NORTHERN TRUST

Common Uses of Delaware Trusts for International Clients

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INTRODUCTION

It is increasingly common for global families to have cross-border circumstances that give rise to a multitude of U.S. income, gift, estate and generation-skipping transfer tax consequences, particularly when trusts are involved. Delaware trusts can and do play a part in the solutions for such international families.

Basic rules of international estate planning:

- U.S. persons are subject to U.S. income taxation on their worldwide income. (I.R.C. §§ 1, 61).
- Individuals who are U.S. persons are also subject to gift, estate and generation-skipping transfer taxation on their worldwide assets. (I.R.C. §§ 2001, 2031-2046, 2601).
- Non-U.S. persons are subject to U.S. income taxation only on their U.S. source income.
- Individuals who are non-U.S. persons are subject to U.S. gift, estate and generation-skipping transfer taxation only on their U.S. situs assets.
- Trusts, like individuals, can be classified as domestic or foreign.

Foreign Trusts for U.S. Tax Purposes

- Objective Rule – A trust is considered domestic for U.S. tax purposes only if:
  - a U.S. court can exercise primary supervision over its administration (the court test); and
  - the U.S. fiduciaries have the authority to control all substantial decisions relating to the trust (the control test).
- A trust that does not satisfy both tests is a foreign trust for U.S. tax purposes.
  - Trusts can become foreign because of appointment of new trustee
  - The use of trusts formed in the U.S. that are foreign for U.S. tax purposes
  - Inadvertent loss of U.S. status

Court Test
Treas. Regs. § 301.7701-7(c)

- A court is able to exercise primary supervision over the trust if a U.S. court has authority to render orders or judgments resolving substantially all issues concerning administration of the entire trust.
- A trust that is registered with a U.S. court under the registration provisions of a statute similar to Article VII of the Uniform Probate Code meets the court test. If the parties take steps with a U.S. court that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test even if both a U.S. court and a foreign court have jurisdiction over the trust.
- A trust fails the court test if the trust instrument includes a migration clause but a clause triggering migration of the trust only in the case of foreign invasion or widespread confiscation or nationalization of property is not regarded as a migration clause.
- Safe Harbor:
  - The trust instrument does not direct that the trust be administered outside of the U.S.
  - The trust is actually administered exclusively in the U.S.
  - The trust is not subject to an automatic migration provision.

Control Test
Treas. Regs. § 301.7701-7(d)

- One or more U.S. persons must have the authority to control all substantial decisions of the trust.
- Substantial decisions include:
  - Whether and when to distribute income or corpus
  - The amount of any distributions
  - The selection of a beneficiary
  - Whether a receipt is allocable to income or principal
  - Whether to terminate the trust
  - Whether to compromise, arbitrate or abandon claims
  - Whether to sue on behalf of the trust or to defend suits against the trust
  - Whether to remove, add or replace a trustee
  - Investment decisions

Control Test Planning

- Note that, subject to a grace period under the Regulations to correct for "inadvertent" changes, a U.S. trust can become foreign due to a trustee change, or a change in the tax residence of a non-U.S. citizen individual holding a power, since "U.S. persons" does not include individuals who are nonresident aliens as to the U.S. Reg. § 684-4(c).
- The rule applies to non-fiduciary powers, not only trustee powers – e.g., a power to add a beneficiary such as in a typical power of appointment, or a power to direct investments if not terminable at the will of U.S. persons. But non-fiduciary powers could be held, for example, by a corporation incorporated under U.S. law (which typically would qualify as a U.S. person).
- Examples of powers under the control test:
  - Power to allocate receipts between income/principal is not "substantial" if the distinction is meaningless under the trust.
  - Power to deal with claims may be a convenient means to create foreign status. See Reg. §301.7701-7(d)(3).
  - Power to remove and replace a trustee can lead to surprising result if trustees have mixed US tax status but a trustee targeted for removal cannot in effect cast a vote due to a conflict of interest.

