

Estate Planning Council of Greater Miami
February 19, 2015

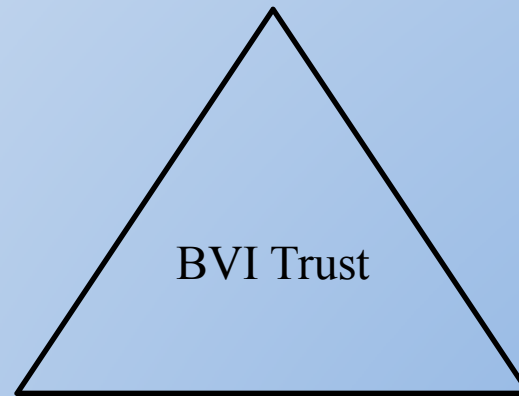
U.S. Tax Considerations for Multi-Jurisdictional Family Trust Planning

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General Disclaimer: This discussion is not all encompassing as to the various U.S. tax issues associated with foreign trusts and the settlors or beneficiaries thereof. The intention of this discussion is to provide a basic and general discussion as to specific common issues which arise in planning for foreign trusts and multi-jurisdictional family members (including U.S. persons). You should not, and cannot, rely upon this discussion as U.S. tax advice. If there are any U.S. tax concerns in relation to a specific inquiry relating to the U.S. tax treatment of foreign trusts, please contact or engage appropriate U.S. tax counsel to advise accordingly.

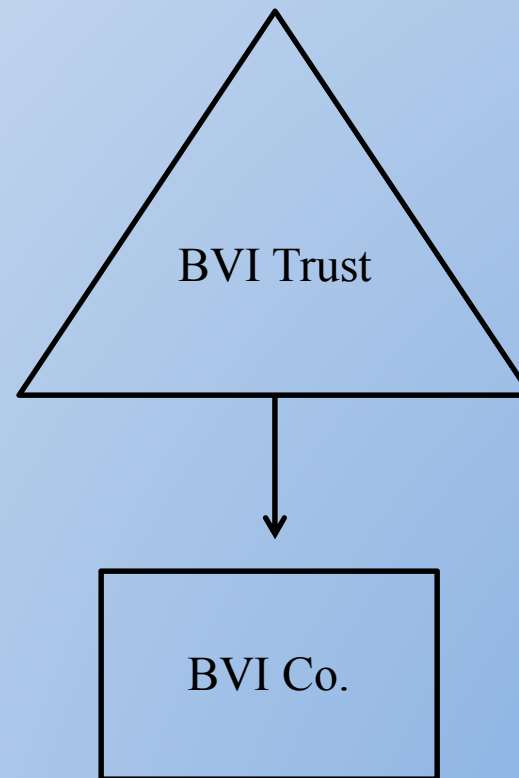
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Case Study 1: The Foreign Grantor Trust



- Revocable trust with a non-U.S. person settlor.
- BVI trust company as trustee.
- The trust is governed by, and administered under, the laws of the BVI.
- The trust is for the primary benefit of the settlor with the settlor having the right to direct income (to the settlor or others).
- There are also U.S. and non-U.S. person remainder beneficiaries upon the settlor's death.

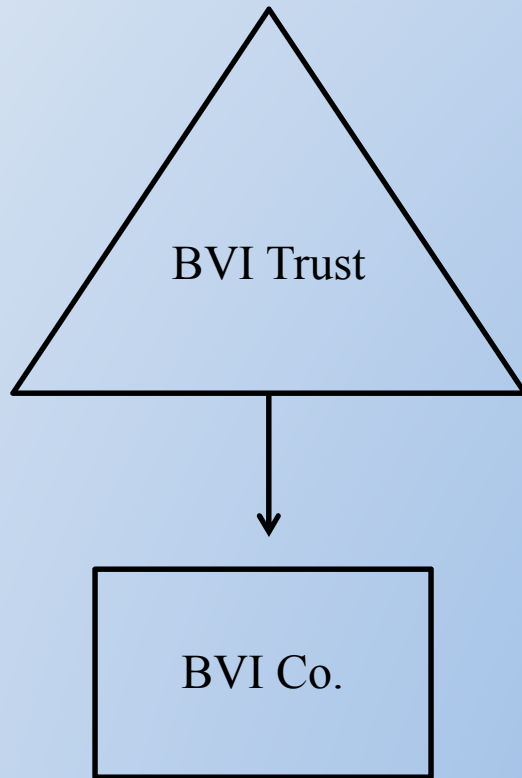
Case Study 1: The Foreign Grantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 1:
The Foreign Grantor Trust

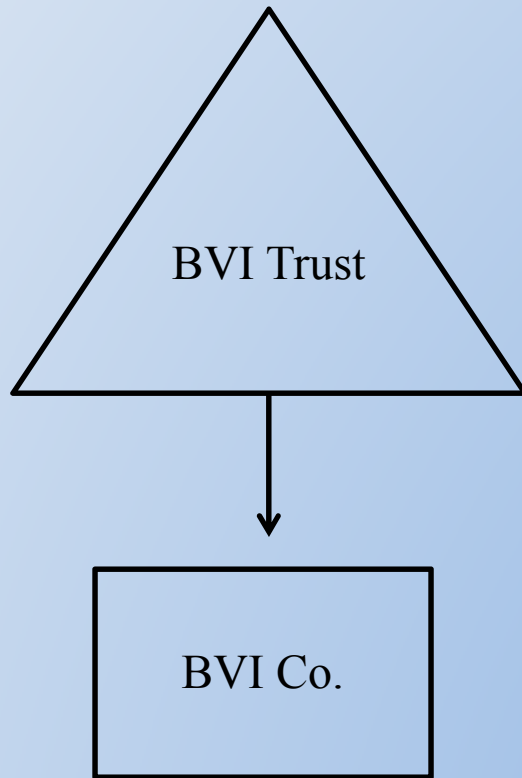


U.S. Income Tax Considerations

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 1:
The Foreign Grantor Trust



Why is it a “foreign” trust for U.S. tax purposes?

Because it is not a “domestic” trust. To be a “domestic” trust, the trust must satisfy both the “court test” and the “control test.”

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Court Test

A U.S. court must be able to exercise primary jurisdiction over the trust, i.e., the authority to determine substantially all issues regarding trust administration.

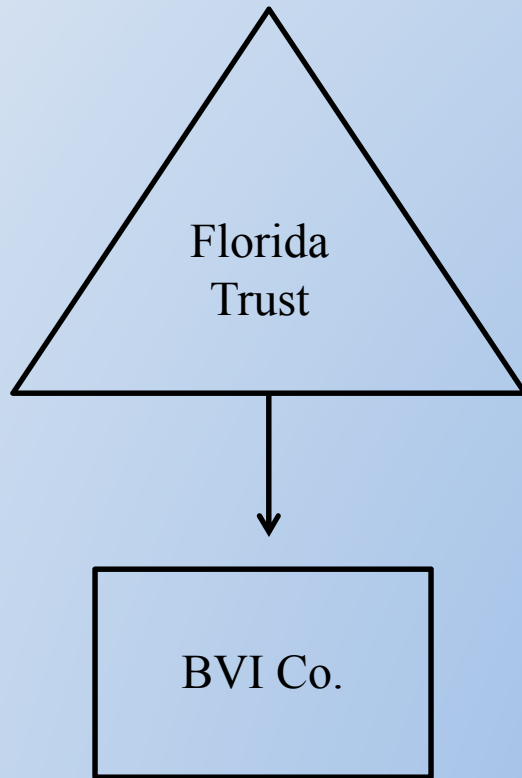
Consider Case Study 1: The trust is subject to, and administered under, the laws of the British Virgin Islands. In Case Study 1, the “court test” is not satisfied.

Control Test

One or more U.S. persons have the power to control all “substantial decisions” of the trust.

Consider Case Study 1: A non-U.S. person settlor has the power to revoke the trust and a non-U.S. person is serving as trustee. In Case Study 1, U.S. persons do not control all “substantial decisions”.

Case Study 1:
The Foreign Grantor Trust

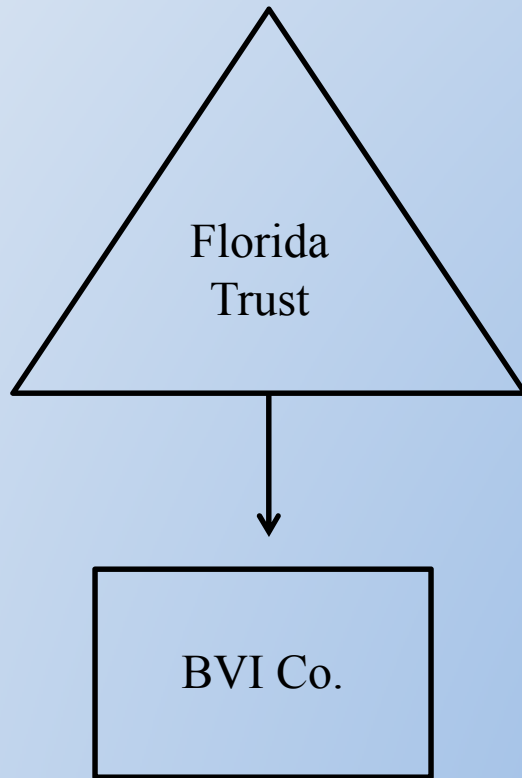


Use the same facts as Case Study 1 except that the trust is a State of Florida revocable trust structure where the trust is governed by, and administered under, the laws of the State of Florida.

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Non- U.S. Portfolio Investments

Case Study 1:
The Foreign Grantor Trust



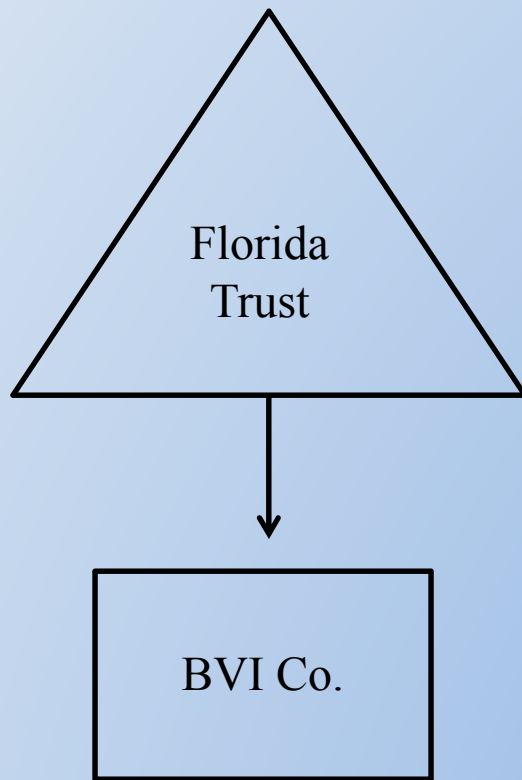
Account 1:
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Non- U.S. Portfolio Investments

The trust is a foreign grantor trust despite the governing law and administration being that of and in the State of Florida.

The “control” test is not satisfied as a result of the fact that U.S. persons do not have the power to control all “substantial decisions” of the trust. The trust is subject to a revocation power in the hands of a non-U.S. person.

Case Study 1:
The Foreign Grantor Trust



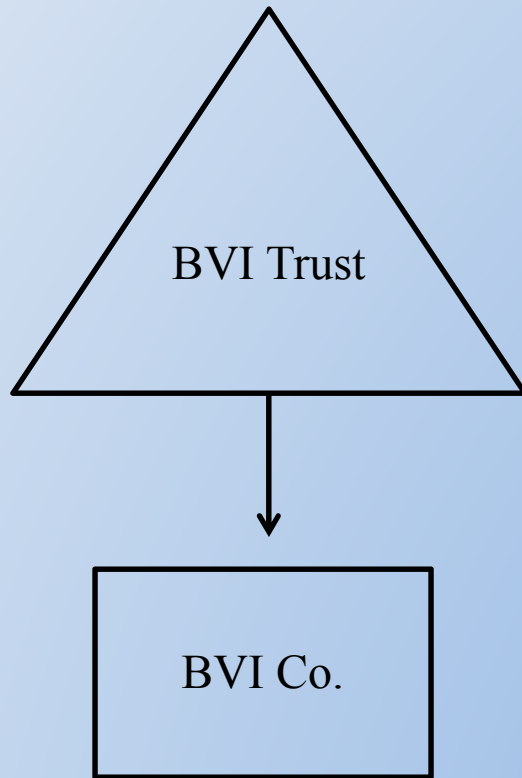
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Other more common “substantial decisions” to consider:

- Whether and when to distribute income or corpus.
- The amount of any distributions.
- The selection of a beneficiary.
- Whether a receipt is allocable to income or principal.
- Whether to terminate the trust.
- Trustee removal and appointment powers when held by the same party. What if a non-U.S. person holds the power to appoint without the corresponding power to remove and is limited to appointing a U.S. person trustee?
- Investment decisions; however, if a U.S. person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the U.S. person if the U.S. person can terminate the investment advisor’s power at will.

