Transfers of Foreign Funds to the U.S.

A Brief History

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Prehistoric Era: Pre-2011

- Investment Reporting
  - Outbound (Form 5472, T.D.F. 90-22.1)
  - Inbound (Forms 5471, 8865, 8858, 3520)
- 2008-2010 IRS Report
  - TAX GAP $458 Billion, up from $450 Billion in 2006
  - Voluntary Compliance down to 81.7% from 83.1%
    - Koskinen quoted 1% increase is about $30 billion tax receipts
    - At the time, not considered to be due to taxpayer behavior change

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The Dawn of FATCA: Hire Act 2010

- March 18, 2010 - New chapter of withholding (Chapter 4, IRC §§ 1471-1474)
- FAT-CAT Swiss Banking Scandals
- Matching program expanded outside the U.S.
  - Inside the U.S. – Report Form 8938
    - 2011 – individuals
    - 2016 – entities
  - Outside the U.S. – Blackmail.
    - Requires foreign financial institutions to report to the IRS information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.
    - U.S. Taxpayers are the police.

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It Worked!

- In August 2010, the IRS announced the realignment of the Large and Mid-Size Business (LMSB) division to create a more centralized organization dedicated to improving international tax compliance, known as the Large Business and International division (LB&I).
- OVDI, OVDP, Streamlined… By November 2016, Offshore Compliance hit a milestone – over 100,000 taxpayers and $10 BILLION revenues in taxes, interest and penalties.
- 195 countries in the world. 113 have signed IGAs with the U.S..

Source: https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx

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Hey, That's Not a Bad Idea:
OECD Common Reporting Standards

- 2014 – "Standard for Automatic Exchange of Financial Account Information" was based on the FATCA design
  - A global reporting standard for the automatic exchange of information (AEoI)
  - More than 96 countries share information on residents' assets and incomes in conformation with reporting standards.
- CRS is more wide reaching than FATCA
  - Penalties based versus withholding based
  - Each participating jurisdiction sets its own rules for compliance, subject to a peer review process
  - Reporting thresholds are lower (more accounts subject to CRS than FATCA)

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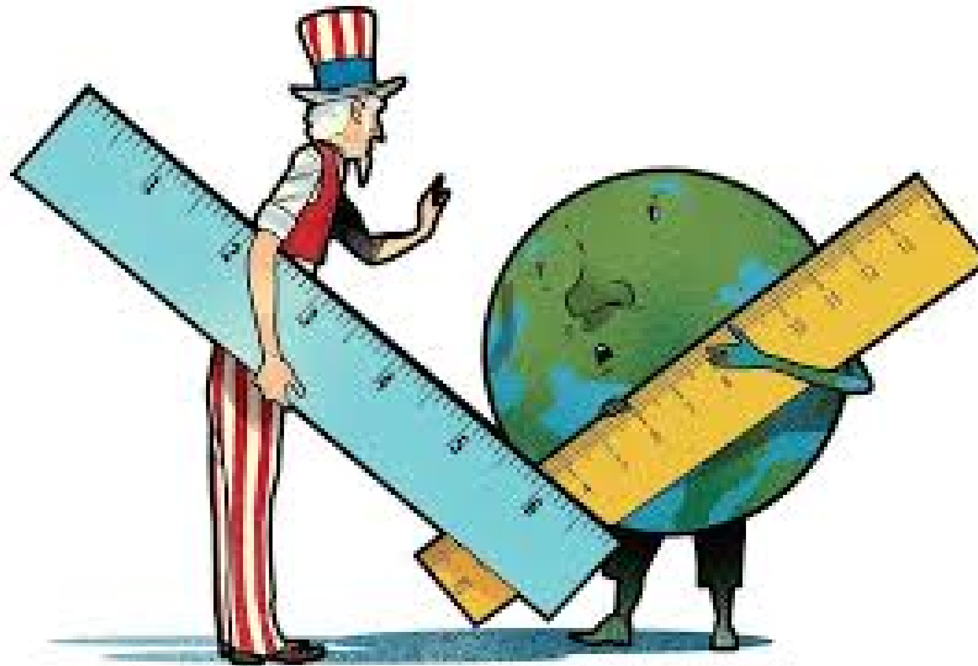
The American Response



