PLANNING TIPS AND PITFALLS FOR INTERNATIONAL ESTATE PLANNERS

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DAY PITNEY LLP

Outline of Presentation

I. Income, Estate and Gift Taxation of Nonresident Alien Individuals

II. Residence v. Domicile

III. Planning with a Noncitizen Spouse

IV. US and Foreign Trusts

V. Inbound Planning: Use of Foreign Trusts and Blockers

VI. Post-Mortem Planning: Unwinding Foreign Trust/Blocker Structure After Grantor's Death

I. INCOME, ESTATE AND GIFT TAXATION OF NONRESIDENT ALIEN INDIVIDUALS

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Tax Treatment of US v. Non-US Individuals

- **Federal Income Tax:**
  - US citizens and residents are taxed on their worldwide income.
  - Nonresident aliens are subject to federal income tax only on income from US sources and income effectively connected with a US trade or business.
- **Federal Estate and Gift Tax:**
  - US citizens and residents are subject to estate and gift tax without regard to location and character of property.
  - Non-US individuals (noncitizens domiciled abroad) are subject to estate tax only with respect to US situs assets and gift tax only with respect to gifts of real or tangible property situated in the US. However, they have a much lower lifetime exemption from the estate tax – only $60,000 – and are entitled only to the annual exclusion for gift tax purposes.

Income Taxation of Non-US Individuals

- ***Nonresidents.*** Nonresident alien individuals are subject to federal income tax on the following types of income:
  - Fixed, Determinable, Annual, or Periodical (FDAP) income (e.g., US source dividends, interest, rents, royalties and other portfolio income, as well as certain types of services income), which is subject to 30% withholding at the source on a gross basis with no deductions.
  - Income that is effectively connected with the conduct of a US trade or business ("effectively connected income" or "ECI"), which is taxed at graduated rates of up to 37%. In some cases, ECI may be eligible for the 20% deduction for qualified business income.
  - State income tax regimes vary, but most states tax nonresidents (if at all) only on income from sources within the state.

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Income Taxation of Non-US Individuals

- ***Exceptions.*** Reduced rates or outright exemptions apply to certain types of income:
  - "Portfolio interest" from most types of corporate and government bonds is exempt from federal income tax in the hands of a non-US holder under Code § 871(h) of the Internal Revenue Code.
  - Interest on bank deposits is similarly excluded under Code § 871(i).
  - Interest, dividends and royalties may be taxed at reduced rates under a treaty. ECI that is not attributable to a "permanent establishment" in the US may be excluded outright.
  - The 3.8% Medicare tax on net investment income of high income earners does not apply to nonresident aliens.
  - Capital gains (other than from the sale of certain US real property and partnership interests) generally are exempt from federal income tax.

Income Taxation of Non-US Individuals

- ***Capital Gains.*** Capital gains generally are not taxable to a nonresident, with two important exceptions:
  - ***183 Day Rule.*** A nonresident present in the US for 183 days or more during a taxable year (e.g., an individual present on a student, diplomatic or other visa that suspends the normal day-counting rules or a dual resident who files as a nonresident pursuant to a “tie breaker” provision in a tax treaty) is subject to federal income tax on gains from the sale of personal property (other than inventory which is governed by different sourcing rules) if his or her “tax home” is in the US.

Income Taxation of Non-US Individuals

- ***Capital Gains (cont.).***
  - ***US Real Property.*** Gains from the sale of US real property, including interests in certain partnerships (domestic or foreign) or domestic corporations that own US real property, are taxable as ECI under the Foreign Investment in Real Property Tax Act ("FIRPTA").
    - Gains on the sale of personal or investment property may be eligible for 20% long-term capital gain rates. (Biden's tax plan does include a proposal to tax long-term capital gains as ordinary income in the case of taxpayers earning more than $1 million per year.)
    - FIRPTA is backstopped by a 15% withholding tax regime wherein buyers are required to withholding 15% of the gross consideration paid to a non-US seller (including noncash consideration such as the assumption of liabilities). This typically results in over-withholding, but the non-US seller can file a tax return and apply for a refund. It is possible to reduce the withholding based on the tax actually owed if the buyer and seller apply for a withholding certificate from the IRS.

Estate Taxation of Non-US Decedents

- **Estates of Non-US Decedents:**
  - ***US Situs Assets.*** Noncitizen nondomiciliaries are subject to estate tax only with respect to "US situs" assets, including real and tangible personal property situated in the US and certain types of intangible property, such as stock in US corporations.
  - ***$60,000 Lifetime Exemption.*** Non-US decedents have a lifetime exemption of only $60,000. However, domiciliaries of treaty jurisdictions may be entitled to a prorated share of the increased exemption for US decedents based on the ratio of US situs assets to worldwide assets. For example, if 20% of an eligible decedent's worldwide estate is comprised of US situs assets, the prorated exemption would be $2,340,000 in 2021 (20% of $11,700,000).
  - ***Marital deduction.*** No unlimited marital deduction unless surviving spouse is a US citizen or the assets are left to a QDOT.

