FOREIGN GRANTOR TRUST PLANNING: A FLEXIBLE PLANNING STRUCTURE FOR U.S. INCOME TAX

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Over the years, U.S. tax practitioners specializing in international taxation have established foreign grantor trusts (FGTs) to assist multi-jurisdictional families with their U.S. tax and succession planning. This is particularly relevant when the client (*e.g.*, a parent) is a non-U.S. person for all U.S. tax purposes.

The approach involves the non-U.S. person parent setting up a grantor trust (that is typically revocable, but may instead be irrevocable in certain circumstances), which directly or indirectly holds certain U.S. and non-U.S. assets. Generally, the U.S.-situs assets are held through a non-U.S. corporation (hereinafter a “foreign corporation” or “FC”). The FC is generally an eligible entity for U.S. tax purposes.

This specific tax planning structure is widely regarded as one of the most effective solutions for families with a non-U.S. person parent that has U.S. children and U.S. grandchildren. The benefits of this arrangement are twofold: 1) it may avoid the U.S. estate tax (with proper planning for U.S.-situs assets) that would otherwise be imposed upon the death of the non-U.S. person parent; and 2) it preserves certain U.S. income tax advantages available to a non-U.S. person investor as long as the trust remains a grantor trust. Overall,

this strategy proves advantageous in navigating the complexities of international taxation for such families.

Who Benefits Most From FGT Strategy

During the settlor's lifetime, a grantor trust, whether established in the U.S. or abroad, is treated as transparent for U.S. income tax purposes.[1] This means that any income or gains generated within the trust are attributed to the settlor (*i.e.*, the "grantor"), and they are liable for taxes on such income.[2] If the settlor is a non-U.S. person, they are exempt from certain U.S. income tax concerning the trust's non-U.S. source income, U.S.-source capital gains, and interest income.[3] Consequently, neither the trust nor its beneficiaries may be subject to U.S. income tax when the trust sells certain appreciated assets (*e.g.*, stock of most publicly traded companies, *e.g.*, Amazon), unless the trust generates U.S.-source business income or other taxable U.S. income.[4] In such cases, the foreign settlor would be accountable for U.S. income tax on the trust's taxable income.[5] Moreover, U.S. beneficiaries would not be taxed on any distributions received from the trust. As a result of these intersecting rules, establishing a FGT can often be a potent tax-saving strategy during the settlor's lifetime for families whose settlor resides outside the U.S. (particularly, if they reside in a low-tax jurisdiction and/or in a country that doesn't tax overseas income within a trust).

In addition, utilizing a FGT during the settlor's lifetime, instead of direct ownership, offers advantages in transferring assets to U.S. beneficiaries. However, a FGT does not provide protection against U.S. gift or

estate tax (transfer taxes) on the U.S.-situs assets. Thus, additional estate tax planning is generally recommended for such assets (as discussed below).[6] Regardless, by passing wealth (comprising non-U.S. situs assets) to their U.S. beneficiaries through a trust upon their death, foreign individuals can avoid any limitations imposed by U.S. tax law on the amount of wealth passing from one generation to the next without incurring transfer taxes. This approach allows the foreign settlor (*i.e.*, the wealth creator) to effectively eliminate all transfer tax concerns for the U.S. beneficiaries throughout future generations, regardless of the size of their wealth. Conversely, if the U.S. beneficiaries inherit the assets directly, those assets will be included in their U.S. estates, subjecting them to issues surrounding transfer taxes when they pass the wealth to their own heirs. By utilizing trusts, the foreign settlor can establish a tax-efficient legacy for his or her U.S. beneficiaries, ensuring a seamless transfer of wealth for the next generations.

Furthermore, FGT planning can be particularly effective for families who currently have nominee arrangements. A typical example would be a family that owns a family business/company and transfers title (but not beneficial ownership) of certain company shares (nominee shares) to his or her children as succession planning. From a U.S. perspective, the patriarch or matriarch is still treated as the beneficial owner of such shares and, thus, can settle a FGT to benefit his or her children and fund the FGT with the nominee share.[7] This strategy helps to further confirm the nominee arrangement along with

provide further confirmation that the children are meant to inherit the shares upon the death of the settlor or beneficial owner.

