Issues Family Offices Face When A Client Marries a Noncitizen

Trusts & Estates

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Four important, but often overlooked, planning scenarios

Most family offices that serve U.S. families are well aware that special planning considerations can arise when a U.S. citizen family member marries a noncitizen. Should the client's estate plan be revised to incorporate a qualified domestic trust (QDOT) to ensure that assets passing to the surviving noncitizen spouse qualify for the federal estate tax marital deduction? Use of QDOT planning may or may notbe appropriate, particularly for couples who reside in jurisdictions, such as France, which strongly disfavor the transfer of wealth through trusts.[1] While QDOT planning will be an important consideration in structuring the couple's estate plan, the well-prepared family office should be aware of the many other tax, property law and information reporting considerations that will need to be addressed, depending on where the couple resides, the nature of their property and the existence of trusts for their benefit. Here are four important, but often overlooked, planning scenarios that family offices and advisors should review proactively in anticipation of a client's marriage to a noncitizen: 1) S corporation planning; 2) premarital agreements; 3) trust beneficiaries residing abroad; and 4) trustees residing abroad.

S Corporation Planning

One of us will never forget the moment, many years ago, when a family office informed us that a young client, who was a beneficiary of several electing small business trusts (ESBTs) that held S corporation stock in a major family business, had married a noncitizen and informed her family after the fact. A nonresident alien isn't an eligible shareholder of an S corporation.[2] Under several trusts, the client had a lifetime limited power of appointment (POA) over trust principal that was exercisable in favor of her spouse. Under the law in effect at that time and the nature of her POA, the client's marriage to the noncitizen had the effect of terminating the S election for the family business. As is the case today, if a nonresident alien is a potential current beneficiary of an ESBT, the S election terminates.[3] Now, however, the Treasury regulations clarify that a person to whom a distribution may be made pursuant to a lifetime or testamentary POA is deemed not to be a potential current beneficiary of an ESBT unless the power is actually exercised in favor of that person.[4] At the time of the client's marriage, the regulations didn't contain the "actual exercise" proviso. Several private letter rulings later, we obtained relief from inadvertent termination of the

S election,[5] though in the process, the client had to release her lifetime POA in favor of her spouse. Subsequently, the regulations were modified to eliminate this trap for the unwary.[6]

While many practitioners are aware that planning for S corporations and nonresident aliens raises special considerations, they often overlook the property law issues that can arise when a client marries a noncitizen. For example, what if the client and the noncitizen spouse decide to reside outside of the United States? A noncitizen spouse who resides in the United States and is a resident alien for income tax purposes is an eligible shareholder of an S corporation, as is a noncitizen spouse who resides outside the United States but elects to file a joint tax return and be treated as a U.S. resident pursuant to Internal Revenue Code Section 6013(g). However, when the couple is building a life outside the United States, the noncitizen spouse may have no desire to elect to be treated as a U.S. resident for income tax purposes, with all of the tax and foreign information reporting complications that the election entails. Moreover, under the property and marital laws of the foreign country, a client's stock in an S corporation formed during the marriage may be considered community property in which both spouses have an equal ownership. In that case, the corporation's S election would be invalid.[7] Thankfully, most civil law jurisdictions with community property rules recognize that one spouse's inherited S corporation stock should be treated as that spouse's separate property. Still, couples living abroad must be aware that local marital property law could affect the client spouse's planning for U.S. assets, not to mention local assets.

Premarital Agreements

For this reason and due to general uncertainty about how foreign property laws will affect a client's property, family offices should consider carefully whether a client who's marrying a noncitizen should have a premarital agreement. While a wealthy client typically will need a premarital agreement, if the prospective spouse is a noncitizen, the family office should pay special attention to the international issues raised by the marriage, especially if the client decides to live in one or more countries before settling down in the United States.

This can be a difficult exercise for a young, globetrotting client who may not need to work and who wants the freedom to be able to live with his spouse in the United States or abroad. Issues that the family office should address include: 1) where the marriage ceremony will take place (as local law may have a bearing on the marital property regime applicable to the couple); 2) in which country will the couple reside after the marriage; 3) the governing law of the agreement; 4) the property law associated with the prospective spouse's countries of citizenship or residence; 5) the forum for divorce proceedings; 6) methods for resolving jurisdictional conflicts; and 7) the integration of a U.S.-style premarital agreement with a premarital or property law agreement in other relevant jurisdictions, such as the couple's country of residence.

