxed on DNI
- What Happens if DNI is Not Distributed Currently (Punitive Tax Treatment of UNI and Throwback Rule)
- 65-day Election
- Loans/Below Market Uses of Trust Property Treated as Distributions
- Intermediary Rules



# U.S. Tax Consequences of Trust Residence and Grantor Trust Status to the Delaware (Foreign) Trust, Grantor and U.S. Beneficiaries (cont'd)

- Use of Foreign Corporation to Avoid Estate Tax if Nonresident Grantor Retains a “String”
  - Controlled Foreign Corporation (CFC) or Passive Foreign Investment Company (PFIC) Rules as a Result of Indirect U.S. Ownership Rules
  - Potential Phantom Income to U.S. Beneficiaries
- U.S. Tax and Reporting Requirements of U.S. Beneficiaries, Foreign Corporation, Delaware Trust and Delaware Trustee

# U.S. Tax Consequences of Trust Residence and Grantor Trust Status to the Delaware (Foreign) Trust, Grantor and U.S. Beneficiaries (cont'd)

- Foreign Grantor Trust with U.S. Grantor and U.S. Beneficiaries
  - Sections 679 and 684
    - Twelve-Month Grace Period to Cure Unintended Change in Status and Prevent Accidental Expatriation of Trust
  - U.S. Tax and Reporting Requirements of U.S. Grantor, U.S. Beneficiaries and Delaware Trustee
  - Gift and Estate Tax Consequences (Defective Grantor Trust)

# Enhanced Reporting for Delaware (Foreign) Trusts

- FinCen Form 114 by Delaware Trustee
- Form 5472 for LLC (Where Foreign Trust Holds Assets Through Single Member LLC) Beginning in 2018 for 2017 Tax Year
- FATCA Classification and Compliance for Trust and Form 8966 Reporting by Trustee
- CRS Classification and Compliance (if Foreign Blocker Corporation Used to Protect Settlor/Grantor from Estate Tax)

# Common Uses for Delaware Trusts

- Gifting Trusts for U.S. Persons
- Pre-Immigration for Nonresident Grantor
- Holding U.S. Real Property
- State Income Tax Advantages
- Confidentiality/Flexibility

# Use of Delaware Jurisdiction for Foreign Trusts That Will Need to Be Domesticated in the Future

- Tax Consequences of Remaining a Foreign Trust vs. U.S. Trust
- Common Structure/Sequence:
  - Foreign Grantor Trust During Grantor's Lifetime
  - Trust Becomes Foreign Nongrantor Trust Upon Settlor's Death
  - Trust is Domesticated So That Assets May Be Held in U.S. Nongrantor Trust for U.S. Beneficiaries

# Use of Delaware Jurisdiction for Foreign Trusts That Will Need to Be Domesticated in the Future (cont'd)

- Mechanism for Domestication of Foreign Trust: Migration v. Decanting (Different Tax Treatment) Foreign Grantor Trust During Grantor's Lifetime
  - Migration of Foreign Nongrantor Trust
    - Rev. Proc. 91-6
  - Decanting of Foreign Nongrantor Trust
  - Sample Language to Migrate or Decant

# Comparison of Taxation of U.S. Beneficiaries of Foreign Nongrantor Trust vs. U.S. Nongrantor Trust

## Tax Consequences of Remaining a Foreign Trust

- The Trust would not have to file a U.S. income tax return unless it had U.S. source income. Foreign trusts file Form 1040NR, if required, and provide U.S. withholding agents with W-8 (either W-8IMY, if foreign grantor trust or W-8BEN-E if nongrantor trust).

## Tax Consequences of U.S. Trust

- The U.S. Trust would have to file a U.S. income tax return each year.

# Comparison of Taxation of U.S. Beneficiaries of Foreign Nongrantor Trust vs. U.S. Nongrantor Trust (cont'd)

## Tax Consequences of Remaining a Foreign Trust

- The Trust would have to prepare a Foreign Nongrantor Trust Beneficiary Statement each year as part of a U.S. beneficiary's Form 3520 filing (see #6 below).

## Tax Consequences of U.S. Trust

- The U.S. Trust would have to prepare K-1 statements each year to report distributions. That would be done in connection with preparation of U.S. income tax returns.



# Comparison of Taxation of U.S. Beneficiaries of Foreign Nongrantor Trust vs. U.S. Nongrantor Trust (cont'd)

## Tax Consequences of Remaining a Foreign Trust

- The Trust would have to keep track of all income earned and gains realized in the Trust after the Settlor's death. To avoid the U.S. beneficiaries being subject to accumulation distribution rules (see #5 below), each Trust would distribute DNI in the year earned or within 65 days thereafter, to the U.S. beneficiaries. If the Trust distributed within 65 days of the close of the year, it would have to affirmatively elect for the distribution to be treated as having been made on December 31st of the prior year.

## Tax Consequences of U.S. Trust

- The U.S. Trust would not be required to distribute DNI annually to avoid adverse tax consequences to U.S. beneficiaries.

# Comparison of Taxation of U.S. Beneficiaries of Foreign Nongrantor Trust vs. U.S. Nongrantor Trust (cont'd)

## Tax Consequences of Remaining a Foreign Trust

- If the Trust did not distribute the DNI currently and chose to accumulate it instead, the Trust would not be taxed on it provided it was from foreign sources. However, the U.S. beneficiaries would face punitive tax consequences on a so-called “accumulation distribution,” as described below.

