PRIVATE CLIENT & OFFSHORE SERVICES - USA

Tax planning for US equities owned in a non-US trust structure

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Introduction

Advisers to international families will often hear US tax professionals using the terms 'basis step up' and 'estate tax blocker'. While a family may never have any US citizen or resident members, keeping in mind US tax basis and estate tax issues while establishing and maintaining a succession planning structure can protect the estate of a non-US settlor from US estate tax and prove beneficial after the settlor's death in the event that a branch of the family moves to the United States or a family member marries a US citizen. Recent changes to the US Tax Code have prompted some US tax advisers to suggest additional layers of entities to the structure, the additional cost and complexity of which may not result in substantial tax savings.

Basic rule: US equities are subject to US estate tax

On the death of a non-US citizen who was not resident in the United States (a non-US individual), US situs property owned by the decedent is subject to US federal estate tax at a top rate of 40%. Stock in US companies is considered US situs property under the estate tax rules. The exemption from estate tax available to the estates of non-US decedents shelters only $60,000 worth of US property from estate tax at death. In some cases, a treaty between the United States and the country of the decedent's domicile will result in US equities being subject to tax only in the country of residence or provide a credit to minimise double taxation; however, for purposes of this article, it is assumed that the non-US decedent was not domiciled in a treaty country. It is also assumed that other than the US equities, the non-US decedent has no other US situs assets or interests in US entities (for further details please see "Overview (March 2018)").

The US tax code uses the concept of basis as the starting point for calculating the gain (or loss) on a sale or other taxable disposal of an asset. A person's basis in property will depend on how the property was acquired, whether by purchase, gift, inheritance or otherwise. A non-US individual who buys US equities generally starts with a basis equal to the purchase price. On the individual's death, the decedent's US and non-US beneficiaries inherit the assets of the estate, net of any estate tax, with their own basis for income tax purposes equal to the fair market value of the assets on date of death. This basis adjustment at death is often referred to as a 'step up' in basis if the asset has appreciated in value over time (but it is also possible that there will be a step down in basis if the asset has decreased in value). When a US beneficiary later sells inherited property, US capital gains tax (at a top rate of 20%) is owed only on appreciation in value (if any) since the date of death.

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Succession planning: US equities owned through foreign grantor trust

Rather than owning US equities outright, the non-US individual is well served by contributing cash to a trust and then investing through the trust structure. All assets of the trust will be attributed to the non-US settlor for US income tax purposes, as long as the trust is either revocable or solely for the benefit of the settlor and the settlor's spouse during the settlor's lifetime. Such a trust is known as a 'foreign grantor trust'. On the death of the settlor, the trustee can continue the management of investments without interruption.

If a foreign grantor trust is properly drafted, all trust property will receive a step up in basis to its fair market value at the date of the settlor's death. For purposes of this article, trust assets are assumed to qualify for this basis step up. Following the death of the settlor, the trust becomes a foreign non-grantor trust and can continue for the benefit of the settlor's US and non-US family members. US equities owned directly in the name of the trust potentially will be subject to US estate tax on the fair market value as of the settlor's date of death.

Avoiding US estate tax: invest in widely owned non-US fund

Rather than owning US equities directly, the non-US individual or the trustee of a foreign grantor trust can instead invest in the US stock market by purchasing shares in one or more investment funds offered to the general public and structured as a non-US corporation for US income tax purposes. Such a widely owned fund should not be considered a US situs asset for estate tax purposes.

More flexibility: invest in US equities through wholly owned non-US company

Wealthy, sophisticated investors may want more tailored investments than what a widely owned, non-US fund can offer (or may want to avoid these funds as they are typically treated as passive foreign investment companies (PFICs) for US tax purposes). The standard planning technique has been for the trustee of the foreign grantor trust to capitalise a wholly owned non-US corporation with cash that the settlor contributed to the trust. That non-US corporation would then invest in hand-picked US equities. On the death of the settlor, no US estate tax is due because what the settlor is deemed to own at death through the grantor trust is the stock of the non-US corporation, which is not a US situs asset. Thus, the non-US corporation is known as an 'estate tax blocker'.

In addition to avoiding US estate tax, on the death of the settlor, the basis in the non-US corporation stock is stepped up to its date of death value. For example, a Bermuda foreign grantor trust owns 100% of the shares of a BVI corporation that holds a portfolio of US equities. The US equities have appreciated in value by $1 million. The non-US settlor dies and, since the trust was properly drafted, the basis in the stock of the BVI corporation is stepped up to its date of death value. However, that basis step up is available only for the BVI corporation stock (the 'outside basis'). The US equities owned by the BVI corporation continue to have their original cost basis (the 'inside basis'). A standard planning technique has been to periodically sell appreciated equities during the non-US settlor's lifetime, thereby reducing the amount of appreciation trapped in the BVI corporation after the settlor's death. Following the settlor's death, the trustee must be aware of US controlled foreign corporation (CFC) rules.

