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US/UK Complexities: Opportunities for Trustees

PRESENTERS

Matthew Sperry
Katten Muchin Rosenman LLP
Partner – Private Wealth

Chris Moorcroft
Harbottle & Lewis
Partner – Private Client and Tax

US TAX CONCEPTS FOR FOREIGN TRUSTS

Foreign vs. U.S. Trust Classification

- A foreign trust is defined under the Internal Revenue Code as any trust other than a U.S. trust
- A trust is a U.S. trust only if the following conditions are met:
  - A court with the US is able to exercise primary supervision over the administration of the trust (the "Court Test"); **and**
  - One or more US persons have the authority to control all substantial decisions of the trust (the "Control Test")
- Thus, the **default** under the Code is that a trust is a **foreign trust** as a trust must meet both the Court and Control Tests to constitute a U.S. trust

Court Test

- Look first to the trust instrument – Would a U.S. court be able to render orders or judgments over issues concerning trust administration?
- If a U.S. trust desired, a safe harbor test exists to satisfy the Court Test:
  - The trust instrument does not direct that the trust be administered outside the U.S.;
  - The trust is in fact administered exclusively in the U.S.; **and**
  - The trust is not subject to an "automatic migration" provision.

Control Test

- Generally easier to fail
- If a foreign person has control over *at least one substantial decision*, the trust will be considered a foreign trust
- Must consider *all* persons who have authority to make substantial (non-ministerial) decisions regarding the trust, not just trust fiduciaries
- If a foreign trust is not desired, limit decision-makers to U.S. persons

Grantor Trusts

- May be revocable or irrevocable
- U.S. Income tax treatment: taxable to the grantor
- U.S. Estate tax treatment: depending on trust provisions the assets may be includable in, or excludable from, grantor's estate for estate tax purposes

Grantor Trusts – How to Qualify

- U.S. grantors: Many paths to qualify. However, a U.S. person who transfers property to a **foreign trust** is deemed the owner of the trust for U.S. income tax purposes if the trust has a U.S. beneficiary (Section 679).
- Foreign grantors: Under Section 672(f), a trust having a foreign grantor is considered a grantor trust only if:
  - The foreign grantor has the power to revoke the trust; **or**
  - The only amounts distributable (whether income or corpus) during the grantor's lifetime are distributable to the grantor or the grantor's spouse

Non-Grantor Trusts

- Irrevocable
- U.S. income tax treatment: Income taxable to the trust, or if income is distributed income is taxed to beneficiaries receiving income
- U.S. estate tax treatment: U.S. trusts generally structured to be excluded from grantor's estate

