Establishing 'foreign' trusts in the United States

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Introduction

Trusts remain a flexible succession planning tool for families wishing to pass wealth to future generations in a responsible manner and can include philanthropic goals. Succession planning trusts are often intended to last in perpetuity, thereby benefiting family members and charity for many generations. The wealth-creating settlor wants to establish such a trust in a jurisdiction with well-established trust laws, a stable business environment, responsive and efficient trust officers and clearly stated comprehensive annual fees. When comparing jurisdictions, the United States should be included.

Well-established trust law

Each US state has its own set of trust laws. The Uniform Trust Code developed by a national commission of lawyers has been adopted in some form by numerous states, so there is significant uniformity. Nevertheless, certain states have distinguished themselves with modern, flexible trust codes, including Delaware, South Dakota, Wyoming and New Hampshire. Key points when considering which state to use to establish a trust are as follows:

- a clear and easily accessible trust law that allows family advisers to answer questions of governance and powers;
- modern trust law provisions that foresee the possibility of moving trusts or decanting so that currently unimagined circumstances can be addressed in the future, including non-judicial settlement agreements allowing interested parties to agree to modify certain trust provisions or change trust situs;
- directed trustee legislation defining the responsibilities and liabilities of fiduciaries so the family can appoint an investment director or distribution director;
- a rule against perpetuities abolished to facilitate long-term planning;
- well-regulated trust companies where oversight by the state banking authority is consistent and effective while not being overly burdensome or intrusive; and
- an efficient court system to hear disputes.

Stable and secure location

The United States itself is a stable and secure location for trust administration. There is little danger of invasion by a hostile neighbour. The weather across the country is relatively stable with states being well-prepared for known seasonal threats such as snow, tornados, hurricanes and drought. The official language is English, which many international families speak, and it is not hard to find trust officers who also speak a second language. The American business environment means families will usually find US trust officers and legal counsel to be responsive and provide quick turnaround of documents and answers to questions.

Today's high-net-worth families often have members living and working across the world. US trust officers are readily accessible by phone or email. Time zones in the United States are the same as those in South and Central America. The time difference of six or seven hours to Europe does not cause extended delays and trust officers with Asian clients work hours designed to capture a portion of the Asian work day.

Consistent tax treatment

Most trusts established in offshore jurisdictions such as Bermuda, the Bahamas or the Cayman Islands are not subject to tax in those jurisdictions. The settlor may be subject to tax in his or her home country and beneficiaries may be subject to tax upon receiving distributions, but the trust is not subject to tax by the offshore jurisdiction. The trust fiduciary business itself provides jobs and revenue. Likewise, a trust can be established in a US state with a US trust company as trustee and not be taxed as a US domestic trust. The presence of successful professional trust companies brings economic advantages to the US state as it does to an offshore jurisdiction.

The tax classification of trusts is clearly defined under US tax law. If a non-US person has the power to make a significant decision for the trust, then the trust is classified as a 'foreign' trust for US tax purposes. If the non-US settlor retains the power to revoke the trust, or if an irrevocable trust is solely for the benefit of the non-US settlor and that settlor's spouse, the trust is also a 'grantor' trust. Income earned in a grantor trust is attributable to the settlor for US tax purposes (for further details, please see "Overview (March 2018)"). Foreign trusts, whether based in or outside the United States, are subject to US withholding tax and reporting under rules applicable to non-resident aliens and to the Foreign Account Tax Compliance Act (FATCA) due diligence and reporting.

In its recent directive requiring banks, legal counsel, investment managers and other advisers to report on certain structures, the European Union included the use of a jurisdiction where the entity is not subject to tax as an indicator of planning to facilitate tax evasion. This sweeping statement is unfortunate because it discounts individuals that are fully tax compliant in their home jurisdictions and dismisses legitimate revenue generating choices, such as value added tax, sales tax and thriving local business. The state of Florida does not tax individuals on passive dividend and interest income, but nevertheless thrives on retirees residing within its sunny borders. A foreign trust established in a US state is not subject to tax as if it were a US person, but it is still subject to US tax levied on US source income. A foreign trust or company, wherever established, that receives US source income (eg, dividends from investments in US stock) is subject to US withholding tax at the highest 30% rate (unless reduced by a treaty). Does this make the United States a jurisdiction where the entity is not subject to tax?

Merely choosing the United States as the place for trust administration should not by itself cast suspicion on the non-US settlor. The United States has substantial tax and reporting laws that apply to US persons when they establish trusts, including trusts outside the United States. Some other countries likewise tax their residents on gifts and other transfers. US trust companies are subject to extensive due diligence requirements and will inquire into the source of funds used to settle a trust and request certification that the settlor is tax compliant in his or her jurisdiction of residence.

Effective due diligence and reporting

US trust companies are state regulated and subject to state banking commission know-your-customer (KYC) and anti-money laundering (AML) due diligence requirements. There are also national charters and federal level regulations. US trust companies are subject to the USA PATRIOT Act and must file suspicious activity reports. Trust companies carry out due diligence on all settlors, beneficiaries and fiduciaries. As in offshore jurisdictions, reputable trust companies have no desire to facilitate money laundering, terrorist financing or tax evasion.

The United States may not be a party to the Common Reporting Standard (CRS), but due diligence and reporting is still extensive. Foreign trusts established under the law of a US state are subject to FATCA (for further details please see "FATCA documentation for US-based trusts"). Unlike some aspects of the CRS, FATCA reporting respects the principal of proportionality. US beneficiaries who receive distributions from a foreign trust have a US reporting obligation, as do US settlors of foreign trusts; both are reportable under FATCA. US trustees and protectors who do not receive distributions have no US reporting obligations and so are not reported under FATCA. Thus, the targeted FATCA reporting combats US tax evasion.