Grantor vs. Non-Grantor

A grantor trust is where the foreign settlor is considered the owner of the trust's income, subject to taxation, which may occur under two specific circumstances.[8] The first scenario arises when distributions from the trust during the settlor's lifetime, whether comprising income or capital, are limited only to the settlor or the settlor's spouse.[9] The second instance occurs when the settlor possesses the unilateral power, or with the agreement of a related or subordinate party, to revest the trust's assets in himself or herself.[10] A "related or subordinate party" is an individual or entity without any beneficial interest in the trust and can include the settlor's spouse if living with the settlor, the settlor's immediate family members (father, mother, descendants, or siblings), employees of the settlor, employees of a corporation where the settlor's equity interest and the trust's equity interest significantly influence voting control, or a subordinate employee of a corporation where the settlor is an executive.[11]

Despite the aforementioned circumstances, if the settlor has not made a gratuitous transfer to the trust, he or she will not be considered the owner of the trust's capital and income for U.S. income tax purposes.[12] However, if the trust is established through a distribution from another trust, the settlor of the transferor trust will be treated as the owner of the capital and income of the transferee trust, unless the person or entity responsible for settling the

transferee trust (typically the trustee of the transferor trust) wields powers extensive enough to be deemed a general power of appointment.[13] A general power of appointment encompasses the authority to appoint assets to oneself, one's creditors, one's estate, or the creditors of one's estate.[14]

The grantor trust rules under §672(f) need to be carefully considered when the foreign settlor is married under the laws of a community property jurisdiction. If the FGT is not drafted carefully in consideration of the community property issues (*e.g.,* the surviving spouse has the power to revest the entire trust property in himself or herself), it is possible that half of the trust could become a non-grantor trust upon the death of the first spouse.

Basics of Foreign vs. U.S. Trusts

Trusts are categorized as either domestic or foreign for U.S. income tax purposes. This distinction relies on two key tests, the "court test"[15] and the "control test." [16] A domestic trust meets both these tests, while a foreign trust fails to satisfy either one.[17] Thus, if a trust does not pass both the court and control tests, it is treated as a foreign trust for U.S. income tax purposes.[18]

To pass the court test, a federal, state, or local court within the 50 U.S. states and the District of Colombia must have the primary authority to oversee the trust's administration, entailing the ability to make decisions concerning all aspects of the trust.[19] In this context, trust administration entails the investment and preservation of trust assets, filing of any and all tax returns or other related filings, defending the trust

form lawsuits or other claims, executing any duties required under the terms of the trust, etc. A safe harbor provision outlines conditions for satisfying the court test, including administering the trust solely within the U.S. and avoiding an "automatic migration clause."[20] The latter is triggered when the trust instrument causes the trust to move away from the U.S. in response to U.S. court jurisdiction.

Commonly, clients will have already set up structures outside the U.S. prior to speaking to a U.S.-based attorney. Some of the most common structures are Panama Foundations, Liechtenstein Foundations, and non-U.S. trusts. Oftentimes, these structures were set up prior to some of the beneficiaries becoming U.S. tax residents or considering becoming U.S. tax residents in the future (*e.g.*, children currently attending college or graduate school in the U.S.). In most cases, it is possible to convert the current structure into a FGT structure without incurring any U.S. taxation. The ability to convert these structures hinges on how the offshore structure is drafted and the laws of the relevant jurisdiction(s) of the current structure.

The control test necessitates that one or more U.S. persons possess the power to control substantial decisions within the trust.[21] These substantial decisions encompass various matters, such as distribution of income or corpus, beneficiary selection, and investment decisions.[22] For a U.S. person to have control, they must hold unchallengeable power over all substantial decisions, without any other person having the authority to veto such decisions.[23]

In cases of inadvertent changes that may impact the control test, a grace period of 12 months is granted to address the situation and make necessary modifications to maintain compliance.[24] For instance, if a trustee changes, this inadvertent change can be rectified within the 12-month period without the trust being considered as failing the control test. [25]

It is important to note that a trust can still be classified as a foreign trust, even if some connections to the U.S. exist, such as being governed by U.S. law and having a U.S. trustee but providing non-U.S. persons the power to appoint or remove the U.S. trustee.[26] Thus, the determination of whether a trust is domestic or foreign involves careful examination and adherence to the specified tests.