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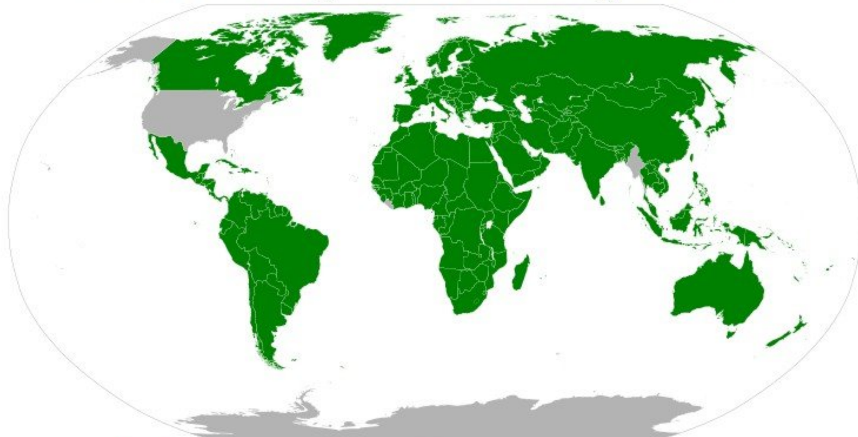

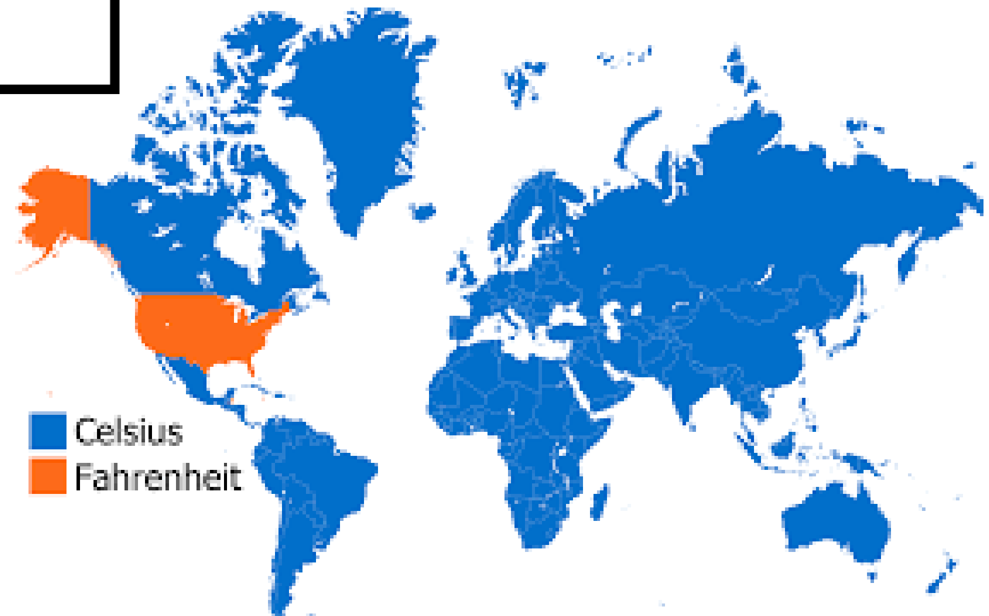

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Impact on the U.S.

- Since U.S. not a participant in CRS, and FATCA is less in scope, practitioners are starting to see an increase in foreign money coming into the U.S.
- 2011-2013 Tax Gap Report will be released in 2019

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Thank you – Questions?

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Transfers of Foreign Funds to the U.S.: Opportunities and Risks for Delaware Trusts

INTRODUCTION

It is increasingly common for global families to have cross-border circumstances that give rise to a multitude of U.S. income, gift, estate and generation-skipping transfer tax consequences, particularly when trusts are involved. Delaware trusts can and do play an important role in the solutions for such international families.