Overview

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I. FATCA & CRS: An Overview

II. Trust Classification per FATCA & CRS

III. FATCA & CRS Conflicting Trust Classification

IV. Takeaways

V. Other Reporting Requirements (Forms 3520 and 3520A)

I. FATCA & CRS: An Overview

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	FATCA*	CRS	Key Points
Governing Authority	United States	104+ separate tax jurisdictions	Requires monitoring of local jurisdictions enforcement provisions to determine compliance risk—jurisdictions subject to peer review by Global Forum
Withholding	30% withholding on Non-compliant Payees/ Intermediaries	No Withholding	Enforcement by the tax authorities of the signatory jurisdictions and specific requirement to establish a penalties scheme

I. FATCA & CRS: An Overview

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	FATCA	CRS	Key Points
Account Scope	US Individual Accounts, US Entity Accounts and Passive NFFE Accounts held by **substantial US owners** (i.e., 10% of stock, profits interest, or beneficial interest of trust)	Individual and Entity accounts held by **tax residents** of any CRS reportable jurisdiction or Passive NFEs with Controlling Persons that are residents in any CRS reportable jurisdiction	The number of CRS reportable accounts for a Reporting Financial Institution is likely to be greater than the number of reportable accounts under FATCA
Thresholds	$50,000 if residing in the US and $200,000 if residing abroad	With the exception of pre-existing entity accounts, *no* applicable thresholds	Potentially limited impact for financial institutions that did not apply thresholds

I. FATCA & CRS: An Overview

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	FATCA	CRS	Key Points
Documentation Requirements	Forms W-8/W-9 may be used to capture all tax data	US Tax forms are not acceptable to capture all CRS data (e.g., multiple tax residences, CRS legal entity classification, place of birth)	- Self-certification will be needed to capture CRS-specific data such as multiple tax residency, CRS legal entity - Controlling persons required to sign or affirm their own self-certification - All Passive NFEs will ultimately have to identify Controlling Persons (i.e., natural persons)

Note: The two global reporting regimes may classify entities differently, resulting in added complexity.

II. Trust Classification per FATCA & CRS

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FATCA	CRS
• FFI – Treas. Reg. § 1.471-5(e)(1) • Custodial Institution – Treas. Reg. § 1.471-5(e)(1)(ii), (e)(3) • Investment Entity – Treas. Reg. § 1.471-5(e)(4) • NFFE – Treas. Reg. §§ 1.1471-1(b)(80), (94)	• FI – CRS § VIII(A)(3) • Custodial Institution – CRS § VIII(A)(4) • Investment Entity – CRS § VII(A)(6) • NFE - CRS § VIII(D)(7)-(9)

Note: The general rules track the same language, meaning a trust will either be a Passive NFFE or NFE if the trustee is an individual and an Investment Entity FFI or FI if the trustee is a professional corporate trustee. However, different circumstances may dictate different results, as illustrated below.

II. Trust Classification per FATCA & CRS

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- Trust managed by an individual*
  - On January 1, 2013, X, an individual, establishes Trust A, a nongrantor foreign trust for the benefit of X's children, Y and Z. X appoints Trustee A, an individual, to act as the trustee of Trust A. Trust A's assets consist solely of financial assets, and its income consists solely of income from those financial assets. Pursuant to the terms of the trust instrument, Trustee A manages and administers the assets of the trust. Trustee A does not hire any entity as a third-party service provider. Trust A is not an investment entity because it is managed solely by Trustee A, an individual. Because of the passive nature of its activities, Trust A will be classified as a Passive NFFE.
  - For CRS purposes, the analysis would be the same if X were a resident in a CRS jurisdiction. Because the trustee is an individual, the trust will be classified as a passive NFE and be required to report on controlling persons who are residents of CRS jurisdictions.

* *See* Treas. Reg. 1.11471-5(e)(4)(v)

II. Trust Classification per FATCA & CRS

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- Trust managed by a trust company*
  - The facts are the same as in [the above example], except that X hires Trust Company, an FFI, to act as trustee on behalf of Trust A. As trustee, Trust Company manages and administers the assets of Trust A in accordance with the terms of the trust instrument for the benefit of Y and Z. Because Trust A is managed by an FFI, Trust A is an investment entity and an FFI for FATCA reporting purposes.
  - Similarly, if X were a resident of a CRS jurisdiction with a trust managed by Trust Company, the trust would be classified as an FI for CRS reporting purposes.