Controlled foreign corporations

The United States treats non-US corporations as CFCs where more than 50% of the vote or value of the stock is owned, or treated as owned, by US persons (individuals and entities) owning at least 10% or more of the CFC. Certain attribution rules can apply to attribute ownership of shares in a non-US corporation to US trust beneficiaries. US owners of a CFC must report and pay US tax on their *pro rata* share of the company's Subpart F income annually, regardless of dividend distributions. A widely owned non-US investment fund should not be considered a CFC for US income tax purposes. Prior to recent changes to the US tax laws, it was the ability to vote the stock that was relevant for determining the 10% owners and ultimately CFC characterisation, so non-US companies within a family structure would sometimes issue non-voting stock to US investors. Now, under the Tax Cuts and Jobs Act 2017, both vote and value of stock are relevant when determining CFC status.

On death of settlor: non-US corporation becomes CFC

The BVI corporation in the example above is potentially a CFC following the death of the non-US settlor. To avoid dealing with the CFC rules following the settlor's death, the non-US corporation generally makes a US entity classification election (commonly known as a 'check-the-box' election) so that the non-US corporation will be disregarded for US tax purposes as of a specified date. Importantly, these elections can be made retroactively for up to 75 days, allowing for some post-death planning. If the BVI corporation in the example above makes such a US check-the-box election, the $1 million appreciation in value of its US equities from the date of purchase to the date of the election will be realised in a deemed liquidation. Prior to the settlor's death, this deemed gain recognition would be attributed to the non-US grantor, but after death, under the CFC rules, a portion of the deemed gain is Subpart F income and may be attributed to the trust's US beneficiaries. As noted above, the periodic sale of appreciated equities during the settlor's lifetime reduces the amount of deemed gain after death.

The CFC rules had always provided that US shareholders of a CFC (including indirect shareholders through a trust) would not be taxable on CFC Subpart F income unless the non-US corporation was classified as a CFC for more than 30 days during the year. Thus, the BVI corporation in the example above would have made the check-the-box election effective within 30 days of the settlor's death. Unfortunately, this 30-day exception was eliminated under the Tax Cuts and Jobs Act 2017. As a result, if the settlor in the above example died on 29 June and the BVI corporation made a check-the-box election to be disregarded effective 1 July, the deemed liquidation would occur at 11:59pm on 30 June, and the BVI corporation would potentially be classified as a CFC following the settlor's death, even if only for one day. The reason for not making the check-the-box election effective as of the settlor's date of death or just before death is to avoid US estate tax on the value of US equities if the BVI company is disregarded for US tax purposes prior to death.

Under the CFC rules, each US shareholder who owns or is deemed to own stock of a CFC on the last day of the taxable year in which the company is a CFC includes in their income a *pro rata* share of the CFC's Subpart F income. Subpart F refers to the portion of the US Internal Revenue Code that details certain taxable income of the CFC that is deemed distributed to US shareholders in the year it is earned by the CFC. Subpart F income includes passive investment income (eg, interest, gains and dividends). The proportion of the CFC's Subpart F income that is deemed distributed equals the ratio of the number of days of CFC status to the total number of days in the year, including days when the company is not, in fact, a CFC.

In order for a US beneficiary of the foreign trust to determine the share of the Subpart F income attributable to stock that the beneficiary is deemed to own, it must first be determined what portion of the year the BVI corporation was a CFC. In the example above, the settlor died on 29 June and the BVI corporation made a check-the-box election effective as of 1 July; therefore, the last day of the BVI corporation's tax year would be 30 June. Thereafter, the BVI corporation would be disregarded for US tax purposes. Thus, the BVI corporation potentially is deemed to be a CFC for one day out of the 181 days that the corporation existed that calendar year (1 January through 30 June). In that case, the US beneficiary includes a *pro rata* share of 1/181 of the corporation's Subpart F income on the beneficiary's US income tax return. Realistically – and especially when appreciated investments are regularly sold prior to the settlor's death – the actual amount of Subpart F income potentially attributed to the US beneficiary will likely be minimal. The resulting tax on any included income and additional accounting fees can be considered the cost of a strong position that no US estate tax is due on the date of death value of the US equities.