In many situations, it may benefit a client to settle a trust that will be "foreign" under these rules during the lifetime of the settlor. To commonly achieve this, at least one substantial power is given to a "foreign" person (*e.g.*, the power to add and remove the trustee — this power in often given to the trust "protector"). Please note that consideration should be given to removing such power(s) from foreign persons upon the death of the settlor in situations where certain beneficiaries are U.S. persons (as discussed elsewhere in this article).

Planning Considerations for FGTs

• *Outright Distribution vs. Dynasty* — One of the most important decisions the settlor of an FGT will make is whether the trust will make outright distributions to the beneficiaries upon the settlor's death (and then

the trust will terminate) or whether the trust will continue to hold the assets for the benefit of the next generation(s). In either case, the settlor may choose to distribute the assets pro-rata to the beneficiaries or give specific assets (or percentages of assets) to each beneficiary. If the trust continues as a foreign trust after the settlor's death, U.S. beneficiaries may be subject to certain U.S. tax implications, as well as certain U.S. tax reporting obligations with respect to distributions received. For example, if the trust holds shares of stock in a foreign company and such foreign company is treated as controlled foreign corporation (CFC),[27] then income earned by such CFC could be subject to tax at the U.S. beneficiary level at year end regardless of whether the CFC makes a distribution to the foreign trust and regardless of whether the foreign trust subsequently makes a distribution to the U.S. beneficiary.[28] In addition, the U.S. beneficiary's receipt of a distribution from a foreign trust or an inheritance from a non-resident alien domiciliary (NRAD) may need to be reported on Form 3520.[29]

In contrast, many clients with a higher net worth prefer to have their trust continue beyond their death, so that they can control how multiple generations benefit from the wealth without concerning themselves with U.S. estate tax planning. It is important to evaluate the different issues relevant to U.S. beneficiaries and non-U.S. beneficiaries. In many cases, advisors recommend splitting the FGT into numerous sub-trusts upon the settlor's death. Thus, one trust signed by the settlor will contain the dispositive provisions for multiple separate trusts, which may have different timelines, fiduciaries, jurisdictions, and beneficiaries. Although this can

make trust drafting complex, it can save the settlor from having the inefficiency of drafting multiple trusts from scratch and having to administer multiple trusts during the settlor's lifetime. There are, however, instances in which it may make sense for the settlor to have multiple trusts to benefit different types of beneficiaries and/or hold different types of assets.

Similarly, splitting the FGT post death can be crucial to maximize the U.S. tax planning for U.S. and non-U.S. beneficiaries. Each beneficiary may have different tax residences in different countries (including the U.S.) at the time of the settlor's death. Thus, each sub-trust should be drafted to consider whether such trust should be a foreign or domestic trust in order to minimize the global tax effect prospectively. Advice from tax counsel in each relevant jurisdiction is necessary to achieve this goal. One common strategy is to provide a separate sub-trust for each beneficiary so each beneficiary's trust could be classified as either a domestic or foreign trust depending on that beneficiary's facts and circumstances (including advice from foreign tax counsel). In addition, the settlor may choose to separate the U.S. assets from the non-U.S. assets for U.S. beneficiaries and non-U.S. beneficiaries, respectively. One strategy could be for the U.S. beneficiaries' sub-trust (taxed as a domestic nongrantor trust) to be funded with U.S. real estate and other U.S. assets that produce U.S. source income, and for the non-U.S. beneficiaries' sub-trusts (taxed as foreign nongrantor trusts) to be funded with U.S. stock and non-U.S. assets which may avoid U.S. income tax when eventually sold.