INTRODUCTORY TAX OUTLINE

- **Basic rules of international estate planning:**
  - U.S. persons (based on citizenship or the residency tests) are subject to U.S. income taxation on their worldwide income. (I.R.C. §§ 1, 61).
  - Individuals who are U.S. persons (based on citizenship or domicile) are also subject to gift, estate and generation-skipping transfer taxation on their worldwide assets. (I.R.C. §§ 2001, 2031-2046, 2601).
  - Non-U.S. persons are subject to U.S. income taxation only on their U.S. source income – dividends, interest, rents and income from effectively connected business in the U.S. (bond portfolio interest and capital gains are not source income).
  - Individuals who are non-U.S. persons (non-citizen, non-domiciliaries) are subject to U.S. gift, estate and generation-skipping transfer taxation only on their U.S. situs assets.
  - *Trusts, like individuals, can be classified as domestic or foreign.*

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FOREIGN TRUSTS FOR U.S. TAX PURPOSES

- **Objective Rule – A trust is considered domestic for U.S. tax purposes only if:**
  - A U.S. court can exercise primary supervision over its administration (the court test); and
  - The U.S. fiduciaries have the authority to control all substantial decisions relating to the trust (the control test).
- **A trust that does not satisfy <u>both</u> tests is a foreign trust for U.S. tax purposes.**
  - Trusts can become foreign because of appointment of new trustee.
  - A trust formed in the U.S. could be foreign for U.S. tax purposes
  - Inadvertent loss of U.S. status

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COURT TEST - TREAS. REGS. § 301.7701-7(C)

- A court is able to exercise primary supervision over the trust if a U.S. court has authority to render orders or judgments resolving substantially all issues concerning administration of the entire trust.

- A trust that is registered with a U.S. court under the registration provisions of a statute similar to Article VII of the Uniform Probate Code meets the court test. If the parties take steps with a U.S. court that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test even if both a U.S. court and a foreign court have jurisdiction over the trust.

- A trust fails the court test if the trust instrument includes a migration clause but a clause triggering migration of the trust only in the case of foreign invasion or widespread confiscation or nationalization of property is not regarded as a migration *clause.*

***Safe Harbor**:*

- The trust instrument does not require trust administration outside of the U.S.
- The trust is actually administered exclusively in the U.S.
- The trust is not subject to an automatic migration provision.

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CONTROL TEST -- TREAS. REGS. § 301.7701-7(D)

- One or more U.S. persons must have the authority to control all substantial decisions of the trust.
- Substantial decisions include:
  - 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
  - Whether to compromise, arbitrate or abandon claims
  - Whether to sue on behalf of the trust or to defend suits against the trust
  - Whether to remove, add or replace a trustee
  - Investment decisions

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CONTROL TEST PLANNING

- Subject to a grace period under the Regulations to correct for "inadvertent" changes, a U.S. trust can become foreign due to a trustee change, or a change in the tax residence of a non-U.S. citizen individual holding a power, since "U.S. persons" does not include individuals who are nonresident aliens as to the United States. Reg. § 684-4(c).

- The rule applies to non-fiduciary powers, not only trustee powers – e.g., a power to add a beneficiary, such as in a typical power of appointment, or a power to direct investments if not terminable at the will of U.S. persons. But non-fiduciary powers could be held, for example, by a corporation incorporated under U.S. law.

FOREIGN TRUST DOMESTICATION: OVERVIEW

- Traditionally, offshore trusts offered unparalleled asset protection and privacy to the grantor and beneficiaries.
- The unrelenting trend in U.S. jurisdictions to modernize the trust laws, has significantly narrowed the competitive gap with foreign trusts.
- U.S. modernization, combined with the compliance and tax burdens imposed on foreign trusts, have been enough to tip the scales in favor of a domestic trust in many situations.

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FOREIGN TRUST DOMESTICATION: THE WHY?