Advanced planning: two-tier, three company structure

Suppose the trustee instead capitalises two non-US corporations (Corporations 1 and 2), which each own 50% of the shares of a third non-US corporation (Corporation 3). Corporation 3 owns the US equities. Following the settlor's death, a series of check-the-box elections are made.

Corporation 3 makes a check-the-box election to be treated as a partnership as of the day before the settlor's death (28 June in the above example). For tax accounting purposes, Corporation 3 is treated as having distributed all of its US equities to its shareholders, Corporations 1 and 2, in complete liquidation as of 11:59pm on 27 June. Corporations 1 and 2 are deemed to have received those US equities in exchange for their stock in Corporation 3, so that the basis of each of the US equities (now treated as owned directly by Corporations 1 and 2) will be their fair market value on 27 June.

Corporation 3's original cost basis is stepped up to fair market value on the books of Corporations 1 and 2. The gains, if any, deemed recognised would not be subject to US income tax because the non-US settlor of the foreign grantor trust is still alive on the effective date of the election, so that the CFC rules are inapplicable. However, under US tax accounting rules, this is not a tax-free reorganisation because neither Corporation 1 nor 2 owns at least 80% of Corporation 3, so the accounting records of Corporations 1 and 2 would show the deemed recognised capital gain (which is potentially Subpart F income for these companies).

Corporations 1 and 2 each make their own check-the-box election effective as of 1 July, two days after the settlor's death to be treated as disregarded entities for US tax purposes. These elections are treated as deemed liquidations but result in little or no additional recognised capital gain because the outside basis in the shares of Corporations 1 and 2 were stepped-up to the 28 June date of death value and the inside basis in the underlying US equities is equal to their fair market value as of 27 June.

Nevertheless, because of the elimination of the 30-day exception, Corporations 1 and 2 will potentially be CFCs for a day. Both corporations have Subpart F income from the deemed liquidation of Corporation 3, a *pro rata* portion of which may be taxable to the US beneficiary just as it was in the single-tier BVI corporation in the example above.

It is easy to see how complicated the US tax accounting becomes using a two-tier structure. The additional expense and complexity of the two-tier structure may not, in fact, result in a significant reduction in Subpart F income attributable to the US beneficiary.

The only clear advantage to this two-tier, three corporation approach is if the settlor dies early enough in the year, thus allowing Corporation 3 to make a check-the-box election effective in the prior tax year. This would result in the deemed recognition of gain from the disposition of Corporation 3's shares (which is potentially Subpart F income for a CFC) being realised by Corporations 1 and 2 in the prior tax year while they are attributable to the settlor and are not CFCs. Thus, the US beneficiary would not have any subpart F income to include.

Although the two-tier, three corporation structure is being advocated by some, its complexity and added cost, when combined with a tax advantage dependent on when the settlor dies, may argue in favour of the family using it only when the pool of investment assets is very large, or consists of large individual holdings, where regularly selling appreciated assets is not a viable option. Note that there is a risk that in certain situations the two-tier, three corporation structure may actually result in a worse tax outcome than the single corporation structure.

What's the risk?

US tax advisers will continue to raise the issues of estate tax blockers, basis step up, CFCs and PFICs because the Internal Revenue Service (IRS) can audit US taxpayers. Professional trust companies serving as trustee of a foreign trust that makes distributions to a US beneficiary will be obliged under the Foreign Account Tax Compliance Act (FATCA) to file a report with the IRS regarding the distribution. In addition, the trustee must provide the US beneficiary with a foreign non-grantor trust beneficiary statement with sufficient details to allow the US beneficiary to accurately report the items of income distributed. Advance planning and accurate accounting records are insurance to guard against the expense, additional tax, interest and penalties of an IRS tax audit.

Comment

The US tax rules are complicated and recent changes have not simplified things. When the family knows that the trust's discretionary beneficiaries will include US individuals following the death of the settlor, it is beneficial to consider how US equities will be held during the settlor' lifetime and take steps to secure a step up in basis for all trust assets at death, including properly drafted trust language and check-the-box elections. Advisers to international families should always consider the following US elements when establishing a family succession planning structure:

- Use a 'grantor' trust where possible given the settlor's country of tax residence.
- Ensure that trust terms allow for trust assets to qualify for the basis step up at the death of the

settlor.

- Ensure that US situs assets are not owned directly by the foreign grantor trust.
- Ensure that the settlor does not contribute US situs assets to the trust.
- Consider whether non-US corporations, whether investment funds or wholly owned holding companies, are used to hold US equities.
- Consider the timing of check-the-box elections following the settlor's death.
- Ensure that the trustee is prepared to maintain US tax accounting records following the death of the settlor.

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