The governing law (and location of the trustee) may also be toggled to enable preferable tax treatment depending on whether the sub-trust benefits U.S. or non-U.S. person beneficiaries and depending on the income situs of the trust's assets. As such, many FGTs are drafted utilizing the U.S. as governing law (most commonly in states with strong asset protection laws, *e.g.*, Delaware, South Dakota, Alaska, or Nevada); however, a non-U.S. jurisdiction is sometimes preferable for tax or other reasons. There are numerous non-U.S. jurisdictions, and each one has its advantages and disadvantages. Generally, a client seeking to have their trust administered outside the U.S. should speak with counsel in each relevant jurisdiction prior to making a decision as to which one is best for his or her facts and circumstances.

In the instance the FGT is drafted to continue for generations, the continuing sub-trust(s) held for U.S. beneficiaries can be drafted in a manner to avoid U.S. estate tax implications for such U.S. beneficiaries. In other words, a properly drafted dynasty trust may help the next generations avoid having the settlor's assets being included in their respective gross estates for U.S. estate tax purposes. Furthermore, if the trust is properly drafted under the laws of an asset protection jurisdiction (*e.g.*, Delaware or Nevada), the beneficiaries may receive certain asset protection from creditors.

• *U.S. Assets* — One of the crucial advantages of the FGT is that the trust may be exempt from U.S. capital gains tax on the sales of certain U.S. assets that produce foreign source capital gains. In particular, the sale of U.S. stock is generally exempt from U.S. income

tax during the lifetime of the non-U.S. settlor.[30] This treatment will result so long as the FGT is considered a grantor trust regardless of whether any of the beneficiaries are U.S. income tax residents.[31] Thus, the FGT is an elegant solution for non-U.S. trust settlors (*e.g.*, patriarch/matriarch) who have U.S. beneficiaries (*e.g.*, children, grandchildren, etc.).

As noted above, however, the income tax advantages of the FGT are complemented with the need to address certain U.S. estate tax issues with appropriate tax planning for the assets held through the FGT. In particular, a settlor that has an FGT may be subject to the U.S. estate tax upon his or her death on the U.S.-situs assets (*e.g.*, U.S. real estate and U.S. stock) held by the FGT.[32] In the context of transfer taxes, an individual's residence is determined by their "domicile." Domicile is acquired by living in a place, even briefly, without a definite intention of later moving away.[33] However, simply maintaining a residence in a place without the intention to remain indefinitely does not establish domicile.[34] As a result, an individual may be considered a U.S. resident for transfer taxes if their domicile is in the United States at the time of the transfer; "United States" includes both the states and the District of Columbia.[35] Determining domicile is subjective and requires careful consideration of individual circumstances.

Similarly, NRADs are subject to certain transfer taxes. NRADs are subject to transfer taxes only on their gratuitous transfers of property situated in the U.S., either during their lifetime or upon death. For U.S. estate tax purposes, property is considered situated in the U.S. if it was located in the U.S. at the time of the

transfer. This includes real property, tangible personal property (except certain works of art on loan for exhibition), certain intangible personal property issued by or enforceable against U.S. residents, corporations, or governmental units, shares of stock issued by a U.S. corporation, debt obligations with U.S. obligors, and deposits with U.S. branches of foreign corporations engaged in commercial banking.

For example, if a NRAD gifts artwork and the artwork is physically in the U.S. at the time of the gift, it becomes subject to U.S. gift tax. However, an important exception applies to NRADs regarding the U.S. gift tax on their gratuitous transfers of "intangible property." The stock of a domestic corporation is considered intangible property, so a NRAD making a lifetime gift of domestic corporation stock may not be subject to gift tax on the transfer, despite the U.S. situs of the property. In the estate tax context, there is no intangible property exception, so if a NRAD owning shares of a U.S. corporation passes away, U.S. estate tax may apply to the full fair market value of the U.S. corporation stock.

As such, the FGT would generally hold the U.S.-situs assets through a structure (*e.g.*, an FC), which would be used to block the U.S. estate tax. Which estate tax blocking structure is best in a given circumstance will depend upon the U.S. asset type, the relevant laws in the settlor's tax residence jurisdiction (*e.g.*, their home country), and, as always, the client's risk tolerance. For example, U.S. real estate may be held through a dual corporate structure (*i.e.*, a FC that owns a domestic corporation) or through a dual partnership (*i.e.*, a foreign partnership that owns a U.S. partnership);

whereas, it is more common for a U.S. investment portfolio consisting of U.S. stocks to be held directly through one or more FCs.