- Migrating a foreign trust to the U.S. may be beneficial, especially in cases where the trust has U.S. beneficiaries. Among the benefits:
  - U.S. grantors and beneficiaries can avoid the onerous tax and reporting requirements imposed on foreign trusts
  - U.S. settlor of a foreign non-grantor trust with U.S. beneficiaries may terminate his responsibility for payment of income taxes under §679.
  - Domestication stops the accumulation of Undistributed Net Income (UNI) under the “throwback” rules.
  - Foreign grantor may be able to take advantage of U.S. trust law without subjecting the trust to U.S. income taxes.
  - A U.S. jurisdiction avoids the negative perceptions associated with offshore trusts.

FOREIGN TRUST DOMESTICATION: THE WHY?

- Reporting Requirements imposed on foreign trusts with U.S. grantors and beneficiaries:
  - Form 3520 – Must be filed by a U.S. person, to satisfy the requirements of I.R.C. § 6048(a), upon the occurrence of a reportable event. A reportable event includes:
    - the creation of a foreign trust
    - a transfer of assets to a foreign trust
    - the receipt of a distribution from a foreign trust
  - The penalty for failure to file Form 3520 is the greater of $10,000 or 35% of the value of property transferred to or received from a foreign trust.

FOREIGN TRUST DOMESTICATION: THE WHY?

- Form 3520-A – Must be filed by a U.S. owner of a foreign trust, to satisfy the requirements of I.R.C. § 6048(b). The U.S. owner must report:
  - The income generated and the assets held by the trust
  - The U.S. beneficiaries of the trust
  - The U.S. owners of the trust
- The penalty for failure to file Form 3520-A is the greater of $10,000 or 5% of the gross value of the trust.
- Additionally, since the U.S. is not a signatory to CRS, domestication and appointment of only U.S. trustees generally will eliminate any entity-level reporting by the trust associated with CRS.
  - Reporting would also not be required for any U.S. accounts (unlike the trust's CRS-jurisdiction accounts).

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FOREIGN TRUST DOMESTICATION: THE WHY?

- U.S. settlor of a foreign non-grantor trust with U.S. beneficiaries may terminate his responsibility for payment of income taxes under §679.
  - I.R.C. § 679 treats the U.S. settlor of any non-grantor foreign trust that has U.S. beneficiaries as the owner of such trust for income tax purposes.
  - Even a foreign settlor who becomes a U.S. person within 5 years of settling the trust will be treated as a U.S. owner under § 679 upon becoming a U.S. person.
  - If the non-grantor foreign trust is repatriated it will become a domestic non-grantor trust and the trust or its beneficiaries will be responsible for the income tax liability.

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FOREIGN TRUST DOMESTICATION: THE WHY?

- U.S. beneficiaries may avoid the application of the “throwback” taxes by domesticating a foreign trust.
  - If a foreign trust does not distribute all income currently (its distributable net income or “DNI”) but accumulates it, the DNI becomes undistributed net income (“UNI”).
  - Upon distributions of UNI to U.S. beneficiaries, an unfavorable set of provisions known as the "throwback” rules will apply to the receipt of any UNI.
  - Under the “throwback” rules, a distribution of UNI is taxed to the beneficiaries in a manner roughly approximating the tax situation if it had actually been distributed in the year earned.
  - Any capital gains lose their character once they become UNI, thus all UNI is taxed as ordinary income in the year it was earned, with interest.

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FOREIGN TRUST DOMESTICATION: THE WHY?

- Since the governing law of the trust is not determinative for tax purposes, it is possible to have a foreign trust governed by the laws of a U.S. jurisdiction.
  - This allows the application of flexible trust law (e.g., Delaware), without the consequences of U.S. income taxation (except for U.S. source income, for which all foreign trusts would be responsible).
- There may be circumstances in which a client wants to change the design of his or her trust to address a particular need, but the laws of the current offshore jurisdiction do not readily facilitate the proposed change.
  - The client wants to appoint investment advisors or distribution advisors for the trust, without any involvement of the trustee in investment or distribution decisions.
  - The client would like to defer informing the beneficiaries of the existence of the trust or client anticipates a potential challenge to the terms of the trust.
  - The client has concerns about his family's personal security and does not want to subject the trust and its underlying entities to asset and income reporting under the Common Reporting Standard. (The U.S. is not a signatory to CRS and has no obligation to report client financial data to participating countries.)