It's important to note that couples in most civil law jurisdictions can formally elect the property law regime that will govern their marital and non-marital assets.[8] In such jurisdictions, including France, Germany and Brazil to name a few, a couple can elect to treat their individually owned or inherited property as separate property in much the same way that a U.S.-style premarital agreement would so specify. Such agreements, which are often signed in the presence of a notary but without legal advice, can be harmonized with the U.S. agreement to minimize jurisdictional conflicts.

Of course, to be valid in most states, the parties to a premarital agreement must have independent legal counsel and provide some level of disclosure of their assets. One obstacle to signing a premarital agreement with a noncitizen is that most countries don't have a tradition of a high level of asset disclosure prior to the marriage.[9] This is especially the case when "family assets," beneficial interests in trusts and potential inheritances are at issue. Noncitizens sometimes balk at asset disclosure best practices, which should be a warning sign, especially given the formerly widespread practice of tax evasion by individuals using jurisdictions such as Switzerland, Liechtenstein and Luxembourg. Particularly if a noncitizen of means has been a resident alien, and therefore subject to reporting certain foreign bank and securities accounts, it will be critical to ensure, in advance of the marriage, that his tax and foreign information reporting affairs are in order, so that your client doesn't start filing joint returns with a non-compliant spouse.

Trust Beneficiaries Living Abroad

Family offices also should be cognizant of how a foreign country will view a client's beneficial interest in a domestic trust when the client is deemed to be a resident of that foreign country for tax purposes. Generally, under most U.S. income tax treaties, a U.S. citizen who enjoys extended vacations or who pursues specific educational opportunities in another country won't be deemed a tax resident of that country. However, if the U.S. citizen begins working in that country, perhaps gets married there or acquires real estate there, at some point, under the applicable treaty, he may be deemed a tax resident of the foreign country. A wealthy U.S. citizen may also be deemed a resident of a foreign country if he simply enjoys living there, whether he works there or has other connections to that country. The family office client may be in for a rude awakening when he learns how the foreign country's tax law treats his beneficial ownership in a domestic trust.

In many civil law countries, a distribution from an irrevocable domestic trust to a U.S. beneficiary who's tax resident in that civil law country will be subject to that country's gift tax. The applicable law doesn't recognize the existence of the trust and simply treats the beneficiary as having received a gift from the settlor of the trust, whether that settlor is deceased or not. In many civil law countries, gift tax is imposed on the recipient of a trust distribution when the beneficiary is tax resident there. For example, the German Federal Tax Court determined that a German resident beneficiary of a domestic trust established by the beneficiary's U.S. grandmother was subject to German gift tax on distributions (both principal and income) from the trust. The court didn't determine how the gift tax on trust distributions relates to income tax on such distributions.[10] France and Japan are two other civil law countries that will subject their residents to gift tax on distributions from domestic trusts.[11] In some of these countries, the U.S. beneficiary may also be subject to income tax on the trust's income, whether he's entitled to, or actually receives, income.

When a U.S. beneficiary of a domestic trust lives in such a jurisdiction, if the trust instrument requires a large distribution to be made on a date certain (whether because he's reached a certain age or because an older trust is due to terminate), he must choose between terminating his residency in such a country or paying a large tax (which likely won't be creditable against any U.S. tax). The act of terminating residency in the foreign country must be done deliberately and with great caution to ensure that the beneficiary hasn't retained connections to that country that would cause him to be deemed to have never left. Physical removal from the country may not be sufficient to sever residency if the beneficiary maintains a home there or leaves dependents behind.

