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Planning for the Use of the United States as a Financial Haven: Part Two

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A prior commentary explained the limited reporting by financial institutions for trusts organized in the United States and how administration of those trusts should be approached so as to minimize CRS and FinCEN reporting to foreign governments.[1] This commentary addresses U.S. tax considerations and planning to minimize the impact of U.S. income and estate taxation on the trust income and assets.

Income Taxation: In order to minimize U.S. income taxation, status as a U.S. person for U.S. income tax purposes is to be avoided. Whether a trust is a U.S. or foreign person for U.S. income tax purposes is determined by an objective test comprised of two prongs, both of which must be satisfied. Violation of either causes a trust — even one organized and administered in the United States — to be a foreign person. First, a court within the United States is able to exercise primary supervision over the administration of the trust (the ''Court Test'').[2] ''Administration'' is defined by Treasury regulations to refer to ''carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.''[3] The Treasury regulations provide a safe harbor under which a trust will satisfy the Court Test if three conditions are met:

(1) the trust instrument does not direct that the trust be administered outside of the United States;

(2) the trust is in fact administered exclusively in the United States; and

(3) the trust is not subject to an automatic migration provision.[4]

Consequently, including an automatic migration provision in the trust instrument is sufficient to cause the trust to fail to satisfy the Court Test and, thereby, be deemed a foreign person for U.S. income tax purposes.

In addition to satisfying the Court Test, one or more U.S. persons must have the authority to control all substantial decisions of the trust (the ''Control Test'') in order for the trust to be considered a U.S. person.[5] Treasury regulations distinguish ministerial decisions from substantial decisions and provide a nonexclusive list of substantial decisions:

- whether and when to distribute trust income or corpus;
- the amount of any distributions;
- the selection of a beneficiary;

[1] Ward, *Planning for the Use of the United States as a Financial Haven: Part One*, 45 Tax Mgmt. Int'l J. 677 (Nov. 11, 2016).

[2] §7701(a)(30)(E)(i).

[3] Reg. §301.7701-7(c)(3)(v).

[4] Reg. §301.7701-7(c)(4)(ii).

[5] §7701(a)(30)(E)(ii).

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- whether a receipt is allocable to income or principal;
- whether to terminate the trust;
- whether to compromise, arbitrate, or abandon claims of the trust;
- whether to sue on behalf of the trust or to defend suits against the trust;
- whether to remove, add, or replace a trustee;
- whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee; and
- investment decisions.

Thus, if any substantial decision is controlled by a foreign person (an individual who is not a citizen or resident of the United States), the trust will be deemed to be a foreign person for U.S. income tax purposes, even though the trustee is a U.S. person and the trust is subject to the jurisdiction of U.S. courts.[6]

Any trust that fails either the Court Test or the Control Test will be treated as a foreign trust. A foreign trust will only be subject to U.S. income taxation on its U.S.-source income.

Income Tax Planning: In order to minimize the U.S. income tax rate to which the U.S.-source income is subject, the income of the trust is best taxed to a foreign settlor. This is because trusts are subject to very ''thin'' income tax brackets.[7]

The foreign settlor of a trust will be treated as the owner of (and taxable on) the income of the trust in only two circumstances. The first circumstance occurs when distributions from the trust (whether income or capital) during the lifetime of the settlor may be made only to the settlor or the settlor's spouse.[8] The second circumstance occurs when the settlor has the power to unilaterally (or with the consent of a related or subordinate party) revest the trust assets in the settlor.[9] A ''related or subordinate party'' is defined by §672 to be any individual or entity that does not have a beneficial interest in the trust and is:

- the settlor's spouse if living with the settlor;
- the settlor's father, mother, descendants, or siblings;
- an employee of the settlor;
- a corporation or any employee of a corporation in which the equity interest of the settlor and the trust are significant for purposes of exercising voting control; or
- a subordinate employee of a corporation in which the settlor is an executive.[10]

The circumstances described above notwithstanding, unless the settlor has made a gratuitous transfer to the trust, the settlor will not be treated as the owner of the capital and income of the trust for U.S. income tax purposes. If the trust is settled by a distribution from another trust, the settlor of the transferor trust will be treated as the owner of the capital and income of the transferee trust unless the person or entity at whose direction the transferee trust was settled (usually a trustee of the transferor trust) had powers broad enough to be characterized as a general power of appointment. A general power of appointment is defined by §2041 as a power to appoint assets to oneself, one's creditors, one's estate, or the creditors of one's estate.

Estate Taxation: As stated above, the foreign status of a trust established in the United States for U.S. income tax purposes will not insulate the trust from U.S. income taxation on U.S.-source income. Similarly, the foreign status of the trust for U.S. estate tax purposes will not protect the settlor of the trust from U.S. estate taxation if: (1) the settlor is also a beneficiary of the trust, and (2) the trust owns assets present or deemed to be present in the United States.[11] Individuals who are not citizens or domiciled in the United States are nonetheless subject to U.S. estate taxation on tangible assets present in the United States (real property and tangible personal property) and intangible assets deemed to be property within the United States (''U.S. Situs Assets''). U.S. Situs Assets include shares of U.S. corporations and debt obligations of U.S. persons (other than portfolio debt obligations).[12] Even in circumstances in which the settlor is not a beneficiary of the trust, if the trust is subject to revocation or amendment by the settlor and contains U.S. Situs Assets, the U.S. Situs Assets will be subject to U.S. estate taxation at the settlor's death.[13] Even if the settlor of the trust is not a beneficiary, if the settlor retains a general power of appointment (as defined above) over the assets of the trust and the trust holds U.S. Situs Assets, the U.S. Situs Assets will be subject to U.S. estate taxation at the settlor's death.

Opportunities for Basis Increases: The cost basis of the trust assets will be adjusted to fair market value at the settlor's death in certain circumstances. In order

[6] Reg. §301.7701-7(d)(1)(ii).

[7] For 2016, trust taxable income in excess of $12,400 is taxed at the maximum U.S. income tax rate of 39.6%. §1(e); Rev. Proc. 2015-53, 2015-44 I.R.B. 615.

[8] §672(f)(2)(A)(ii).

[9] §672(f)(2)(A)(i).

[10] *See* §672(c).

[11] *See* §2036.

[12] §2104.

[13] §2038.

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to achieve such a basis adjustment, the assets of the trust need not be subject to U.S. estate taxation at the settlor's death.[14]

- The basis adjustment is available in the case of a trust holding U.S. Situs Assets if the income from the trust is payable during the settlor's lifetime to the settlor or as the settlor directs and the settlor reserved the right at all times before death to revoke the trust.[15]
- In the case of an irrevocable trust, the basis adjustment also applies to the U.S. Situs Assets of the trust if the income of the trust was subject to payment during the settlor's lifetime to the settlor or others at the settlor's direction and the settlor reserved the right at all times prior to the settlor's death to make any change in the enjoyment of the income through the exercise of a power to alter, amend, or terminate the trust.[16]

It should be unnecessary to explain (although human experience clearly dictates otherwise) that the use of a trust to evade foreign or U.S. income tax laws, engage in money laundering, or otherwise violate foreign or U.S. laws is to be avoided. Review or explanation of those laws is beyond the scope of this commentary. However, a word to the wise should be sufficient.

[14] Rev. Rul. 84-139, 1984-2 C.B. 168.

[15] §1014(b)(2).

[16] §1014(b)(3).

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