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FOREIGN TRUST DOMESTICATION: THE WHEN?

- Consistent with the reasons for migrating a trust to the U.S., a good time to consider migration may be:
  - Upon the death of a foreign grantor if there are U.S. beneficiaries
    - If a trust is migrated before any UNI is accumulated, then the beneficiaries will never have to deal with UNI issues or “throwback” rules.
    - Beneficiaries can also reduce or eliminate the related reporting burdens.
  - When a beneficiary of a foreign non-grantor trust becomes a U.S. person
    - This would similarly avoid the UNI issues.
    - Alternatively, a second domestic trust may be established to receive all DNI and avoid the foreign trust accumulating UNI.

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FOREIGN TRUST DOMESTICATION: THE HOW?

- A foreign trust can be domesticated in the following ways:
  - Replacing the existing trustee with a U. S. trustee (assuming trustee makes all “substantial decisions”) and moving the place of administration to a U.S. jurisdiction
  - Decanting the foreign trust into a new domestic trust
  - Termination of a trust and recreation of a new trust by original beneficiaries

FOREIGN TRUST DOMESTICATION: THE HOW?

Trust Domestication		
Replace Trustee	**Decant**	**Termination/Recreation**
• In essence requires changes that cause the trust to satisfy the court and the control tests. • Subject to the trust's rules for appointing a new trustee. • Delaware law applies to a trust administered in Delaware. • In Delaware changing the trustee will thwart choice of law provision in a trust, unless expressly preserved.	• The power to decant must be derived from local statutes or the trust document. • Foreign jurisdictions may not have the liberal decanting statutes available in Delaware • Delaware requires the trustee to have power to distribute trust corpus. • Generally, the new trust must match any ascertainable distribution standards in the old trust.	• The trustee or another party must have power to terminate trust. • In essence, not a domestication method but it achieves the goal. • Severe transfer tax consequences may result from an application of this method. • *Buhl v. Kavanagh* – Applicability of precedent may not be universal under different facts.

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FOREIGN TRUST DOMESTICATION: THE HOW?

- Replacing the existing trustee with a U. S. trustee and transfer the place of administration to a U.S. jurisdiction.
  - The simplest way to domesticate a trust is to replace the foreign trustee with a U.S. trustee. Generally, the appointment of a U.S. trustee would change the place of administration to the trustee's U.S. jurisdiction.
  - Many jurisdictions allow their courts to exercise jurisdiction over trusts administered in their jurisdiction.
  - This would classify the trust as a U.S. trust by both subjecting the trust to the jurisdiction of courts in the U.S. and placing all substantial decisions in the hands of a U.S. person.

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FOREIGN TRUST DOMESTICATION: THE HOW?

- The biggest challenge to this simple method is the language of the trust itself that may include a foreign governing law.
- Under Delaware law, unless expressly provided by the terms of the trust, the laws of the state apply to a trust administered in the state (12 *Del. C*. § 3332).
- The Delaware Supreme Court recently held that if a trust allowed a change of trustee without geographic limitation, then the appointment of a Delaware trustee will change the place of administration of the trust to Delaware.
  - This applies regardless of a choice of law provision in the trust documents
  - Exception – If the trust expressly provides that a change in trustee does not change the governing law.

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FOREIGN TRUST DOMESTICATION: THE HOW?

- Termination/divestiture of a trust and recreation of a new trust by original beneficiaries.
  - Terminating or divesting an existing trust and funding a new one is not a method of domesticating a trust, but a method of obtaining the desired result.
  - Although there is precedent for treating a termination followed by a recreation as a mere change in form, there is a chance that the IRS may adopt the split transaction view and impose taxes on the receipt and subsequent disposition of the assets.

