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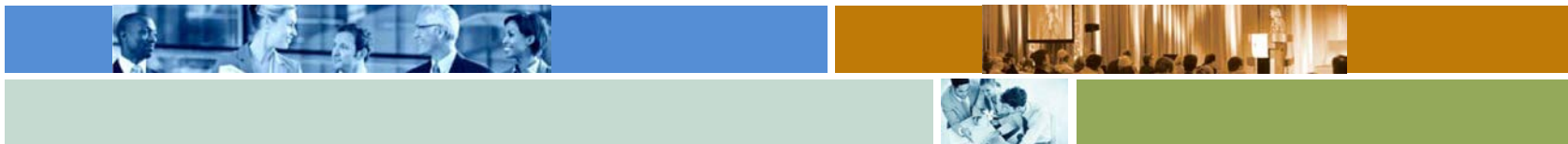


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# U.S. PFTCs and Foreign Trusts, Foreign Assets, and Non-U.S. Resident Family Members

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# Global Wealthy in the Crosshairs

- Sensible US efforts to combat money-laundering and terrorist financing has led to intergovernmental efforts to promote transparency and cooperation in exchange of information and revenue collection
- Governments can agree on one thing: wealthy families must be identified, tagged and classified for further study and taxation
- Trend toward public disclosure of beneficial owners of trusts and companies
- Real risk of sensitive family information falling into the wrong hands
- How to comply with bank and regulatory disclosure requirements while safeguarding family information?
- What happens when you combine governmental incompetence with information sharing?

# Must Know Terminology and Acronyms

- KYC (Know your customer/client)
- OECD (Organization for Economic Cooperation and Development)
- FATF (Financial Action Task Force)
- AML (Anti-money laundering)
- FATCA (Foreign Account Tax Compliance Act)
- IGA (Intergovernmental Agreement) (Model 1 or Model 2)
- Fourth European Directive on AML
- CRS (Common Reporting and Due Diligence Standard)
- CAA (Competent Authority Agreement)
- OT (British Overseas Territories)

# Common Cross-Border Scenarios for Global Families

- Trust beneficiary studying, working, living abroad
- Trust beneficiary marrying non-US citizen
- Domicile, residency and the modern multi-jurisdictional family
- The peripatetic family member with extensive non-US holdings
- The “migratory” trust
- Trustees residing abroad
- Domestic trust with non-US beneficiaries
- Foreign trust with US beneficiaries
- Expatriation

# Distinguishing between Domestic and Foreign Trusts

- A trust is a foreign trust if it fails either:
  - Court Test or
  - Control Test

# Court Test

- Safe harbor:
  - Trust instrument does not direct that trust be administered outside U.S.; and
  - Trust is administered exclusively within the U.S; and
  - Trust does not have an automatic migration clauseor
- U.S. court is able to exercise *primary* supervision over administration of trust

## Control Test

- One or more U.S. persons have authority to control all substantial decisions of the trust
- Substantial decisions include:
  - Distribution decisions
  - Selection of beneficiaries
  - Power to terminate
  - Power to remove, add or replace trustees
  - Investment decisions

## Curing Inadvertent Trust Migrations

- IRS recognizes that a domestic trust unintentionally may become a foreign trust through changes in identity of individuals who control substantial decisions.
- If “death, incapacity, resignation, change in residency or other change” with respect to such an individual would cause the trust to flunk the control test, trust has 12 months to “cure” the migration. Treas. Reg. §301.7701-7(d)(2)(i).
- How to cure – replace the person who caused the change in status, or, that person becomes a U.S. person during the 12-month period.



## “Expatriating” a Domestic Non-Grantor Trust

- One of the easiest ways to turn an old domestic, irrevocable non-grantor trust into a grantor trust is to make it a foreign trust.
- Deliberately flunk the control test by giving a non-U.S. person control over one substantial decision, e.g., power to remove the trustee (“remover”).
- Outbound migration requires filing Form 3520 and requires annual form 3520-A filings while trust is a foreign grantor trust.
- Turn off grantor trust status by substituting a U.S. person for the foreign remover.

## “Expatriating” a Domestic Non-Grantor Trust (cont’d)

- Risk -- if the grantor dies while the trust is a foreign trust, a deemed disposition will occur under §684.
- To mitigate this risk, trust should regularly sell assets to generate basis.
- This strategy of selling capital gain assets is consistent with overall grantor trust strategy of facilitating gift-tax free gifting to the irrevocable trust.
- Another way to address §684 risk -- if grantor is in bad shape, foreign remover can resign in favor of domestic remover, thereby domesticating trust.