If a U.S. beneficiary intends to become tax resident in a country that will subject trust distributions to a hefty gift tax (not to mention income tax), the family office should review what steps might be taken to mitigate the tax risk. For example, if a senior generation family member intends to establish an irrevocable discretionary trust for the individual, the drafting attorney might insert language that clarifies that the individual won't be eligible for distributions while he's tax resident in the country at issue. That is, his beneficial interest is suspended for a period of time. The drafting attorney should also include language that empowers a protector or independent trustee to amend the trust for tax purposes. These provisions at least will provide a measure of flexibility that could be used to prevent the imposition of tax. If the U.S. beneficiary is already a beneficiary of an older trust, the family office should consider whether it's possible to decant the trust to a new trust that provides that the beneficiary's interest is suspended for such time as he lives in a foreign country. If such remedial actions aren't possible, the family office should investigate whether a properly documented and secured loan from the trust to the beneficiary will avoid taxation as a distribution under applicable local law.

Whether or not distributions to the U.S. beneficiary will be subject to gift tax in a foreign country, the family office also must consider whether foreign law will require the existence of the trust to be disclosed. For several years now, France has been at the forefront of requiring information disclosure about trusts and their connections to France. Since 2011, French law has required resident beneficiaries, for instance, to file reports with the tax authorities that provide details on their trusts. As of June 30, 2016, France's registry of trust information is publicly available on the Internet.[12] The publicly available information includes the names, dates and places of birth of resident beneficiaries. The name of the trust and its address (presumably the address of the trustee), along with the date of creation and the identity of the trustee, settlor and beneficiaries are also available. Whether other jurisdictions will follow France's lead remains to be seen, but some, such as the United Kingdom, have considered establishing or are implementing government databases for trusts or companies.

Trustees Living Abroad

What if a U.S. beneficiary living abroad is also serving as the sole trustee of a trust for his benefit? Assume that the U.S. beneficiary is living in a foreign country that has no particular view on how distributions from a domestic trust should or shouldn't be taxed. Does the U.S. beneficiary's activity as trustee raise any issues? Assume also that maintaining the income tax classification of the trust as a domestic trust is desirable. If the U.S. beneficiary resides abroad indefinitely and has minimal contacts with the United States, does the trust satisfy the court test? A trust is a foreign trust if it isn't a domestic trust. Under IRC Section 7701(a)(30)(E), a trust is a domestic trust if it meets both of the following requirements:

- A court within the United States is able to exercise primary supervision over the administration of the trust (court test); and

- One or more U.S. persons have the authority to control all substantial decisions of the trust (control test).

The Internal Revenue Service will apply both the terms of the trust instrument and applicable law to determine whether a trust passes the court test and control test.[13]

If the U.S. beneficiary is acting as sole trustee, the control test will be satisfied because a U.S. person will control all substantial decisions related to the trust. But, will the trust satisfy the court test? To do so, a federal, state or local court in the United States must be able to exercise primary supervision over the administration of the trust.[14] As a safe harbor, the regulations provide that a trust will satisfy the court test if it meets the following three criteria:

- The trust instrument doesn't direct that the trust be administered outside of the United States;

- The trust is in fact administered exclusively in the United States; and

• The trust isn't subject to an automatic migration provision described in the regulations.[15]

For purposes of the court test, the regulations define "administration" as:

> . . . carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.[16]

As long as the U.S. beneficiary lives abroad, his trust may not satisfy the second element of the safe harbor—that the trust in fact be administered exclusively in the United States. As sole trustee, he'll no doubt perform administrative duties while living abroad.

Not satisfying the safe harbor doesn't mean that the trust at issue won't satisfy the court test. The test will be satisfied if a U.S. court is able to exercise primary supervision over the administration of the trust. According to the regulations, a court is "able to exercise" primary supervision if the court has or would have the authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust.[17] Under the regulations, the term "primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.[18] A court may have primary supervision of a trust even if another court has jurisdiction over the trustee, a beneficiary or trust property.[19]

Due to the U.S. beneficiary's residency in a foreign country, it isn't clear that a U.S. court would be able to exercise primary supervision over his trust because a U.S. court may not have personal jurisdiction over the U.S. beneficiary. A U.S. court's ability to exercise personal jurisdiction over an individual requires that the individual have a certain level of personal contacts with the jurisdiction. Court decisions in this area focus on whether the individual purposefully availed himself of the benefits of doing business and conducting activities in the jurisdiction. Because physical presence or at least deliberate contacts are important, the beneficiary's U.S. citizenship alone would probably not provide a basis for personal jurisdiction. If the U.S. beneficiary has no sufficient minimum contacts with a state, the trust may fail the court test and be classified as a foreign trust, with all of the tax and reporting complexities such status entails.

