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Cross-Border Trusts

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Fast Facts on Cross-Border Trusts: Taxation and Trust Design
Mobility is a fact of modern life, and it is increasingly common for families to own assets internationally or have family members living in other countries. These cross-border circumstances give rise to a range of U.S. income, gift, estate and generation-skipping transfer tax consequences, particularly when trusts are involved. One area of particular complexity is the U.S. taxation of trusts, grantors and beneficiaries with cross-border contacts. This article offers a high level overview of certain aspects of the taxation of cross-border trusts from the U.S. perspective, as well as some tips for planning. (For more comprehensive information on this topic, see *A Guide to Cross-Border Trust Design and Administration*).

U.S. INCOME TAXES

U.S. citizens, residents taxed on worldwide income, including trusts and estates
U.S. citizens and U.S. residents, as well as U.S. trusts and estates, are subject to U.S. income taxation on their worldwide income. "Residents" of the U.S. are subject to U.S. income taxation on their worldwide income, even if they are not U.S. citizens. This includes U.S. resident trusts and estates. Conversely, non-citizens not resident in the U.S. (foreign persons or non-resident aliens) and foreign trusts and estates generally are only subject to U.S. income taxation on their U.S.-source income.

A trust is treated as a "domestic trust" for U.S. income tax purposes if the trust is subject to supervision by a U.S. court, and the trust is controlled solely by a U.S. person or persons.[1]

Tip: *If a trust is intended to be a domestic trust for U.S. income tax purposes, consider including a statement of this intention in the governing instrument and expressly providing that no non-U.S. person may exercise powers controlling substantial decisions. In the case of jointly held powers, consider providing that the decision of the U.S. person controls. In order to maintain a current record of the status of a trust as a domestic trust or a foreign trust, consider including an analysis of the status of the trust in the periodic review of the trust.*

Grantor trusts and asset ownership for U.S. income tax purposes
There are two types of trusts for U.S. income tax purposes – grantor trusts and non-grantor trusts. Under Subpart E of the Internal Revenue Code the grantor typically is treated as the owner of the trust and income, deductions and credits of a grantor trust flow-through to the grantor of the trust (or in limited circumstances, to a beneficiary with significant powers over the trust property).[2]

When a U.S. person creates a foreign trust, during his lifetime the U.S. person ordinarily is treated as the owner of the trust for U.S. income tax purposes if the foreign trust has a U.S. beneficiary.[3] Hence, income, deductions and credits will flow through to the grantor, even if the trust is irrevocable and the grantor has no powers over or interests in the trust.
When a non-U.S. person creates a U.S. domestic trust, the non-U.S. person is treated as the owner of the trust during his lifetime and the trust is taxed as a flow-through grantor trust only if either the non-U.S. person has the power to revoke the trust without the approval or consent of any other person, or distributions of income and principal from the trust may only be made to the non-U.S. person who created the trust or the person's spouse while that non-U.S. person is living.[4]

A U.S. beneficiary is treated as the owner of any part or all of the assets of a trust if the beneficiary has the power, exercisable alone, to vest any part or all of the corpus or the income of the trust in himself, provided the grantor of the trust is not otherwise treated as the owner of the trust.[5] However, if a foreign beneficiary has these powers over a trust, the trust will be treated as a non-grantor trust taxed as a separate taxpayer, not as a grantor trust with flow-through treatment.

Tip: *If the income tax planning strategy is to remove income from a U.S. grantor, creation of a foreign trust by a U.S. person with a U.S. beneficiary is not an effective tool.*

Non-grantor trusts and beneficiary distributions
A non-grantor U.S. trust that has a foreign beneficiary has additional income tax withholding requirements. Non-resident aliens are subject to U.S. income tax on all income from whatever source that is effectively connected to the conduct of a U.S. business, and a flat tax of 30% on all fixed or determinable annual or periodic income from U.S. sources that is not connected to the conduct of any U.S. business, subject to treaty modifications.[6]

U.S. beneficiaries of a non-grantor foreign trust are subject to complex tax rules. Generally distributions from a foreign non-grantor trust are first treated as distributions of the trust's distributable net income (DNI), both U.S. and non-U.S. income. Unlike a U.S. trust, this includes capital gains from the sale of assets.[7] Accumulation distributions from foreign trusts to U.S. beneficiaries are subject to the throwback tax that has been repealed for U.S. trusts and to an additional interest charge. Accumulation distributions lose any tax-preferred character and are treated as ordinary taxable income. U.S. beneficiaries having an interest in or receiving distributions from foreign trusts have additional reporting and tax compliance obligations.