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# Foreign Trusts

- Foreign grantor trust with U.S. grantor and U.S. beneficiaries
- Foreign non-grantor trust
- Foreign grantor trust with NRA grantor

## Taxation of Foreign Grantor Trust with U.S. Person as Grantor

- Taxed in same manner as a domestic grantor trust
- Foreign trust will be deemed to have a U.S. beneficiary unless both of the following tests are satisfied:
  - No part of income or principal of trust may be paid or accumulated for the direct or indirect benefit of a U.S. person; and
  - If the trust is terminated, no part of the income or principal can be paid, either directly or indirectly, to a U.S. person
- Determination of whether trust has U.S. beneficiary is made annually

## Foreign Trusts with U.S. Grantor

- Exceptions to the general rule under §679 include:
  - Transfer to a foreign trust by reason of the death of the U.S. transferor
  - Transfer to various tax-exempt foreign trusts
  - Transfer to a foreign trust in exchange for the property's fair market value
- If NRA transfers property to a foreign trust and becomes U.S. person within 5 years, the transfer is deemed to take place on date NRA became U.S. person

# Taxation of Foreign Non-Grantor Trust

- Trust is taxed as NRA
- U.S. source income is subject to U.S. income tax
- Distributions to U.S. beneficiary taxable to U.S. beneficiary
- Applicability of “throwback rules”
- Difficult, if not impossible, to cleanse the accumulated income

## Distributions from Foreign Trusts

- U.S. beneficiary must treat receipt of any distribution from foreign trust as a distribution from a non-grantor trust unless beneficiary can establish otherwise. §6048(c)(2).
- If distribution from foreign non-grantor trust does not exceed trust's DNI, beneficiary includes DNI deemed distributed on his U.S. tax return.
  - Foreign trust's DNI includes trust's realized capital gains.
  - Like a nonresident alien, foreign non-grantor trust not subject to U.S. income tax on capital gains from sale of U.S. assets (excluding real property).
  - Inclusion of foreign trust's realized capital gain in its DNI effectively makes its capital gains subject to U.S. income tax to the extent the trustee makes a distribution to a U.S. beneficiary

## Throwback Tax on Accumulation Distributions

- Distribution from foreign non-grantor trust in excess of trust's DNI is an "accumulation distribution" and triggers "throwback tax".
- Accumulation distribution is based on trust's undistributed net income ("UNI") for prior years.
- Because a foreign trust's DNI includes its realized gains, trust could have substantial amounts of UNI, causing a large accumulation distribution.
- Purpose of throwback tax is to capture the U.S. tax that would have been paid had the trust distributed accumulated income to the U.S. beneficiary on a current basis.



## Throwback Tax on Accumulation Distributions (cont'd)

- Throwback tax triggers income tax for previous years even though beneficiary may never have received a distribution from trust in previous years.
- Interest payments on tax could wipe out much of the accumulation distribution.
- Throwback tax applies without regard to whether the UNI was capital gain or ordinary income, thereby eliminating benefit of lower capital gains tax rates for U.S. beneficiary.

