



Coming to America

Gideon Rothschild and Ira Zlotnick consider the benefits of US situs trusts for non-US persons

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Historically, many non-US persons who have settled trusts have failed to consider establishing them in a US jurisdiction. In the past, these individuals were often concerned about unnecessarily exposing their foreign assets to taxation in the US. In 1996, the *Internal Revenue Code* was amended so as to enable foreigners to settle trusts that would be governed under the laws of a particular jurisdiction in the US, but still be treated as foreign trusts for US income tax purposes (commonly referred to as 'hybrid trusts'). The ability of foreigners to create these hybrid trusts and avail themselves of many substantive advantages of having US law govern their trusts, has forced many to abandon traditional thinking and instead consider settling new trusts (and/or re-domiciling older trusts where permitted under the terms of the existing trust) in the US.

In order to create a hybrid trust, a non-US person must be given substantial decision-making power over at least one key aspect of the trust. IRS Regulations offer several examples of what types of decisions constitute substantial decision-making ability, including the ability to determine (i) whether and when to distribute income and/or principal, (ii) the amount of any distribution, (iii) the selection of a beneficiary, (iv) whether to terminate the trust, and (v) whether to remove, add or name a successor trustee, to name just a few. Given this fairly expansive list, the threshold for creating a hybrid trust is not very difficult

to meet. Assuming that hybrid trust status is achieved, such trust will only be subject to US income tax on its US source income, which will effectively leave the non-US person in the same situation as he or she would have been in had such trust not been created. Depending on the nature of the powers retained by the settlor, it may be necessary, however, to own any US situs assets such as US securities in an underlying foreign company to avoid US estate tax.

Given that it is possible for a non-US person to create a US situs trust with no adverse US tax consequences, the next question that needs to be examined is what the potential advantages are for such person in creating such a trust.

Self-settled trusts

Traditionally, most offshore jurisdictions have cited public policy considerations for denying settlors of 'self-settled' spendthrift trusts (trusts that benefit the settlor) the ability to withstand the challenge of the settlor's own creditors. These jurisdictions still follow the Statute of Elizabeth thereby permitting fraudulent transfer challenges even years after the trust is settled. This has been true even where a settlor's only beneficial interest in the trust is the possibility of receiving distributions within the discretion of an independent trustee. Moreover, in such jurisdictions it is

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also deemed irrelevant whether the settlor's creditors are present or future, reasonably anticipated or impossible to foresee, as having intent to defraud creditors is not required for the application of this rule. Over the last 11 years, ten US states have enacted legislation providing creditor protection to a settlor-beneficiary of a discretionary trust. The ability to create a trust while remaining a discretionary beneficiary thereof can be an extremely useful tool for someone who is concerned with asset protection.

Rule against perpetuities

Many offshore jurisdictions still have statutes that mandate that a trust terminate within a set period of time from its creation (often 21 years after the death of a set class of lives in being). Currently there are 18 jurisdictions in the US that have repealed the so-called 'rule against perpetuities' and instead permit a trust to last indefinitely (and seven other jurisdictions that permit trusts to last for a period in excess of 360 years). The benefit of creating a perpetual trust (also commonly referred to as a 'dynasty trust') is two-fold: first, it provides a lifetime trust for the beneficiaries, thereby protecting them against potential creditors, including an ex-spouse; second, it may enable the transferred property to pass down innumerable generations in a tax efficient manner.

Forced heirship rules

For those non-US persons who reside in civil law countries, forced heirship rules often limit one's ability to dispose of property as he or she sees fit and instead generally requires the testator to leave a portion of his or her estate to a spouse and children. (In fact, similar rules are applicable in Muslim countries that have adopted Shari'a law.) By creating a trust in a US jurisdiction, however, a domiciliary of

a civil law jurisdiction (or a jurisdiction that applies Shari'a law) can potentially circumvent these rules and dispose of their property in a manner that might be more appropriate given such person's individual circumstances.

Investment control

Settlers of trusts are often particularly concerned about relinquishing investment control over the assets being transferred. In response to these concerns, several US states have passed legislation explicitly permitting the trust to remove investment authority from the hands of the trustee and instead shift such authority to a third-party investment advisor. In addition to removing investment responsibility from some third-party institutional trustee with whom the settlor has little or no relationship, these so called 'directed trusts' also have the effect of providing the trustee with reduced liability, which in turn permits trustees to charge significantly reduced fees for serving in such capacity.

Tax savings

Depending upon a settlor's country of residence and the tax regime applicable in such home country, a non-US person might prefer to shy away from the hybrid trust formula described above and instead create a US situs trust that is taxed as a domestic trust for US income tax purposes because of lower income tax rates. In general, the tax benefits associated with creating a domestic trust may inure to the benefit of residents of countries with whom the US has income tax treaties and results from the fact that the US currently applies relatively low tax rates to passive income (15 per cent long-term capital gains tax rate and a tax of 15 per cent on corporate dividends). The low rate of taxation on the federal side, coupled with

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the fact that a number of US states do not impose a state level of taxation on income accumulated in or capital gains taxes on assets held in an irrevocable trust (so long as the beneficiaries reside out-of-state), may result in significant tax savings for the non-US person and may be a decisive factor in determining where the trust is situated and how the trust is structured.

Additional tax savings can be realised where non-US persons wish to benefit US persons by creating a perpetual trust for the US person (and his or her descendants) thus escaping both the US estate tax and the US generation-skipping transfer tax that would otherwise be imposed at each generational level.

Non-US persons owning US real property are often unaware that the property is subject to US estate tax upon their death (currently at a rate of 45 per cent). The use of a properly structured trust with an underlying entity might also avoid the imposition of such tax.

Other advantages

Additional advantages associated with the creation of US situs trusts (whether hybrid or domestic) include the ability to benefit from well-established trust law in a jurisdiction that is not on any blacklist or considered a tax haven (which is of substantial import in that it avoids the potential application of special tax rates and reporting requirements), as well as having the opportunity to have a greater degree of security with regard to investments.

Summary

A non-US person's ability to create a US situs trust (either hybrid or domestic) is a powerful tool, and, although such trusts are not for every non-US person, should be considered by both foreigners and their advisors when contemplating the creation of a new trust. ■

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