UK TAX ISSUES WITH US-CONNECTED TRUSTS

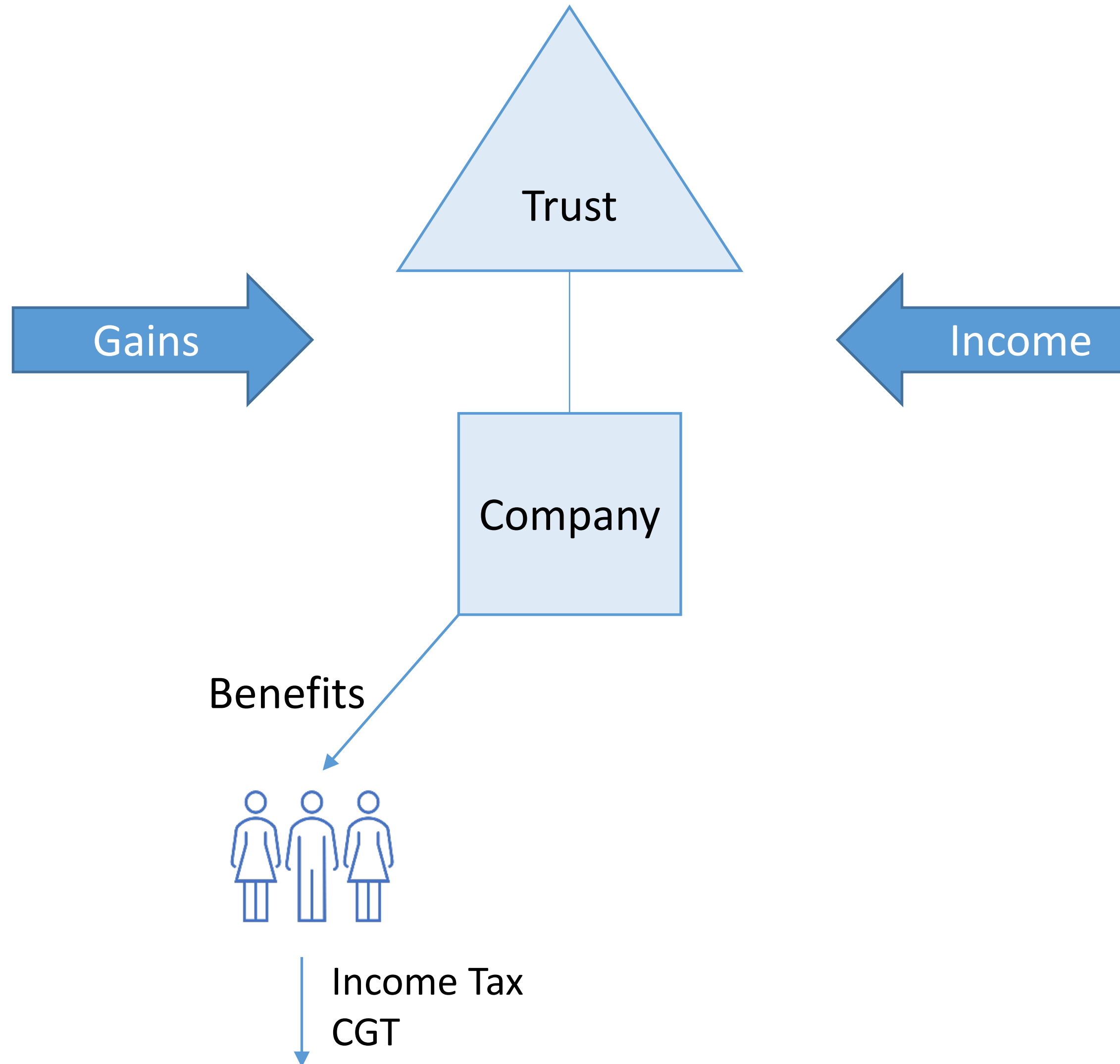
UK ‘protected’ trusts regime - general

- Guernsey Trust with UK resident Beneficiaries
- Non-UK domiciled (or deemed domiciled) Settlor settles Trust

GENERAL POSITION

- No UK tax on set up so long as assets not UK situs
- ‘Protected’ trust regime - general principle that non-UK income and gains taxed when ‘matched’ with benefits to beneficiaries
  - ‘Benefits’ do not need to be monetary benefits and can include occupation of real estate, for example
  - Tax liability (generally) falls on beneficiary
  - Surcharge can apply to the rate of CGT – similar to ‘throwback’ rules in US

UK ‘protected’ trusts regime



UK ‘protected’ trusts regime - general

INCOME TAX PROVISIONS

•‘Transfer of Assets Abroad’ legislation under Income Tax Act 2007

•‘Settlements’ legislation under Income Tax (Trading and Other Income) Act 2005

CAPITAL GAINS TAX PROVISIONS

•s3 Taxation of Chargeable Gains Act 1992 (TCGA)

•Gains are usually matched with benefits under s87 TCGA

UK ‘protected’ trusts regime

- However, don’t assume that the general position always applies
  - s3 TCGA attribution to shareholders is subject to a motive defence
  - Gains are usually matched with benefits under s87 TCGA. This regime might not apply where there is no element of ‘bounty’
  - Income is usually matched with benefits under either:
    - ‘Settlements’ legislation under Income Tax (Trading and Other Income) Act 2005 – which might not necessarily apply if the Settlor has not retained a benefit
    - ‘Transfer of Assets Abroad’ legislation under Income Tax Act 2007 – which might not necessarily apply if the ‘motive’ defence applies

US TAX ISSUES INVOLVING FOREIGN TRUSTS

Foreign Non-Grantor Trusts

- U.S. beneficiaries are generally subject to U.S. income taxation on distributions to or for the benefit of the U.S. beneficiaries
- Tax consequences of these distributions depends on whether the distributions are characterized as distributions of Distributable net income (current income – retains original tax character) (“DNI”), Fiduciary Accounting Income (“FAI” – tax free in excess of DNI), Undistributed net income (accumulated income) (“UNI”), or Trust principal
- **<u>Distributions deemed from UNI subject to punitive “Throwback Tax” regime</u>** – capital gains taxed as ordinary income plus a nondeductible interest charge is levied under a weighted average method

The Throwback Regime

- There can be extremely adverse U.S. income tax consequences for a U.S. person that constitutes a beneficiary of a foreign nongrantor trust.
- The so-called “throwback regime” is an anti-deferral regime that applies to U.S. beneficiaries of foreign nongrantor trusts.
- Ultimately, when the throwback regime applies, distributions to U.S. beneficiaries are taxed at ordinary rates (plus an additional interest charge) on the portion of distributions attributable to income earned by the trust in prior years.
- The “throwback regime” does <u>not</u> apply to foreign estates.