Case Study 1:
The Foreign Grantor Trust



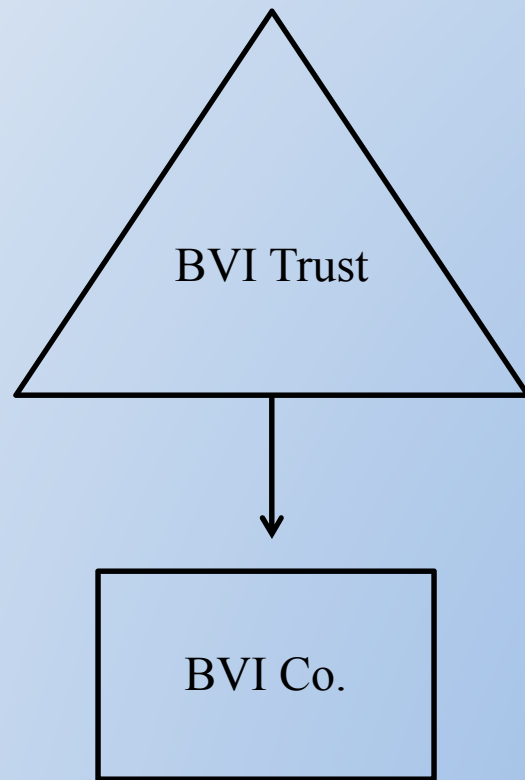
What is a grantor trust for U.S. income tax purposes?

The grantor trust rules are used to determine who is the owner of all or a portion of the trust for U.S. income tax purposes. Generally, the tax attributes (e.g., income, deductions, expenses and credits) are attributable to the “owner.”

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 1:
The Foreign Grantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Why is this trust a grantor trust for U.S. tax purposes?

A foreign grantor will be deemed the owner of property transferred to a trust if: (a) the foreign grantor retains the power to revoke the trust; or (b) the only distributions made from the trust during the grantor's life are to the grantor or the grantor's spouse. Our scenario deals with (a), the power to revoke the trust.

Drafting tip in relation to the power to revoke...

Most revocable trust documents contain a standard revocation clause that allows the settlor to revoke the trust upon giving a written instruction to the trustee.

What happens to the revocation power in the event the settlor is under a disability or incapacity? Does the revocation power cease temporarily? If the revocation power ceases, does the trust become a foreign nongrantor trust? If the trust becomes a foreign nongrantor trust, the U.S. “tax clock” begins to tick at which time many advantages could be lost in respect of U.S. person beneficiaries and many complications will arise.

Drafting tip in relation to the power to revoke...

Consider drafting for incapacity in order to present stronger arguments that grantor trust status continues during the disability or incapacity of the settlor.

The applicable Regulations indicate that the power to revest (i.e., revoke) can be exercisable solely by the grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) without the approval or consent of any other person.

Who can serve as the “other person” for this purpose? How about a trustee, power of attorney or other authorized individual?

Practical tip in relation to foreign grantor trusts which are jointly settled by husband and wife...

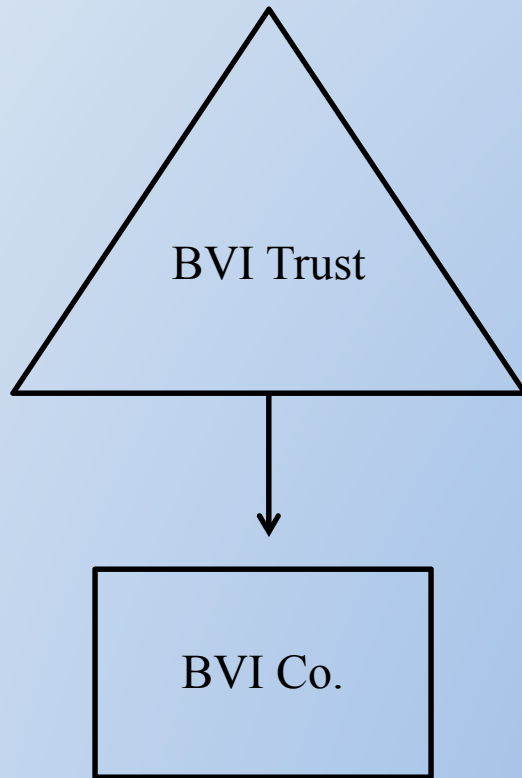
In a jointly settled revocable trust, the revocation power generally remains exercisable by the surviving spouse upon the death of the first settlor.

Due to a technical U.S. tax rule, the trust could arguably be grantor as to one-half (the surviving spouse's half) and nongrantor as to the remaining one-half (the deceased spouse's half).

Practical tip in relation to foreign grantor trusts which are jointly settled by husband and wife...

Consideration should be given to having the surviving spouse settle a new revocable trust upon the death of the first spouse or consideration should be given to distributing the shares of the underlying corporation to the surviving spouse so that the surviving spouse can then recontribute the shares back to the same trust. Actual stock powers, share certificates and updated registries should be used to effectuate the transfers out of and back into the trust.

Case Study 1:
The Foreign Grantor Trust



Account 1:
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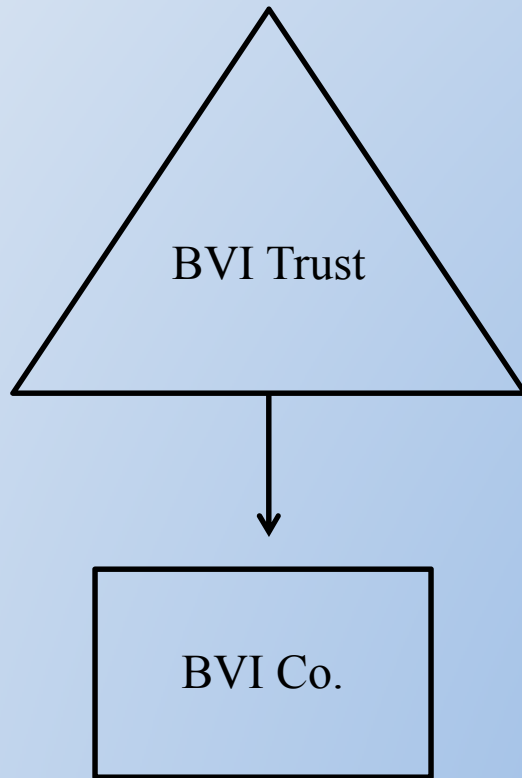
Account 2:
Non- U.S. Portfolio Investments

So we know that the settlor is treated as the owner for U.S. tax purposes....

What if distributions are made to U.S. person beneficiaries during the lifetime of the settlor, while the settlor is not disabled (or incapacitated) and the trust still remains revocable?

Subject to certain points discussed in the slides that follow, any such distribution should be considered a gift from the settlor and not taxed as a distribution from a foreign trust.

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The Foreign Grantor Trust

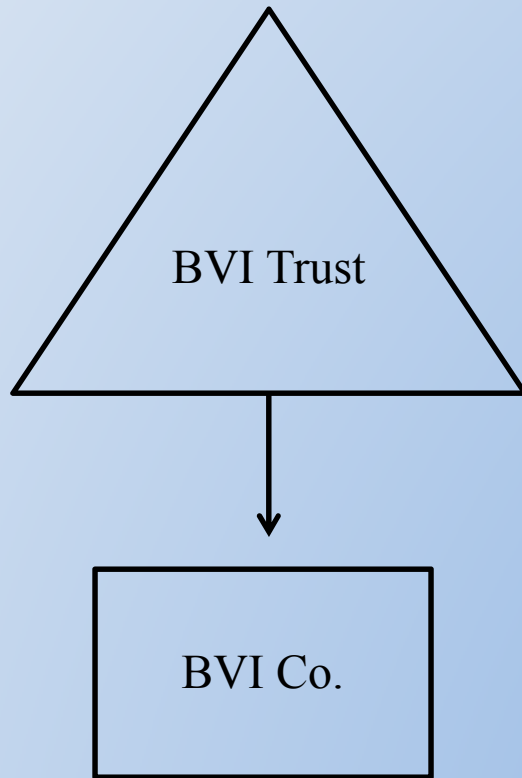


Is there a difference if the physical distribution comes from the foreign grantor trust or the underlying non-U.S. corporation?

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Case Study 1:
The Foreign Grantor Trust



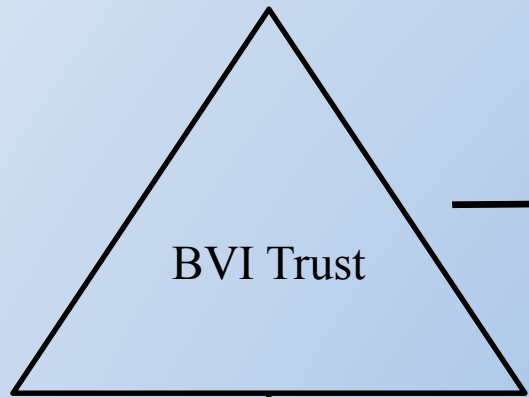
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CAUTION as a result of the rules relating to the recharacterization of purported gifts...

- ...if a United States donee directly or indirectly receives a purported gift or bequest from any foreign corporation, the purported gift or bequest must be included in the United States donee's gross income as if it were a distribution from the foreign corporation...
- ...the United States donee is not treated as having basis in the stock of the foreign corporation...

Case Study 1:
The Foreign Grantor Trust



Preferred method for distribution to the U.S. person beneficiary. Use a non-U.S. cash account in the name of the trust.

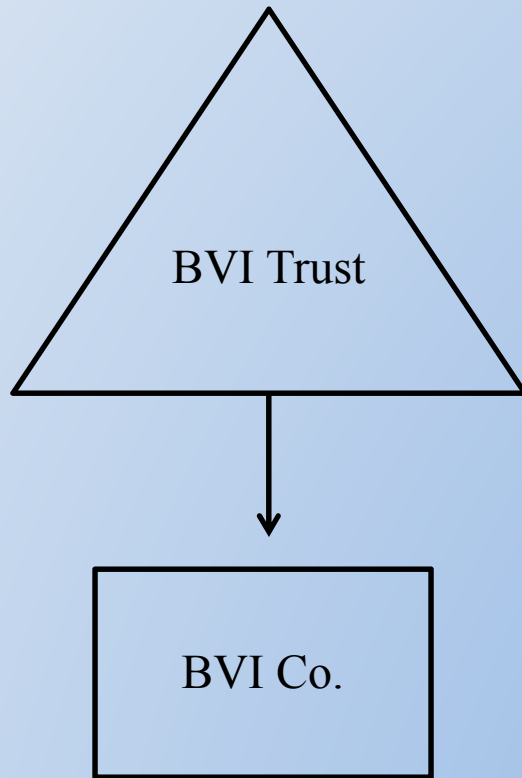


Method should be avoided as a result of the recharacterization rules.

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Case Study 1:
The Foreign Grantor Trust



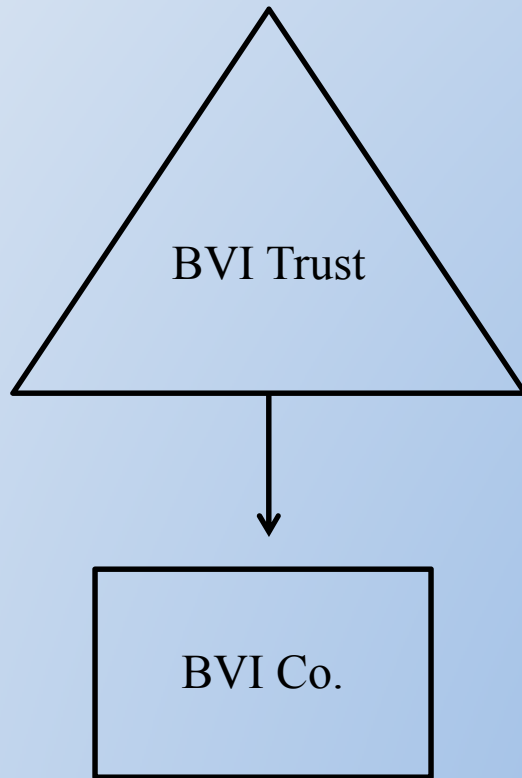
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The rules relating to the recharacterization of purported gifts is a presumption. There are exceptions, and one common exception to note is as follows:

The recharacterization will not occur if, in the non-U.S. person's country of residence and for purposes of that country's tax laws, said person treats and reports the purported gift or bequest as a distribution to himself or herself followed by a subsequent gift or bequest to the U.S. person donee. The burden is on the U.S. person donee to prove that this was done.

