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# Pre-residency Tax Planning and Offshore Trusts

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An individual who is not resident in the United States and not a citizen of the United States (a 'non-resident alien' (NRA)), but who is intending to immigrate to the United States, should carefully consider the US tax laws and available planning opportunities, especially when that individual has funded an offshore trust. The basic US tax rules relevant to NRAs and US residents are detailed in the Overview (March 2003). The complexity and breadth of those basic rules generally result in the taxation of income earned in the offshore trust to the US-resident settlor. Pre-residency tax planning may ameliorate this result, especially where the settlor is not planning to remain in the United States indefinitely.

### Offshore Trust Funded Within Five Years of Immigration

If the NRA settlor funded the foreign trust within five years of immigration to the United States, then the settlor will be deemed to have made a transfer to the foreign trust on the date he or she becomes a US income tax resident. The now US-resident settlor will be treated as the owner of the trust assets for income tax purposes under the grantor trust rules. (The test for whether a trust is taxed as foreign or domestic and details of the grantor trust rules are set out in "Taxation of Offshore Trusts and Impact of New Lower Tax Rates".) As a result, the settlor will be subject to US tax on the trust's worldwide income. Income earned before the US residency starting date will not be subject to US tax, unless it was US-source income subject to the withholding tax. The trust will be considered a foreign grantor trust for US tax purposes.

Where the settlor has not retained an interest in the trust that would otherwise trigger US grantor trust treatment, the deemed transfer result can be avoided if the foreign trust does not have any US beneficiaries once the settlor becomes a US income tax resident. As potential and future beneficiaries are considered, the trust document should include language prohibiting the addition of US persons as beneficiaries. Pre-residency tax planning can effectively address these issues.

If the NRA settlor has not transferred assets to the foreign trust within the five years prior to immigration, then there will be no deemed transfer to the trust upon the settlor's immigration to the United States. The settlor will not be treated as the owner of the trust assets for US income tax purposes, assuming no transfers are made to the trust while resident in the United States and provided the settlor has not retained an interest in the trust that would otherwise trigger US grantor trust treatment, as discussed below.

**Grantor Trust as a Result of Settlor's Retained Interests**

Regardless of when the settlor transferred assets to the offshore trust, the income of a foreign trust will be taxed to the now US-resident settlor under the US grantor trust rules if the settlor has retained certain rights, benefits or powers over the trust. For example, a common planning technique is for an NRA settlor to fund a foreign trust that is revocable by the NRA settlor. Such a trust can benefit the settlor's US children and grandchildren without their being subject to US income tax. Alternatively, the NRA settlor may have settled an offshore trust that is solely for the benefit of the settlor and the settlor's spouse during the settlor's lifetime. This trust can accumulate income free of US tax (other than withholding tax on US-source income) during the settlor's lifetime and then be paid out to the settlor's US children and grandchildren or to a US domestic trust for their benefit at the death of the settlor, with favourable US tax consequences.

However, when the NRA settlor of such a trust becomes a US income tax resident, the trust will be considered a grantor trust and the settlor will be subject to US tax on the trust's worldwide income. Pre-residency tax planning may be able to avoid this result by resettling the trust, amending its provisions or otherwise providing for the release of the settlor's retained interests.

**Grantor Trust Owning Stock of Foreign Corporation**

In addition to the income tax impact on a now US-resident settlor of a foreign grantor trust, the trust's holdings of corporate stock could cause application of the complex and far-reaching US foreign personal holding company, controlled foreign corporation or passive foreign investment company rules. These rules can lead to income earned in the company being attributed to the US-resident settlor even though no dividends have been paid, as in the case of a controlled foreign corporation or foreign personal holding company. If the company is a passive foreign investment company, the settlor will incur an interest charge upon the sale of stock while the settlor is a US income tax resident and departure from the United States may trigger a taxable deemed disposition of the stock.

Pre-residency tax planning can be beneficial in situations where the NRA's offshore trust holds stock in a foreign corporation, as it is generally too late to avoid adverse US income tax consequences when these corporate shareholdings are restructured after the NRA becomes a US income tax resident.

**Foreign Non-grantor Trusts**

If the offshore trust is not considered a grantor trust for US income tax purposes, the trust will be taxed as a foreign non-grantor trust. Non-grantor trusts, rather than allocating income to the settlor, are treated as taxable entities. Income is passed through to the beneficiaries to the extent of distributions, while income not passed through to the beneficiaries is taxed to the trust itself.

Pre-residency tax planning can evaluate whether such trust's ownership of foreign investment companies will be subject to the foreign personal holding company, controlled foreign corporation or passive foreign investment company rules. In addition, pre-residency tax planning can prepare the family for the tax and interest charges levied on the US beneficiaries receiving distributions from the foreign non-grantor trust, as well as advise on the US reporting requirements (for further details please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates"). If the foreign trust is expected to accumulate income, the trustee should consider possibly converting the foreign trust to a US domestic trust.

**Whether to Convert a Foreign Non-Grantor Trust to a US Domestic Trust**

Whether to convert a foreign trust to a US domestic trust is a fact-specific decision that should take into account the following:

- whether the trust has or will acquire US beneficiaries;

- how long the existing or potential US beneficiaries will remain US income tax resident; and

- the trust's investment and distribution strategy both at the time of conversion and in the future.

The possibility of a change in US tax law should also be considered.

