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Pre-Residency Planning for Your Client's Trust

Trust domestication in the international context

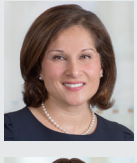
Trust domestication has become increasingly common for global family trust structures. Whenever U.S. beneficiaries or U.S. settlors are in the mix (including non-U.S. settlors who later become U.S. persons), trust domestication can be critical to avoiding punitive tax rules and compliance headaches. For many foreign grantor trust structures with U.S. beneficiaries,[1] this is the last stage of the foreign settlor's[2] succession plan, to be implemented after the settlor's death. Domestication also may be driven by a change of circumstances. For example, the settlor may be moving to the United States, and allowing the trust to remain foreign for U.S. tax purposes could expose the settlor to adverse tax consequences. Similarly, a beneficiary's move to the United States may warrant a partial domestication if the structure wasn't established with U.S. beneficiaries in mind. Even if neither the grantor nor any of the beneficiaries are expected to become U.S. persons, a domestic trust may be an attractive vehicle to hold U.S. real estate or business assets.

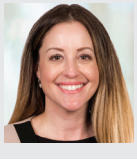
Why Domesticate?

Life cycle of a foreign grantor trust. When a grantor trust is established offshore for U.S. beneficiaries, domestication ordinarily occurs after the settlor's death. If the trust is properly drafted with U.S. tax considerations in mind, it will qualify as a grantor trust during the foreign settlor's lifetime, either because the settlor has the power to revoke the trust or because distributions may be made only to the settlor or to the settlor's spouse during the life of the settlor.[3] When permissible under local law, the trust also will include provisions allowing for a basis step-up with respect to its assets on the settlor's death.[4]

If a trust qualifies as a grantor trust for U.S. income tax purposes, then it generally will be ignored and any items of income, gain, loss or deduction accrued by the trust will be deemed to be earned directly by the settlor. Because the settlor will be the tax owner of any income earned by the trust, the U.S. beneficiaries won't be subject to tax in the United States on income or gains recognized by the foreign grantor trust during the foreign settlor's lifetime, regardless of whether they receive distributions.[5] Further, if the settlor is a non-U.S. person, then the trust's income won't be taxable to the settlor unless it's from U.S. sources or is effectively connected with the conduct of a trade or business in the United States.

Most foreign grantor trusts will hold U.S. equities and any other U.S. situs investments that give rise to U.S. source income through a foreign "blocker" corporation to shield the foreign settlor from U.S. estate tax exposure with respect to the underlying assets.[6] This also has the effect of insulating the foreign settlor from direct U.S. income tax exposure and reporting obligations. Even in the absence of U.S. situs assets, many foreign trustees prefer to hold investments through a foreign holding company. While indirect beneficial ownership of closely held foreign companies (or even widely held foreign





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investment funds) can expose U.S. beneficiaries of a foreign trust to phantom income inclusions and other adverse tax consequences, so long as the trust remains a grantor trust, there will be no attribution of ownership to the beneficiaries because the grantor will be considered the owner.[7]

Once the foreign settlor dies, the trust will automatically become a foreign nongrantor trust. A number of potentially adverse tax consequences flow from this change in status:

- When a grantor trust becomes a nongrantor trust, it loses its tax transparency and becomes a separate taxable entity for U.S. income tax purposes. Accordingly, income and gain recognized by the trust after the settlor's death will become part of the trust's distributable net income (DNI).[8] If the DNI is distributed in the year earned (or in the first 65 days of the following calendar year pursuant to a "65-day election" under Internal Revenue Code Section 663(b)), then it will be taxable to U.S. beneficiaries who receive distributions, but beneficial tax attributes (such as qualified dividends and long-term capital gains) will be preserved in the hands of the beneficiaries.[9]
- DNI that's allowed to accumulate will become undistributed net income (UNI), which may be taxed at much higher rates when it's eventually distributed to a U.S. beneficiary. With the exception of tax-exempt interest, most items of DNI lose their character when they become UNI and thus are taxed as ordinary income. Further, under the throwback tax rules, UNI is subject to an interest charge that can be confiscatory if enough time has elapsed between the year the income was accumulated and the year it's finally distributed to a U.S. person. Further, with limited exceptions, UNI is generally carried out before clean capital.
- If the trust holds investments through a foreign holding company, that company may become a controlled foreign corporation (CFC) after the settlor's death because ownership of the underlying stock may be attributed to the U.S. beneficiaries of a foreign nongrantor trust.[10] A foreign corporation is a CFC if it's more than 50% owned (directly, indirectly or constructively) by 10% U.S. owners (referred to by statute as "United States shareholders"). If the holding company becomes a CFC, then U.S. beneficiaries who have a sufficient beneficial interest to be considered U.S. shareholders may be taxed on their pro rata shares of the holding company's earnings under Subpart F of the IRC and global intangible low taxed income (commonly called "GILTI") regimes,[11] even if those earnings aren't distributed.

Domestication often is in order when the settlor of a foreign trust relocates to the United States.