• *Non-U.S. Assets* — Another vital tax planning aspect of the FGT is that income from non-U.S. sources may not be subject to taxation in the U.S. during the lifetime of the non-U.S. settlor.**[36]** Non-U.S. settlors that own assets in their home country (or other countries outside the U.S.) may desire to gift them to the FGT for their beneficiaries. One common example is stock of the family business, where the settlor owns all or a portion of a non-U.S. company that operates outside the U.S. The settlor may desire for his or her children (or other heirs) to benefit from the family business during his or her lifetime and/or after his or her death. The settlor, however, does not want the related non-U.S. source income to be subject to U.S. income tax until (at minimum) after his or her death. The FGT can solve this issue as it allows the FGT to be administered in the U.S., have current U.S. beneficiaries (if the trust is revocable), and yet protect the non-U.S. source income from U.S. taxation. As discussed in the section of this article relating to non-U.S. beneficiaries, if the FGT is meant to be a dynasty trust and continue beyond the life of the settlor, and only benefits non-U.S. persons, then it may be best to have the trust administered outside the U.S. at all times or, at minimum, upon the death of the settlor. “Moving” the trust offshore at the time of the settlor’s death may be achieved through careful drafting; however, to avoid certain U.S. tax implications, it may be preferable to administer the trust outside the U.S. from the start. In particular, if the trust is administered in the U.S. subsequent to the settlor’s death, the trust

would likely be treated as a U.S. non-grantor trust (*i.e.*, a transformer trust). This may be preferable for U.S. beneficiaries (see section of article regarding such beneficiaries); however, it could cause U.S. taxation of non-U.S. source income at the trust level. As such, non-U.S. beneficiaries of an FGT that holds assets earning non-U.S. source income may benefit from having their trust administered offshore to avoid this tax trap.[37] Thus, it may be beneficial to split an FGT into multiple sub-trusts post the settlor's death (or create multiple trusts from the start) to allow the non-U.S. beneficiaries to benefit from a non-US non-grantor trust, and to allow the U.S. beneficiaries to benefit from a U.S. non-grantor trust. Please note, however, that this tax trap may also be avoided by providing in the sub-trust(s) foreign persons with certain substantial decisions as defined under Treas. Reg. §301.7701-7(c) as this may also cause the trust to be treated as a foreign trust for U.S. income tax purposes.

• *U.S. Beneficiaries* — U.S. beneficiaries can benefit significantly from FGT planning. Since the trust is drafted as a grantor trust, the settlor remains the beneficial owner of the trust assets for U.S. tax purposes.[38] Thus, the FGT may allow U.S. beneficiaries to benefit from the trust (*i.e.*, receive distributions) during the settlor's lifetime without being subject to any U.S. taxation.[39] Instead, these distributions are treated as gifts from the non-U.S. settlor, which may require the U.S. beneficiary to report them on Form 3520.[40] As such, it is important to coordinate with a U.S. beneficiary's U.S. tax accountant to make sure such form is timely and accurately filed. This preferable U.S. tax treatment may

allow an FGT during the lifetime of the settlor to 1) own U.S. stock and securities; 2) sell these assets at a gain without triggering any U.S. tax; and 3) to distribute the U.S. tax-free proceeds to the U.S. beneficiaries without causing any U.S. tax for the U.S. beneficiaries.[41] As a result, FGT planning is often very helpful when non-U.S. settlors own U.S. investment portfolios and want U.S. people to benefit from their trust planning during their lifetimes.

One of the most overlooked and valuable aspects of FGT planning is "setting the board" for additional U.S. tax planning upon the settlor's death. In that regard, the first crucial element for U.S. beneficiaries is to draft the trust to ensure that it will be treated as a U.S. trust (rather than a foreign trust) for U.S. income tax purposes after the settlor's death.[42] This is done by ensuring that the sub-trust held for U.S. beneficiaries meets the court test and the control test. Thus, non-U.S. persons should be precluded from holding any powers that constitute making "substantial decisions."[43] If drafted carefully, the trust will "transform" immediately upon the settlor's death from being an FGT into an irrevocable U.S. non-grantor trust for U.S. income tax purposes. Thus, we coined the term "transformer trust" to describe these unique trusts.