## Tax Consequences of U.S. Trust

- The U.S. Trust would be taxed currently on all income earned or gains realized. The current tax rate on long term capital gain is 20%, The current tax rate on ordinary income is 39.6%. An additional 3.8% Medicare tax also may apply.

# Comparison of Taxation of U.S. Beneficiaries of Foreign Nongrantor Trust vs. U.S. Nongrantor Trust (cont'd)

## Tax Consequences of Remaining a Foreign Trust

- Distributions of UNI would be taxed to the U.S. beneficiaries at higher ordinary income rates. Currently, ordinary income is taxed at up to 39.6%. In addition, distributions of UNI would be subject to “throwback tax” and an interest charge. Depending on the circumstances, these additional charges can push the effective tax on an accumulation distribution above 50%.

## Tax Consequences of U.S. Trust

- Distributions of accumulated income or capital gains realized by the U.S. Trust would not be taxed to the U.S. beneficiaries.

# Comparison of Taxation of U.S. Beneficiaries of Foreign Nongrantor Trust vs. U.S. Nongrantor Trust (cont'd)

## Tax Consequences of Remaining a Foreign Trust

- U.S. beneficiaries would have to file Form 3520 each year to report trust distributions. The penalty for late filing of Form 3520 is the greater of \$10,000 or 35% of the gross distribution.
- U.S. beneficiaries would have to disclose their interest in the Trust on Form 8938, as an attachment to their individual income tax returns. The minimum penalty for failing to disclose is \$10,000.

## Tax Consequences of U.S. Trust

- No Form 3520 would be required for distributions from the U.S. Trust nor would any particular disclosure be required on the U.S. beneficiaries' tax returns.

# Comparison of Taxation of U.S. Beneficiaries of Foreign Nongrantor Trust vs. U.S. Nongrantor Trust (cont'd)

## Tax Consequences of Remaining a Foreign Trust

- A U.S. beneficiary using Trust property must either pay rent or be treated as receiving a distribution from the trust equal to the imputed rent, which potentially could carry out DNI or UNI to the U.S. beneficiary. A U.S. beneficiary who borrows money from the Trust is subject to the “qualified obligation” rules.

## Tax Consequences of U.S. Trust

- These imputed rent rules do not apply to the U.S. Trust. The qualified obligation rules do not apply to the U.S. Trust.

# Sample Migration Language

The Trustee shall have the power, with the written consent of the Protector, to change the governing law and trust situs of any one or more of the trusts created hereunder from one jurisdiction to another jurisdiction (and shall amend the provisions hereof as necessary to insure the continuing effectiveness of the trust under such new governing law) and if the Trustee elects to change the governing law and trust situs as so provided, the laws of such other jurisdiction shall apply (provided that no rule against perpetuities then applicable to the trust is infringed thereby) and the courts of such other jurisdiction shall have the exclusive power to adjudicate all claims, actions or proceedings relating to this Trust Agreement. The power to change the governing law and trust situs shall be a continuing power which may be exercised at any time or from time to time. The determination of the Trustee and the Protector as to any such change shall be conclusive and binding on all persons interested or claiming to be interested in any trust hereunder. In exercising discretion, the Trustee may take into account such factors as the Trustee may deem appropriate, including but not limited to the residence of one or more of the beneficiaries of such trust, taxation, investment, political stability, anonymity and any other matters such Trustee considers relevant. If the Trustee determines that such a change would be appropriate but for the fact that the Trustee is not qualified to act as trustee in such other jurisdiction, then the Trustee may resign so that a qualifying trustee may be appointed. Notwithstanding the authority of the Trustee to change the governing law and situs of any trust with the Protector's consent, neither the Trustee nor the Protector shall be under any duty to do so nor shall the Trustee or the Protector be liable to any person interested in a trust by reason of any expense incurred in either changing the governing law and situs or failing to change the governing law and situs of the trust.

# Sample Decanting Language

The Trustee shall have the power, with the written consent of the Protector, to (i) amend the administrative provisions of this Trust Agreement for the purpose of limiting or granting powers necessary for prompt and effective administration of the trusts hereunder or for the purpose of obtaining or preserving favorable tax treatment, provided that no power granted to the Trustee in this Section grants any implied power to change beneficial interest under this Trust Agreement; and (ii) appoint any or all the property of any trust hereunder to the trustee of any other trust having a perpetuities period not exceeding the perpetuities period of the trust hereunder, whenever and by whomsoever made, including any other trust or trusts made by the Trustee hereunder, and wherever the trustee of such other trust may reside or be domiciled or incorporated, the beneficiaries of which shall include (not necessarily exclusively) all or any one or more of the beneficiaries of the trust hereunder, to be held, administered and distributed as part of the principal of such other trust, free from the trust hereunder. Notwithstanding the foregoing, the Trustee and the Protector exercising the power granted in this Section shall not be a beneficiary (directly or indirectly) of the trust to which any such property is so transferred. These powers shall be exercised by a written instrument filed with this Trust Agreement. In exercising these powers, the Trustee and the Protector shall observe the general fiduciary duties of loyalty, good faith, fairness and due care.