Gift Taxation of Non-US Individuals

- **Gift Taxation of Non-US Individuals:**
  - Noncitizen nondomiciliaries are subject to gift tax only with respect to gifts of real and tangible personal property situated in the US. Gifts of intangible property are not subject to gift tax.
  - Planning Points:
    - There would be no gift tax on a gift of stock in a US corporation even though the same stock could be subject to estate tax if held at death.
    - There is a $15,000 annual gift exclusion. The exclusion for gifts to a noncitizen spouse is $159,000 in 2021. These thresholds are indexed for inflation.
    - An unlimited marital deduction is available for gifts to a US citizen spouse.
    - Gifts of cash (possibly including checks) may be subject to gift tax if the cash is in the US at the time of transfer. Thus, gifts of cash by a non-US person to a US person, including a US trust, should always be made from a non-US account of the donor.

Federal Estate Tax: Situs Chart

Type of Asset	Situs of Asset
Real estate located in the US	US situs
Works of art held in the US	US situs, with exception for certain loans of artwork to US museums
Other tangible personal property located in the US (i.e., jewelry, furniture, gold bars, etc.)	US situs
Cash held in a US brokerage account or safe deposit box located in the US	US situs
Cash held in a US bank account	Foreign situs
US corporate and Treasury bonds and other noncontingent debt obligations issued in "registered" form after July 18, 1984	Generally foreign situs if decedent was eligible for portfolio interest exemption at time of death

Federal Estate Tax: Situs Chart

Type of Asset	Situs of Asset
Shares of stock issued by US corporation (including US mutual funds and other publicly traded securities)	US situs w/o regard to situs of underlying assets or where shares custodied
Shares of stock issued by foreign corporation	Foreign situs w/o regard to situs of underlying assets
Life insurance policy issued by a US carrier on life of the decedent	Foreign situs
Life insurance policy issued by a US carrier on life of person other than the decedent	US situs
Interest in a US partnership (including most US private equity and hedge funds)	Unsettled, but likely US situs
Interest in a foreign partnership (including non-US investment funds structured as partnerships for US tax purposes)	Unsettled, but stronger argument against US situs if multi-tiered

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Blocker Structures

- Foreign corporations are often used as “blockers” to hold US stock portfolios, US real estate or other US situs assets.
  - If the blocker will be holding US real estate, a separate US corporate subsidiary often will be set up under the blocker for each real estate investment. This is to allow for the tax-free repatriation of earnings (which would have been taxed at the subsidiary level) without a second level of tax on repatriation.
  - Two-tiered partnerships are also sometimes used to hold US situs assets because they do not add an extra level of tax. However, the law is not entirely settled regarding the situs of partnership interests.
  - Sometimes an irrevocable trust can be used as a blocker if the foreign settlor does not retain any impermissible strings.

Traps for the Unwary

- Life insurance proceeds paid by a US insurer on the life of a non-US person is not US situs property. *However, the value of a policy owned by a non-US person on the life of another person is US situs property if issued by a US insurer.*
- Bank accounts (checking, savings, time deposits and CDs) maintained with US banks are not US situs property, *but cash deposits with US brokers, money market accounts with US mutual funds and cash in US safe deposit boxes are considered US situs assets.*
- Gifts of cash from *ANY* account in the US – bank or brokerage – may be treated as a gift of tangible personal property situated in the US.

Treaty Relief

- Tax treaties may alter the tax treatment of certain assets:
  - Interest, dividends and royalties often are eligible for reduced withholding rates for eligible residents of a treaty jurisdiction.
  - Business profits also may be excluded if the taxpayer does not have a permanent establishment in the source country.
  - Estate tax treaties may change the situs of certain assets, granting the source country exclusive taxing rights over intangible property (for example, stock in a US corporation).
  - Other treaties may increase a non-US decedent's exemption.
  - Most income tax treaties do not offer any relief for income and gains from real property (including real property holding corporations) and most estate tax treaties allow the country in which real property is located primary taxing rights.

II. RESIDENCE V. DOMICILE

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When is Someone a US Person?