To prevent the classification of the trust as foreign, a U.S. citizen or resident who actually lives in the United States could be appointed to act as co-trustee with the U.S. beneficiary. If that U.S. person were vested with responsibility for the administration of the trust, a U.S. court would be able to exercise primary supervision over the administration of the trust, and the court test likely would be satisfied. The U.S. beneficiary can still play a role as co-trustee in distribution or investment decisions, as otherwise appropriate under the trust instrument, as long as the trust is clearly administered in the United States.

Other Considerations

The above topics comprise just a few of the issues a family office will confront when a client marries a noncitizen. In our view, they're among the most important. Other considerations include: 1) structuring and supporting a client's foreign business operations or investments; 2) ever-evolving foreign information reporting requirements; 3) structuring wealth transfers to future generations who live abroad; and 4) whether expatriation makes sense for the client who lives abroad permanently. Oh, and don't forget to consider the QDOT!

Endnotes

1. *See* Jerome Assouline and G. Warren Whitaker, "Dangerous Liaisons: Beware of Creating Trusts for U.S. Citizens Residing in France," *Trusts & Estates* (March 2015), at p. 19.

2. Internal Revenue Code Section 1361(b); Treasury Regulations Section 1.1361-1(g)(1)(i).

3. Treas. Regs. Section 1.1361-1(m)(5)(iii).

4. Treas. Regs. Section 1.1361-1(m)(4)(vi).

5. IRC Section 1362(f); Treas. Regs. Section 1.1361-4.

6. *See* T.D. 9422, 73 FR 47526-47531, Aug. 14, 2008, amending Treas. Regs. Section 1.1361-1(m)(4)(vi)(a) to provide that a person to whom a distribution may be made under a power of appointment (POA) isn't a potential current beneficiary unless the power is exercised in favor of that person during the period. Prior to this amendment, Treas. Regs. Section 1.1361-1(m)(4)(vi)(a) provided that a person to whom a distribution is or may be made during a period pursuant to a POA is a potential current beneficiary.

7. *See* Treas. Regs. Section 1.1361-1(g)(1)(ii), Ex. 1 and 2.

8. *See* Leigh-Alexandra Basha, "Estate Planning for the Multinational Couple: It's a Small, But Complex World," *Holland & Knight Newsletter* (October 2010) (describing the marital property regimes applicable in France).

9. *See Radmacher v. Granatino*, ([2010) UKSC 42 (describing English law on premarital and post-nuptial agreements in the context of a German premarital agreement between a German national and a French national residing in England, in which no asset disclosure had occurred prior to execution of the agreement).

10. Bundesfinanzhof, Sept. 27, 2012, II R 45/10. See also Florian Reichthalhammer and J. Andrew P. Stone, "German Federal Tax Court: Distributions from U.S. Trusts Are Subject to German Gift Tax" (April 9, 2013), *www.lexology.com/library/detail.aspx?g=21680d10-ea0a-4bf1-a0af-e208f5a2f61b*.

11. For the French trust legislation, see Article 14 of the Amended Finance Law n° 2011-900 (loi n° 2011-900 du 29 juillet 2011 de finances rectificative). Compare Belgium's views on the taxation of trusts, Marc Quaghebeur, "Belgium's De Facto Position on the Taxation of Trusts," *Tax Notes International* (May 24, 2010), at 661.

12. *See* Decree n° 2016-567 of May 10, 2016 in Journal Officiel n° 0109 of May 11, 2016, text n° 25.

13. Treas. Regs. Section 301.7701-7(b).

14. IRC Section 7701(a)(30)(E)(i).

15. Treas. Regs. Section 301.7701-7(c)(1).

16. Treas. Regs. Section 301.7701-7(c)(3)(v).

17. Treas. Regs. Section 301.7701-7(c)(3)(iii).

18. Treas. Regs. Section 301.7701-7(c)(3)(iv).

19. *See* ibid.