Use of Foreign Companies

- Two potentially devastating US income tax regimes may apply when trust structures with US beneficiaries hold non-US companies:

  — The "controlled foreign corporation" ("**CFC")** regime; or

  — The "passive foreign investment company" ("**PFIC**") regime.

- If a non-US company constitutes a CFC, the applicable US beneficiary would pay current US income tax on his or her share of the CFC's earnings (at the highest US income tax rates) irrespective of whether the CFC distributed dividends.

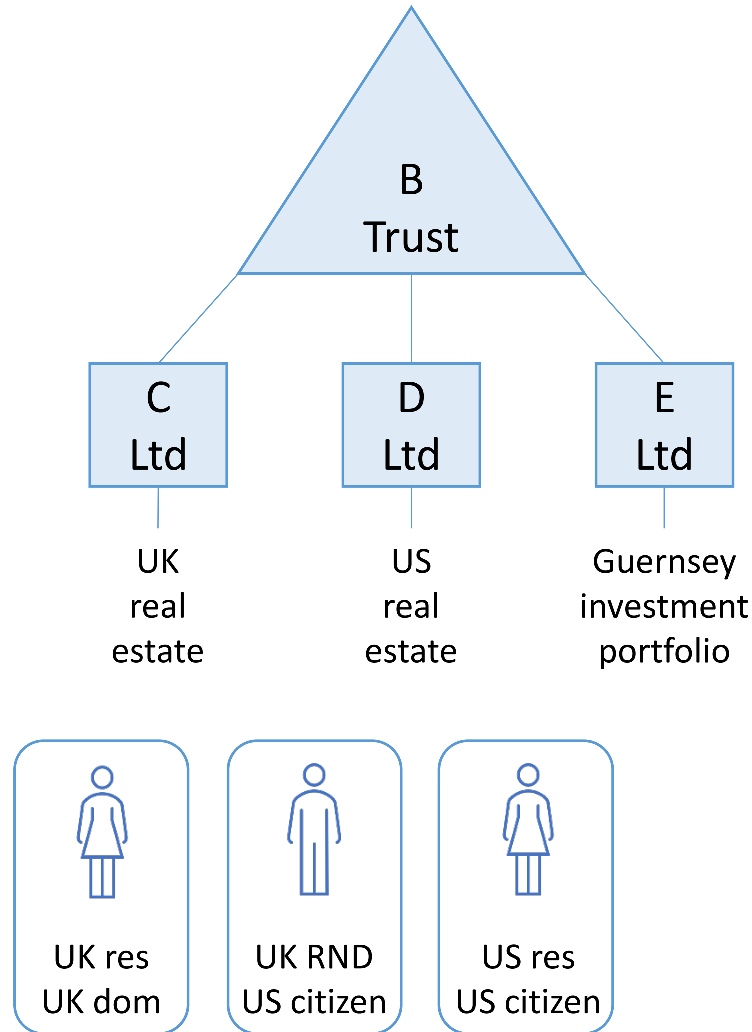
- If a non-US company constitutes a PFIC, absent additional planning, certain distributions to the US beneficiary from the PFIC, or gains from the sale of shares in the PFIC, would be taxed at ordinary (high!) rates with a punitive interest charge.

Case Study

Case Study

- Client A domiciled in Australia/Saudi/Brazil (not US or UK!)
- A settles an irrevocable trust, the B Trust, in Guernsey
- Assets held through three companies:
  - C Ltd which owns real estate in the UK
  - D Ltd which owns real estate in the US
  - E Ltd which owns a Guernsey investment portfolio
- Beneficiaries include:
  - X who is UK resident and deemed domiciled
  - Y who is UK resident, domiciled in California and a US citizen
  - Z who is Florida resident and a US citizen

Case Study



PLANNING OPPORTUNITIES

Planning Opportunity: Foreign Grantor Trusts

- Guernsey Trust with US Beneficiaries

- Non-US Settlor settles Trust qualifying as a Foreign Grantor Trust

- No US tax consequences / implications to US Beneficiaries while the Grantor is living - distributions (treated as gifts) must be reported to the IRS but are not taxable

- US investments held by the Trust continue to enjoy US tax advantages such as no US income tax on most capital gains (notable exception being gains on US real estate investments)

- Must plan for eventual transition of the trust to a “nongrantor” trust upon the death of the Settlor

- Planning opportunities to perpetuate foreign grantor trust status beyond the Settlor’s death

The Throwback Regime — Mitigation Techniques

- Migrate the foreign nongrantor trust to the United States (but there may be compelling reasons to leave the trust offshore – see next slide).