- If there isn't sufficient beneficial ownership by U.S. shareholders to cause the trust's foreign holding companies to become CFCs (for example, because most of the beneficiaries are non-U.S. persons), the holding company would likely become a passive foreign investment company (PFIC). A foreign corporation is a PFIC if at least 75% of its income is passive investment income or at least 50% of its assets would be considered passive assets (such as stocks, bonds, in most cases cash and other liquid assets). U.S. owners of a PFIC, including U.S. beneficiaries of a foreign nongrantor trust that owns a PFIC, are taxed at ordinary income rates on any income or gain from a PFIC and may be subject to an interest charge and taxation at the top marginal rate on all or a portion of a PFIC distribution or the gain from the sale or redemption of a PFIC within the trust. Even in the absence of a holding company, foreign mutual funds and ETFs owned by a foreign nongrantor trust would typically be considered PFICs.

A typical post-mortem plan will include use of entity classification elections to step up the basis of the underlying assets of any foreign holding companies, "turn off" application of the CFC and PFIC rules,[12] the sale or redemption of foreign

investment funds that could be considered PFICs and the domestication of the trust (or the portion of the trust that will be benefit U.S. persons). While domesticating all or a portion of a foreign nongrantor trust will bring all of the domesticated trust's earnings into the U.S. tax net, it will prevent application of the throwback tax rules, which generally don't apply to domestic trusts.[13] It also can greatly streamline compliance for the trust and its U.S. beneficiaries on a going forward basis.

Pre-immigration planning for settlor. Domestication often is in order when the settlor of a foreign trust relocates to the United States. Once the settlor of a foreign trust becomes a U.S. person, a much broader range of grantor trust provisions come into play. Most notably, IRC Section 679 can cause an individual who's made, directly or indirectly, a gratuitous transfer of property to a foreign trust[14] at any time during the five years preceding such individual's residency starting date to be treated as the owner of the trust for U.S. income tax purposes once the individual becomes a U.S. taxpayer if the trust has a U.S. beneficiary or is deemed to have a U.S. beneficiary under broad presumption rules.[15]

Even if the trust has been carefully structured to avoid the impact of Section 679, one must also analyze whether any other grantor trust powers are present.

If the trust becomes a grantor trust as to the (now) U.S. settlor, the settlor will be taxed on the trust's income, and gain and may be subject to phantom income inclusions and interest charges under the CFC and PFIC rules, depending on the holdings of the trust. In addition to the tax liabilities, foreign grantor trust status carries with it burdensome information reporting requirements for the U.S. settlor, including reporting on Internal Revenue Service Forms 3520 and 3520-A, as well as other foreign information returns with respect to underlying foreign companies.[16] U.S. beneficiaries who receive distributions would be subject to Form 3520 reporting as well.

There could be further taxes on the foreign grantor trust's conversion to a nongrantor trust, whether that happens during the settlor's life or on death. Which taxes apply depend in part on the terms of the trust and in part on whether proposals included in the current version of the House reconciliation bill (H.R. 5376) become law:

- Under current law, if the pre-residency trust is structured to be excluded from the settlor's taxable estate and the trust becomes a grantor trust when the settlor becomes a U.S. resident, then the settlor will be deemed to sell the trust's assets for fair market value (FMV) when that trust ceases to qualify as a grantor trust for U.S. income tax purposes.[17] Assuming no changes are made to the trust that would cause it to become a nongrantor trust during the grantor's lifetime, this gain recognition would occur when the trust becomes a nongrantor trust on the settlor's death.[18] This "exit" tax is imposed on the gross gain—that is, there's no deemed sale of loss assets and thus no netting of losses against gains.[19]
- If Section 138209 of H.R. 5376 (introducing new IRC Section 2901) becomes law, grantor trusts would be treated as incomplete gift trusts. Any assets held in a grantor trust formed or funded after the date of enactment (or any portion of a pre-enactment trust that's attributable to amounts contributed after the date of enactment) would be includible in the settlor's estate. While this would cut off application of IRC Section 684 and the resulting exit tax, the outcome likely would be worse, as the estate tax would apply at a rate of 40% on the entire amount. Further, the trust would no longer be considered a completed gift trust, meaning that any further distributions from the trust to any beneficiary other than the settlor would potentially be subject to gift tax (or reduce the settlor's lifetime exemption). Even turning off grantor trust status would be considered a taxable gift.

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analyze whether any other grantor trust powers are present, as any Section 673 through 677 powers can activate grantor trust status once the foreign settlor becomes a U.S. taxpayer *regardless of whether the trust is a U.S. or foreign trust at that point*. One common example found in foreign trust deeds is the power to add beneficiaries, which under Section 674(c) will force grantor trust status regardless of by whom held.

Domesticating the trust is advisable in this situation, as this can take the Section 684 "exit" tax, as well as foreign trust income and distribution reporting obligations off the table. However, if Section 2901 is added to the IRC in the current reconciliation bill, it also may be necessary to vet the domesticated trust agreement for any administrative powers (such as the aforementioned power to add beneficiaries) or other provisions that could still trigger grantor trust status after domestication and pull the assets back into the settlor's estate.