- An individual is a US person for US tax purposes if he or she is either (a) a US citizen (including a citizen residing abroad) or (b) a US resident.
- ***Different rules apply for purposes of determining whether an individual is a US resident for income tax purposes than for purposes of establishing residence status for estate and gift tax purposes.***

US Person for Income Tax Purposes

- **US Resident for *Income Tax* Purposes:**
  - A green card holder (lawful permanent resident)
  - A person who, regardless of visa status. satisfies the "substantial presence" test under Code §7701(b):
    - To be considered a resident under the substantial presence test, an individual must (1) be physically in the US for at least 31 days during the current calendar year, <u>and</u> (2) be physically present in the US for at least 183 days on a "weighted" basis, taking into account all days present during the current calendar year, 1/3 of the days present during the preceding calendar year and 1/6 of the days present during the second preceding calendar year.
    - This averages out to approximately 122 days per year.

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Substantial Presence Test: Exceptions

- **There are several Code and treaty-based exceptions to the substantial presence test pursuant to which one can either remain a nonresident or determine his or her tax liability as a nonresident:**
  - Exempt resident individual status
  - Medical emergencies
  - Closer Connection Test
  - Treaty “tie-breaker” provisions for dual residents

Substantial Presence Test: Exceptions

- "Exempt" individuals are not required to count days of presence in the US:
  - Students, teachers, trainees and professional athletes may be present for more than 183 days without becoming residents for a period of time – up to 2 years in a 6-year period for teachers and trainees and up to 5 years for students.
  - Students may be present even longer without becoming residents if they can establish a closer connection to a foreign country by filing Form 8843 (even if they have a tax home in the US).
- An individual who intended to leave but was unable to do so because of a medical condition that arose while in the US may suspend normal day-counting rules by filing Form 8843:
  - Does not apply to preexisting medical conditions.
  - Days in US prior to when medical condition arose are not excluded.

Substantial Presence Test: Closer Connection Exception

- An individual who otherwise satisfies the substantial presence test, but whose US presence is less than 183 days during the current calendar year, can still claim nonresident status by establishing on Form 8840 that he maintains a tax home and closer connection to a foreign country and has not taken affirmative steps to become a permanent resident.
- A taxpayer's eligibility for the closer connection test is expressly conditioned on the timely filing of Form 8840.
  - The term "tax home" refers to an individual's regular or principal place of business or if there is none, his or her regular place of abode.
  - The Treasury regulations have a list of nonexclusive factors relevant to establishing a closer connection. Treas. Reg. § 301.7701(b)-2(d).

Treaty Tie-Breaker Exception

- An individual who is a dual resident of the US and a treaty country may claim to be a nonresident under the treaty tie-breaker provision by filing Form 8833 with his tax return.
- Dual resident who takes a treaty-based return position to be a nonresident is still considered a US resident for most other federal income tax purposes.
  - The IRS has begun eliminating some (but not all) extraneous information return filing obligations for dual resident taxpayers (for example, Forms 8621 and 8938). However, FBARs and Forms 5471 are still required and taxpayer is still considered a US person for other tax purposes.
- If such individual has held a green card for 8 of the last 15 years, taking a treaty nonresidence position on a tax return could trigger the expatriation provisions. Code §7701(b)(6).

US Person for Estate and Gift Tax Purposes

- **US Resident for *Estate and Gift Tax* Purposes:**
  - A person whose primary residence or "domicile" is in the United States is a resident for estate and gift tax purposes. An individual is a US domiciliary if he or she lives in the United States and has no definite present intent to leave, as shown by the surrounding facts and circumstances. See Treas. Reg. § 20.0-1(b)(1) and (2).
  - There is no equivalent to the substantial presence test.
  - An individual can become a US resident for income tax purposes under the substantial presence test without becoming a resident for estate and gift tax purposes if he or she does not intend to remain indefinitely – for example, someone visiting for a few years on a temporary work assignment.
  - Applying for a green card is a strong factor suggesting an intent to remain indefinitely.

Domicile Factors

- Intent is measured by objective factors including, among others:
  - Length of time spent in U.S. and abroad
  - Visa and income tax filing status
  - Location, value and size of real and personal property and, in the case of real property, whether such property is owned or rented
  - Social, business and religious affiliations
  - Jurisdiction(s) where an individual was registered to vote
  - Jurisdiction(s) where an individual has been issued a driver's license; and
  - Statements of domicile made in legal documents
- *Caution:* Visa status does not control. Law in this area is highly fact-dependent and the IRS could argue whatever position is most favorable.