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GENERATION-SKIPPING TAX IMPLICATIONS

- GST tax-exempt trusts may lose their tax-exempt status
  - A generation skipping tax exempt trust is a trust to which the generation skipping tax provisions do not apply because:
    - it was irrevocable as of September 25, 1985
    - it was funded by a non-resident alien with non-U.S. situs property
    - the trust has an inclusion ratio of zero.
- Certain modifications of a trust will result in the loss of the GST tax-exempt status.

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GENERATION-SKIPPING TAX IMPLICATIONS

- The IRS takes the position that any change in a trust that "alters the quality, value, or timing of any powers, beneficial interests, rights, or expectancies," will lose it GST tax exempt status.
- The IRS has ruled that a change in the trust situs does not cause a loss of the GST exempt status in cases where it does not also change the governing law of the trust.
- The IRS has not ruled on whether a change in trust situs along with a change in governing law results in the loss of the GST-exempt status.

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GENERATION-SKIPPING TAX IMPLICATIONS

- The Treasury Regulations have provided for safe harbors that prevent the loss of GST tax-exempt status. These safe harbors include:
  - The exercise by a trustee of power to distribute principal to a new trust. Requirements:
    - The distribution must be authorized either by the trust instrument or the governing law in existence at the time the trust became irrevocable.
    - The new trust's terms do not extend the time for vesting of any interest.
  - A modification of the trust that:
    - Does not shift the beneficial interest in the trust to a lower generation.
    - The new terms do not extend the time for vesting of any interest.

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RULE AGAINST PERPETUITIES IMPLICATIONS

- The common law rule against perpetuities ("RAP") requires any interest in property to vest within 21 years of a life in being.
- Many jurisdictions have extended or eliminated the common law rule, so taking advantage of ever longer perpetuities periods is a large motivator to move to a new jurisdiction.
  - Generally, the RAP of the jurisdiction where real property is located will apply to a trust directly holding such real estate.
  - Some jurisdictions apply shorter RAPs to real estate (e.g., Wyoming 1000 yr. RAP to personal property and 21 yr. RAP for real estate)
- Merely changing the situs of the trust will usually not result in the application of the new jurisdiction's RAP.

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RULE AGAINST PERPETUITIES IMPLICATIONS

- Practically all jurisdictions treat the RAP as an issue of validity and not administration, so the validity of the trust must be tested at inception under the then-applicable RAP.
- Delaware is the exception in that it offers a procedure that results in the application of Delaware's RAP to a trust settled under a shorter RAP.
- Although a trust decanted into a new Delaware trust retains its original RAP, if that trust is further decanted into another Delaware trust, Delaware’s perpetual RAP applies to the second trust.
- <u>May not be an end-all solution</u>: This procedure fails the safe harbor provisions and will likely result in a loss of the GST tax-exempt status of a trust.

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TAKEAWAYS

- The domestication of a foreign trust may be in the best interest of U.S. beneficiaries that would otherwise be subject of onerous reporting requirements and punitive tax regimes.
- Although various methods exist to migrate a trust to the U.S., extreme care must be taken to avoid incurring unfavorable tax consequences.
- Special care should be taken to ensure that a valuable GST tax exemption is preserved after any transaction designed to migrate a trust.
- Migrating a trust is not generally a realistic option if the goal is to obtain a new rule against perpetuities.

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Alternative Entities

Corporations and LLCs

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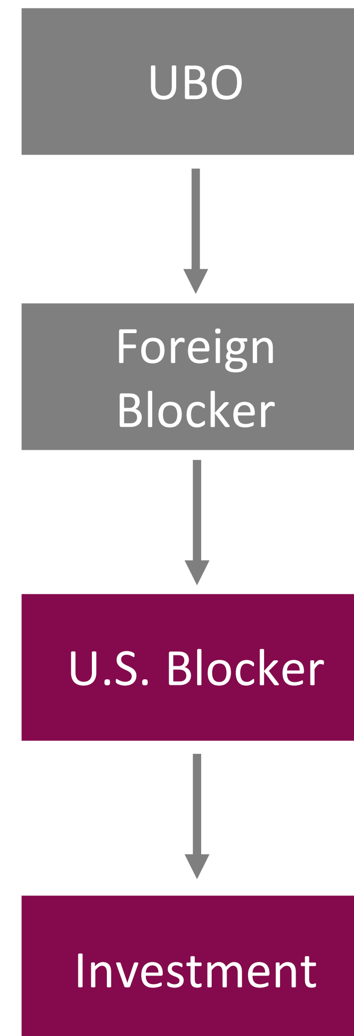
Blocker Corporations