Pre-immigration planning for beneficiary. If a nonresident alien beneficiary of a foreign nongrantor trust is moving to the United States, you might consider domesticating a portion of the trust for the same reasons you might domesticate a foreign grantor trust after the settlor dies and the trust becomes a foreign nongrantor trust—that is, avoiding the throwback tax on accumulated income. However, somewhat different considerations may apply:

- If the beneficiary will be a resident for a finite amount of time, then it may make more sense to make a large distribution to the beneficiary in advance of the residency starting date and then to revocably exclude the beneficiary while in the United States to avoid attribution under the CFC or PFIC rules.[20]
- If the beneficiary will be moving to the United States indefinitely, then decanting a portion of the trust to a new U.S. trust for the beneficiary's benefit may be the best option. However, if there's a pool of accumulated income or the trust owns PFICs, advance planning will be required to avoid potentially onerous U.S. tax liabilities for the U.S. trust.

U.S. real property investments. Domestication (or ideally setting up a U.S. trust in the first place) also may make sense in the case of a foreign trust that owns U.S. real estate if the U.S. real estate is the trust's primary asset. If the property is rented out or sold, the rental income or gains will be taxable regardless of whether the trust is U.S. or foreign. One benefit of a foreign trust is that, in contrast to a domestic trust, it's not subject to the 3.8% Medicare tax on net investment income.[21] However, a U.S. trust can offer a number of potential advantages:

- The sale of U.S. real estate by a foreign seller (including a foreign nongrantor trust) is both taxable and subject to 15% withholding under the Foreign Investment in Real Property Tax Act (FIRPTA).[22] Because the withholding is on 15% of the gross proceeds rather than the gain, this typically will result in significant over-withholding. The buyer and foreign seller can jointly apply to the IRS for a withholding certificate to reduce the amount required to be withheld to the actual tax owed, but many buyers will simply withhold the statutory amount and leave it to the foreign seller to file a tax return to apply for a refund the next year. Domesticating the trust takes FIRPTA withholding off the table. A domestic trust can minimize the compliance burdens:

> Knowing your client—and particularly why your non-U.S. client wants a U.S. trust—is more important than ever.

  - U.S. beneficiaries allowed to use property of a foreign nongrantor trust rent-free are deemed to receive a constructive distribution equal to the fair rental value of their use of the property.[23] These constructive distributions are reportable on Form 3520 and can carry out DNI or UNI that will be taxable to the U.S. beneficiaries.[24] There's no similar rule for domestic trusts.
  - Foreign beneficiaries also may prefer a domestic trust, particularly after a sale, because gains

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from a property sale would be included in a foreign nongrantor trust's DNI and thus would be carried out to them when the proceeds are distributed, triggering return filing obligations for the foreign beneficiaries. In contrast, if a U.S. nongrantor trust sells the property, it would pay the tax and file the relevant returns and could then distribute the proceeds tax free to the foreign beneficiaries.[25]

Domestication double take. Domestication may not be warranted or appropriate in every case. In each of the scenarios described above, there are compelling reasons to domesticate either because the settlor or beneficiaries are (or will become) U.S. persons or because the trust will be investing in U.S. real property and the existing structure may no longer be tax efficient. However, if there's no apparent legal or business justification for choosing the United States—for example, none of the parties is (or plans to become) a U.S. person and there are no U.S. holdings in the trust—then this could be a potential red flag for compliance issues overseas.

SPOT LIGHT

Psychadelic

Roll the Barrel by Erik Parker sold for $52,920 at Phillips New Now New York Auction on Sept. 28, 2021 in New York City. Parker's colorful paintings draw inspiration from a variety of sources, ranging from comic books to graffiti art. The neon scenes feature everything from flowers to distorted faces and combine elements of traditional portraiture and landscapes.

When domesticating a foreign trust, it's important to vet the trust deed for any powers that could inadvertently cause the trust to become foreign again.

There's been growing concern among U.S. and foreign regulators about the potential use of U.S. trusts and LLCs to shield assets from foreign creditors and tax authorities back home. The United States has taken a number of steps to combat such abuses, including the new Corporate Transparency Act,[26] which requires disclosure and filing with FinCEN of corporate entities but doesn't yet apply to trusts. The scrutiny of structures established in certain U.S. jurisdictions is likely to intensify as stories such as the recent Pandora Papers make front-page news.[27] Knowing your client—and particularly why your non-U.S. client wants a U.S. trust—is more important than ever.

Practical Considerations

Trust residence and risk of accidental expatriation. The U.S. tax laws governing the residence of a trust are intentionally skewed towards foreign trust status and prevent a trust from being classified as a U.S. person unless a two-part test based on both jurisdiction and control over the trust is satisfied. In particular, IRC Section 7701(a)(30)(E) defines the term "Unites States person" to include "any trust if—(i) a court within the United States is able to exercise primary supervision over the administration of the trust" (the court test), and "(ii) one or more United

States persons have the authority to control all substantial decisions of the trust" (the control test). A "foreign trust" is any trust other than a trust defined as a U.S. person in Section 7701(a)(30)(E).[28] Thus, unless it can pass both the court test and the control test, a trust is a foreign trust by default.

If a trust company located in the United States is appointed to serve as trustee, a trust should easily meet the court test.[29] Further, since most trustee-type decisions are considered substantial for purposes of the control test, having a U.S. fiduciary is a useful step towards meeting the control test, but not necessarily sufficient. In the international context, it's also important to review the income tax residency of all substantial decision makers, including beneficiaries holding powers of appointment, to ensure the control test is met. For example, if a U.S. trust company is appointed to serve as sole trustee, but the trust has a foreign protector who could remove or replace the trustee or is directed by foreign beneficiaries with respect to trust distributions, then the trust will fail the control test and be classified as a foreign trust for U.S. tax purposes because U.S. persons won't be considered to control all substantial decisions of the trust.