Estate and Gift Tax Treaties

- **Impact of Treaty on Domicile:**
  - An individual's domicile may be modified by an estate or gift tax treaty. Typically, these provisions provide more bright-line rules for when an individual from another country is considered to be domiciled in the US or in the other treaty country.
  - Examples:
    - US-France Treaty provides that an individual domiciled in both treaty countries, but a citizen of only one country, will be deemed to be domiciled only in the country of citizenship if he or she was domiciled less than 5 years during the 7-year period prior to death or the transfer.
    - US-UK Treaty provides that a UK national domiciled in both countries shall be deemed to be domiciled in the UK if he or she had not been resident in the US for *federal income tax purposes* in 7 or more of the 10 taxable years ending with the year in which the transfer occurs. There is a reciprocal rule for the treatment of a US national.

III. TRANSFERS BETWEEN SPOUSES

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QDT Planning with a Noncitizen Spouse

- **Qualified Domestic Trust (QDT)**
  - Whether an individual is a U.S. or non-U.S. person, he or she is entitled to a 100% estate tax marital deduction for assets left to his or her surviving spouse ***if the spouse is a US citizen***.
  - If the surviving spouse is not a U.S. citizen, the estate tax marital deduction is not available – *even if the surviving spouse is a green card holder* – unless the deceased spouse leaves assets in a Qualified Domestic Trust (“QDT”), or unless the surviving spouse creates a QDT and adds the assets to it.
  - To qualify, a QDT must meet the requirements on the following slide:

QDT Planning with a Noncitizen Spouse

- **Requirements for Qualified Domestic Trusts:**
  - All income must be payable to the surviving spouse for life.
  - No principal distributions are permissible to anyone other than the surviving spouse during his or her life, and the principal is subject to estate tax upon the death of the surviving spouse or upon an earlier distribution.
  - At least one U.S. trustee with the power to withhold estate tax on any such distribution.
  - If the value of the assets transferred to the trust exceeds $2 million – or if the value of offshore real property held by the trust exceeds 35% of its total assets – then either a U.S. institutional trustee must be appointed or a bond or letter of credit must be posted in an amount equal to 65% of the initial value of the trust's assets.

Gifts to Noncitizen Spouse

- **Gifts to US Citizen and Noncitizen Spouse:**
  - ***Citizen spouse.*** Whether an individual is a U.S. or non-U.S. person, he or she can make unlimited gifts to a U.S. citizen spouse without any gift tax consequences. Such gifts will not be includable in the donee spouse's income.
  - ***Noncitizen spouse.*** If the donee spouse is not a U.S. citizen (regardless of whether or not the donor spouse is a U.S. citizen or resident), then the unlimited marital deduction is not available. There is an annual exclusion of $159,000 in 2021 and a U.S. donor could apply his or her lifetime exemption for gifts in excess of this amount. This limitation applies even if the donee spouse is a green card holder.

Gifts to Noncitizen Spouse

- When one spouse dies, the surviving spouse generally becomes the sole owner of any property held as joint tenants.
  - If the surviving spouse is not a U.S. citizen, then the entire property is included in the decedent's estate unless the executor can show that the surviving spouse paid for his or her share.
  - In the case of joint acquisitions of real estate or other large purchases, it is important to keep careful records.
  - If a couple already owns the property as joint tenants and they did not make equal contributions, then they might consider severing the joint tenancy in proportion to their contributions so that they hold the property as tenants in common. Provisions can be made, for example, to put the property in a QDOT for the noncitizen spouse.
    - *Planning Point:* Adding a noncontributing spouse as a joint tenant is not a taxable gift, but severing the joint tenancy could be taxable if the noncontributing spouse receives more than he or she contributed.

Gifts to Noncitizen Spouse

- **Joint Accounts:**
  - If one spouse creates and funds a joint bank account with his or her spouse, and the spouse who created the account can regain the entire account without the other spouse's consent, then there is a gift when the other spouse draws on the account.
  - However, in states where the other spouse has an immediate right to half the balance, there may be a gift upon the initial funding of the account.

Income Tax Consequences of Certain Transfers Between Spouses

- Gifts are generally not subject to income tax. However, transfers for consideration generally are potentially taxable unless an exception applies under the Code.
- Section 1041 generally shields transfers between spouses from income tax even when the transfer is for consideration and would otherwise be taxable.
  - The exemption does not apply if the recipient spouse is not a U.S. citizen or resident.
  - Unlike the estate and gift tax marital deduction, the exemption under Section 1041 applies if the recipient spouse is a resident alien.

IV. US AND FOREIGN TRUST STATUS

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Planning Considerations for Non-US Grantors with US Beneficiaries

- **Unlimited Gifts of Intangible and Non-US Situs Property:**
  - Non-US individuals (i.e., noncitizens domiciled abroad) can make unlimited gifts of tangible property located outside the US, as well as intangible property (without regard to situs).
  - This presents unique planning opportunities:
    - Non-US individuals can make gifts of intangible US situs assets (for example, stock in a US company) that would otherwise be includable in their estates without triggering gift tax. This could even include shares in a cooperative apartment if such shares are treated as intangible property under local law.
    - If the right trust structure is put in place, a non-US grantor potentially could transfer unlimited amounts in trust for the benefit of US descendants or other US beneficiaries without the assets being included in either the grantor’s or the beneficiaries’ estates.