Case Study 1:
The Foreign Grantor Trust



The U.S. person beneficiary will use Form 3520 to report the distribution from the foreign grantor trust.

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Form 3520 Department of the Treasury Internal Revenue Service	Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts	OMB No. 1545-0108 <div style="border: 1px solid black; padding: 2px; display: inline-block;">2014</div>
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* Information about Form 3520 and its separate instructions is at www.irs.gov/form3520.

Note. All information must be in English. Show all amounts in U.S. dollars. File a separate Form 3520 for each foreign trust.

For calendar year 2014, or tax year beginning 2014, ending 20.

A. Check appropriate boxes: ☐ Initial return ☐ Initial return (extension filed) ☐ Final return ☐ Amended return

B. Check box that applies to person filing return: ☐ Individual ☐ Partnership ☐ Corporation ☐ Trust ☐ Executor

Check all applicable boxes:

☐ (a) You are a U.S. transferor who, directly or indirectly, transferred money or other property during the current tax year to a foreign trust.

☐ (b) You held an outstanding obligation of a related foreign trust (or a person related to the trust) issued during the current tax year, that you reported as a "qualified obligation" (defined in the instructions) during the current tax year, or (c) You are the executor of the estate of a U.S. decedent and (1) the decedent made a transfer to a foreign trust by reason of death, (2) the decedent was treated as the owner of any portion of a foreign trust immediately prior to death, or (3) the decedent's estate included any portion of the assets of a foreign trust. **Complete all applicable identifying information requested below and Part I of the form and see the instructions for Part I.**

☐ You are a U.S. owner of all or any portion of a foreign trust at any time during the tax year. **Complete all applicable identifying information requested below and Part II of the form and see the instructions for Part II.**

☐ (a) You are a U.S. person who, during the current tax year, received a distribution from a foreign trust, or (b) You are a U.S. person who is also a grantor or beneficiary of a foreign trust (1) that has made a loan of cash or marketable securities, directly or indirectly, to you or a U.S. person related to you during the current tax year, or (2) from which you or a U.S. person related to you received the uncompensated use of trust property. **Complete all applicable identifying information requested below and Part III of the form and see the instructions for Part III.**

☐ You are a U.S. person who, during the current tax year, received certain gifts or bequests from a foreign person. **Complete all applicable identifying information requested below and Part IV of the form and see the instructions for Part IV.**

1a. Name of U.S. person(s) with respect to whom this Form 3520 is being filed (see instructions)

b. Identification number

c. Number, street, and room or suite no. (if a P.O. box, see instructions)

d. Spouse's identification number

e. City or town

f. State or province

g. ZIP or foreign postal code

h. Country

i. Check the box if you are married and filing a joint 2014 income tax return, but you are filing separate Forms 3520. ☐

j. Service center where U.S. person's tax return is filed

k. If an extension was requested for the tax return, check this box ☐ and enter the form number of the tax return to be filed.

2a. Name of foreign trust (if applicable)

b(1). Employer identification number (if any)

c. Number, street, and room or suite no. (if a P.O. box, see instructions)

b(2). Reference ID number (see instructions)

d. City or town

e. State or province

f. ZIP or foreign postal code

g. Country

3. Did the foreign trust appoint a U.S. agent (defined in the instructions) who can provide the IRS with all relevant trust information? ☐ Yes ☐ No

If "Yes," complete lines 3a through 3g. If "No," be sure to complete Part I, lines 13 through 15.

3a. Name of U.S. agent

b. Identification number (if any)

c. Number, street, and room or suite no. (if a P.O. box, see instructions)

d. City or town

e. State or province

f. ZIP or postal code

g. Country

4a. Name of U.S. decedent (see instructions)

b. Address

c. SSN of decedent

d. Date of death

e. EIN of estate

f. Check applicable box:

☐ U.S. decedent made transfer to a foreign trust by reason of death.

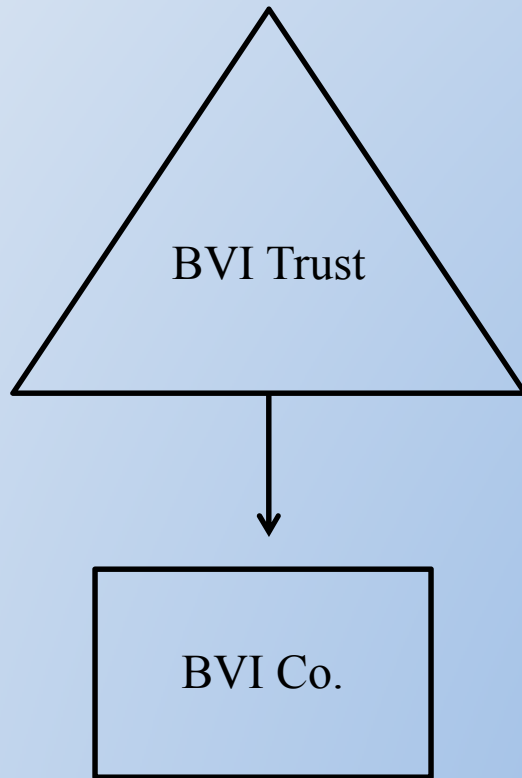
☐ U.S. decedent treated as owner of foreign trust immediately prior to death.

☐ Assets of foreign trust were included in estate of U.S. decedent.

For Privacy Act and Paperwork Reduction Act Notice, see instructions.

OMB No. 1545-0108 Form **3520** (2014)

Case Study 1:
The Foreign Grantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Some important notes to consider in relation to Form 3520:

- On the next few slides, notice the difference between the information required in relation to reporting a distribution from a foreign grantor trust versus the information needed to report a gift from a non-U.S. person.
- Notice the line of questioning on Form 3520 in relation to distributions from foreign corporations (and foreign partnerships).

20	21	22	23	24
Name of other foreign trust owners, if any	Address	Country of residence	Identification number, if any	Report Code 99500

21	60	60	60
Country code of country where foreign trust was created	Country code of country whose law governs the foreign trust	Date foreign trust was created	

23 Enter the gross value of the portion of the foreign trust that you are treated as owning at the end of the tax year: **5**

24 Cash amounts or FMV of property received, directly or indirectly, during the current tax year, from the foreign trust (exclude items included on line 2)

[illegible][illegible]

Total 8

Note. You are considered to have received a loan if you (or a U.S. person related to you) were provided the uncompensated use of trust property (as described in section 6438). See instructions for additional information, including how to complete columns (d) through (g) for such transactions.

[illegible][illegible]

Note: Generally, you must answer "Yes" if you checked "Yes" in column (c) of line 25.

27 Total distributions received during the current tax year. Add line 24, column (b), and line 25, column (b) ▶ 3

	10	20	30	40	50
10					
20					
30					
40					
50					

(d) Date of original loan transaction	Tax year qualified obligation first reported	Amount of principal payments made during the tax year	Amount of interest payments made during the tax year	Could the taxpayer make the claims of a qualified obligation?	
				Yes	No

Form 3520 (2014) Page **5**

Part III Distributions to a U.S. Person From a Foreign Trust During the Current Tax Year (Continued)

29 Did you receive a Foreign Grantor Trust Beneficiary Statement from the foreign trust with respect to a distribution? ☐ Yes ☐ No ☐ N/A
 If "Yes," attach the statement and do not complete the remainder of Part III with respect to that distribution.
 If "No," complete Schedule A with respect to that distribution. Also complete Schedule C if you enter an amount greater than zero on line 37.

30 Did you receive a Foreign Nongrantor Trust Beneficiary Statement from the foreign trust with respect to a distribution? ☐ Yes ☐ No ☐ N/A
 If "Yes," attach the statement and complete either Schedule A or Schedule B below (see instructions). Also complete Schedule C if you enter an amount greater than zero on line 37 or line 41a.
 If "No," complete Schedule A with respect to that distribution. Also complete Schedule C if you enter an amount greater than zero on line 37.

Schedule A—Default Calculation of Trust Distributions (see instructions)

31 Enter amount from line 27

32 Number of years the trust has been a foreign trust (see instructions) ▶

33 Enter total distributions received from the foreign trust during the 3 preceding tax years or during the number of years the trust has been a foreign trust, if fewer than 3

34 Multiply line 33 by 1.25

35 Average distribution. Divide line 34 by 3 (or the number of years the trust has been a foreign trust, if fewer than 3) and enter the result

36 Amount treated as ordinary income earned in the current year. Enter the smaller of line 31 or line 35

37 Amount treated as accumulation distribution. Subtract line 36 from line 31. If -0-, do not complete the rest of Part III

38 Applicable number of years of trust. Divide line 32 by 2 and enter the result here ▶

Schedule B—Actual Calculation of Trust Distributions (see instructions)

39 Enter amount from line 27

40a Amount treated as ordinary income in the current tax year

b Qualified dividends ▶

41a Amount treated as accumulation distribution. If -0-, do not complete Schedule C, Part III

b Amount of line 41a that is tax-exempt ▶

42a Amount treated as net short-term capital gain in the current tax year

b Amount treated as net long-term capital gain in the current tax year ▶

c 20% rate gain ▶

d Unrecaptured section 1252 gain ▶

43 Amount treated as distribution from trust corpus

44 Enter any other distributed amount received from the foreign trust not included on lines 40a, 41a, 42a, 42b, and 43 (attach explanation)

45 Amount of foreign trust's aggregate undistributed net income

46 Amount of foreign trust's weighted undistributed net income

47 Applicable number of years of trust. Divide line 46 by line 45 and enter the result here ▶

Schedule C—Calculation of Interest Charge (see instructions)

48 Enter accumulation distribution from line 37 or 41a, as applicable

49 Enter tax on total accumulation distribution from line 28 of Form 4870 (attach Form 4870—see instructions)

50 Enter applicable number of years of foreign trust from line 38 or 47, as applicable (round to nearest half year) ▶

51 Combined interest rate imposed on the total accumulation distribution (see instructions)

52 Interest charge. Multiply the amount on line 49 by the combined interest rate on line 51

53 Tax attributable to accumulation distributions. Add lines 49 and 52. Enter here and as "additional tax" on your income tax return

Form **3520** (2014)

Form 3520 (2014) Page **6**

Part IV U.S. Recipients of Gifts or Bequests Received During the Current Tax Year From Foreign Persons
(see instructions)

54 During the current tax year, did you receive more than \$120,000 that you treated as gifts or bequests from a nonresident alien or a foreign estate? See instructions for special rules regarding related donors. ☐ Yes ☐ No

If "Yes," complete columns (a) through (c) with respect to each such gift or bequest in blocks of \$5,000. If more space is needed, attach a statement.

(a) Date of gift or bequest	(b) Description of property received	(c) FMV of property received
Total		\$

55 During the current tax year, did you receive more than \$15,000 that you treated as gifts from a foreign corporation or a foreign partnership? See instructions regarding related donors. ☐ Yes ☐ No

If "Yes," complete columns (a) through (g) with respect to each such gift. If more space is needed, attach a statement.

(a) Date of gift	(b) Name of foreign donor	(c) Address of foreign donor	(d) Identification number, if any	(e) Check the box that applies to the foreign donor: Corporation <input type="checkbox"/> Partnership <input type="checkbox"/>	(f) Description of property received	(g) FMV of property received

56 Do you have any reason to believe that the foreign donor, in making any gift or bequest described in lines 54 and 55, was acting as a nominee or intermediary for any other person? If "Yes," see instructions. ☐ Yes ☐ No

Under penalties of perjury, I declare that I have examined this return, including any accompanying reports, schedules, or statements, and to the best of my knowledge and belief, it is true, correct, and complete.

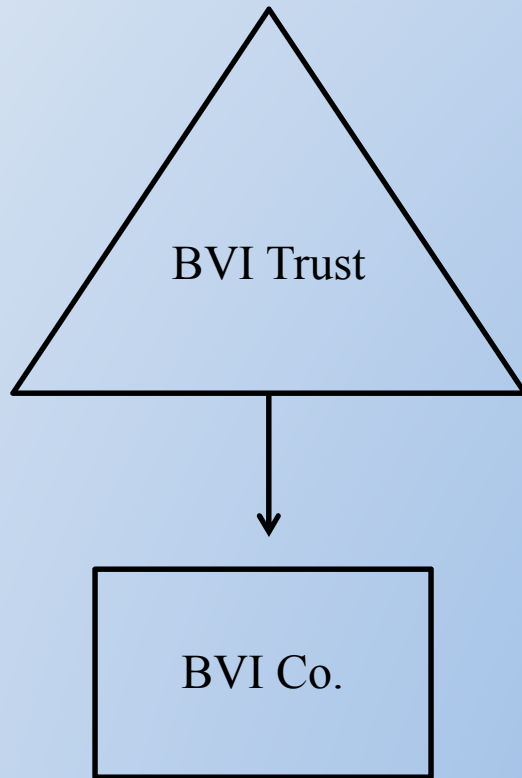
Sign Here Date

Signature _____

Print Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
Print address			Print e-mail	
Print address			Phone no.	