* *See* Treas. Reg. 1.11471-5(e)(4)(v)

III. FATCA & CRS Conflicting Trust Classification

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- Illustration of conflicting classification issue
- On January 1, 2013, X, an individual resident in a CRS country, establishes Trust A, a foreign nongrantor trust for the benefit of X's children, Y (U.S. citizen) and Z (U.S. Citizen) under a CRS country's law. The trust provides for mandatory distributions to be made annually to X and Z. X appoints Trustee A, an individual, to act as the trustee of Trust A. Trust A's assets consists solely of financial assets, and its income consists solely of income from those financial assets. Pursuant to the terms of the trust instrument, Trustee A is authorized to delegate management and administration of the assets of the trust. Trustee A hires an entity that is a professional corporate money manager as a third-party service provider for Trust A's entire investment portfolio.
- FATCA: Because the Trust's investment assets are professionally managed, without guidance otherwise, Trust A could be classified as an Investment Entity FFI for FATCA reporting purposes. Thus, the trust would need to do FATCA reporting with respect to any of its U.S. Reportable Accounts.
- CRS: Trust A is a Passive NFE for CRS reporting purposes because it is managed solely by Trustee A, an individual. However, if Trust A held an account at a bank in a CRS country, then it would need to provide information to the bank on its Controlling Persons (X as settlor) that are resident in a CRS country.

IV. Takeaways

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- If there is no account in a CRS jurisdiction, there is no CRS reporting requirement even if the beneficial owner is a resident of a CRS jurisdiction
- If controlling person resides in the U.S. there is no reporting CRS requirement even if the account is in a CRS reporting jurisdiction
- If the account is in a CRS jurisdiction and the controlling person is a resident of a CRS jurisdiction, there will be CRS reporting obligations
- For purposes of FATCA, U.S. citizenship controls

V. Other Reporting (Forms 3520 and 3520A)

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- Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts Due April 15
  - U.S. person creates or transfers money or property to a foreign trust
  - Receives (directly or indirectly) any distributions from a foreign trust
  - Receives certain gifts or bequests from foreign entities
  - Note: no reporting for migration of trust to U.S.
  - Note: no longer automatically extended with an income tax return extension and will need a separate extension request for 2016 tax year
- Form 3520-A, - Annual Information Return of Foreign Trust with a U.S. Owner (under Section 6048(b)) Due March 15
  - This form provides info about the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust

MODERN CROSS-BORDER SCENARIOS: THE GENEROUS PARENT

Scenario 1: The Generous Parent

Parent is a Belgian citizen and resident. She would like to make a substantial lifetime gift for the benefit of her daughter, a Belgian national with a U.S. green card, residing in the United States. (Daughter intends to remain indefinitely in the U.S.)

- Should the parent make the gift outright or establish an irrevocable gift trust in the United States?
- If a trust, will U.S. gift taxes apply and will the trust be subject to future estate or generation-skipping transfer taxes?
- How will the trust be taxed for U.S. income tax purposes?

HOW THE GENEROUS PARENT CAN SAVE U.S. TRANSFER TAXES

- **Gift tax:** Intangible assets do not have a U.S. situs for gift tax purposes (cash can be an intangible if delivered to an account outside the U.S.). If the gift from the Belgian parent consists of cash or securities, it will not be subject to U.S. gift tax.
- **Estate Tax:** U.S. citizens (wherever they live) and U.S. "residents" (regardless of their citizenship) are subject to U.S. gift, estate and generation-skipping transfer taxes on their worldwide assets. U.S. estate tax is imposed on all wealth transferred directly from U.S. daughter upon her death.
- **Proper use of a U.S. trust** will give the daughter economic benefit of the assets (income, discretionary principal), but keep the assets out of daughter's estate and avoid subjecting the mother's gift to U.S. estate tax in future U.S. generations.

Practice tips:
(1) Beneficiary's interest in trust must not include a power to appoint the trust assets to herself, her estate or her creditors.
(2) Watch for tax consequences of the gift in the donor's home country.
(3) Gifts from foreign persons to U.S. persons, including U.S. trusts, are subject to information reporting requirements.