Traditional Blocker Scenario

- "UBO"- Ultimate Beneficial Owner
- Foreign Blocker - foreign structure recognized by USA as a corporation §301.7701-3
- U.S. Blocker - Corporation or U.S. LLC (w/corporate election)
- U.S. Investment - LLC, corporate stock, U.S.-sited assets



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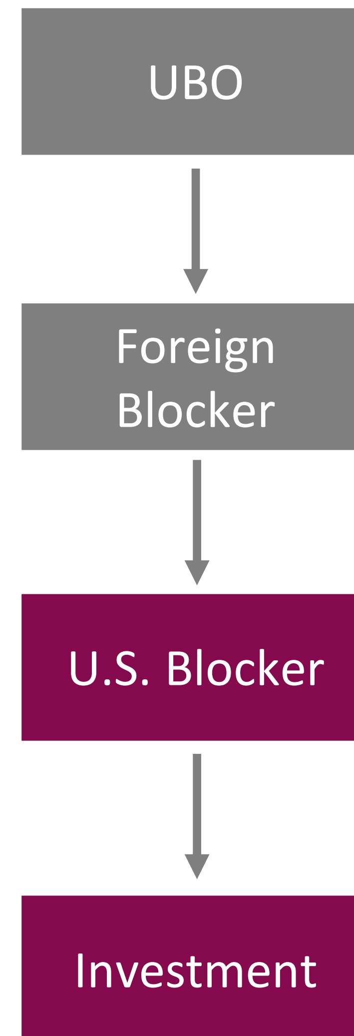
Blocker Corporations

- Foreign Blocker Role
  - “Blocks” ownership of UBO of U.S.-sited corporate stock
  - Preferential Treaty rates on dividends paid to corporate owners
    - Model Treaty Dividend Withholding Rates (Article 10):
      - 5% withholding if paid to foreign corporation that owns at least 10%
      - 15% in other cases
    - Model Treaty LOB provisions (Article 22)
- U.S. Blocker Role = domesticate U.S. Investments



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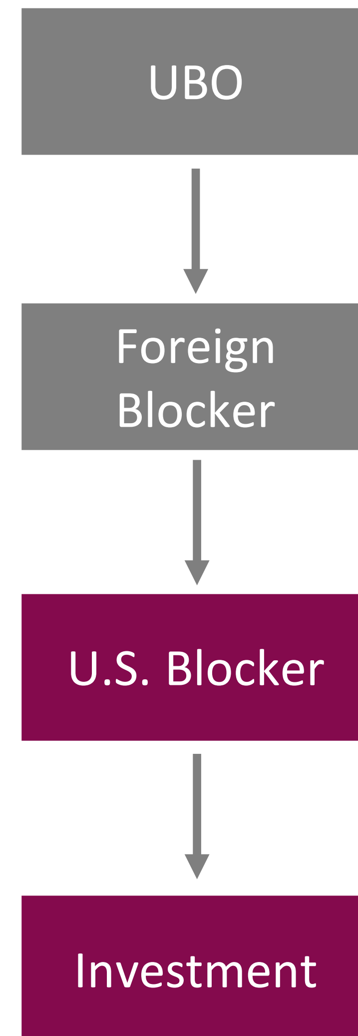
Blocker Corporations: Income Tax Effects

- U.S. Blocker
  - Reports income on 1120
  - DE 1902b
  - Form 5472
- Dividends paid to Foreign Blocker
  - Form 1042
  - W-8BEN-E required on file
- "Investment" = U.S. Real Estate
  - Election to treat as ECI under §871(d)
  - FIRPTA Withholding 10% under §1445