- Distribute the income of the foreign nongrantor trust to its beneficiaries on an annual basis.

- Impose structural elements underneath the foreign nongrantor trust to mitigate the application of the throwback regime.

- If the trust was a foreign grantor trust with a non-U.S. owner who held a revocation power, make an election under Code Section 645 (to treat the foreign trust as part of the non-U.S. owner's foreign estate) as a temporary measure.

Planning Opportunity: Foreign Non-Grantor Trusts

- Guernsey Trust with US Beneficiaries – The case not to move the Trust to the United States.

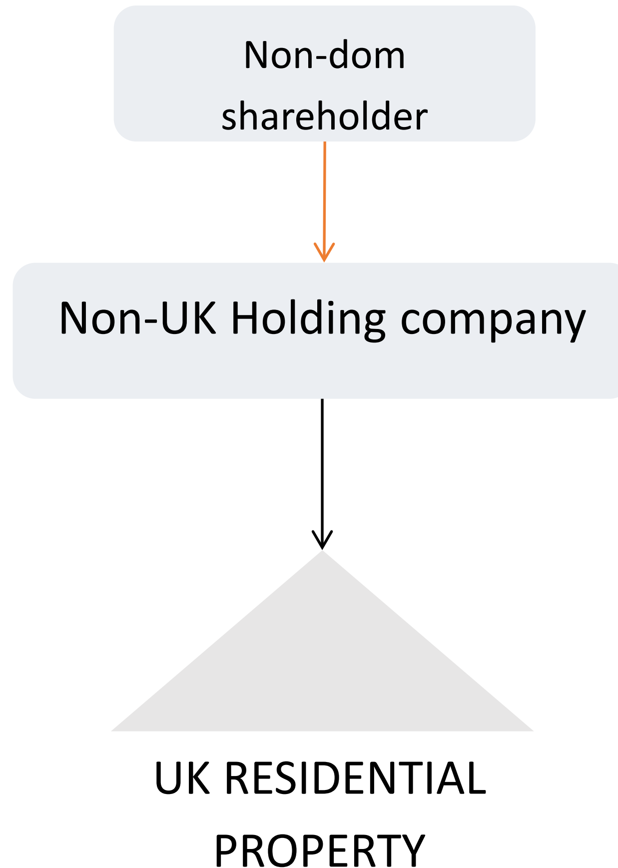
- Non-US Settlor settles new trust with US Beneficiaries to qualify as a foreign non-grantor trust.

- Alternative (very common): Existing foreign non-grantor trust with US beneficiaries.

- Although the US beneficiaries are exposed to the "throwback regime", there is a massive opportunity to grow the trust on a US tax-free basis **IF** distributions to US beneficiaries can be satisfied out of current year income.

- As the Trust fund grows faster due to not being subject to US taxation, the amount that can be distributed to US beneficiaries out of current year income should increase every year.

Planning Opportunity: UK residential real estate (1)



Planning Opportunity: UK residential real estate (2)

- General position is that non-UK company no longer provides a 'blocker' for inheritance tax purposes – Inheritance Tax Act 1984, Schedule A1
- HOWEVER, this may not be the case where Americans own UK residential property through non-UK holding companies due to the operation of the UK/US Estate Tax Treaty
- Such treatment can apply in various scenarios, including where the shareholder is a US national and US domiciled at the date of death, and NOT a UK national, nor US domiciled

THE US AS A TRUST JURISDICTION FOR INTERNATIONAL FAMILIES

Offshore Trust Companies: US Trends

- Many offshore trust companies have expanded their footprint to the United States

- Rationale: Non-US families seeking US law trusts
  - US trusts in many respects default to "foreign" trusts for US tax purposes – such that they are tax neutral to non-US families
  - Privacy
  - Asset Protection

- US trust jurisdictions attractive to offshore trust companies include Delaware, South Dakota, Wyoming, Nevada and New Hampshire.

US Trusts: Privacy Considerations

- Trend of Non-US Families seeking to move trusts / structures to the US due to privacy motivations
- US not a signatory to the CRS
- But there are tools for foreign tax authorities in seeking information from the US:
  - — Tax Treaties
  - — Tax Information Exchange Agreements
  - — Reciprocal reporting under certain FATCA IGAs
  - — John Doe Summonses
- Corporate Transparency Act

Matthew Sperry
Katten Muchin Rosenman LLP
Partner
Private Wealth
matthew.sperry@katten.com

Chris Moorcroft
Harbottle & Lewis
Partner
Private Client and Tax
Chris.Moorcroft@harbottle.com