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Planning for International Families with Children or Other Heirs in the U.S.

The U.S. has long been a country to which wealthy families around the world have chosen to immigrate. In recent years this movement of wealthy individuals and families coming to the U.S. from Asia, Latin America, the Middle East and elsewhere has only increased. There are numerous reasons for this movement of affluent people, including standard of living, security concerns, and business opportunities here in the U.S.

Although wealthy families sometimes choose to move to the U.S., very often the length of stay is unplanned or unintended. A child of a wealthy international family comes to the U.S. to attend college or graduate school; he or she remains in the U.S. after completing education and begins a professional career here; the child may marry a U.S. resident, and may have children here (who are automatically U.S. citizens); he or she may ultimately find it more convenient or even necessary to become a U.S. citizen or permanent resident (a "green card" holder). The end result is that a wealthy family that had no intention of living in the U.S. long term now has a branch of the family permanently established here.

Whether planned or unplanned, wealthy families transitioning to the U.S. often do not understand the planning considerations of their moves. The purpose of this article is to alert foreign families who are transitioning to the U.S., or who have children or other heirs in the U.S., that planning structures exist that can be highly beneficial to their families. Taking advantage of these planning opportunities may mean, quite simply, that future generations of their families in the U.S. will have more wealth, pay less tax, and be better protected than if the planning had not taken place.

Planning Problems for the Child in the U.S.

International families with children in the U.S. often do not think about some of the problems that their children will face upon receiving or inheriting wealth. These problems may include the following:

- *Estate and Gift Taxes*: Relatively few countries around the world have estate and gift tax systems like the one in the U.S. The U.S. estate and gift tax system in most cases taxes assets at each generational level as wealth is passed down in a family—from parent to child, from child to grandchild, from grandchild to great-grandchild, etc. Many international families, coming from countries that do not impose an estate tax or that have very different systems, are not aware of how destructive the U.S. estate tax system can be to family wealth over extended periods of time.

- *Income Taxes*: International families are also often unfamiliar with the income tax system in the U.S., and are not aware that tax can be imposed both at the federal level and at the state and local level as well. U.S. children who live in high-tax states may be subject to multiple layers of income tax, which can have a material impact over time on the growth of family wealth that has been received.

- *Liability Concerns*: There are many aspects of American culture that are justly celebrated around the world. An aspect of our culture that is *not* celebrated overseas is the American penchant for litigation. Litigation and resulting liability may arise out of a profession (such as medicine), from business dealings gone wrong, from the ownership of specific assets, or because of a divorce. International families are often generally aware of this risk to family members in the U.S., but they may not have any strategy to address the risk.

- *U.S. Tax Reporting for Foreign Entities and Holdings*: The IRS has been working for many years to make life very complicated for U.S. taxpayers who have interests in overseas trusts, companies and accounts. Rules relating to "foreign" entities and accounts have been in place for some time, but in 2014 the provisions of the Foreign Account Tax Compliance Act (FATCA) added another layer of regulatory burden to international families with connections to the U.S. U.S. taxpayers with interests in non-U.S. entities and accounts (perhaps the family company overseas) may be unwittingly violating U.S. tax rules and triggering significant penalties.

All of these factors are in the background of the planning for U.S. children of wealthy international families. Fortunately, with proper planning it is possible to mitigate and even eliminate some or all of these risks. Indeed, with proper planning it is possible to put the U.S. child of a wealthy international family in a *better position* relative to taxes and risk than a child of a U.S. family at a comparable wealth level.

Favorable U.S. Rules Regarding Foreign Gifts, Inheritances and Income

Successful planning for the U.S. children of international families takes advantage of certain favorable tax rules that apply to foreign persons. Here are some of the rules that are important in this context:

No U.S. Gift Tax on Most Gifts by Foreign Donors: The U.S. imposes gift tax on the donor (i.e. the giver) of a gift, not on the donee (the recipient). Moreover, if a gift is made by a foreign person who is not a U.S. taxpayer the U.S. imposes no gift tax at all on the gift (unless the gift consisted of real estate or certain tangible personal property located in the U.S.). Thus the U.S. child of a foreign parent can receive, directly or indirectly, unlimited gifts from a foreign parent without any U.S. gift tax consequences. Moreover, a gift is not considered income for U.S. tax purposes.

Foreign Estates Not Subject to U.S. Estate Tax: Many countries around the world tax inherited wealth by imposing an *inheritance tax* on the person receiving the wealth. The U.S. is in the minority of countries that tax the "estate" of the deceased person, rather than the person inheriting the wealth. Subject to certain limited exceptions[1], estates of persons who are not U.S. taxpayers are not subject to U.S. estate tax. Just as a U.S. child of a foreign parent can receive unlimited gifts without U.S. gift tax consequences, a U.S. child can also inherit from a foreign parent without U.S. tax consequences in most circumstances. Also, as with gifts, inheritances are not treated as income for U.S. tax purposes.