Planning Considerations for Non-US Grantors with US Beneficiaries

- **Trust Options for Non-US Donors:**
  - ***Foreign grantor trusts.*** A non-US person who does not plan to become a US resident will often settle a foreign trust that qualifies as a grantor trust in order to avoid US income taxation on foreign source income and capital gains during his or her lifetime. The trust can be structured to allow for domestication and a basis step-up after the grantor dies.
  - ***US nongrantor trusts.*** A non-US person moving to the US or buying real estate for US beneficiaries might consider settling an irrevocable US trust instead. This could avoid adverse tax consequences of a foreign trust in such case for both the grantor and the beneficiaries.

US and Foreign Trust Status

- ***Court and Control Tests.*** A trust is a foreign trust for US tax purposes unless it satisfies <u>both</u> a "court" test and a "control" test under Section 7701(a)(30)(E) and regulations thereunder. This two-part test is tilted in favor of foreign status.
  - ***Court Test:*** A United States court must be able to exercise primary supervision over the administration of the trust. Primary jurisdiction does not necessarily mean exclusive jurisdiction (e.g., a foreign court may share jurisdiction over some matters). In most states, a resident trustee will be sufficient to satisfy the court test.
  - ***Control Test:*** One or more US persons must have the power to control all substantial decisions of the trust (the "control" test). As discussed later, even if the trustee is a US person and the trust is administered in the US, control or veto power by a non-US person over one substantial decision will cause the trust to fail the control test, thereby becoming a foreign trust.

US and Foreign Trust Status

- ***The Court Test – Safe Harbor.*** Under a safe harbor, a trust will satisfy the Court Test if:
  - The trust instrument does not direct that the trust be administered outside the US;
  - The trust is administered exclusively in the US; <u>and</u>
  - The trust is not subject to an automatic migration provision which provides that a US court's attempt to assert jurisdiction or otherwise supervise the administration of the trust would cause the trust to migrate from the US.

US and Foreign Trust Status

- ***Control Test.*** A trust will satisfy the Control Test if US persons control <u>all</u> substantial decisions of the trust.
  - "Substantial decisions" are decisions authorized or required under the trust instrument that are not ministerial and include:
    - Whether and when to make distributions and how much to distribute;
    - The selection of beneficiaries;
    - Whether a receipt is allocable to income or principal;
    - Whether to terminate the trust;
    - Decisions on whether to pursue, settle or abandon claims of the trust or defend the trust against same;
    - Whether to remove, add, or replace a trustee;
    - Whether to appoint a successor-trustee, unless power is limited such that it cannot change the trust's residency;
    - Investment decisions, but see exception on next slide.

US and Foreign Trust Status

- ***Control Test (cont.):***
  - Investment Advisor Exception:
    - 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. Treas. Reg. §301.7701-7(d)(ii)
  - A US person under foreign control is still a US person:
    - For example, a domestic corporation is a US person regardless of whether its shareholders are US or foreign persons. Treas. Reg. §301.7701-7(d) (1)(i). This can come in handy where the preferred protector is not a US person, but US residence is preferred for tax purposes.
    - Veto powers and powers held by non-fiduciaries are taken into account (e.g., a veto or consent right over a substantial decision can cause a trust to flunk the control test).

US and Foreign Trust Status

- ***Hybrid Trusts.*** A trust can be settled in Delaware, New Hampshire, South Dakota or another US jurisdiction with a US trust company as independent trustee and still be considered a foreign trust for US tax purposes.
  - For example, a foreign protector with the power to remove or replace the trustee would cause such a trust to be treated as a foreign trust for US tax purposes.
  - By definition, a trust that may be revoked by its foreign grantor is a foreign (grantor) trust even if it has a US trustee.
  - Where there is an interest in keeping the trust as a US trust and also retaining the ability to remove and replace the trustee and there is no US individual who is suitable to the grantor, a US corporation controlled by a non-US person could serve as protector.