Form **3520** (2014)

Case Study 1:
The Foreign Grantor Trust

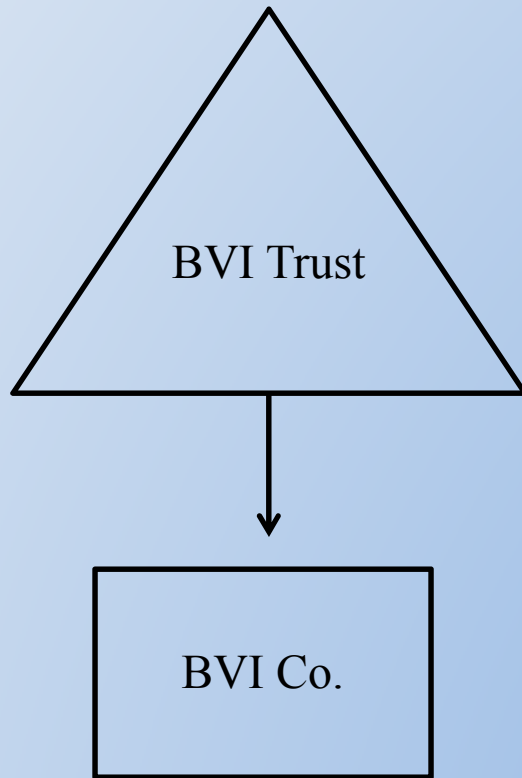


U.S. Gift Tax Considerations

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U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 1:
The Foreign Grantor Trust



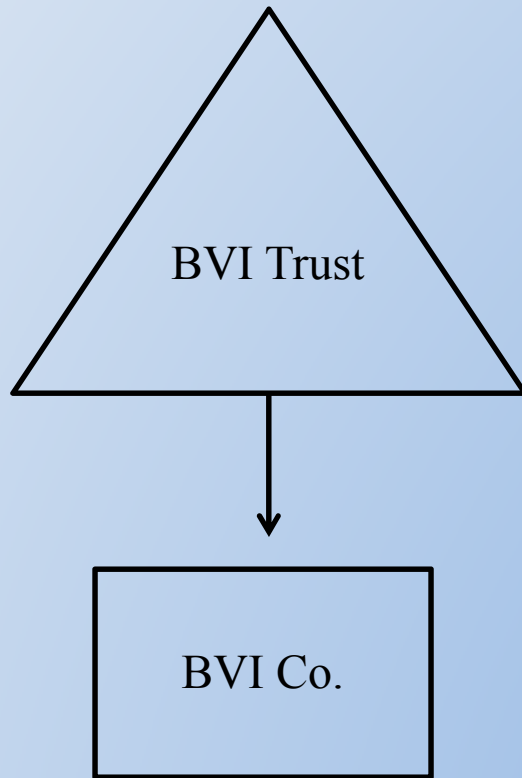
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Non- U.S. Portfolio Investments

Assuming the distribution is treated as a gift from the non-U.S. person settlor, if the gift is considered a transfer of anything other than U.S. tangible property, the transfer should be free from the U.S. gift tax.

See Code § 2511 and applicable Regs.

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Non- U.S. Portfolio Investments

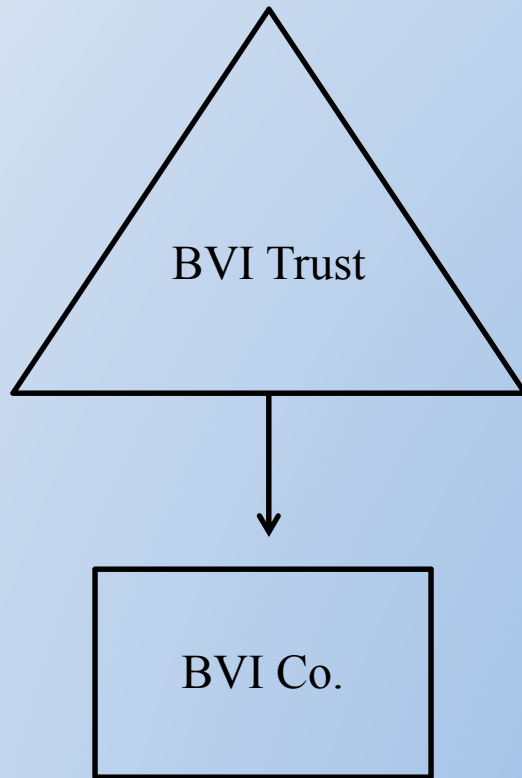
Examples of U.S. tangible property:

- U.S. real estate.
- U.S. situated cars, boats and artwork.
- Cash on deposit at a U.S. bank?

Examples of transfers which should not be subject to the U.S. gift tax:

- Non-U.S. real estate.
- Non-U.S. tangible personal property.
- Cash on deposit at a non-U.S. bank.
- Non-U.S. intangible property (e.g., stock of a BVI corporation).
- U.S. intangible property (e.g., stock of a U.S. corporation).

Case Study 1:
The Foreign Grantor Trust



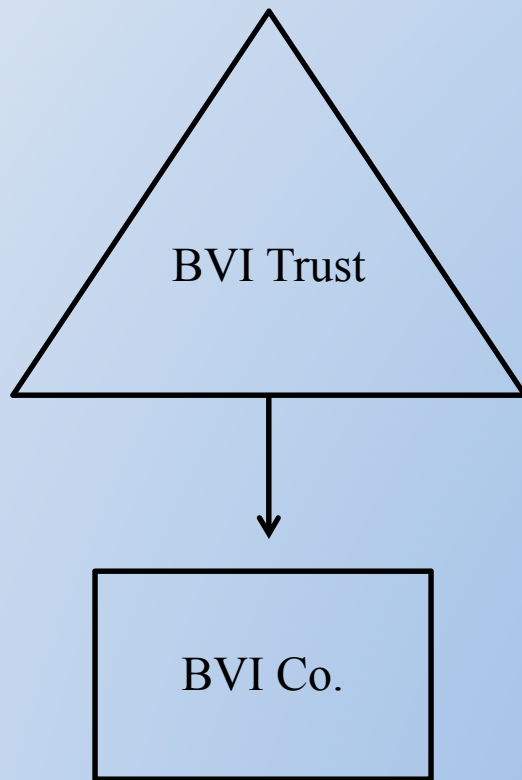
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Consider the fact that a U.S. person donee is required to file a Form 3520 when the value of the gift from a non-U.S. person is more than \$100,000 (certain related party aggregation rules need to be considered in relation to this amount).

Compare this to the requirement of needing to file Form 3520 in relation to a distribution from a foreign trust regardless of the amount of the distribution (even if \$1). Again, consider the differences in information to be reported on Form 3520 when comparing a gift from a non-U.S. person versus a distribution from a foreign trust.

Case Study 1:
The Foreign Grantor Trust

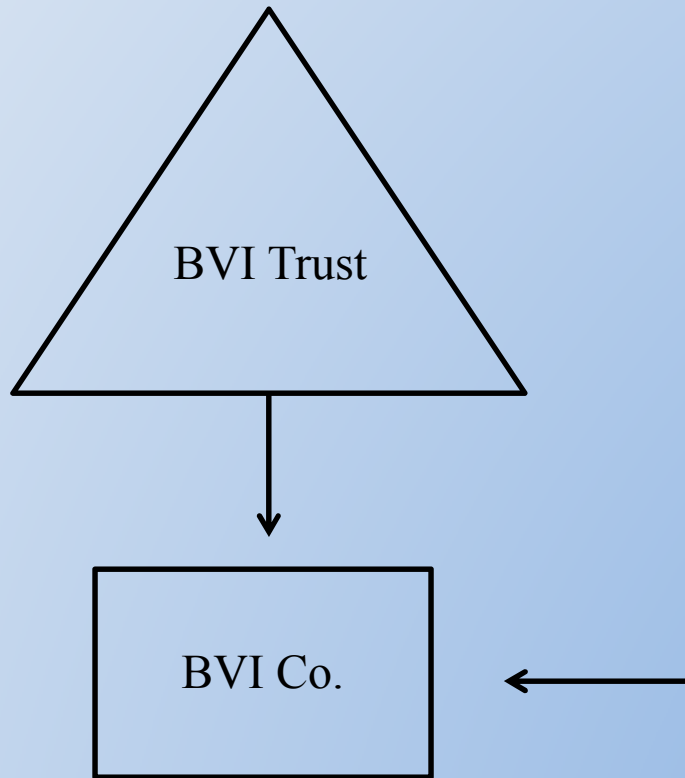


U.S. Estate Tax Considerations

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Account 2:
Non- U.S. Portfolio Investments

Case Study 1:
The Foreign Grantor Trust



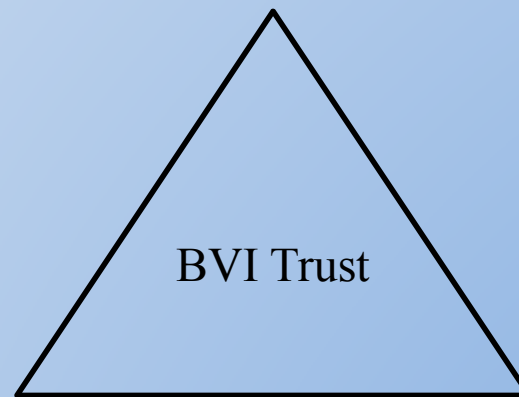
Use of a non-U.S. corporation should shield underlying U.S. situs assets from the U.S. estate tax.

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

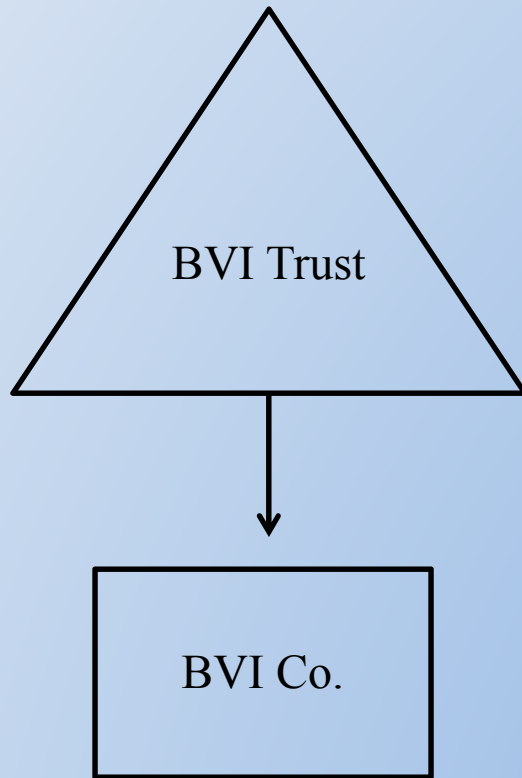
See Code §§ 2103, 2014 and 2015 and the applicable Regs.

Case Study 2: The Foreign Nongrantor Trust



Same trust as Case Study 1, but the settlor has now died, and per the terms of the agreement, the trust is now irrevocable. The trust is now a foreign nongrantor trust for U.S. tax purposes.

Case Study 2:
The Foreign Nongrantor Trust



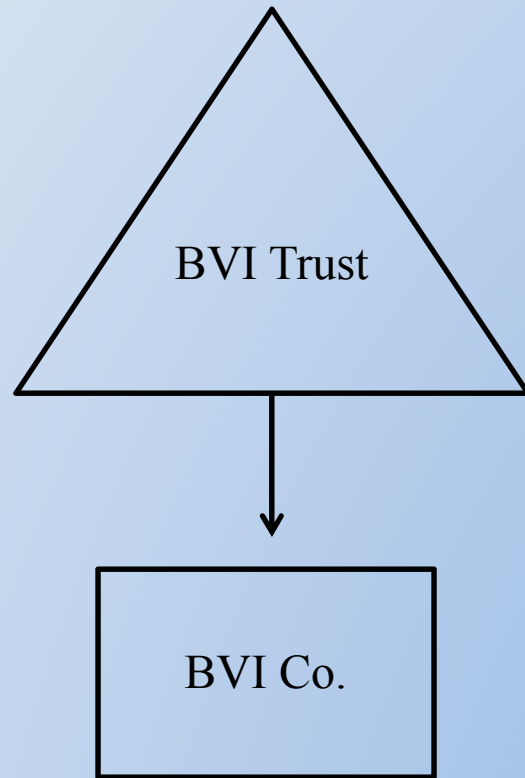
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

U.S. Income Tax Considerations

Upon conversion from foreign grantor trust to foreign nongrantor trust, the U.S. “tax clock” begins to tick....