When domesticating a foreign trust, it's important to vet the trust deed for any powers that could inadvertently cause the trust to become foreign again. It's equally important to monitor the U.S. status of persons who control substantial decisions of the trust. For example, a protector who gives up a Green Card and moves abroad could cause the trust to fail the control test and trigger an expatriation. A sole trustee who's a U.S. citizen potentially could cause the trust to fail the court test by moving abroad, depending on the laws of the jurisdiction where that trustee reside. The consequences could be quite severe:

- If the settlor is already deceased or is a non-U.S. person, then a subsequent expatriation of the trust would generally be considered a transfer to a foreign nongrantor trust, potentially triggering gain recognition under Section 684.[30]
- If the settlor is still alive and has become a U.S. person, then depending on the trust terms and when the trust was funded, the trust either would become a foreign grantor trust as to the U.S. settlor, with all of the potential adverse tax and reporting implications (including potential application of proposed Section 2901), or it would become a foreign nongrantor trust, triggering upfront gain under Section 684.
- The Treasury regulations allow a 12-month grace period to cure an inadvertent change of residency and prevent a trust from becoming a foreign trust, but often these events aren't discovered until years after the fact.[31]

Domestication mechanics. There are generally two separate pathways to domesticating a foreign nongrantor trust: migration and decanting. Although typically viewed as distinct options, the lines of separation can be blurred depending on the changes made in the process.

Ordinarily, a migration occurs by: (1) having the foreign trustee and any other substantial decision makers who aren't U.S. persons step down, (2) appointing a U.S. person to serve as trustee and in other key substantial decision-making roles, and (3) changing the governing law of the trust to that of the new situs jurisdiction. Most foreign trust deeds have sufficient flexibility built in to accommodate such a trust relocation. However, domestication accomplished in this manner raises its own challenges, as U.S. trust companies may find administering the foreign trust deed difficult under local law. Thus, even after a trust migration, trustees may consider amending and restating the trust deed to a more "U.S. friendly" format or decanting the new U.S. trust in any event to allow for a more streamlined administration.

In contrast, decanting is the process by which a fiduciary exercises a discretionary power to appoint the assets from one trust to another, which may or may not have similar terms with respect to trust governance and the timing and manner of distributions. Because many foreign trust deeds either contain an express decanting provision or provide the trustee with the power to add to the beneficial class, decanting is usually possible by relying solely on the existing instrument. However, exercise care in determining the appropriate approach in any case, as the exact methodology matters. For example, a trustee may have broad powers of advancement

enabling it to accomplish the decanting. Yet, relying on broad distribution powers that may be exercised "for the benefit of" a beneficiary may be viewed as a distribution to that beneficiary followed by such beneficiary's resettlement of the U.S. trust, thereby eliminating the estate tax and generation-skipping transfer (GST) tax protection of the structure. In addition, any participation by the U.S. beneficiary in the decanting could: (1) cause the U.S. beneficiary and not the domesticated trust to be taxed on any DNI or UNI carried out in the deemed distribution, and (2) be viewed as an indirect gift from the beneficiary for gift tax purposes if it results in a diminished beneficial interest. Carefully review deeds of appointment and trustee resolutions executed in connection with a trust decanting, as any indication of beneficiary involvement may be problematic.

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U.S. Tax Considerations

Different tax treatment of migration and decanting. There's a key difference between a migration and a decanting for income tax purposes. When a foreign nongrantor trust decants only a portion of its assets to a new trust (or decants all of its assets to a new trust with substantively different dispositive terms), the decanting generally is treated as a distribution for income tax purposes, meaning that the decanting can carry out DNI and UNI to the new trust. If the new trust is a U.S. trust, then the distribution will be reportable on Form 3520, and the trust will be taxed on any DNI and UNI carried out in the distribution. As previously noted, U.S. beneficiaries of a complex foreign nongrantor trust (like beneficiaries of a complex domestic trust) are generally subject to U.S. income tax if and when they receive distributions to the extent of their pro rata share of the trust's DNI earned in that year. In the case of a foreign trust, this includes capital gains. If the nongrantor trust is foreign and makes a distribution in excess of the trust's DNI and fiduciary accounting income for the year, then any UNI in the trust can be carried out to the recipients to the extent that the distribution exceeds the trust's DNI for the year. A decanting of a large portion of a trust's assets could very well exceed both DNI and fiduciary accounting income, thereby carrying out UNI to the recipient trust, which could be subject to adverse U.S. income tax consequences on the distribution under the throwback tax rules (described previously).[32]

While a trust migration potentially could be treated as a distribution if there are enough changes to the trust terms, a trust migration that's accomplished by swapping foreign fiduciaries for U.S. counterparts, with few changes made to the trust deed other than changing the governing law of administration, shouldn't be viewed as a trust distribution. As such, the migration shouldn't immediately carry out DNI or UNI or trigger Form 3520 reporting obligations. That said, a domestication accomplished in this way doesn't make the issue of UNI go away if the trust has significant accumulations of income from prior years because the UNI will be preserved within the migrated trust and may ultimately be taxed at punitive rates when it's finally distributed to a U.S. beneficiary of the domesticated trust.[33]

On the other hand, a migration that entails enough changes to the dispositive provisions of the trust potentially could be recharacterized as a distribution by the IRS. If there's any uncertainty, the migrated trust might consider filing a protective Form 3520 to report the otherwise unreportable migration to start the statute of limitations running and avoid a potential 35% penalty for failing to file if the IRS were to recast the migration as a distribution.