V. INBOUND PLANNING WITH FOREIGN TRUSTS AND BLOCKERS

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Foreign Blocker/Grantor Trust Structure

- **Non-US individuals typically will invest in US situs assets through foreign "blocker" corporations:**
  - Noncitizen nondomiciliaries are subject to US estate tax with respect to US situs assets (discussed above).
  - A foreign corporation generally is an effective estate tax blocker if the parties observe corporate formalities. The corporation also insulates the non-US shareholder from direct income tax exposure (without additional tax costs in the case of most traditional securities other than certain partnerships and real estate funds).
  - The foreign blocker often is held through a foreign revocable trust (which is treated as a grantor trust).
  - If ownership of the foreign blocker will pass to US owners (including a foreign trust with US beneficiaries), it is critical to plan ahead to avoid the imposition of foreign anti-deferral rules.

Foreign Grantor Trusts

- ***Distributions from a Foreign Grantor Trust.*** Distributions from a foreign grantor trust (e.g., a revocable trust) to a US beneficiary do not carry out any income and thus are not taxable to the beneficiary.
  - The US beneficiary must report the amounts distributed, as well as loans from the trust or uncompensated use of trust property on IRS Form 3520. <u>*The penalty for failure to timely file Form 3520 to report a distribution from a foreign trust is the greater of $10,000 or 35% of the amount distributed. The IRS has greatly stepped up enforcement in this area.*</u>
  - Income that is not distributed will simply become principal without adverse tax consequences for the US beneficiaries.

Foreign Grantor Trusts

- ***Qualifying a Trust Settled by a Non-US Person as a Grantor Trust.*** Other than in the context of certain compensatory arrangements, it is difficult to qualify a trust settled by a non-US person as a grantor trust. In order to qualify, it must satisfy either of the following tests under Code § 672(f)(2):
  - The grantor must retain the power to revoke the trust and revest the assets in herself. (We generally recommend including provisions allowing a guardian or designated individual to act on behalf of the grantor in the event of her incapacity.)
  - If the trust is irrevocable, then distributions may only be made to the grantor or the grantor's spouse during the grantor's lifetime.

Foreign Grantor Trusts

- ***Qualifying the Foreign Grantor Trust for a Basis Step-Up Upon the Grantor's Death.*** The tax basis of the trust's assets may be stepped up (or down) to fair market value at the grantor's death if the grantor reserves certain powers in the trust agreement:
  - (1) The trust income must be payable during the grantor's lifetime to or on the order of the grantor, <u>and</u>
  - (2) The grantor must reserve the right at all times before death to revoke the trust or make changes in beneficial enjoyment through the exercise of a power to alter, amend or terminate the trust.

Foreign Nongrantor Trusts

- ***Taxation of Current Distributions.*** Unlike distributions from a grantor trust, distributions from a foreign nongrantor trust are potentially taxable to US beneficiaries.
  - US beneficiaries are subject to federal (and possibly state) income tax on distributions of “distributable net income” (DNI) from a foreign nongrantor trust.
  - DNI includes not only income that is taxable to the foreign trust, but also foreign source income and capital gains (which would not be included in the DNI of a US trust). See Code § 643(a)(6).
  - Most items comprising DNI preserve their character if distributed in the year earned (or in the first 65 days of the following year if the trust makes a timely election).
  - Distributions from a foreign nongrantor trust (whether comprised of DNI, UNI or principal) must be reported on Form 3520.

Foreign Nongrantor Trusts

- ***Taxation of Accumulation Distributions.*** DNI that is not distributed accumulates within a foreign nongrantor trust as "undistributed net income" (UNI).
- ***UNI.*** UNI is fully subject to US income tax when it is eventually distributed to a US beneficiary, and has the following additional negative consequences:
  - Capital gains realized by the trust in prior years are part of its DNI and are carried out to the beneficiary as ordinary income.
  - An interest charge is imposed on the tax due by the beneficiary on the accumulated income per annum from the date the income was originally earned by the trust.
  - Income may be taxed at the beneficiary's highest marginal rate for the year in which it was earned under the "throwback" rule.

Foreign Nongrantor Trust Mitigation Strategies

- **Strategies to Prevent or Manage UNI Accumulations:**
  - ***Distribute all DNI currently.*** If the trust distributes all of its DNI each year, then the DNI will not become UNI and tax-favored items, such as long-term capital gains and qualified dividends, will preserve their character in the hands of US beneficiaries.
  - ***US pour-over trust.*** If there is a need to keep core trust assets offshore and the US beneficiaries do not need all the DNI, a US pour-over trust could be established for their benefit.
  - ***Clearing distributions.*** A trust with US and non-US beneficiaries could make a large distribution to non-US beneficiaries to clear out UNI. (Distributions to US beneficiaries should be avoided that year.)
  - ***Default method.*** US beneficiary could elect to report distributions as ordinary income (up to a ceiling of 125% of the trailing three-year average). However, once a beneficiary elects to use the default method, he or she is locked in until the trust terminates.