Case Study 2:
The Foreign Nongrantor Trust

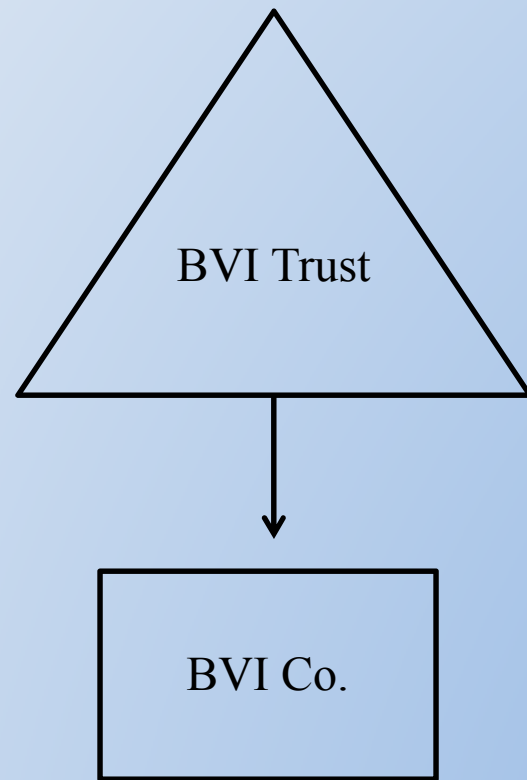


A foreign nongrantor trust may create unfavorable tax results and issues for the U.S. person beneficiary.

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 2:
The Foreign Nongrantor Trust

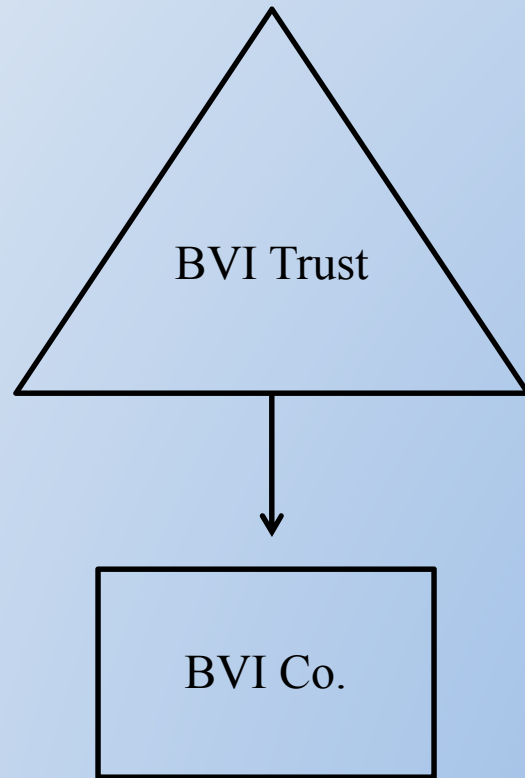


Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

- A foreign nongrantor trust is subject to U.S. income tax in a manner similar to a non-resident individual.
- A foreign nongrantor trust will only be subject to U.S. income tax on its: (1) non-exempt “passive” income from U.S. sources (e.g., dividends from U.S. corporations, interest payments received from certain U.S. persons, rents from U.S. real estate, etc.); and (2) income effectively connected with the conduct of a U.S. trade or business (including U.S. real estate gains).

Case Study 2:
The Foreign Nongrantor Trust



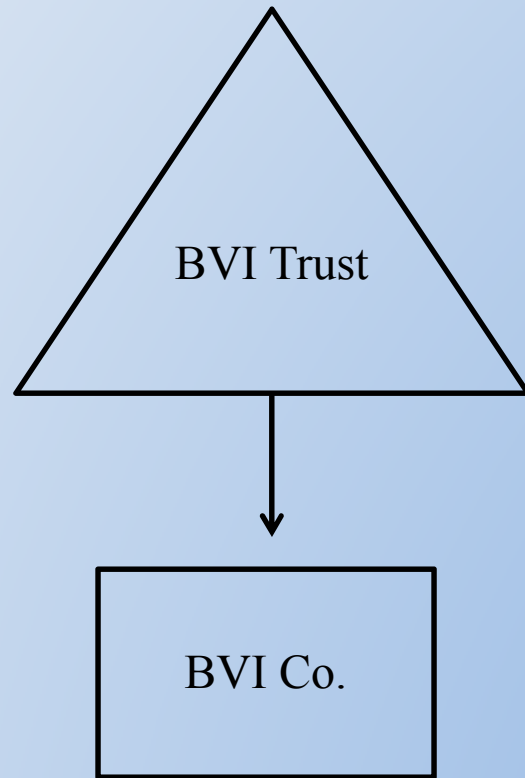
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

A U.S. person beneficiary is subject to U.S. income tax on the income of the trust to the extent such beneficiary receives distributions of such trust's current income or gains, or has an unconditional right to receive a distribution of such income or gains, but only to the extent of such trust's worldwide "distributable net income" or "DNI".

The trust gets a corresponding deduction for DNI distributed to avoid potential double taxation.

Case Study 2:
The Foreign Nongrantor Trust



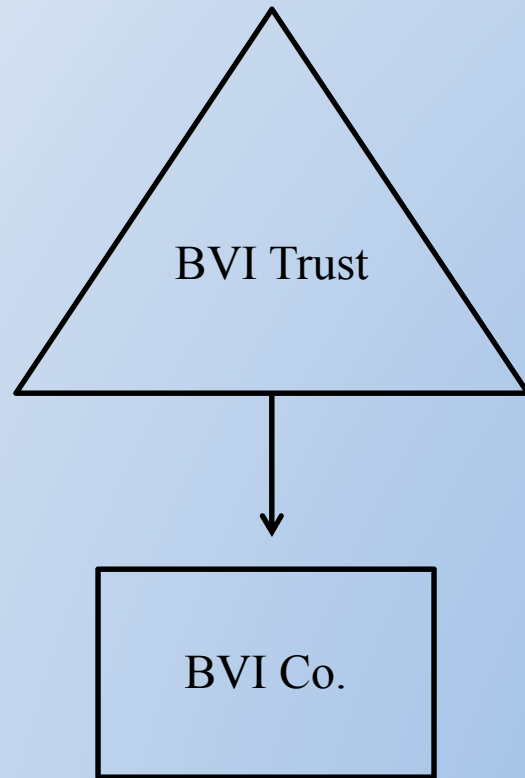
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

DNI is a concept somewhat similar to taxable income (determined under U.S. income tax accounting principles), with certain adjustments.

See Code § 643 and the applicable Regs.

Case Study 2:
The Foreign Nongrantor Trust



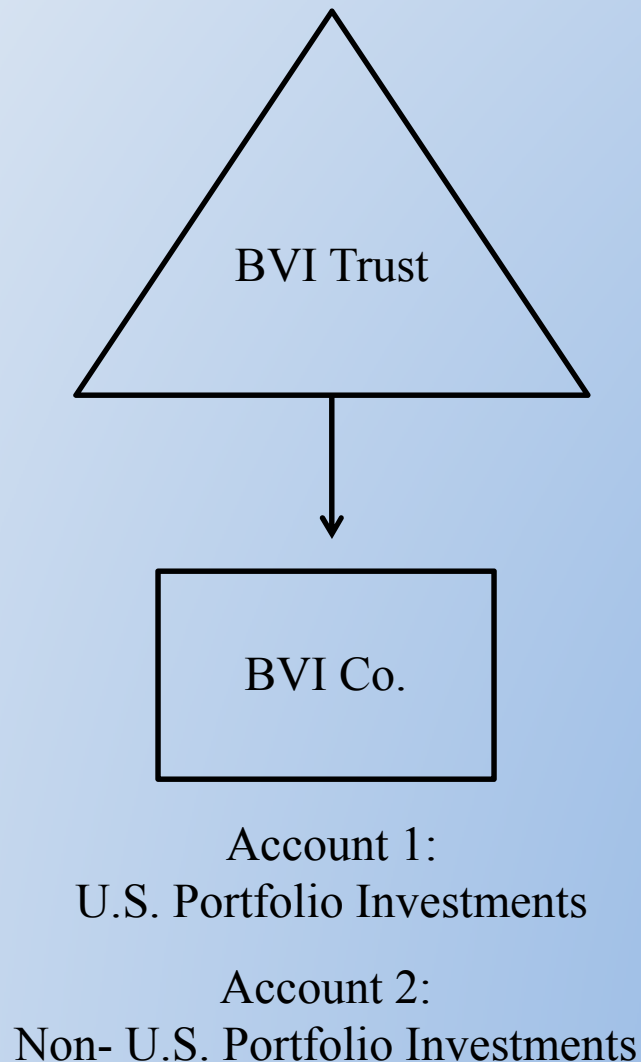
In the case of a foreign nongrantor trust, net capital gains are included in DNI, even if allocable to trust principal under local law or the terms of the trust agreement.

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

See Code § 643 and the applicable Regs.

Case Study 2:
The Foreign Nongrantor Trust

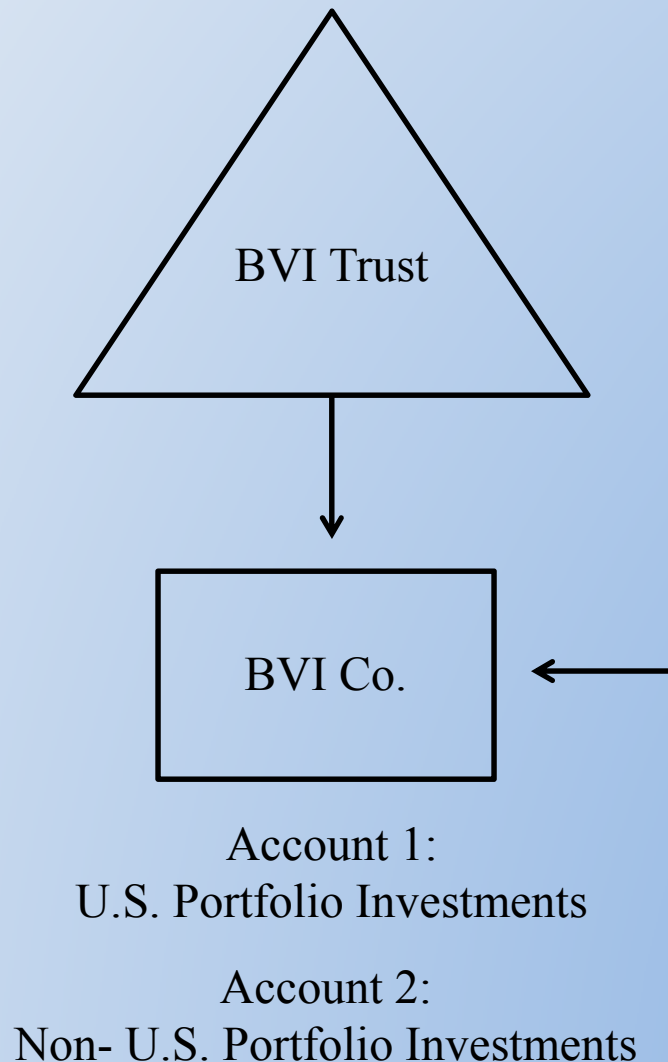


If the trust accumulates any income (including capital gains) instead of distributing them annually (i.e., “undistributed net income” or “UNI”):

- capital gains and other classes of income are reclassified as “ordinary income” (thus losing potential U.S. tax benefits otherwise afforded to such classes, such as the treatment of long-term capital gains).
- When a U.S. person beneficiary receives a distribution of accumulated income or gains from prior years (an “Accumulation Distribution”), such beneficiary is subject to a special tax and to a varying interest charge.

See Code §§ 665, 666, 667 and 668 and the applicable Regs.