Managing pre-domestication DNI/UNI. If the foreign settlor recently passed away and the trust qualified as a foreign grantor trust, the domestication process often is relatively straightforward from a tax standpoint, and the decision on whether to migrate

or decant will boil down to logistics rather than tax treatment. The DNI earned after death should be distributed out to a beneficiary (and if the trust is migrated it should be distributed from the migrated trust) in the same calendar year of the grantor's death to avoid becoming UNI. However, there wouldn't be any accumulations of UNI from prior years while the trust was a grantor trust. Assuming the trust was drafted with basis step-up provisions, any DNI generated from the unwinding of any holding companies generally would be limited to post-death appreciation. Further, if the trust was revocable, a Section 645 election could allow for the trust to be taxed as a foreign estate, in which case any foreign source income or gain recognized in the first year after the settlor's death wouldn't be treated as DNI. In some cases, trustees will pause domestication for a year or two to take advantage of this election.

Which strategy makes the most sense will depend in part on the mix of beneficiaries and in part on the underlying income and assets of the trust.

However, in many cases, U.S. tax advice is sought many years after the foreign settlor's death, when income has been accumulating in the structure for some time. In those cases, there may be a significant pool of UNI to contend with, and the impact of the throwback rules must be analyzed. Which strategy makes the most sense will depend in part on the mix of beneficiaries and in part on the underlying income and assets of the trust:

- If a foreign nongrantor trust has both U.S. and foreign beneficiaries and a substantial pool of UNI, the trustee may be able to clear out the DNI/UNI in a calendar year through a decanting to another foreign trust established for the benefit of the foreign beneficiaries followed by a domestication in the subsequent calendar year, either by migrating the residual trust or by decanting the remaining assets to a new U.S. trust established for the U.S. beneficiaries. A trust can be a beneficiary of another trust for DNI purposes,[34] so in principle, a foreign nongrantor trust should be able to distribute its DNI and UNI to another foreign nongrantor trust regardless of whether the receptacle trust is added as a beneficiary of the distributing trust or the decanting is accomplished through the foreign trustee's specific decanting power in the trust instrument.

SPOT LIGHT

Colorblock

Reflect by Alex Olson sold for 20,160 at Phillips New Now New York Auction on Sept. 28, 2021 in New York City. Olson is an American artist who works and lives in Los Angeles. Her paintings most often feature oil paint and modeling paste on canvas. In an interview published on Phaidon's website, Olson admits that she destroys many paintings that fail.

- However, it's important that the receptacle trust truly be viewed as a new trust for tax purposes, which generally means, at a minimum, that it should have significantly different dispositive provisions for trust distributions. In several private letter rulings,[35] the IRS reached the conclusion that there was no Section 661 deduction allowed to the transferor trusts and no Section 662 inclusion for the new trusts when the new trusts had the same dispositive provisions for distributions as the old trusts, and most of the assets were transferred to the successor trusts because the creation and funding of such successor trusts was merely a continuation of the old trusts. Without a trust distribution, any UNI would remain trapped in the initial foreign nongrantor trust.
- If a stripping distribution isn't a viable option, either because there isn't sufficient flexibility to do so safely under the trust instrument or the governing law or because there's no foreign recipient who could receive the accumulated income without adverse tax consequences in another jurisdiction, then it may make more sense to set up a pour-over trust in the United States and manage the distributions so that the trust never distributes more than the greater of DNI and trust accounting income in a given year (and thus doesn't distribute any UNI). This strategy may be particularly useful if it's possible to spike DNI in a given year, for example, by forcing a recognition event that would give rise to long-term capital gains taxed at more favorable rates than UNI.[36] An election also could be made under Section 643(e)(3) to treat the trust as having sold the distributed assets for FMV, creating a capital gains event that would boost DNI. However, consider whether there's sufficient liquidity for the U.S. trust to pay the capital gains tax in that case.

SPOT LIGHT

Explosive

Flash Point by Nicholas Krushenick sold for $15,120 at Phillips New Now New York Auction on Sept. 28, 2021 in New York City. An American abstract painter, Krushenick worked in his own signature pop art style. His use of geometric shapes and comic book-like qualities in his works made him somewhat of an outlier in the art world during his time period.

Carefully consider whether the decanting results in a shift of the proportionate interests of the beneficiaries.

- Another option if DNI is too limiting is to use the "default method" in the Form 3520 instructions. Under this approach, a U.S. beneficiary may treat each distribution up to a certain ceiling as ordinary income without the additional interest charge that otherwise would apply to UNI. The amount that may be distributed pursuant to the default method is capped at 125% of the trailing 3-year average of distributions, so this strategy generally will be viable only in situations in which there's a long enough runway to fund the U.S. trust completely. Further, because the beneficiary is locked into this method for future tax years, it only makes

sense when most of the amount it will receive will be comprised of UNI; otherwise one would be converting principal into taxable income.