"Setting the board" often involves additional tax planning in anticipation of the eventually settlor's passing. For example, many non-U.S. settlors own interests in non-U.S. companies that are treated as "per se" corporations for U.S. tax purposes.[44] Common examples of per se entities include: Sociedad anonima in various countries, such as Panama, Chile, Brazil, etc.; public limited company in

various locales, such as the United Kingdom and Hong Kong, and many others.[45] Since these entities are required to be treated as corporations for U.S. tax purposes, they are not eligible to elect to change their default U.S. tax classification status. In contrast, "eligible entities" (*i.e.*, any entity not listed as a "per se" entity under Treas. Reg. §301.7701-2(b)(8)) can elect to change their classification (*e.g.*, to a passthrough entity for U.S. tax purposes, such as a partnership or disregarded entity depending on the number of owners of the entity).[46] It is often possible to convert these "per se" entities into "eligible entities" (*e.g.*, converting a Panama S.A. to a Panama S. de R.L., if applicable) without causing significant tax or corporate issues in the relevant jurisdiction. In such scenarios, it may greatly benefit the U.S. beneficiaries to have the "per se" entities converted to "eligible entities" prior to the settlor's death. Oftentimes, we accomplish this goal at the time of setting up the FGT to avoid issues down the road. This article does not go into detail on the U.S. income tax planning advantages of having entities that are eligible to elect to change their U.S. tax classification (*i.e.*, make a so-called "check the box" election on Form 8832); however, rest assured, setting the board in this manner can result in significant tax savings if proper tax planning is implemented shortly after the settlor's death.

Beyond the conversion of certain entities into more flexible entities as discussed above, there may also be a significant advantage to reorganizing the corporate structure of the assets held in the FGT prior to the settlor's death. Once the settlor dies, the trust may become an irrevocable non-grantor trust and its U.S.

beneficiaries may be treated as constructively/indirectly owning certain trust assets. In the case of stock, oftentimes, in closely held companies (*e.g.*, family companies), the CFC and passive foreign investment company (PFIC) rules can become problematic for a U.S. beneficiary who is deemed to constructively/indirectly own such assets for U.S. income tax purposes.[47] In our experience, many FGTs are funded with stock in closely held companies. Thus, reorganizing the related corporate structure (generally, at the time of formation of the FGT) is often critical to minimizing the global tax exposure for the U.S. beneficiaries post the settlor's death.

Please note that U.S. beneficiaries would likely need to report their inheritance from the non-U.S. settlor by filing Form 3520.[48] As such, it is important to coordinate with a U.S. beneficiary's U.S. tax accountant to make sure such forms get filed timely and accurately. If, however, the FGT transforms into a foreign nongrantor trust upon the settlor's death and has U.S. beneficiaries, then such trust should be drafted to consider the "throwback rules." A non-grantor trust mainly functions as conduit. In other words, when income is distributed to beneficiaries in the same year it is generated, the trust receives a deduction for the distributed amount and the income tax responsibility is effectively shifted to the beneficiaries.[49] Conversely, if the income is retained in the trust, the trust itself is liable for the income tax on such income. When a foreign non-grantor trust accumulates income, it pays no U.S. income tax on that income (except for withholding tax on U.S. source income or tax on income connected with a U.S. trade

or business). Likewise, no U.S. income tax is currently payable by potential beneficiaries on that income (unless distributable net income (DNI) is distributed to a U.S. beneficiary). However, the accumulation of undistributed net income (UNI) may have negative tax consequences if distributed to a U.S. beneficiary in the future under the "throwback rules."

If a foreign trust has UNI from prior years and distributes an amount not exceeding the greater of the current year's DNI or fiduciary accounting income to beneficiaries (including U.S. beneficiaries), the U.S. beneficiaries are taxed solely on their share of the DNI.[50] Foreign trusts' DNI includes realized capital gains, taxed at the lower capital gains rate (currently 20%).