***Tax-free accumulation of income***

A foreign non-grantor trust can accumulate income tax free (except for withholding tax on US-source income). However, any distribution to a US beneficiary of amounts accumulated in a foreign trust will be subject to an interest charge and the throw-back rules (for further details please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates"). Distributions of current income to a US beneficiary are not subject to the interest charge or throw-back rules. Similarly, distributions from accumulated capital gains (but not current-year gains) will be taxed at ordinary income rates when received by a US beneficiary.

Allowing income to accumulate in a foreign trust for several years is one alternative that should be considered as part of any pre-residency tax planning. After several years of accumulating income tax free, the trust could then start distributing current income (including capital gains). This strategy allows the trust to build up a larger asset base, which in turn generates more current income each year. If the deferral period is long and the trust generates a sufficient return on its assets, accumulating income tax-free for several years to build a large asset base and then distributing the larger future current income stream to US beneficiaries may produce a better economic result than converting the trust to a US domestic trust.

***Accumulated income retains foreign character in converted trust***

Migrating a foreign trust to the United States is an alternative to leaving the trust offshore. A pre-residency tax planning evaluation would detail any further changes necessary for the trust to be taxed as a US domestic trust. However, even after qualifying as a US domestic trust, amounts accumulated while offshore will retain their foreign character so that a distribution to a US beneficiary of such accumulated income will be subject to the above-mentioned interest charge and throw-back rules on accumulation distributions from foreign trusts. Trust income earned after converting the trust to a US domestic trust will be taxed to the trust if accumulated or to the beneficiary if distributed.

Pre-residency tax planning involving a pour-over to other trusts (or non-US beneficiaries) prior to the conversion, or even after, may reduce the US tax impact on previously accumulated income.

***Converted trust's ownership of foreign company stock***

In all cases the NRA needs to know whether any investment companies owned by the trust will be subject to the foreign personal holding company, controlled foreign corporation or passive foreign investment company tax regimes. If so, then the NRA should restructure the companies early in order to avoid application of the rules. For example, the investment entities can be reorganized as partnerships or limited liability companies. This conversion to partnership status could be accomplished through a check-the-box election or possibly through an amendment of the organization's governing instrument. If possible, a restructuring of the investment companies owned by the trust should be completed prior to the NRA's immigration into the United States, since the restructuring generally will be treated as a corporate liquidation for US tax purposes.

**Unfavourable Tax Implications of Returning Home**

Application of the US grantor trust rules can have unfavourable tax results for the NRA who settles a foreign trust, immigrates to the United States and becomes a US taxpayer, and then returns to his or her home country (the 'round-trip NRA'). Most individuals, and wealthy immigrants to the United States in particular, prefer to maintain flexibility. The following analysis suggests that the desire for such flexibility risks an inflexible tax result without careful pre-residency tax planning.

An NRA settlor who becomes a US tax resident within five years of directly or indirectly transferring property to a foreign trust is treated as transferring the property to the foreign trust on the settlor's residency starting date. The now US-resident settlor is treated as owning the assets of the foreign trust under the grantor trust rules.

Regulations to the Internal Revenue Code provide that if any portion of a foreign trust treated as owned by a US person under the grantor trust rules ceases to be treated as owned by that person (other than by reason of an actual transfer of property from the trust), the US person will be treated as having transferred, immediately before (but on the same date that) the trust is no longer treated as owned by that US person, the assets of such portion to a foreign trust. The settlor must then recognize a taxable gain equal to the excess of the property's fair market value over its adjusted basis.

Examples provided in the regulations include foreign trusts where the US person ceases to be treated as the owner because:

- the foreign trust ceases to have a US beneficiary;
- the US grantor dies; or
- the US grantor releases a power to revoke a foreign trust that has no US beneficiaries.

It seems that a similar result follows when the US person ceases to be treated as the owner of the foreign trust under the five-year deemed transfer rule, because that person has abandoned his or her US tax residency.

For example, assume that in 2000 an NRA settlor creates an irrevocable trust for the benefit of the settlor's US and non-US children and grandchildren, which is a foreign non-grantor trust for US tax purposes. Now assume that the NRA settlor becomes a US income tax resident in 2004. The settlor, under the five-year deemed transfer rule, is now treated as the owner of the trust assets under the US grantor trust rules, solely due to his or her current status as a US taxpayer. Now assume that the settlor abandons US residency and returns to his or her home country. The trust is no longer treated as owned by a US person.

There is a real risk that abandoning US taxpayer status under these circumstances will be treated as a taxable transfer by a US person to a foreign non-grantor trust, with the transfer being deemed to have occurred immediately before (but on the same date) as the settlor loses his or her US residency status. A tax would then be due on the recognition of gain as if the trust property had been sold or exchanged for its fair market value.

This round-trip NRA typically will be in a worse tax position than the long-term US resident whose expatriation had for one of its principal purposes the avoidance of taxes. The long-term resident (an individual who is a lawful permanent resident of the United States in at least eight of the last 15 years) receives the benefit of an inbound step-up in basis for purposes of determining any tax imposed by reason of such expatriation, and may be entitled to an exception to immediate gain recognition if he or she agrees to treat income from such property as US source during the 10-year period following expatriation, neither of which is available to the round-trip NRA. For further discussion of the tax consequences of a tax-motivated loss of residence please see the Overview (March 2003).

Whether or not an NRA intending to immigrate to the US plans to return home, the benefits of pre-residency tax planning are tangible both in the sense of tax savings and in educating the family as to US tax reporting and compliance issues.

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