Avoiding beneficiary recognition events. Particularly in situations in which not all of the beneficiaries are U.S. persons, carefully consider whether the decanting results in a shift of the proportionate interests of the beneficiaries. The IRS has indicated that it may consider a beneficiary as realizing gain if the beneficiary's interest in a trust is altered, changed or swapped for an interest or property that's so materially different, it's essentially equivalent to a sale. The logic is based on *Cottage Savings Assn. v. United States*,[37] a U.S. Supreme Court case in which mortgage notes were exchanged, and the Court found that the property received was "materially different" and thus a sale had occurred under IRC Section 1001. This analysis can be particularly difficult if the trust is wholly discretionary, and historically, distributions haven't been made.

The IRS has been willing to extend the application of the regulatory safe harbors to non-grandfathered trusts that were exempt from GST tax for other reasons.

The IRS has issued several non-binding PLRs on the topic.[38] When the IRS has determined that gain was recognized by the beneficiaries on account of a severance of interests at the trust level, the beneficiaries usually have participated in the transaction in some way (for example, a consent right).[39] In contrast, the IRS found no taxable exchange occurred in situations in which the shift in interests was entirely out of the beneficiaries' control (for example, there was no implied consent or acquiescence because they had no right to object to begin with).[40]

As is typical with a foreign nongrantor trust, some of the trust's investments, such as foreign mutual funds and private equity investments, also may be classified as PFICs for U.S. income tax purposes, and any shift in ownership among the U.S. and non-U.S. beneficiaries could constitute an indirect PFIC disposition.[41] While there's little formal guidance on how to attribute PFIC ownership through a foreign nongrantor trust, the long outstanding proposed PFIC regulations do provide that, if a foreign nongrantor trust directly or indirectly owns stock of a PFIC, each beneficiary of such trust is considered to own a "proportionate" amount of such stock.[42] Without a strong history of distributions, ancillary documents such as letters of wishes may be helpful or harmful in determining whether a sale has occurred.

When moving a structure onshore, take care to avoid any direct transfers from foreign corporations or partnerships owned by the offshore structure to the new U.S. trust. Such gratuitous transfers can be re-characterized as income, even if the transferor entity has elected to be disregarded for U.S. tax purposes.[43] Further, if the foreign corporation from which such a direct transfer is made is classified as a PFIC, the distribution could be re-characterized as a PFIC distribution and taxed as ordinary income when received by the U.S. trust (potentially with a PFIC interest charge depending on the applicable holding period). While there's an exception to this anti-abuse rule if: (1) the donor treats the distribution for local tax and reporting purposes as having been made from the foreign company to the donor and then from the donor to the U.S. donee; and (2) the U.S. donee duly reports the gift on IRS Form 3520, if the donor is deceased or has established the trust to minimize local county tax and reporting consequences, the exception may not be available. This is a practical consideration as much as a tax issue because often the trust won't have an account at trust-level from which a distribution can be made.

Preserving the transfer tax exempt status of the trust. Many foreign nongrantor trusts that benefit U.S. persons at one time had a foreign settlor who funded the trust solely with non-U.S. situs assets for U.S. gift and estate tax purposes. If such a trust is decanted to a new domestic trust solely in the discretion of a foreign trustee without the

participation of any U.S. person, the distributing trust should be completely outside of the scope of Chapter 13[44] and, if properly structured, the recipient trust should never enter the U.S. transfer tax system either. Nevertheless, the regulatory safe harbors that apply to protect the GST tax-exempt status of a trust that's modified through a decanting are an informal guide.[45] While these safe harbor provisions only explicitly apply to a "grandfathered trust," the IRS has been willing in a number of PLRs to extend the application of the regulatory safe harbor to non-grandfathered trusts that were exempt from GST tax for other reasons (for example, because GST tax exemption was allocated).[46]

The first relevant safe harbor applies when a trustee distributes trust principal to a new trust if: (1) the trustee is authorized to make distributions to a new trust without the consent or approval of any beneficiary or court under either the terms of the governing instrument or state law in existence at the time the trust became irrevocable; and (2) the terms of the governing instrument of the new trust or continuing trust don't extend the time for vesting of any beneficial interest in the trust so as to postpone or suspend vesting, absolute ownership or the power of alienation of an interest in property beyond a described period.[47] For this purpose, the exercise of a distribution power by a trustee that validly postpones or suspends vesting, absolute ownership or alienation for a term that won't exceed 90 years from the date the original trust became irrevocable won't be considered an exercise that violates this federal perpetuities period.[48]

Complying with the aforementioned safe harbor may not be practical if the originating trust has no perpetuities period and there's a desire to decant to an equally perpetual arrangement. The relevant Treasury regulations also provide that a modification of the governing instrument of a trust (including a modification through a trustee's exercise of a power to distribute) won't cause a trust to be subject to GST tax if: (1) the modification doesn't shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification; and (2) the modification doesn't extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.[49] To determine whether a modification of an irrevocable trust will shift a beneficial interest to a lower generation, the effect of the instrument on the date of the modification is compared to the effect immediately before the modification. If the effect can't be immediately determined, a shift to a lower generation is deemed to have occurred.[50] The presumption that a downward shift has occurred can be troublesome when planning with a wholly discretionary trust without a clear history of distributions.[51]