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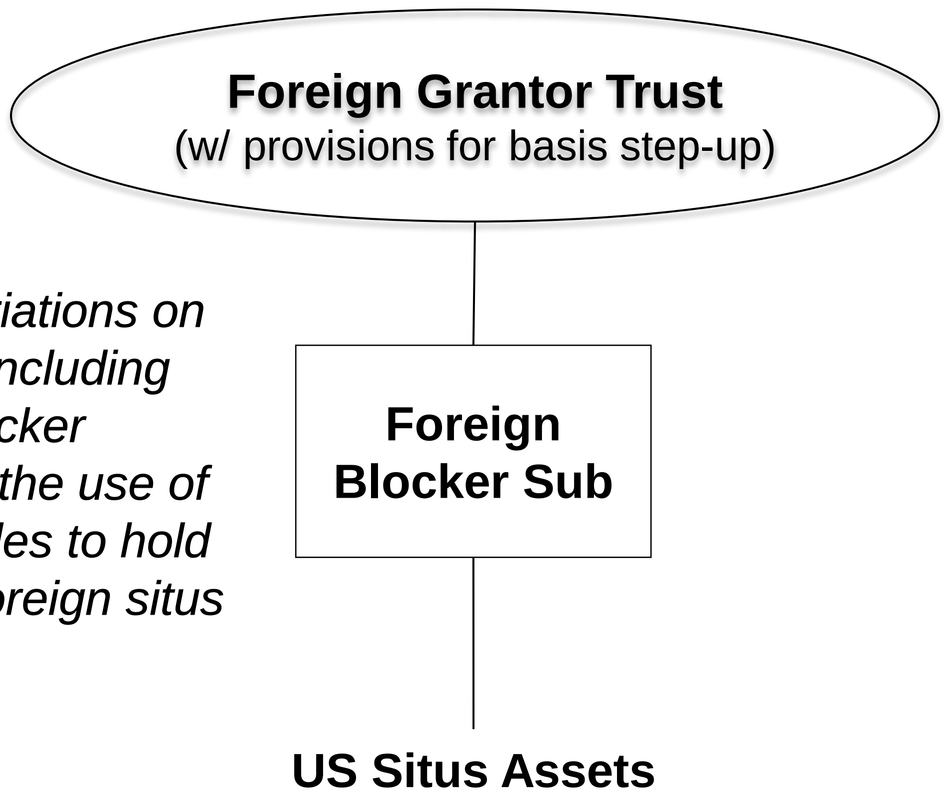
Foreign Nongrantor Trusts

- ***Constructive Distributions.*** Uncompensated use of property of a foreign nongrantor trust by a US beneficiary is considered a constructive distribution (reportable on IRS Form 3520) and can carry out DNI or UNI (as the case may be).
- ***Use of Intermediaries.***
  - When property is transferred to a US person by another person (the intermediary) who has received property from a foreign nongrantor trust, the US person is treated as having received the property directly from the foreign trust if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of US tax.
  - Presumption rules apply for transfers to a US person within a two year window before or after the distribution from the foreign nongrantor trust to the intermediary.

Foreign Blocker Structure

- **Illustration:***



** There are variations on this structure, including multi-tiered blocker structures and the use of separate vehicles to hold US situs and foreign situs assets.*

VI. POST-MORTEM PLANNING: UNWINDING FOREIGN TRUST/BLOCKER STRUCTURE AFTER GRANTOR'S DEATH

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Death of Grantor and Post-Mortem Planning

- ***Foreign Nongrantor Trust Status.*** Upon the death of the grantor, the trust will become a foreign nongrantor trust.
  - As noted, distributions of income accumulated after the death of the grantor will be taxable to US beneficiaries, potentially at punitive rates if post-death income is allowed to accumulate within the trust.
  - US beneficiaries could be subject to phantom income inclusions from gains and other income recognized by the foreign blocker corporation if the blocker is a controlled foreign corporation (“CFC”), as well as from the disposition by the trust or the blocker corporation of foreign mutual funds under the passive foreign investment company (“PFIC”) rules.

CFC Rules

- **CFCs and United States Shareholders:**
  - A foreign corporation is a CFC if it is owned more than 50% (in value or voting control) by "United States shareholders."
  - A United States shareholder is a US person who owns (directly, indirectly or constructively) at least 10% of the stock of a foreign corporation (by vote or value).
- **Phantom Income Inclusions:**
  - If the corporation is a CFC during any part of the taxable year, each US person who is a United States shareholder on the last day of the CFC's taxable year is deemed to receive, and is taxed on, his or her pro rata share of "Subpart F" income or "global intangible low-taxed income" ("GILTI") of the CFC.
  - Subpart F income includes passive income and certain related party sales income and GILTI picks up most other types of income.