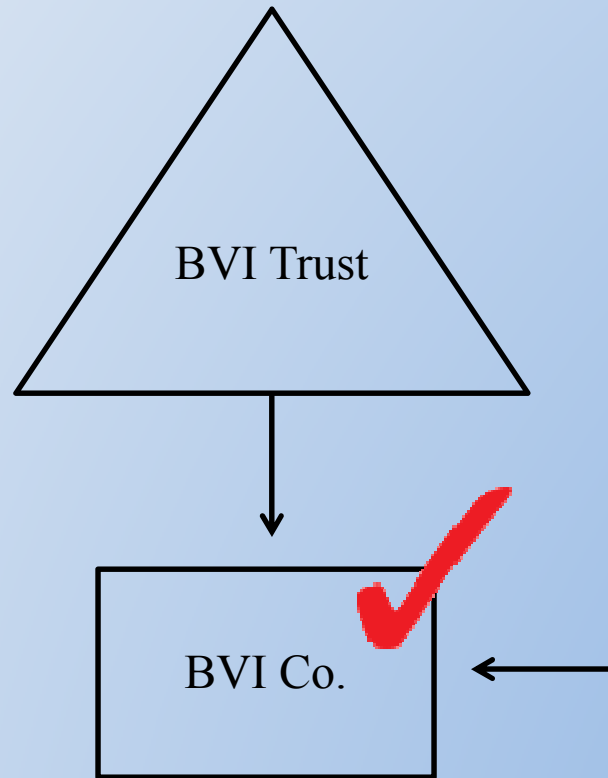
Case Study 2:
The Foreign Nongrantor Trust



Additionally, because of certain attribution rules under the Internal Revenue Code, the shares of the non-U.S. corporation will be attributable to the U.S. person beneficiaries for U.S. tax purposes. In this regard, one has to be cautious of the U.S. anti-deferral tax regimes (the “controlled foreign corporation” or “CFC” regime and the “passive foreign investment company” or “PFIC” regime).

See Code §§ 951-962, 964. See Code §§ 1291, 1293-1298.

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

A good solution to the anti-deferral regime issue is to get rid of the non-U.S. corporation solely for U.S. tax purposes. How? Form 8832 should be utilized to make the so-called "check-the-box" election.

Form 8832 (Rev. December 2013) Department of the Treasury Internal Revenue Service	Entity Classification Election ► Information about Form 8832 and its instructions is at www.irs.gov/form8832 .	OMB No. 1545-1516
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	Name of eligible entity making election	Employer identification number
Type or Print	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	

► Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

Part I	Election Information
---------------	-----------------------------

1 Type of election (see instructions):

a ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

a Name of owner ► _____
b Identifying number of owner ► _____

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

a Name of parent corporation ► _____
b Employer identification number ► _____

For Paperwork Reduction Act Notice, see instructions. Cat. No. 22598R **Form 8832** (Rev. 12-2013)

6 **Type of entity** (see instructions):

- 7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ► _____

8 Election is to be effective beginning (month, day, year) (see instructions)

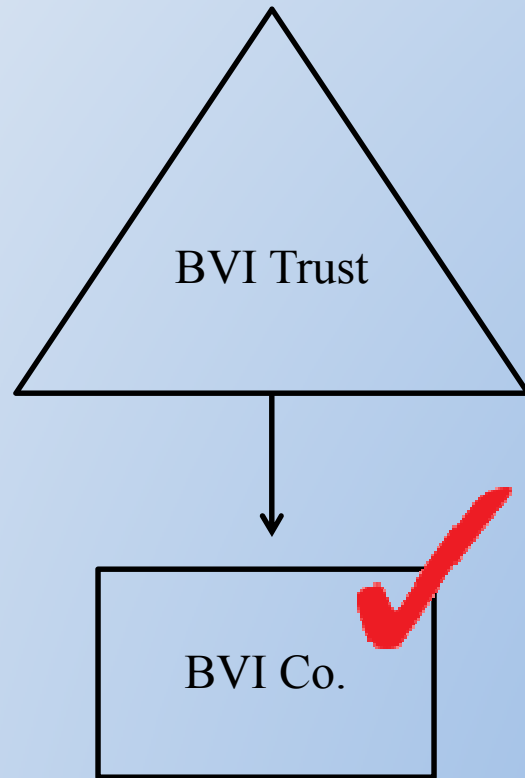
9 Name and title of contact person whom the IRS may call for more information

10 Contact person's telephone number

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

[illegible]

Case Study 2:
The Foreign Nongrantor Trust



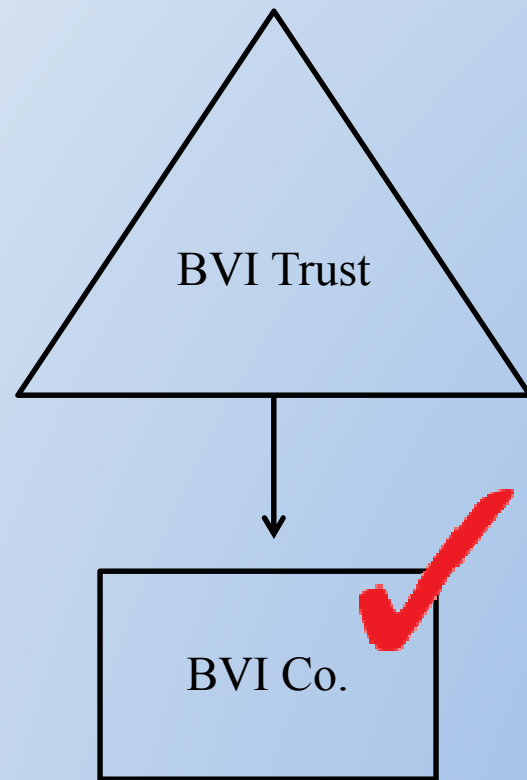
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

The consequences of making the “check-the-box” election is a deemed liquidation of the non-U.S. corporation for U.S. tax purposes.

The liquidation is deemed to occur at the end of the day of the date immediately prior to the “effective date” of the check-the-box election.

Case Study 2:
The Foreign Nongrantor Trust



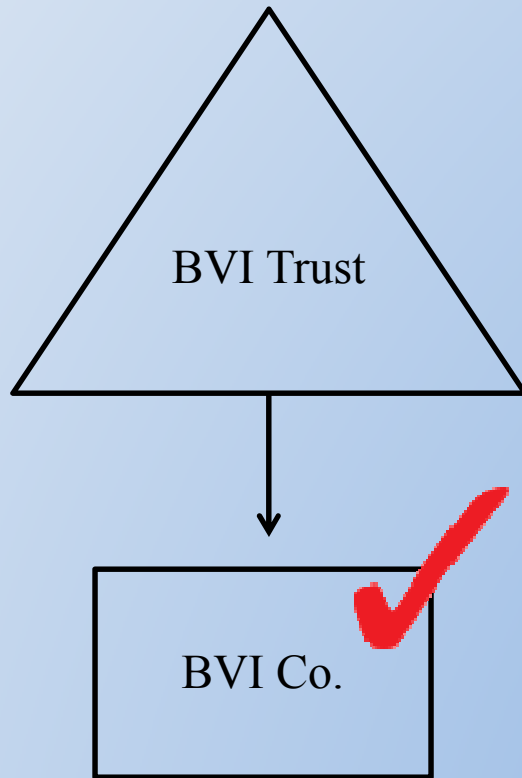
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

What happens if the effective date of the check-the-box election is the actual date of death?
What about the date after the date of death?
What about two days after?

CAUTION as to causing U.S. situs assets to be included in the U.S. gross estate, and, thus, subject to the U.S. estate tax.

Case Study 2:
The Foreign Nongrantor Trust

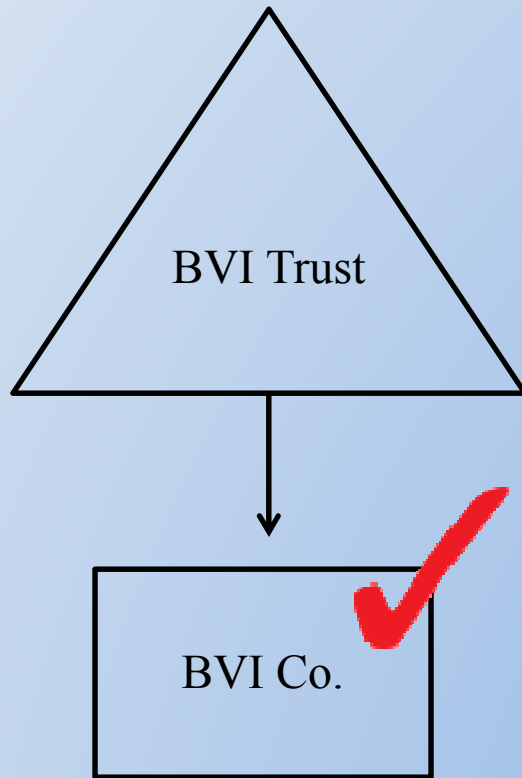


How soon do we have to file the Form 8832 to make the check-the-box election?

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

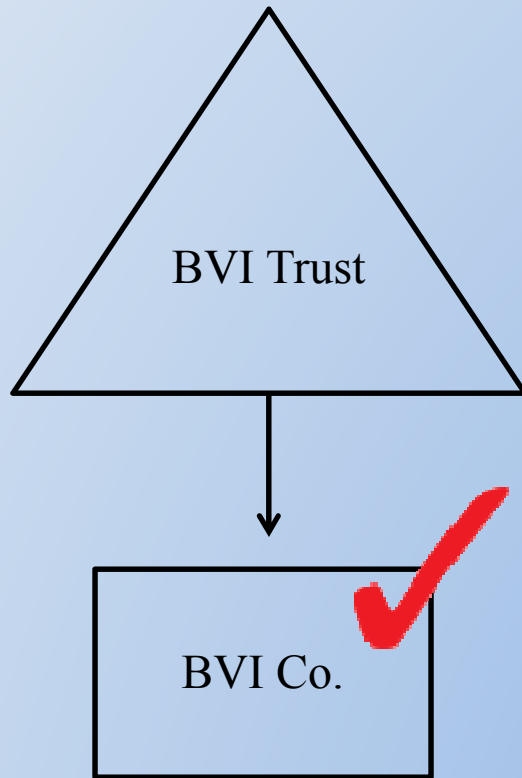
Account 2:
Non- U.S. Portfolio Investments

As noted, the effect of making the check-the-box election is a deemed liquidation.

If the trust agreement is not properly worded, a capital gain could be triggered when making the check-the-box election, and such capital gain will be considered DNI.

Consider the following example....

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

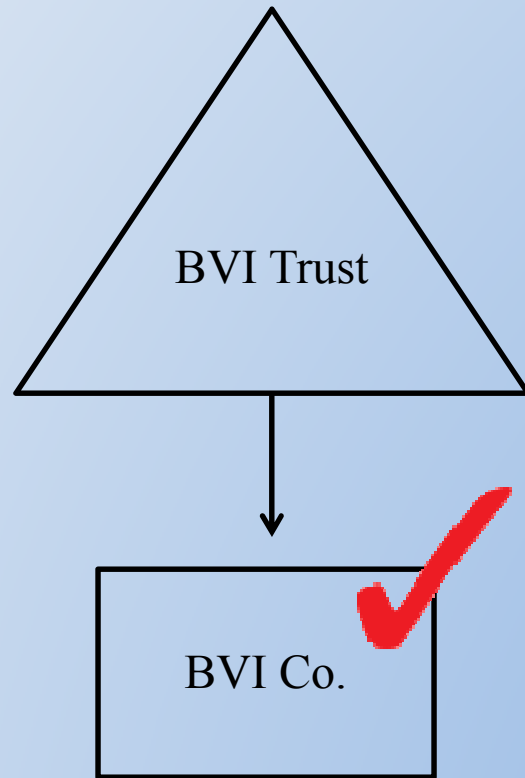
Account 2:
Non- U.S. Portfolio Investments

Settlor initially funds non-U.S. corporation with \$1 Million, and said cash is used to purchase the initial assets held in the portfolios. At the date of the Settlor's death, the fair market value of the portfolios, and, thus, the fair market value of the non-U.S. corporation is \$1.5 Million.

If the trust does not receive a "step-up" in basis as to the trust's ownership of the shares of stock in the non-U.S. corporation, then, upon making the check-the-box election (a deemed liquidation in which there is a deemed sale or exchange), the transaction will generate a \$500,000 capital gain.

Said capital gain will be included in DNI. If the trust received a "step-up" in basis, there would be no gain to the trust upon making the check-the-box election.

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Remember, if any such gain was accumulated and not paid out in the year earned, said gain would be taxed as ordinary income when it did come out and would otherwise be considered an Accumulation Distribution subject to the throwback tax and related interest charge.

Drafting tip in relation to the “step-up” in basis...

Generally, the tax basis or tax cost of property in the hands of a person acquiring property from a decedent will be the fair market value of the property at the date of the decedent's death. This “step-up” in basis can be quite beneficial as it basically nullifies the appreciation that remains unrealized at the time of the decedent's death without a corresponding income tax consequence.

