

Repatriation of Foreign Trusts

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If one were to ask U.S. estate planners about the greatest changes they've seen to the estate planning landscape in the last 20 years, most would probably mention the increased popularity of family limited partnerships, the advent of Grantor Retained Annuity Trusts and the recent dramatic increase in the estate tax exemption. Somewhat lost in the shuffle of those momentous changes is a more subtle but nonetheless important trend: the increasingly international nature of estate planning clientele. Only a generation ago, U.S. estate planning overwhelmingly had a domestic focus, and international planning was the purview of only a small number of specialists, while now it seems that any reasonably sophisticated planning practice or trust department has a number of international clients. Economists, demographers and others can perhaps explain the reasons behind this development, but regardless, many more people in the planning and trust businesses now need to educate themselves about the unique issues that confront international clients.

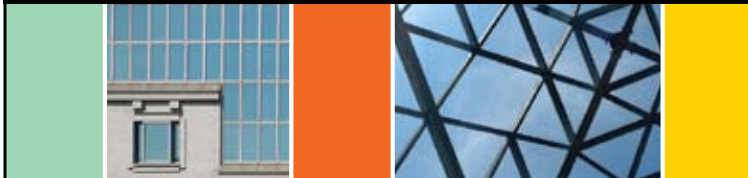
The focus of this article is on the issues involved in the repatriation of foreign trusts, which is arguably a fairly esoteric subset of international planning issues. However, to gain any meaningful grasp of foreign trust repatriation issues, one needs a considerable amount of background knowledge on broader international planning matters. Consequently, after a brief word on terminology, and before diving into the more specific topic at hand, we will go over a number of basic concepts. It is my hope, therefore, that this article

will serve not only as a discussion of an inherently interesting but narrow topic, but also as a fairly broad introduction/review that should prove useful in other contexts as well.

Terminology

Technically, "repatriation" implies returning to the U.S., having originated there but having previously departed the jurisdiction. However, most foreign trusts that become U.S. trusts were never U.S. trusts in the first place. Similarly, most assets flowing from foreign trusts to U.S. trusts did not originate in the U.S. A more accurate term would therefore be "domestication" rather than "repatriation." However, "repatriation" has become a term of art, so notwithstanding the slight inaccuracy, it will continue to be used in this article.

We should also clarify what we mean by "foreign trust." That term could mean various things: a trust governed by non-U.S. law, a trust administered by a non-U.S. trustee, etc. However, we will stick to the Federal tax definition. The Tax Code provides a not-terribly-helpful definition of a foreign trust as a trust other than a U.S. trust. Fortunately, it defines a U.S. trust with greater precision, as a trust where (i) a court in the U.S. has primary jurisdiction over the administration of the trust—the "court test"—and (ii) one or more U.S. persons are authorized to control all substantial decisions of the trust—the "control test." Note that this definition favors foreign treatment: if one substantial decision of a trust can be controlled by a non-U.S.



person, the trust will be a foreign trust even though the trust is administered in the U.S. by a U.S. trustee according to the laws of a U.S. state.

Basic Income Taxation Background

For Federal income tax purposes, U.S. persons are taxed on their worldwide income, while non-U.S. persons are only taxed on their U.S. source income. Though this is an oversimplification, for most trust-related purposes, U.S. source income is limited to dividends from U.S. corporations and rents from U.S. real property; most interest is not U.S. source even if the debt is issued by U.S. corporations or governmental entities, and capital gains are not U.S. source income, even if from the sale of U.S. situs assets. Since U.S. trusts are U.S. persons (and foreign trusts are non-U.S. persons), these rules apply equally well to trusts. However, trust taxation has its own complexities, so some additional background is recommended.

For Federal income tax purposes, trusts are taxed according to one of two regimes: a modified pass-through regime or a grantor trust regime. Non-grantor trusts (sometimes referred to as simple or complex trusts) are separate taxpayers, but ordinary income distributed to beneficiaries is deductible by the trust and picked up into income by the beneficiaries. In contrast, all items of income, gain, loss, etc. of a grantor trust are the responsibility of the grantor. Various rules trigger grantor trust treatment, and though a full discussion of those rules is beyond our scope, it is worth noting that a U.S. trust can generally be structured as a grantor trust if desirable. That is not true of foreign trusts, however: foreign trusts will only be grantor trusts if (i) distributions can only be made to the grantor and/or the grantor's spouse during the grantor's lifetime, or (ii) the trust is revocable by the grantor alone or with the consent of a related or subordinate party.

A foreign grantor trust is essentially taxed like a non-resident individual, which is not true of a foreign non-grantor trust. Although a foreign non-grantor trust is taxed only on its U.S. source income, all of its income—U.S. source or not—accumulated in one year but distributed to a U.S. person in a later year is treated as an accumulation distribution. Accumulation distributions are subject to tax at ordinary income tax rates (even on capital gains) and also subject to a significant interest charge. Consequently, it is usually tax-advantageous for a non-grantor trust with U.S. beneficiaries to be a U.S. trust rather than a foreign trust. Note that there are no accumulation distributions issues with a foreign grantor trust during the grantor's life, which is a significant benefit relative to foreign non-grantor trusts if present or future beneficiaries may be U.S. persons.

Basic Estate/Gift Taxation Background

For estate tax purposes, the U.S. taxes both its citizens and its residents on their worldwide estates, while non-resident aliens are taxed only on their U.S. situs property. U.S. situs property includes real or tangible personal property located in U.S., stock in U.S. corporations and interests in U.S. mutual funds and money market funds but does not include bonds whose interest is not U.S. source income or money on deposit in a U.S. bank. Standard rules on inclusion of trusts in the gross estate apply to non-resident aliens, but only to the extent of U.S. situs assets owned by the trust.