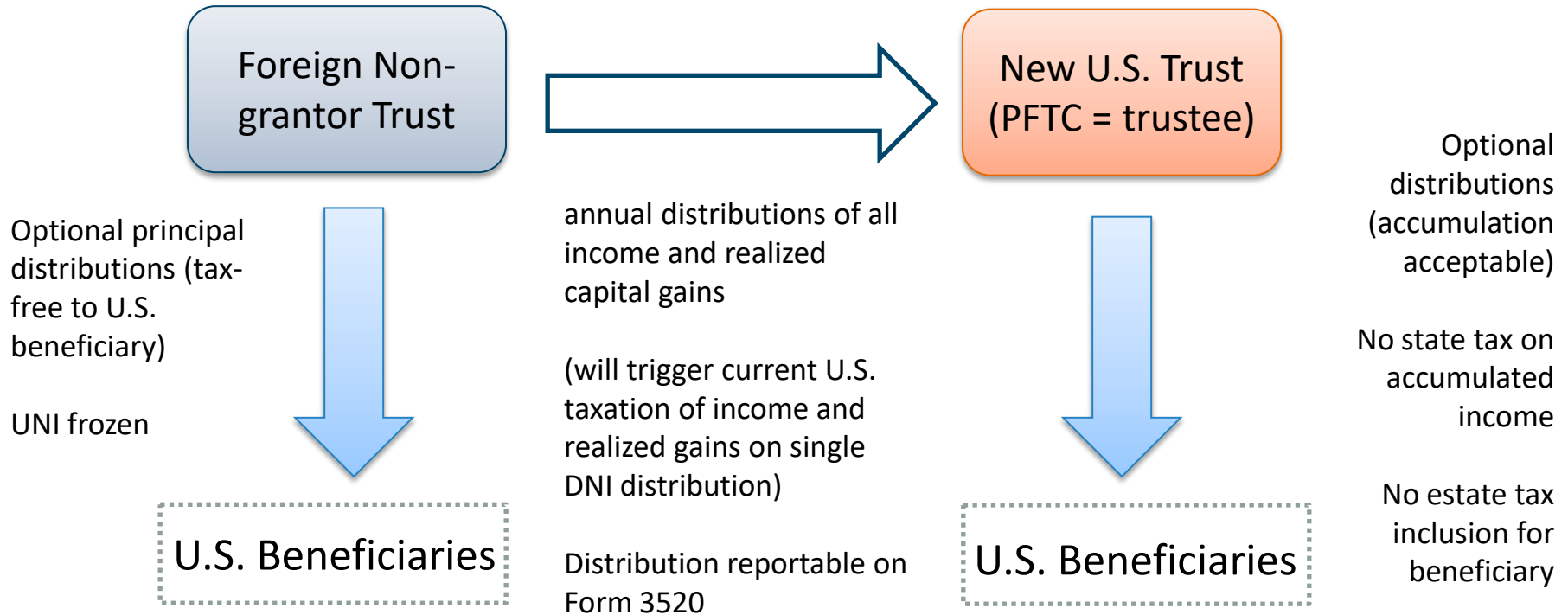
## Avoiding Throwback Tax

- Distributing all DNI to U.S. beneficiary on annual basis avoids build-up of UNI and avoids throwback tax on accumulation distributions.
- But U.S. beneficiary may not want or need all DNI.
- U.S. beneficiary might prefer to keep assets out of her estate:
  - for U.S. estate tax purposes
  - for creditor protection purposes
- Also, policy of distributing all DNI to beneficiaries may not be desirable if foreign trust also has non-U.S. beneficiaries.

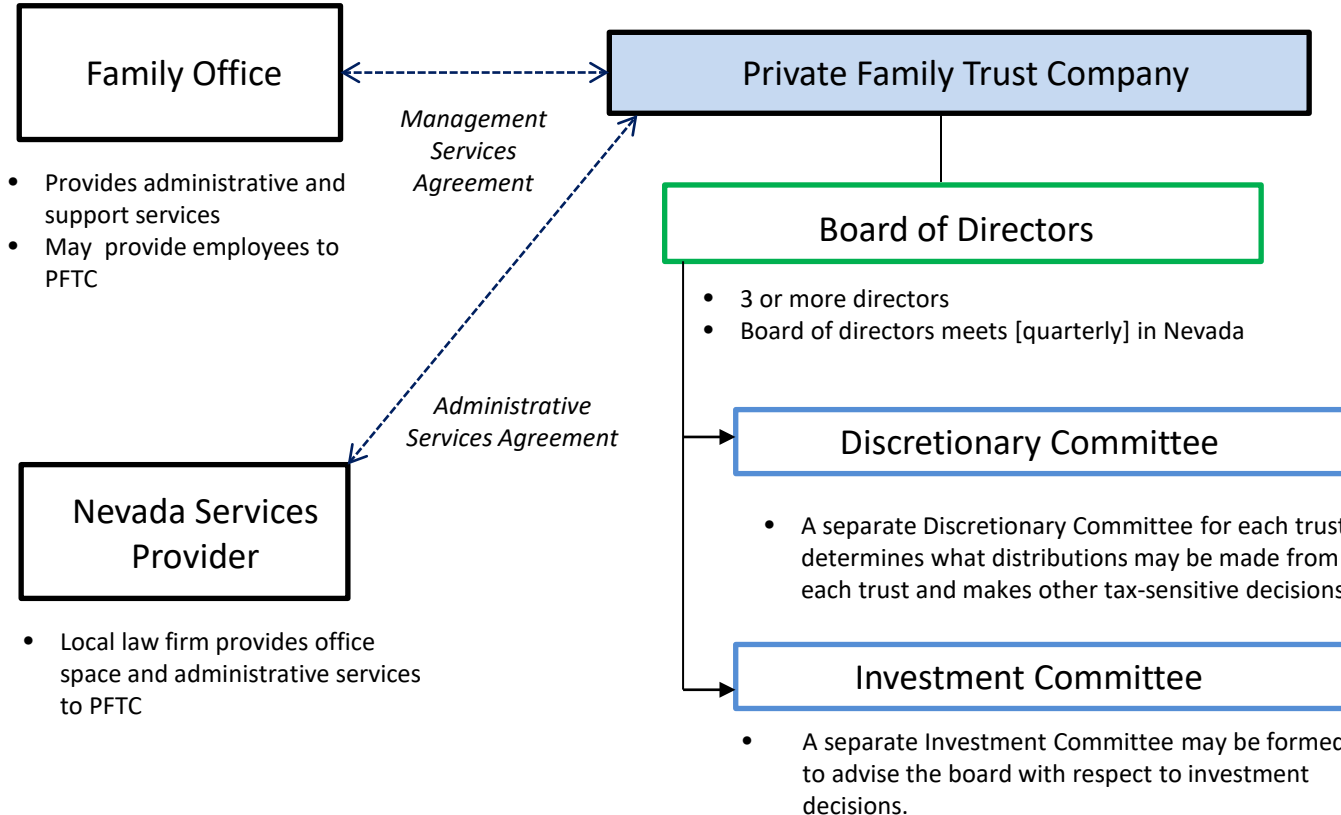
## Solution: Distribute Excess DNI to U.S. Receptacle Trust