Said “step-up” in basis is only beneficial to the extent there was appreciation at the date of death. Consideration should be given as to what can occur if the value of the assets at the date of death are less than the tax basis or tax cost.

Drafting tip in relation to the “step-up” in basis...

In a situation such as Case Study 1 (now Case Study 2), the basis adjustment would only be available if one of the following is satisfied:

- The property is transferred by the decedent during lifetime in trust to pay the income for life, to, or, on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust.
- The property is transferred by the decedent during lifetime in trust to pay the income for life, to, or, on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

Drafting tip in relation to the “step-up” in basis...

In a situation such as Case Study 1 (now Case Study 2), the settlor will have either the right to revoke or the right to alter, amend, (i.e., modify) or terminate (and possibly will have the right to exercise all such powers).

Drafting tip in relation to the “step-up” in basis...

What about the “income interest”? The applicable Internal Revenue Code Section says the trust must “pay the income for life, to, or, on the order or direction of the decedent.”

Drafting tip in relation to the “step-up” in basis...

Try to draft so that the settlor has the right to direct the payment of income to the settlor or others until the date of death.

What happens in the event of the settlor's incapacity or disability when the settlor can no longer direct the payment of income?

Drafting tip in relation to the “step-up” in basis...

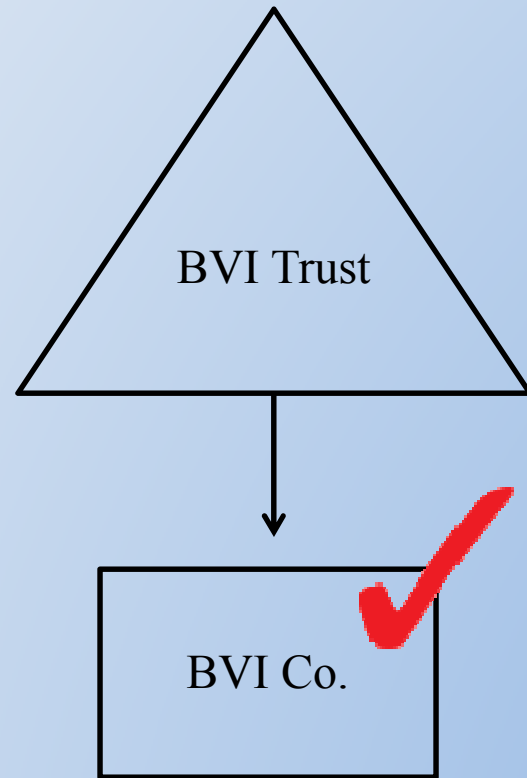
Consider a clause that requires the trustee to distribute income to or for the benefit of the settlor in the event of incapacity or disability.

The “magic” wording will be there for U.S. tax purposes but for practical purposes does it really matter?

What is “income” to the trust? Dividends from the underlying non-U.S. corporation that would not be declared unless the funds were needed.

Everybody wins....

Case Study 2:
The Foreign Nongrantor Trust



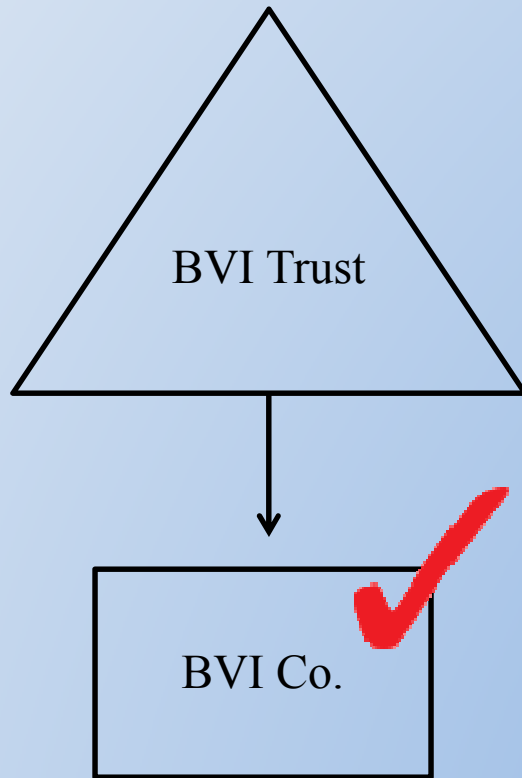
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Recap of where we are:

- The settlor has died and trust is a foreign nongrantor trust.
- A Form 8832 has been filed so as to liquidate the non-U.S. corporation (i.e., BVI Co.) for U.S. tax purposes.
- Going forward, there is no need to worry about anti-deferral regimes in relation to BVI Co. It will still exist for all purposes other than U.S. tax purposes. What about non-U.S. portfolio investments such as foreign hedge funds or foreign mutual funds? Are there PFIC issues?
- Upon the deemed liquidation, we want to draft the trust so that no capital gain is included in DNI when the check-the-box election is made.

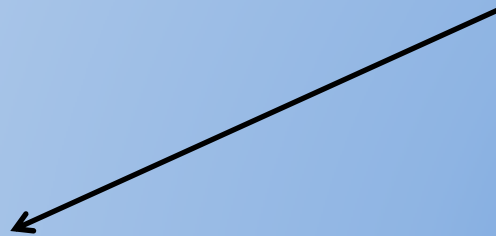
Case Study 2:
The Foreign Nongrantor Trust



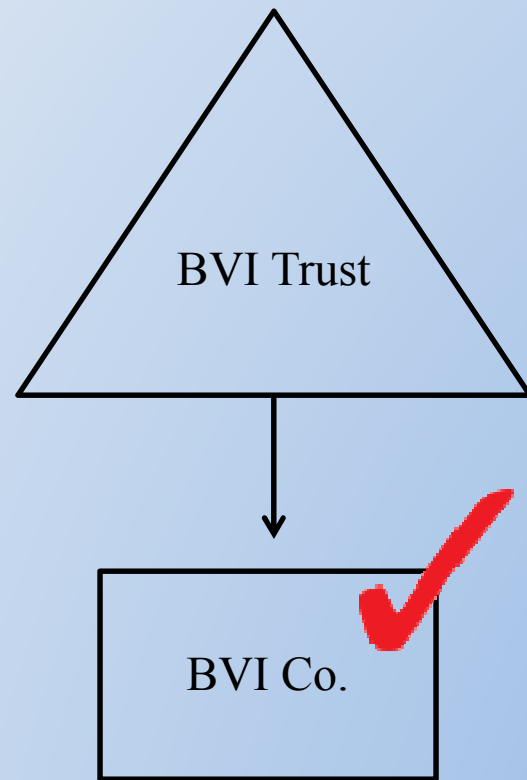
Interest income, dividends, gains, etc. generated in the portfolios will now be considered as earned directly by the trust and will be included in DNI.

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments



Case Study 2:
The Foreign Nongrantor Trust



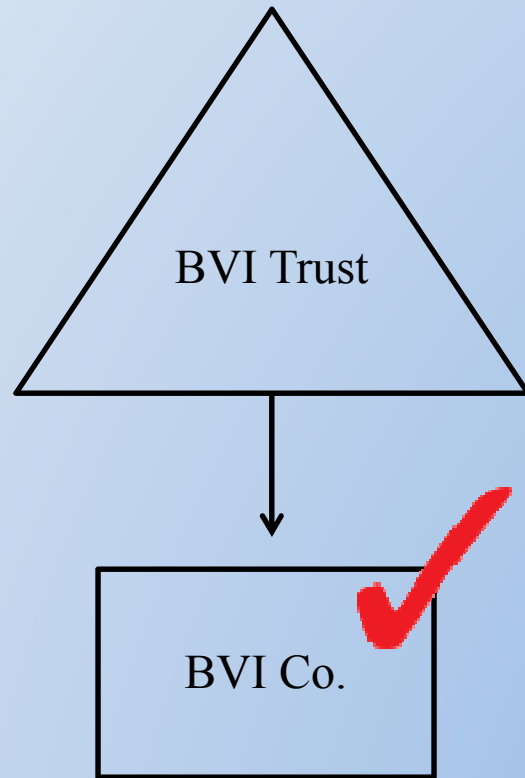
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Some common ways to deal with the DNI generated on annual basis:

- Distribute current year income and gains on an annual basis (to the U.S. person beneficiary or to a domestic sub-trust benefiting the beneficiary).
- Use the “FAI limitation” rule.
- Consider non-income generating products such as special life insurance products.
- Consider tax-exempt income.
- Consider an actual trust domestication.
- Use a charitable remainder trust.
- Planning for Internal Revenue Code Section 645.

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

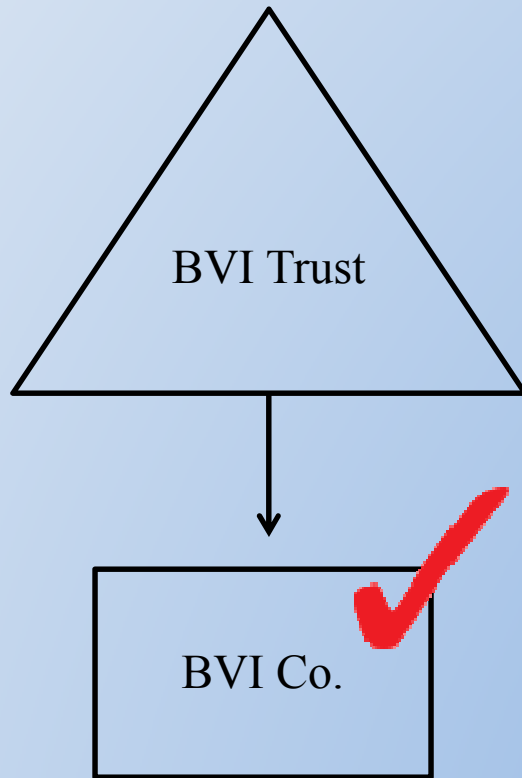
Account 2:
Non- U.S. Portfolio Investments

It is virtually impossible to know the DNI of any given year by December 31st of that year. So how do we know the exact amount of DNI to deal with by year-end?

The solution lies in the so-called “65-day rule.”

See Code § 663(b).

Case Study 2:
The Foreign Nongrantor Trust

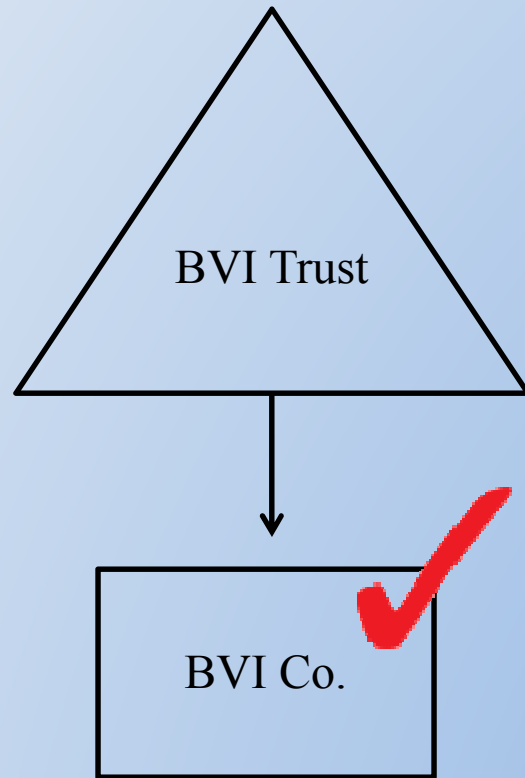


If within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year. This rule only applies if the fiduciary makes the proper election.

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 2:
The Foreign Nongrantor Trust



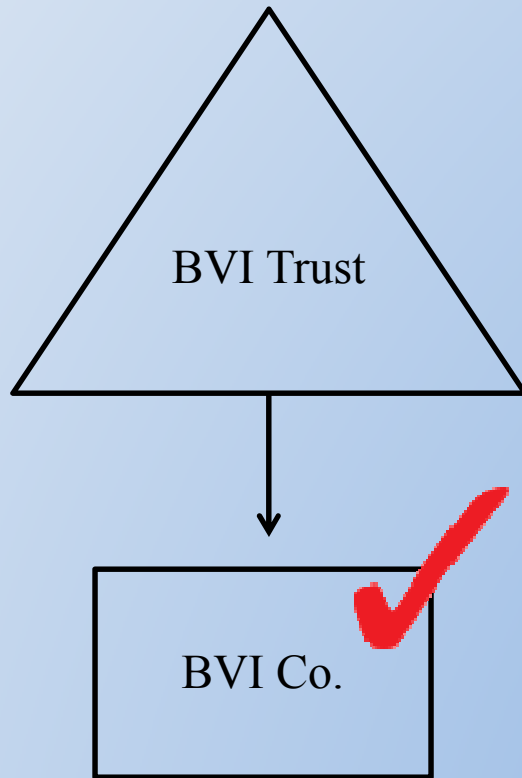
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Another option in planning for DNI is to consider drafting for specific gifts in no more than three installments.