PFIC Rules

- Generally, a foreign corporation is classified as a PFIC under Section 1297 if it meets either an income test or an asset test:
  - A foreign corporation is a PFIC under the income test if 75% or more of its gross income is passive income (dividends, interest, royalties, rents and the like).
  - A foreign corporation is a PFIC under the asset test if at least 50% of the average percentage of assets held by the corporation during the tax year is comprised of assets that produce passive income or are held for the production of passive income.
- Most foreign mutual funds would be considered PFICs.
- Unless certain elections are made, gains from the disposition of a PFIC are taxed at ordinary income rates and potentially subject to an additional interest charge.

Indirect Ownership of a PFIC or CFC

- **No Attribution to Beneficiaries During Grantor's Lifetime:**
  - During the grantor's lifetime, so long as the trust remains a grantor trust, there is no attribution of ownership to the US beneficiaries under the CFC and PFIC rules and no accumulation of income within the trust that could later be taxable to the US beneficiaries.
- **Attribution to US Beneficiaries After Grantor's Death**
  - If enough of the beneficiaries are US persons, the foreign blocker may become a CFC. US beneficiaries with sufficient beneficial ownership of the trust may become indirect United States shareholders of the blocker/CFC under the attribution rules (based on distribution patterns and other factors) and thus may be subject to phantom income under the Subpart F and/or GILTI regimes.
  - Similar attribution rules apply to PFICs. Accordingly, dispositions of underlying PFICs could trigger phantom PFIC gains.

Unwinding Foreign Trust and Blocker Structure

- Both the phantom income inclusions under the CFC and PFIC rules and the accumulation distribution rules can be mitigated:
  - ***Entity classification elections.*** The trustees can "check the box" on the foreign blockers (filing IRS Form 8832 to treat the corporation's as disregarded entities for tax purposes) to step-up the basis of the underlying assets and prevent the blocker from becoming a CFC or PFIC. However, this requires careful planning ahead of time to prevent (or reduce) a phantom income inclusion from the deemed sale of the underlying assets.
  - ***Harvesting gains.*** Phantom income may be reduced by harvesting gains while the trust is a grantor trust (during the grantor's lifetime) to reduce the amount of gains recognized after the grantor's death.
  - ***Two-tier blocker structure.*** A two-tiered blocker structure can help to reduce the amount of phantom income recognized when the trustee checks the box on the blocker structure.

Unwinding Foreign Trust and Blocker Structure

- Other tax mitigation steps include:
  - ***Managing PFIC exposure.*** Selling all of the foreign mutual funds held by the trust or the foreign blocker corporation will cut off application of the PFIC rules. Investment managers should be mindful of lock-up periods when acquiring interests in foreign investment funds so that they can be quickly sold after the grantor dies and the trust becomes a nongrantor trust.
  - ***Domestication of trust.*** Assets allocable to US beneficiaries could be distributed to a US trust for their benefit to prevent application of the accumulation distribution rules. In the alternative, the trust itself could be domesticated (for example, by replacing a foreign protector with a US protector).

US Reporting Requirements Associated with Foreign Trusts

- Depending on the trust structure and underlying holdings, various information returns may be required:
  - IRS Forms 3520 and 8938 to report distributions from a foreign trust to a US beneficiary (whether the trust is a grantor or nongrantor trust).
  - Once the trust becomes a foreign nongrantor trust, IRS From 8621 to report an interest in a PFIC.
  - Once the trust becomes a foreign nongrantor trust, IRS Form 5471 to report an interest in a CFC.
  - If assets are held through a single-member LLC, IRS Form 5472 to report related party transactions.
  - FinCEN Form 114 (FBAR) to report foreign bank accounts of trust or foreign underlying entity (filed by US trustee of foreign trust)

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Dina Kapur Sanna has over 20 years of experience in advising US and non-US taxpayers on wealth management structures which accommodate multi-jurisdictional tax and legal considerations. Her practice involves foreign trusts, pre-immigration and expatriation planning, planning for the purchase of US property by non-US persons and compliance with tax and reporting obligations for those with overseas interests in foreign accounts, corporations and trusts.

Dina is recognized as a leading international estate planning attorney by Chambers USA, Chambers Global and The International Who's Who of Private Client Lawyers. Dina is a frequent speaker at estate planning seminars around the world. She has written numerous articles that appear in legal periodicals in the US and abroad.

Dina is a fellow of the American College of Trust and Estate Counsel (ACTEC) and a member of its International Estate Planning Committee. In addition, she is an Academician of The International Academy of Estate and Trust Law.