In addition to FATCA, US trust companies comply with all applicable laws and regulations, including as follows:

- Distributions to US beneficiaries from foreign trusts are reported to the Internal Revenue Service (IRS) under FATCA.
- Under FATCA, a US trustee of a foreign trust must subject distributions to withholding unless the recipient beneficiary provides status certification.
- US financial institutions collect foreign tax identification numbers.
- Distributions to non-US beneficiaries are subject to US withholding tax to the extent that the distribution includes US source dividends and interest and these amounts are reported to the IRS, including the beneficiary's name and foreign tax identification number.
- The Bank Secrecy Act requires the reporting of certain currency transactions and is not limited to traditional banks.
- A trust's non-US bank accounts are reported by the US trustee on an annual foreign bank account report (commonly referred to as an 'FBAR').
- The United Sates is party to treaty and tax information exchange agreements with numerous countries, which results in information being available to law enforcement and government authorities.
- Although the likelihood of enactment is uncertain, former President Barack Obama submitted to the US Senate an amendment to the Convention on Mutual Administrative Assistance in Tax Matters, which would implement automatic exchange of information.

The EU directive indicates that the use of entities in jurisdictions without automatic exchange of information is another indicator of a structure motivated by tax avoidance. US trust companies stand ready to comply with any new laws, as evidenced by the recent reporting requirement for US limited liability companies (LLCs) owned by non-US persons, including foreign trusts (for further details, please see "Completing and filing Form 5472 for foreign-owned US LLC"). The fact that legislation implementing automatic exchange of information has not been enacted by the federal government should not eliminate US trust companies from consideration as responsible fiduciaries. Avoiding creditors and evading tax laws have never been acceptable reasons for establishing trusts. US trust companies, like their counterparts in the offshore jurisdictions, expect settlors to be fully tax compliant in the settlor's country of tax residence. There is nothing to be gained by reputable US trust companies facilitating tax evasion, money laundering or terrorist financing.

Tax planning options preserved

A non-US settlor wishing to establish a foreign trust under the law of a US state will likely want to use an underlying corporation to act as a blocker against US estate tax on US situs investments (for further details please see "Overview (March 2018)"). This is an accepted form of tax planning used globally and does not violate any US tax laws. In certain circumstances, a US Virgin Islands (USVI) corporation may be an option. The USVI is a US territory. Its close proximity to the United States and ease of travel and communication makes it a good fit for a holding company established by a foreign grantor trust in a US state where the family does not currently have US members. Because for tax purposes a 'US person' does not include entities established outside the 50 states and the District of Columbia, some trusts may be able to establish a USVI corporation to hold US investments, shielding the non-US settlor from US estate tax, just as is the case with, for example, a British Virgin Islands company. A USVI company can be exempt from USVI income tax as long as it is not owned by a US person or a USVI resident.

Under the FATCA regulations, territory entities that meet the criteria of an investment entity must certify to a FATCA status of 'passive non-financial foreign entity (NFFE)' and provide information on any substantial US owners. The USVI is not a party to the CRS, so the USVI entity itself does not have CRS due diligence or reporting obligations. Nevertheless, CRS reporting can occur. A USVI corporation classified as an investment entity because it is managed by another investment entity will be treated as a 'passive NFE' by financial institutions in CRS participating jurisdictions, which will collect and report information on the entity's controlling persons. Financial institutions in the United States will collect all information required by US law, regularly run names through federally mandated AML and anti-terrorist financing (ATF) screening lists and cooperate with investigators.

Some differences to note when using a USVI company in a family succession planning structure include as follows:

- A USVI corporation cannot make an entity classification election (commonly called a 'check-the-box' election) to be disregarded for US tax purposes.
- An LLC can be created under USVI law but will be required to file Form 5472 annually in order to report transactions with its foreign owner.
- The definition of 'US person' is different under US securities laws so that a USVI corporation cannot participate in fund investments that exclude US persons, even though the USVI corporation is not a US person under tax law and is subject to US withholding tax.

Families wishing to use a USVI corporation in their US-based succession planning structures should note that the European Union recently added the USVI to its blacklist of tax havens and has requested the Organisation for Economic Co-operation and Development (OECD) to analyse whether the United States should be blacklisted. This blacklisting is unfortunate, since trust registers and publicly available lists of beneficial owners are not substitutes for reputable company service providers that carefully consider due diligence documentation and actively maintain AML and ATF screens. The irony of the United States having previously participated in OECD initiatives declaring certain offshore jurisdictions as engaging in unfair tax competition is not lost on those in this field.

Comment

US trust laws and US trust companies are not motivated by a desire to facilitate tax evasion, money laundering or terrorist financing. Family matriarchs and patriarchs who have built businesses and legally amassed wealth often wish to pass that wealth onto future generations in a responsible manner. Trust structures are time tested in meeting such goals, including foreign trusts established in the United States. Ignoring traditional boundaries regarding individual rights to privacy, the European Union is leaning more and more on reporting and public access to personal information in an attempt to decrease tax evasion. This may cause non-EU families who are motivated by succession planning – not tax evasion – to move away from traditional European and offshore trust and company service providers and investment firms. Instead, these families may choose the stability and flexibility of US trusts with US trust companies and US investment firms that are careful not to facilitate tax evasion, money laundering or terrorist financing and fully comply with all applicable tax and reporting obligations, but have not fallen subject to short-sighted political currents subjecting personal details to public display.

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