Special rules exist which are designed to allow U.S. income tax-free distributions even in the case where the trust has DNI or UNI which if distributed would be taxable to the U.S. person beneficiaries.

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

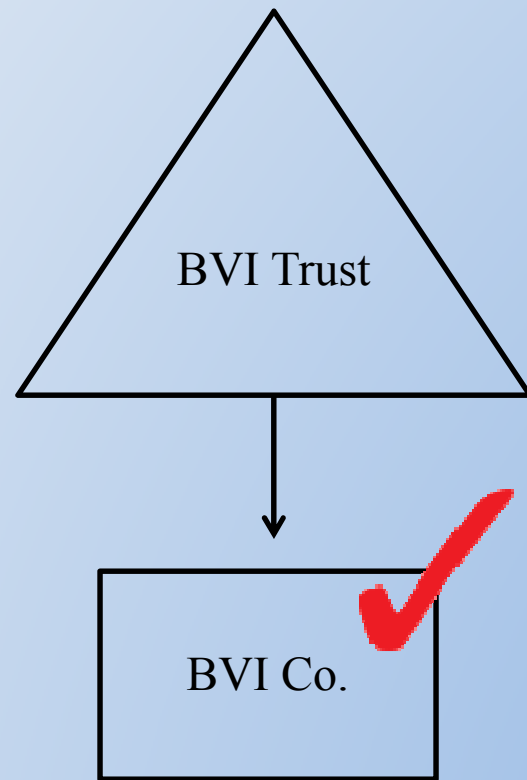
Account 2:
Non- U.S. Portfolio Investments

Three payment rule...

This rule applies to “[a]ny amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments.” Distributions that meet these conditions are tax-free to the U.S. person beneficiary.

See Code § 663(a)(1).

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

It is important to note that DNI is distributable “net” income, and, thus, expenses can be utilized.

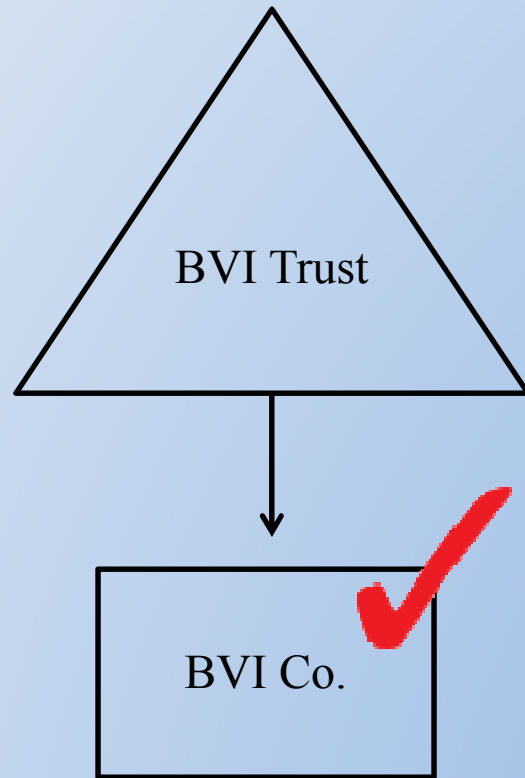
Expenses can be “direct” and “indirect” and the fiduciary has certain discretion to allocate indirect expenses to various classes of income.

In this regard, consideration should be given to allocating indirect expenses to classes of income which carry a higher rate of U.S. income tax.

Tax exempt income requires a prorata allocation of expenses.

See Regs. § 1.652(b)-3.

Case Study 2:
The Foreign Nongrantor Trust



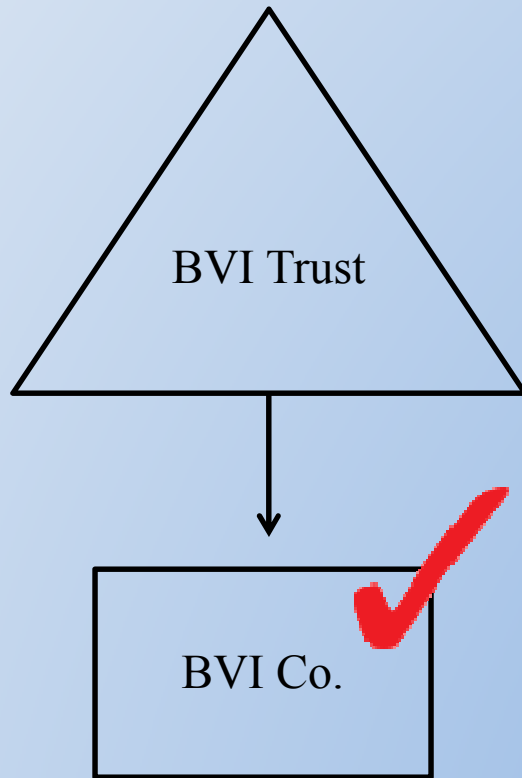
Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

It is very common to see a discretionary trust drafted in a manner that allows the trustee to distribute to any one or more of the beneficiaries in the trustee's discretion.

How does such a discretionary pool of beneficiaries impact the computation of DNI? If there are U.S. and non-U.S. person beneficiaries, complications could arise. Consider utilizing separate shares created for the benefit of each such beneficiary.

Case Study 2:
The Foreign Nongrantor Trust



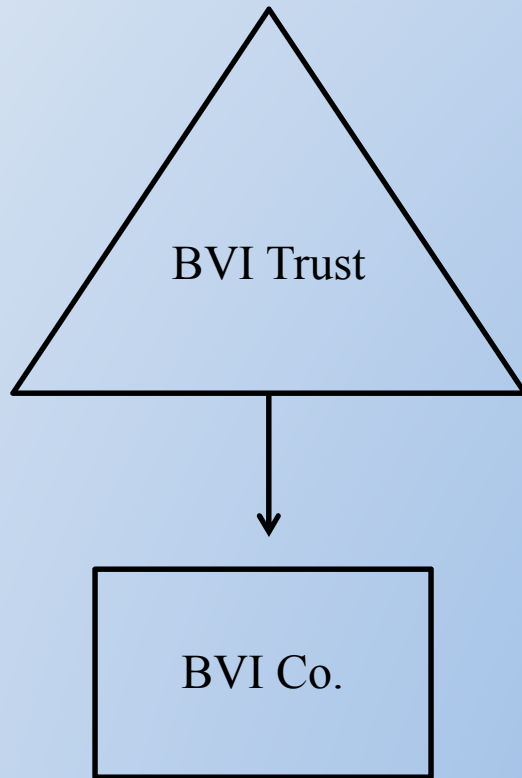
For the sole purpose of determining the amount of DNI, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts.

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

See Code§ 663(c).

Case Study 2:
The Foreign Nongrantor Trust

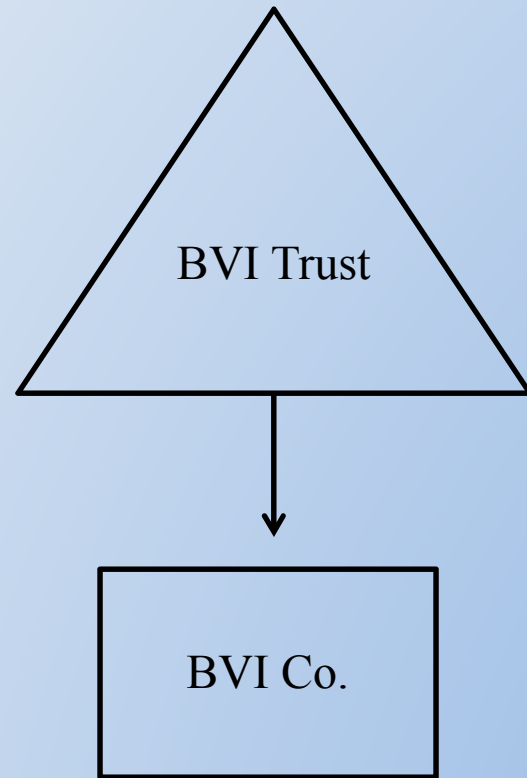


Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

U.S. Estate Tax Considerations

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

U.S. Estate Tax Considerations

- A properly drafted discretionary trust should keep the assets out of the U.S. person beneficiary's U.S. gross estate for U.S. estate tax purposes.
- A properly drafted discretionary trust should also afford general creditor protection.
- Avoid giving a general powers of appointment ("GPOA") wherein the U.S. person beneficiary can appoint to anyone including himself, herself or his or her estate or creditors.

Drafting tip in relation to avoiding general powers of appointment...

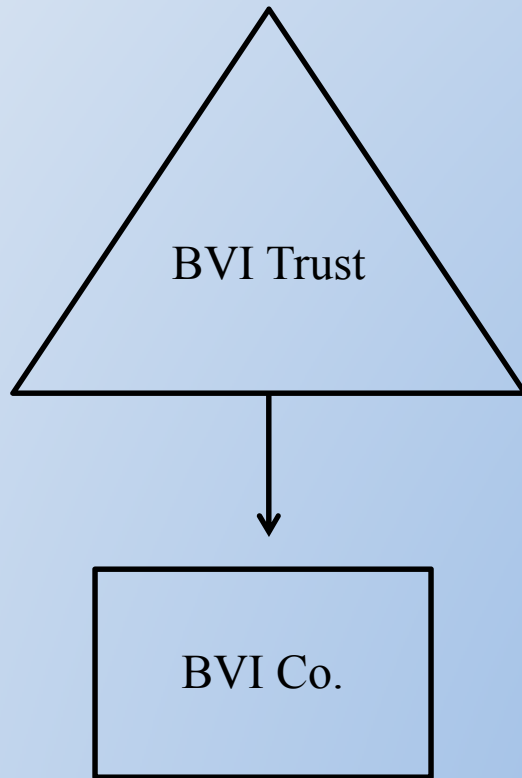
Many trust documents contain a standard power allowing one or more parties to remove and appoint trustees. Many times this power is given to beneficiaries. What if there is no limitation on who the beneficiary can appoint? What if the beneficiary could appoint himself or herself?

If a U.S. person beneficiary has the power to remove and appoint trustees, the trust document should provide that any such trustee shall be a trustee that is not “related or subordinate” to the beneficiary within the meaning of Code § 672(c).

Drafting tip in relation to avoiding general powers of appointment...

If a beneficiary is able to serve as trustee, make sure there is a clause therein prohibiting the beneficiary from exercising certain powers that would be considered a GPOA (e.g., prohibit the beneficiary from being able to make discretionary distributions to himself or herself).

Case Study 2:
The Foreign Nongrantor Trust

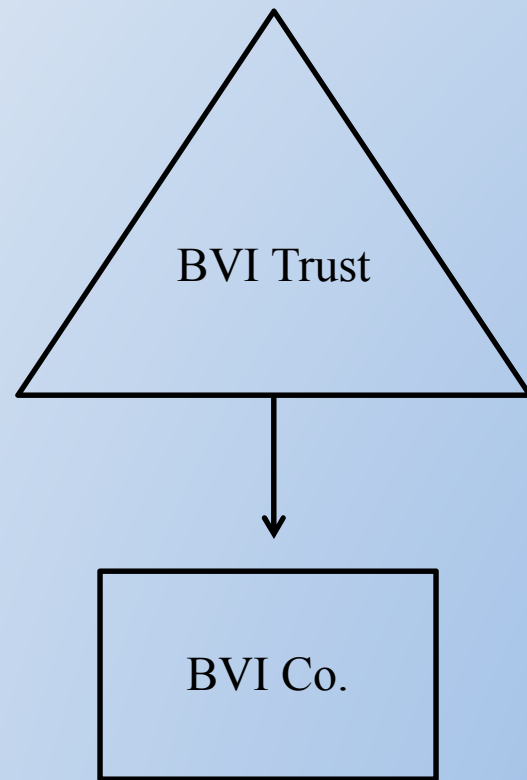


U.S. Gift Tax Considerations

Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

Case Study 2:
The Foreign Nongrantor Trust



Account 1:
U.S. Portfolio Investments

Account 2:
Non- U.S. Portfolio Investments

U.S. Gift Tax Considerations

- The U.S. gift tax is generally not an issue for the U.S. person beneficiary in relation to his or her beneficial interest in the trust.
- The trust should contain clauses which prohibit the U.S. person beneficiary from assigning, pledging or otherwise encumbering his or her beneficial interest in the trust.
- The use of a special power of appointment may allow a beneficiary to have control over beneficial enjoyment during life or at death without causing a taxable transfer for U.S. gift tax purposes.