DELAWARE TRUSTS SAVE U.S. TRANSFER TAXES

A Delaware trust can continue indefinitely, without any fixed term. The economic benefit of a Delaware dynasty trust, in comparison to an outright gift, is inescapable.

	Delaware Dynasty Trust Transfers in Trust To the Next Generation Every 25 Years	**Taxable Outright** Transfers To the Next Generation Every 25 Years
Year 1	$1,000,000	$1,000,000
Year 25 Value	$16,289,000	$16,289,000
Transfer Tax	—	*$6,450,200*
Year 50 Value	$55,160,000	$33,865,000
Transfer Tax	—	*$13,238,400*
Year 75 Value	$184,900,000	$67,245,000
Transfer Tax	—	*$26,900,000*
Ending Value	$184,900,000	$40,345,000
Dynasty Benefit =	**$144,555,000**	

Assumptions:

Federal estate tax rate: 40%* Return on investment assets: 5%
No state income taxes.
No distributions from trust or consumption of principal or income by persons receiving outright transfers.

* 2016 highest marginal estate tax rate.

MODERN CROSS-BORDER SCENARIOS: THE FOREIGN NON-GRANTOR TRUST

Scenario 2: The Foreign Non-Grantor Trust

Many years ago, grandparents in Europe established a foreign grantor trust for their lifetimes, with the ultimate benefit passing to their grandchildren.

Grandchildren are U.S. citizens and residents. The surviving grandparent recently died and the grandchildren will now receive distributions from the foreign trust.

- How will a distribution from a foreign trust to a U.S. beneficiary be taxed?
- Would a U.S. domestic trust result in a better outcome?

DEALING WITH A FOREIGN TRUST WITH U.S. BENEFICIARIES

When the non-U.S. grantor of a foreign trust dies leaving U.S. family members as beneficiaries, the trust becomes a foreign non-grantor trust. A foreign non-grantor trust is subject to unfavorable U.S. income tax rules on its undistributed net income (UNI), i.e., any distributable net income (DNI) that was not fully distributed in prior years.

- Distributions from the foreign trust will likely carry out accumulated income that is subject to income tax and an interest charge based on a dollar-weighted number of years of accumulation.
- Capital gains and qualified dividends included in the accumulation will be treated as ordinary income and taxed at ordinary income tax rates.
- U.S. persons who receive distributions from foreign trusts are subject to additional reporting obligations, with substantial penalties for noncompliance.

Practice tips:
(1) The interest charge is based on the rate for tax underpayment under Code § 6621.
(2) The interest charge cannot exceed the amount of the accumulation distribution.

OPTIONS FOR A FOREIGN NON-GRANTOR TRUST WITH U.S. BENEFICIARIES

The family should consider deploying one of several options to avoid the unfavorable U.S. income tax consequences of UNI:

- Domesticating the foreign non-grantor trust into a U.S. domestic trust if it is possible to do so before it accumulates undistributed net income.
- Cleansing the foreign trust of UNI by making distributions to another beneficiary, who independently makes a gift to a U.S. domestic trust.
- Establishing a separate mirror trust in the U.S. to receive annual distributions of DNI, leaving the principal and UNI in the foreign trust.
- Have the U.S. beneficiary elect the “default method” under which all distributions are ordinary income but avoid the interest charge if they remain less than 125% of the 3-year average of distributions to the beneficiary.

POSITIONING FOR DOMESTICATION

- Appoint U.S. trustee and other power holders for the foreign trust. Make sure foreign persons connected with trust renounce all powers.
  - Settlor powers
  - Foreign co-trustee
  - Trust protector
  - Investment managers
- Adopt U.S.-style trust agreement for domestic trust
  - Directed trust provisions for investment and distribution advisors
  - Delaware governing law
  - Choose U.S. courts for primary supervision
  - Negate Rule against Perpetuities
- U.S. trustee accepts trust documents for new domestic trust
- Post-domestication decanting
  - Trustee of domesticated foreign trust exercises discretion over principal to distribute all assets to the new U.S. domestic trust.

FLIPPING THE SWITCH: FOREIGN TO DOMESTIC

- Resulting trust should satisfy the court test and the control test to attain domestic trust status.
  - Delaware Court of Chancery should be designated as primary court for trust supervision.
  - Non-U.S. persons should have no authority over substantial decisions.