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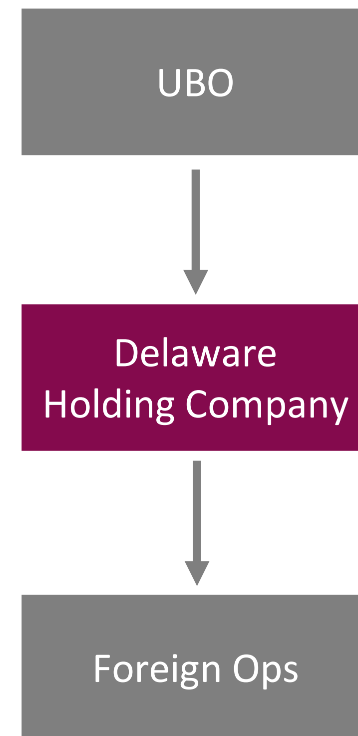
U.S. Holding Company

- Typical scenario:
  - Latin America (typically no treaty with these countries)
  - E-commerce, online businesses
- Why?
  - High sense of political mistrust, unrest and corruption
  - History repeats itself – currency controls
  - USA (DE) is "financially stable, home of success"
- Cash account may be in the USA
  - Permits transactions in stable USD
  - Invoice with U.S. Address
  - Intercompany transactions



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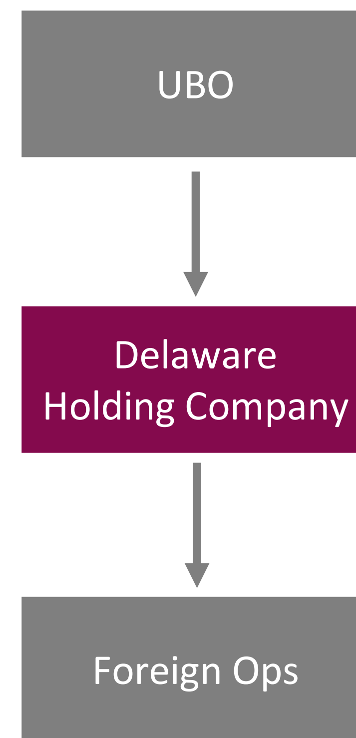
Holding Company: Income Tax Effects

- U.S. Holding Company Annual Filing
  - Reports income on Form 1120
  - Must report for foreign sub:
    - GAAP financials on Forms 5471/8865/8858
    - E&P adjustments
    - Recognize U.S. income for Subpart F (if applicable)
  - Form 5472 still required
  - Possibly FBAR (FinCEN 114)
- Dividends paid to UBO
  - 1042
  - W-8BEN on file
- Note: Foreign Blocker may still be used



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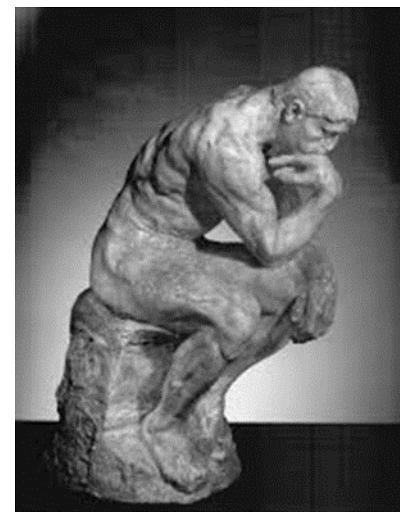
Other Reporting Considerations

- 5472 for Disregarded Entities in 2017 (Reg §1.6038A)
  - SMLLCs and IDGTs considered "corporations"
    - Must file 5472 and a pro-forma 1120
    - Must obtain U.S. EIN
    - Must keep adequate books and records
  - Thoughts on series LLCs – Proposed Reg. §301.7701-1
- Transfer pricing exposures – the arm's length standard
  - Interest on loans – must be documented
  - Operations
    - Foreign parent typically bears f/x risk
    - Delaware Holding Company has intangible = License Agreements
    - Foreign Parent manages sub = Management Services Agreement
    - Officer Wages = Employment Contract
- High Penalties



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