When a foreign nongrantor trust with UNI pays out to beneficiaries in a calendar year an amount surpassing both the current year's DNI and the current year's fiduciary accounting income, UNI is distributed.[51] Any excess amount beyond DNI in this scenario carries out UNI. UNI distributed to U.S. beneficiaries is fully subject to U.S. income tax and incurs additional negative consequences such as taxing capital gains as ordinary income[52] and adding a daily compounded interest charge.[53]

Considering the foregoing, it is important for practitioners to consider whether having a foreign nongrantor trust is necessary. If there are specific reasons to keep such a structure in place, practitioners should carefully draft the trust to avoid the interest charge under §668.[54]

• *Non-U.S. Beneficiaries* — As discussed above, the issues facing non-U.S. beneficiaries can be much different from their U.S. beneficiary counterparts. In particular, the non-U.S. beneficiaries may benefit from having the trust remain a foreign trust for U.S. tax purposes after the settlor's death. In situations in which there are both U.S. and non-U.S. beneficiaries (which is common), it is often advisable to split the trust into multiple sub-trusts post the settlor's death. This may allow the non-U.S. beneficiaries to continue to be exempt (indirectly) from U.S. taxation on the sale of certain U.S. capital assets (*e.g.*, Amazon, Tesla, or many other U.S. publicly-traded shares). In these scenarios, consideration should be given at the time of drafting the FGT as to how to split the FGT assets among the multiple successor sub-trusts. In certain situations, it may be preferable to allocate U.S. stock to the sub-trust benefiting the non-U.S. beneficiaries. This may depend on whether the stock often distributes dividends (which will generally be taxable at a 30% withholding rate) and whether a U.S. income tax treaty may reduce such withholding rate. Similarly, there may be a tax preference to allocate certain non-U.S. assets to the non-U.S. beneficiaries' sub-trust as any related non-U.S. source income should also avoid U.S. taxation. In contrast, it may be preferable to allocate to the sub-trust benefiting U.S. persons assets that create U.S. source income (*e.g.*, U.S. real estate, certain U.S. active companies, etc.) as such assets may be taxable in the U.S. regardless of which sub-trust owns them. Granted, some families choose to split the assets equally amongst all beneficiaries (and some even reject the option of having multiple sub-trusts, although this is less common) regardless of whether the beneficiaries are U.S. or non-U.S. persons. In these

scenarios, additional tax planning may be needed to minimize the global income and estate tax exposure for the non-U.S. beneficiaries after the settlor's death. Generally, the estate tax exposure may be able to be minimized (or eliminated) through careful drafting of the sub-trusts; however, in situations where the sub-trusts must be drafted in a particular manner for non-U.S. reasons, there may still be a need for an estate tax blocking structure under the trust to hold the U.S.-situs assets.

In addition, the income tax minimization planning for a non-U.S. beneficiary may be complicated depending on the type of assets and the laws where the beneficiary is tax resident. For example, strategies may be available to minimize the U.S. tax with regard to certain U.S. assets and related U.S. source income. Similarly, in the event the non-U.S. persons are beneficiaries of a sub-trust that is treated as a U.S. trust for U.S. income tax purposes, outbound tax planning may be needed to minimize the global tax applicable to the trust's non-U.S. assets and related non-U.S. source income.

Conclusion

As discussed above, an FGT may enable a foreign settlor to provide an efficient and effective transfer of wealth for his or her next generations. This strategy may allow the foreign settlor's wealth to pass to the next generations without incurring transfer taxes. Furthermore, the foreign settlor may continue to be exempt from U.S. tax on certain non-U.S. source income, non-U.S. real estate capital gains, and interest income. Therefore, the FGT planning may ultimately provide the advantage of current U.S. income tax

saving benefits during the foreign settlor's lifetime while allowing U.S. beneficiaries to avoid being taxed on the distributions received.

[1] *See* §671.

[2] *Id*.

[3] *See* §864(b)(2) and §871(h).

[4] *See* §671.

[5] *Id*.

[6] *See* §2036, §2038, and §2041.