Endnotes

1. Any reference herein to a "U.S. person" includes a U.S. citizen and any individual who would be considered a resident for U.S. federal income tax purposes and domiciled in the United States for U.S. federal, gift, estate and generation-skipping transfer (GST) tax purposes. In general, an individual who's a U.S. citizen, Green Card holder or who meets the "substantial presence" test (based on weighted day count) will be resident in the United States for income tax purposes. Internal Revenue Code Section 7701(a)(30). An individual is domiciled in the United States if they live in the United States and have no definite present intent to leave, as shown by the surrounding facts and circumstances. Treasury Regulations Section 20.0-1(b). It's possible to be a U.S. person for income tax purposes while still a non-domiciliary for estate tax purposes (for example, someone sent to the United States for a few years by a foreign employer who plans to return home after his assignment).
2. Although it's common in a number of jurisdictions to have someone other than the main contributor legally settle the trust, U.S. tax law generally ignores the formalities of how a trust was legally settled and treats a person as an owner under the grantor trust rules only to the extent that such person make a gratuitous transfer of cash or other property (including a transfer for less than fair market value) to the trust. *See* Treas. Regs. Section 1.671-2(e). As used herein, the terms "settlor" or "grantor" refer to someone who has made a gratuitous transfer to a trust.
3. IRC Section 672(f)(2).
4. Non-U.S. situs assets held in a trust settled by a nonresident settlor will be eligible for a basis step-up on the settlor's death only if: (1) income from the trust is payable during the settlor's lifetime to or on the order or direction of the settlor, and (2) the right is reserved to the decedent at all times before their death to revoke the trust or make any change in the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust. IRC Sections 1014(b)(2) and (3).
5. Revenue Ruling 69-70. Distributions will nonetheless be reportable by the U.S. beneficiaries in Part III of Internal Revenue Service Form 3520.
6. Generally, a corporation is a considered to be a domestic corporation for U.S.

tax purposes if it's organized in the United States and a foreign corporation for U.S. tax purposes if it's organized under the laws of a foreign country. *See* Sections 7701(a)(4) and (5). Stock of a foreign corporation isn't a U.S. situs assets for estate tax purposes. Treas. Regs. Section 20.2105-1(f).

7. Treas. Regs. Sections 1.958-1(b), 1.958-2(c)(1)(ii)(b), 1.1291-1(b)(8)(iii)(D).
8. Unlike the case with a domestic nongrantor trust, capital gains recognized by a foreign nongrantor trust are automatically included in distributable net income (DNI). IRC Section 643(a)(6).
9. Section 661(a). The trust will receive an offsetting deduction for any DNI distributed under Section 662(a), but foreign source income and gain wouldn't be taxable to a foreign nongrantor trust in the first place.
10. Treas. Regs. Sections 1.958-1(b), 1.958-2(c)(1)(ii)(a).
11. A discussion of Subpart F and global intangible low taxed income is beyond the scope of this article, but both present the potential for phantom income inclusions in the hands of the U.S. shareholders.
12. Even if the trust includes basis step-up provisions, this will only step up the basis of the trust's shares of the holding company itself. The elections are needed to step up the basis of the underlying assets. If the holding company doesn't own any U.S. situs assets, then the election (which may be filed up to 75 days after the effective date) could be made effective on or prior to the settlor's date of death so that the holding company never becomes a controlled foreign corporation (CFC) or passive foreign investment company (PFIC), and the underlying assets are deemed to be held directly by the trust for purposes of the basis step-up provisions. If the holding company owns significant U.S. situs assets, then the elections will typically be made effective two days after the date of death to eliminate the risk that the settlor could be deemed to have died owning U.S. situs assets for estate tax purposes. In that case, the election will result in a deemed liquidation, which itself would step the basis of the underlying assets. This can result in a one-time tax charge to the U.S. beneficiaries under the CFC or PFIC rules, but this is usually preferable to an estate tax inclusion. A discussion of post-mortem entity classification planning is beyond the scope of this article, but there are a number of strategies for potentially mitigating tax leakage in this scenario.
13. The isn't the case when a foreign nongrantor trust already has a pool of UNI when it's imigrated to the United States. *See* Rev. Rul. 91-6.
14. A release or lapse of a grantor trust power is treated as a transfer for this purpose. Treas. Regs. Section 1.679-5(b).
15. Treas. Regs. Section 1.679-2.
16. Technically, it's the trustee that's required to file Form 3520-A, but if the foreign trustee doesn't file the form, then the U.S. settlor must file or face the imposition of penalties.
17. IRC Section 684; Treas. Regs. Section 1.684-2(e)(1).
18. Treas. Regs. Section 1.684-2(e)(2), Ex. 2.
19. Treas. Regs. Section 1.684-1(a)(2).
20. Even this may not be necessary if the beneficiary is studying in the United States on an academic visa and plans to return home after completing their studies, as an F-1 visa may prevent them from becoming a resident for income tax purposes in the first place.
21. Section 1411(e).
22. IRC Sections 897 and 1445.
23. Section 643(i).
24. Note that the Form 3520 instructions appear to impose a reporting obligation even if the trust is a grantor trust. It's not clear whether the IRS intended to require reporting in situations that aren't covered by Section 643(i) but from a policy perspective it makes sense that constructive distributions should be reported from a grantor trust when actual distributions are required to be reported.
25. Other income may be carried out, but if such income is passive investment income (for example, dividends or interest) and properly reported and subject to withholding by the trust, this alone won't trigger return filing obligation for foreign beneficiaries.
26. Passed as part of the National Defense Authorization Act for Fiscal Year 2021.
27. This latest release by the International Consortium of Investigative Journalists follows on the heels of the earlier Panama Papers and Paradise Papers.
28. *See* Section 7701(a)(31)(B).
29. If the trustees are individuals and they live and administer the trust abroad, then there may be a question as to whether the trust can satisfy the court test even if all of the decision makers are U.S. persons and the trust satisfies the control test. Because the court test hinges on whether a court in the United States could exercise primary supervision over the administration of the trust, one would have to look to the laws of the jurisdiction in which the individual trustees and beneficiaries reside and where the trust res is located to determine whether a U.S. court or a foreign court would have primary jurisdiction. Exclusive jurisdiction isn't required and a U.S. and foreign court could both assert jurisdiction over the trust, and it could be governed by foreign law but still meet the court test if the U.S. court has primary jurisdiction.
30. This assumes the trust wasn't structured to qualify as a grantor trust as to a non-U.S. settlor under Section 672(f)(2).
31. This "inadvertent change" rule covers the death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust that would cause a change its residency but that wasn't intended to change its residency. If the necessary change is made within 12 months, the trust is treated as retaining its pre-change residency during the 12-month period. If the necessary change isn't made within 12 months, the trust's residency changes as of the date of the inadvertent change. Treas. Regs. Section 301.7701-7(d)(2)(i).
32. These rules are contained in IRC Sections 665 - 668.
33. *See* Rev. Rul. 91-6.
34. Treas. Regs. Section 1.643(c)-1.
35. Private Letter Ruling 200607015 (Nov. 4, 2005), in which the new trusts had the same dispositive provisions, the IRS determined that the decanting