- Trustee of foreign non-grantor trust can distribute excess DNI to a domestic non-grantor trust for the beneficiary (“receptacle trust”).
- If desirable, income and gains can accumulate in receptacle trust without attracting throwback tax.
- Terms of receptacle trust may (but need not) mirror terms of foreign trust.
- Trust may be structured so as not to be includible in U.S. beneficiary’s estate.
- U.S. beneficiary may have non-general power of appointment on death.

# Distribution of Excess DNI to U.S. Receptacle Trust



# Representative Nevada PFTC Structure



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# Taxation of Foreign Grantor Trust with NRA Grantor

- Most beneficial from a tax perspective
- No U.S. income tax except on U.S. source income
- Distributions to U.S. person do not carry out DNI

## Taxation of Foreign Grantor Trust with NRA as Grantor (Cont'd) §672(f)(2)

- Revocable without consent of another or with consent of subservient person

or

- The grantor and/or the grantor's spouse are the sole beneficiaries of the trust during grantor's lifetime

# Recognition of Gain on Transfers to Foreign Trusts and §684

- Immediate recognition of gain upon transfer of appreciated property by a U.S. person to a foreign trust
- Applies to direct, indirect and constructive transfers to a foreign trust



# Recognition of Gain on Transfer to Foreign Trusts and §684 (Cont'd)

## ➤ Exceptions:

- A transfer to a foreign trust which is a grantor trust
- A transfer to a foreign trust which is exempt under 501(c)(3)
- A transfer to a foreign trust by reason of death of the U.S. person if property is includable in the transferor's estate
- A transfer to a foreign trust in exchange for fair market value

## Use of Domestic Situs Trusts for Non-U.S. Beneficiaries

### ➤ Advantages:

- Grantor/Beneficiaries may be domiciled in civil law jurisdictions that do not recognize trusts (caveat: may not be suitable for grantors or beneficiaries who are tax resident in certain jurisdictions)
- Stable political/economic environment
- Well established trust law
- Little or no state income tax
- Several states offer ability to continue in perpetuity
- Creditor protection

# Common Reporting Standards

- Global response to FATCA (led by OECD)
- Automatic exchange of information
- United States has not signed on to CRS (why not?)
- Implications for U.S. trustees (including PFTCs)
- Privacy considerations and foreign trusts with U.S. trustee

# Bank-Secrecy Act and OFAC Considerations

- PFTC may not be required to implement AML program but PFTC custodian will be required to have AML program
- Consider delegation, if foreign co-trustee
- PFTC required to maintain customer identification program, identification of foreign parties
- Office of Foreign Assets Control (OFAC) compliance and screening

➤ Thank you for your time and attention!

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