MODERN CROSS-BORDER SCENARIOS: THE FOREIGN "U.S." TRUST

"Grab some lederhosen, Sutfin. We're about to climb aboard the globalization bandwagon."

Scenario 3: The Foreign "U.S." Trust

Patriarch is the life income beneficiary of an irrevocable Guernsey trust established by his father some years ago. At patriarch's death, his children – all of whom are U.S. citizens -- will become successor beneficiaries under the trust deed.

Patriarch wants to anticipate the U.S. income tax consequences that will occur following his death. He also wants to keep the trust "silent" until his children are sufficiently mature.

- Can a Delaware trust offer greater flexibility?
- What are the U.S. income tax consequences with a foreign U.S. trust?

MOVING A FOREIGN TRUST TO THE U.S. FOR SIGNIFICANT MODIFICATIONS

- There may be circumstances in which a client wants to change the design of his or her trust to address a particular need, but the laws of the current offshore jurisdiction do not readily facilitate the proposed change.
  - The client wants to appoint investment advisors or distribution advisors for the trust, without any involvement of the trustee in investment or distribution decisions.
  - The client would like to defer informing the beneficiaries of the existence of the trust or client anticipates a potential challenge to the terms of the trust.
  - The client has concerns about his family's personal security and does not want to subject the trust and its underlying entities to asset and income reporting under the Common Reporting Standard. (The U.S. is not a signatory to CRS and has no obligation to report client financial data to participating countries.)
- In these and other circumstances, a Delaware trust may be the answer.

Practice tips:
(1)This foreign trust may not be suitable for U.S. beneficiaries because of U.S. income tax considerations.
(2) As a consequence of the CRS look-through rule, a trust's entire structure should be domesticated if a client seeks to avoid reporting under CRS.

MOVING A FOREIGN TRUST TO THE U.S. WITHOUT U.S. INCOME TAX

- Non-U.S. clients can maintain a trust with a U.S. trustee, governed by U.S. state law, but ensure that the trust is treated as a foreign trust for U.S. income tax purposes. By giving a non-U.S. person authority over any substantial decisions involving a trust, the trust will fail the "control" test and qualify as a foreign trust.
- "Substantial decisions" include:
  - Whether and when to distribute income or principal
  - The amount of distributions
  - Whether to terminate a trust
  - Whether to remove, add or replace a trustee
  - Investment decisions
- Only U.S. source income will be subject to U.S. income tax. Generally speaking, U.S. source income includes interest (but not portfolio interest from U.S. bills, notes and bonds), dividends from U.S. corporations, and proceeds and rents from U.S. properties. Capital gains on intangible U.S. assets are not source income.

Practice tip: This foreign trust may not be suitable for U.S. beneficiaries because of U.S. income tax considerations.

FOREIGN GRANTOR SHOULD AVOID THE FIVE-YEAR "TRAP"

- The point of the foreign "domestic" trust is to have the advantages of U.S. trust law without subjecting the trust to U.S. income and transfer taxes.
- If an NRA grantor moves to the U.S. within five years of transferring assets to a foreign trust or the foreign trust *may have* U.S. beneficiaries, the trust will be treated as a grantor trust and the grantor will be subject to income tax on all of the foreign trust's income accruing after the NRA becomes a U.S. resident.
- If the grantor dies or ceases to be a U.S. person, there may be a gain recognition event unless a domestic trust has the right to withdraw the assets of the foreign trust upon either such event.

POSITIONING FOR DOMESTICATION INTO A FOREIGN U.S. TRUST

- Adopt U.S.-style trust agreement for foreign trust, through amendment or decanting.
  - Directed trust provisions
  - Delaware governing law
  - Choose U.S. courts for primary supervision
  - Negate Rule against Perpetuities
- Protector appoints U.S. trustee and other power holders for the foreign trust. Ensure foreign persons remain connected with trust.
  - Settlor powers
  - Foreign co-trustee
  - Trust protector
  - Investment managers
- If protector or current trustee cannot (or will not) amend the existing trust, new U.S. trustee will have to modify trust or exercise decanting power to distribute all assets to new foreign trust.