wasn't a trust distribution. *Accord also* PLRs 200723014 (Feb. 5, 2007), 200736002 (May 22, 2007) and 200527007 (March 24, 2005).

36. H.R. 5376 would increase long-term capital gain rates to 25% for high earnings and most trusts (28.8% if one includes the 3.8% Medicare tax), but this would still be much better than the throwback tax.
37. *Cottage Savings Assn. v. United States*, 499 U.S. 554 (1991).
38. In PLR 200013015 (Dec. 22, 1999), the IRS found no gain under *Cottage Savings Assn.* when interests remained nearly the same. Contrast with PLR 200736002 (May 22, 2007), in which the IRS indicated that a beneficiary might realize gain if the beneficiary's interest in a successor trust, pursuant to a pro rata division of a trust, was "materially" different than in the original trust.
39. *See* Rev. Rul. 69-486 (holding that there was a sale when the beneficiaries agreed to a non-pro rata distribution that wasn't authorized by the trust terms).
40. In PLR 200010037 (Dec. 13, 1999), when the trustee proposed to divide the trust into three separate trusts, the IRS held that a sale or exchange didn't occur because the beneficiaries weren't exchanging their interests. Rather, their interests in the new trusts were acquired by reason of the exercise by the trustee of its discretionary powers. *Accord also* PLR 200207018 (Nov. 16, 2001) (deciding a sale or exchange hadn't occurred by reason of a trustee exercising its discretionary powers with respect to which the beneficiaries weren't involved and distinguishing Rev. Rul. 69-486, which held that there was a sale because the distribution required the beneficiaries' consent).
41. Proposed Treas. Regs. Section 1.1291-3(b)(1), 1.1291-6(b)(1).
42. IRC Section 1298(a)(3); Treas. Regs. Section 1.1291-1(b)(8)(iii)(C).
43. IRC Section 672(f)(4); Treas. Regs. Section 1.672(f)-4(a)(2).
44. IRC Section 2663.
45. Treas. Regs. Section 26.2601-1(b)(4)(i).
46. For example, PLR 200923014 (Feb. 27, 2009); PLR 200924018 (Feb. 25, 2009); PLR 200919018 (Jan. 12, 2009); PLR 200841027 (May 30, 2008); PLR 200841023 (May 20, 2008); PLR 200822008 (Feb. 6, 2008); and PLR 200743028 (May 29, 2007).
47. Treas. Regs. Section 26.2601-1(b)(b)(4)(i)(A).
48. *Ibid.*
49. Treas. Regs. Section 26.2601-1(b)(4)(i)(D)(1).
50. Treas. Regs. Section 26.2601-1(b)(4)(i)(D)(2).
51. However, one example in the Treasury regulations is particularly helpful if the decanting is being used as a means of creating separate trusts for each branch of a family. Treas. Regs. Section 26.2601-1(b)(4)(i)(E), Example 5.

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