[7] *See, e.g., Matut v. Commissioner*, 88 T.C. 1250 (1987); *Estate of Robert L. Allen v. Commissioner*, T.C. Memo 1989-111; *Estate of Larch M. Cummins v. Commissioner*, T.C. Memo 1993-518; Jacob S. Kamborian, 56 T.C. 847 (1971), *affirmed sub nom Estate of Jacob S. Kamborian v. Commissioner*, 469 F.2d 219 (1st Cir. 1972); *National Bellas Hess, Inc.*, 20 T.C. 636 (1953), acq. in part, 1953-2 C.B. 5, affirmed, 220 F.2d 415 (8th Cir. 1955), *rehearing denied*, 225 F.2d 340 (8th Cir. 1955); *Griswold Co.*, 33 B.T.A. 537 (1935), acq., XV-1 C.B. 10; *Ridgewood Cemetery Co.*, 26 B.T.A. 626 (1932); Rev. Rul. 84-79, 1984-1 C.B. 190; *National Carbide Corp.*, 49-1 USTC ¶9223 (S.Ct.) ("National Carbide"); *Berthold v. Commissioner*, 12 BTA 1306 (1928); *Gerling International Insurance Co. v. Comm'r*, 87 T.C. 679 (1986).

[8] *See* §672(f)(2).

[9] *See* §672(f)(2)(A)(ii).

[10] *See* §672(f)(2)(A)(i).

[11] *See* §672(c).

[12] *See* Treas. Reg. §1.671-2(e)(1).

[13] *See* Treas. Reg. §1.671-2(e)(5).

[14] *See* §2041.

[15] *See* Treas. Reg. §301.7701-7(c).

[16] *See* Treas. Reg. §301.7701-7(d).

[17] *See* Treas. Reg. §301.7701-7(a)(2).

[18] *Id*.

[19] *See* Treas. Reg. §301.7701-7(c).

[20] *See* Treas. Reg. §301.7701-7(c)(1)(iii).

[21] *See* Treas. Reg. §301.7701-7(d).

[22] *See* Treas. Reg. §301.7701-7(d)(1)(ii).

[23] *See* Treas. Reg. §301.7701-7(d)(1)(iii).

[24] *See* Treas. Reg. §301.7701-7(d)(2).

[25] *Id*.

[26] *See* Treas. Reg. §301.7701-7(d)(1)(ii)(H).

[27] An FC is a CFC if U.S. shareholders own more than 50% of the FC stock (by vote or value). *See* I.R.C. §957(a). A U.S. shareholder is a U.S. person who owns either directly or indirectly, through one or more foreign entities or through the application of certain constructive ownership rules, at least 10% of the total

combined voting power of all classes of stock entitled to vote, or who owns 10% or more of the total value of shares of all classes of stock of an FC. *See* §951(b).

[28] *See, e.g.*, §951(a) and §951A(a).

[29] *See* §6039F.

[30] *See* §§862 and 864(b)(2).

[31] *See* §671.

[32] *See* §§2001, 2105, 2036, and 2038.

[33] *See* Treas. Reg. §20.0-1(b)(1).

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *See* §§862 and 864(b)(2).

[38] *See* §671.

[39] *Id.*

[40] *See* §6039F.

[41] *See* §671.

[42] *See* Treas. Reg. §301.7701-7(c).

[43] *See* Treas. Reg. §301.7701-7(d)(ii).

[44] *See* Treas. Reg. §301.7701-2(b)(8).

[45] *See* Treas. Reg. §301.7701-2(b)(8)(i).

[46] *See* Treas. Reg. §301.7701-3(a).

[47] *See* §§958(a)(2) and 1298(a)(3), and Treas. Reg. §1.1291-1(b)(8)(iii)(C).

[48] *See* §6039F.

[49] *See* §661 and §662.

[50] *Id*.

[51] *See* §665(a) and (b).

[52] *See* §667(e).

[53] *See* §667(a)(3) and §668.

[54] Practitioners can consider the application of §663(a) to avoid carrying out DNI to the beneficiaries under §662, which is outside the scope of this article.

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This column is submitted on behalf of the Tax Section, Shawn Wolf, chair, and Charlotte A. Erdmann, Daniel W. Hudson, Angie Miller, and Abrahm Smith, editors.

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