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A common estate planning structure for a non-resident alien is therefore to establish a revocable trust, so it is a grantor trust with respect to the non-resident alien, but for the trust to hold only an interest in a non-U.S. corporation, so at the death of the grantor, no U.S. situs property will be held by the trust and therefore nothing will be includible in the estate of the grantor. Any U.S. situs assets can be held within the non-U.S. corporation without risking estate tax inclusion. And for gift tax purposes, there is no tax on transfers of intangible personal property by a non-resident alien, even if U.S. situs, so there is generally no U.S. gift tax on funding of the trust.

Repatriation

Though there are various possible reasons it might make sense for a trust to repatriate, the prior discussion suggests two: (i) if the beneficiaries of a foreign non-grantor trust become U.S. persons, or (ii) at the death of the grantor of a foreign grantor trust if the trust continues for the benefit of the grantor's descendants who are U.S. persons. In either case, it likely becomes tax-advantageous for the trust to become a U.S. trust because a foreign non-grantor trust with U.S. beneficiaries may have accumulation distribution issues.

There are two basic means of repatriation, which we will refer to as the "resignation and appointment" method and the "decanting" method. Resignation and appointment is where the foreign trustee

resigns and a U.S. trustee is appointed. It is straightforward and is subject to fewer reporting requirements, but it may not work if there are other foreign parties besides the trustee responsible for substantial decisions of the trust. In addition, the U.S. trustee may have responsibility for any foreign tax or other filings. If the trust is governed by the laws of a non-U.S. jurisdiction, U.S. institutional trustees may be restricted by charter from serving, though many trusts contain change-of-law provisions and those that don't can generally be amended via a court proceeding. But even if the governing law can easily be changed, the substantive provisions of trusts established in non-U.S. jurisdictions, as foreign trusts often are, can be quite different than those in U.S. jurisdictions, and U.S. trustees may be uncomfortable with those provisions. For these reasons, the decanting method may be preferable. Decanting is where a new trust instrument is drafted to create a U.S. trust, and pursuant to authority in the original foreign trust, the trustee of that trust pours the assets over into the new U.S. trust. Decanting entails more reporting obligations (as discussed below), and also the time and expense of drafting a new trust instrument, though the chance to influence the terms of the new trust may be perceived as an advantage by the beneficiaries.

From a reporting perspective, the most basic requirement is IRS Form 3520, which must be filed by a U.S. person (including a U.S. trust) who receives distributions from a foreign trust. Form 3520 is required in a decanting scenario, but not in a resignation and appointment scenario because there is no actual distribution to a U.S. trust, only a conversion of a U.S. trust to a foreign trust. Penalties for failure to file the Form are severe—35% of the amount distributed—but a reasonable cause exception applies. In addition, the so-called "FBAR" may be required regardless of which method of repatriation is employed, depending on the assets held in the new U.S. trust. A thorough examination of the FBAR requirements is beyond our scope, but it is important to note that the definitions of U.S. person and foreign account are very broad and not necessarily consistent with the standard Tax Code definitions, and again, penalties for failure to file may be severe. Therefore, in any repatriation situation a U.S. trustee should obtain expert advice on any potential FBAR issues.

There are also certain income tax reporting issues involved in repatriations. In particular, where assets are decanted from a foreign trust to a new U.S. trust, accumulation distribution issues may arise. Fortunately, as mentioned above, many instances of a foreign trust being repatriated will occur at the death of the grantor of a foreign grantor trust, at which time the trust will cease to be a grantor trust, and only income earned after the foreign trust ceases to be a grantor trust will be relevant for accumulation distribution purposes. If the distribution to the U.S. trust occurs in the same tax year as the grantor's death, there will be no accumulated income, and therefore no accumulation distribution, but if the distribution to the U.S. trust occurs in a tax year subsequent to the year of the grantor's death, the potential for an accumulation distribution exists. Note that if a foreign trust simply converts to a U.S. trust through a resignation and appointment, there should be no accumulation distribution upon conversion even if there is accumulated income from a prior tax year. However, any distribution in a subsequent year that is in excess of the then-current income would be deemed



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an accumulation distribution to the extent of the income accumulated from the prior tax year. Also, any income earned by the trust prior to conversion but in the same tax year would, if not distributed in that year, be deemed accumulated income for purposes of subsequent distributions. In other words, resignation and appointment does not eliminate accumulation-related issues but rather merely postpones them, whereas a decanting forces those issues to be addressed up-front.

Finally, there are certain income tax issues that need to be addressed if the repatriated trust owns a foreign corporation. As mentioned above, it is a common estate planning technique for non-resident aliens to have a revocable trust owning a foreign corporation, which averts U.S. estate taxation because any U.S. situs assets are owned not by the trust but by the corporation, which isn't looked through for estate tax purposes. However, after the death of the non-resident alien, for Federal income tax purposes those foreign corporations may be treated as Controlled Foreign Corporations or Passive Foreign Investment Companies, each of which has its own potential adverse income tax consequences. Even a cursory discussion of those consequences is beyond our scope, but it is critical to obtain expert tax and legal advice both during the non-resident alien's life and after his or her death to mitigate those consequences.

Conclusion

For either estate planners or trustees with an international clientele, an understanding of the issues involved in repatriating foreign trusts is highly recommended, particularly in the current

era of increasing international mobility. And though trust repatriation is only one topic of many that arises when servicing international clients, it touches upon a great many issues that also arise in other contexts, so devoting attention to it may well provide dividends even when seemingly unrelated issues arise.



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