Tip: *When administering a foreign non-grantor trust with a U.S. beneficiary, consider the timing of the recognition of capital gains by the trust, the timing of distributions to the U.S. beneficiary, and the availability of the 65-day election to preserve the tax character of items of income and limit interest charges on accumulation distributions.*

Transfers to foreign trusts and estates
Subject to certain limited exceptions, if a U.S. person transfers property to a foreign estate or trust, the transfer is treated as a sale or exchange and results in the recognition of gain.[8] However, this is not the case if the transfer is to a trust treated as a grantor trust with respect to the U.S. person.[9]

Tip: *Be aware of triggers to deemed dispositions when foreign non-grantor trusts are involved. Consider the timing of transfers to foreign non-grantor trusts, particularly when an asset has or is expected to appreciate.*

U.S. GIFT, ESTATE AND TRANSFER TAXES

U.S. citizens and U.S. domiciled persons are subject to U.S. gift, estate and generation-skipping transfer taxes on their worldwide assets, whereas non-citizen non-domiciliaries are subject to U.S. gift, estate and generation-skipping transfer tax on their U.S. "situs" assets. Note that U.S. transfer taxation focuses on "domicile" – the place where the individual lives with no definite present intention of departing.

For non-domiciliaries who are not U.S. citizens, the situs of their property determines whether they will be subject to U.S. transfer taxes. For both gift and estate tax purposes, real property and tangible personal property physically located in the U.S. is deemed to have a U.S. situs.[10] For gift tax purposes, intangible personal property is not considered a U.S. situs asset, whatever its source or location.[11] However, for estate tax purposes, intangible personal property has a U.S. situs if it is derived from a U.S. person or entity.

Transfer tax deductions, credits, exclusions
U.S. transfer taxes are subject to numerous deductions, credits and exclusions of particular significance in cross-border transfer tax planning, including the marital deduction and the unified or applicable credit. The unlimited marital deduction (for transfers to U.S. citizen spouses) permits assets to be transferred between the couple free of transfer taxes. Thus, transfer taxes may be deferred in full until the death of the surviving spouse. However, the unlimited marital deduction does not apply if the spouse is not a U.S. citizen. U.S. citizens and domiciliaries are allowed a gift and estate tax applicable exclusion by which $5,340,000 may be excluded from gift and estate tax in 2014. Non-U.S citizen non-U.S. domiciliaries with assets in the U.S. are allowed an estate tax credit of only $13,000 (an exclusion equivalent of $60,000), but there is no similar credit for the gift tax.[12] A foreign person may make annual gifts up to $14,000 (adjusted annually for inflation) of U.S. situs assets (or an unlimited amount of foreign situs assets) to a donee in 2014 without incurring U.S. gift tax.[13] However, gift-splitting is not permitted. An increased annual gift exclusion amount of $145,000 in 2014 (adjusted annually for inflation) is available for gifts to a non-U.S. citizen spouse.[14]

Qualified domestic trusts
The unlimited U.S. estate tax marital deduction not otherwise available for transfers to spouses who are not U.S. citizens may be preserved through the use of a qualified domestic trust (QDOT). A QDOT may be anticipatorily included in the estate plan of the citizen spouse, or post-mortem transfers to a QDOT by the non-citizen spouse may preserve the estate tax marital deduction. Typically, however, there will be gift tax consequences to the surviving spouse upon a post-mortem transfer to a QDOT.

Tip: *To avoid a completed gift upon a post-mortem transfer to a QDOT, the spouse may reserve a special power of appointment over the trust, the exercise of which will avoid gift tax consequences.*

Tip: *When drafting the estate plan, the planner may provide for relief from the QDOT limitations if the non-citizen spouse subsequently becomes a U.S. citizen and the requirements of the regulations are fulfilled, thereby making the QDOT unnecessary.*

Conclusion
The tax implications of cross-border trusts described above are merely a brief overview of some (but far from all) issues to consider when planning and administering cross-border trusts. Cross-border trust planning and administration will require a team of professionals to evaluate both the U.S. and foreign tax implications and planning issues. Additionally, there are ever expanding asset and account disclosure requirements with respect to foreign interests that require close attention.