Favorable U.S. Income Tax Rules for Income Received by a Foreign Person: Income taxes in the U.S. are something that wealthy clients justifiably fear. However, as aggressive as the U.S. income tax system may be, there is a fundamental fact that many foreign investors overlook: many types of income received by a foreign person (a non-U.S. taxpayer) are not subject to U.S. income tax at all. For example, many forms of capital gain income and interest income are not subject to U.S. income tax when they are received by a foreign taxpayer, even if they are generated

[1] The exceptions mainly relate to assets that are deemed to have a U.S. "situs," such as U.S. real estate.

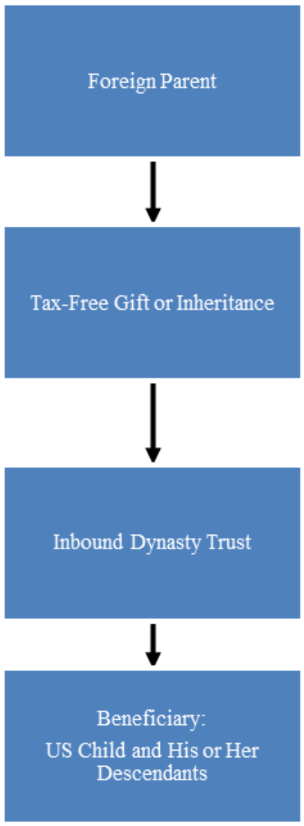
from U.S. sources and held at U.S. financial institutions. These favorable rules may be even further improved by specific tax treaties between the U.S. and the home country of the foreign taxpayer, which may make additional categories of income entirely exempt from U.S. tax or subject to tax at reduced rates.

The Inbound Dynasty Trust

When planning a gift or inheritance for a U.S. child, families are glad to hear about the favorable rules noted above. Subject to a few limitations, a U.S. child can receive a gift or inheritance from a foreign parent without any U.S. tax consequences.[2] If a child can receive unlimited wealth tax-free, why bother with any planning? The answer is simple: the U.S. child may be able to *receive* assets from a foreign parent tax-free, but then he or she has all the problems of any other wealthy person in the U.S.: income taxes imposed at federal, state and sometimes local levels on income generated from wealth during lifetime; gift tax on transfers of wealth during lifetime; estate tax imposed on the entire estate at death; and the ever-present risk of losing wealth from lawsuits, liabilities and divorce.

The *Inbound Dynasty Trust* is the standard planning strategy for international families who wish to optimally structure a gift or inheritance to a child or heir in the U.S. The concept is quite simple: rather than making a gift or leaving an inheritance directly to a child, the gift or inheritance is made to a trust that has certain special features. The trust can continue indefinitely, benefitting successive generations of a family. The trust is usually established under the laws of a state like Delaware that imposes no state or local income taxes on trust income. The trust is not subject to any claims made by creditors of a beneficiary, including claims made in divorce. Most importantly, the death of any particular trust beneficiary triggers no estate taxes, and distributions can be made from the trust to beneficiaries without triggering any gift taxes.

The use of the word "inbound" in the title of this type of trust refers to its source of funding. The Inbound Dynasty Trust can receive funding either via a gift from a foreign parent during the parent's lifetime, or at the death of the foreign parent. The trust may be created and lie dormant for years before it receives funding at a future date. Upon receipt of funding, the Trustee of the Dynasty Trust is required to report the gift or inheritance to the IRS[3], but no U.S. tax is due. The U.S. child is not permitted to add his or her own assets to the trust. Assets held in the trust can be reinvested into a broad range of investments, both domestically in the U.S. and overseas. On an ongoing basis the Inbound Dynasty Trust is required to file an annual income tax return (Form 1041) with the IRS and pay federal income tax on income generated from its assets under standard U.S. tax rules. However, if the trust was created under the laws of a favorable state such as Delaware, the trust will not be subject to state or local income taxes in the U.S., and the trust will not be required to undertake any complex tax reporting due to being treated as a "foreign" entity.



The Inbound Dynasty Trust is always created as an irrevocable trust, but if structured correctly the trust has a great deal of flexibility. Distributions can be made from the trust to the U.S. child who is the beneficiary in any amounts that are desired. If appropriate, the U.S. beneficiary can have a great deal of control over the trust during his or her lifetime, including control of investments. The U.S. beneficiary can also have the power to decide how the assets of the trust will pass down to his or her family at death. The Inbound Dynasty Trust can largely be customized to suit the needs of the U.S. child who is the beneficiary of the trust and the international family that funds it.

[2] The U.S. child may have reporting obligations with respect to a gift or inheritance, even if no tax is due.
[3] The reporting is done on Form 3520.

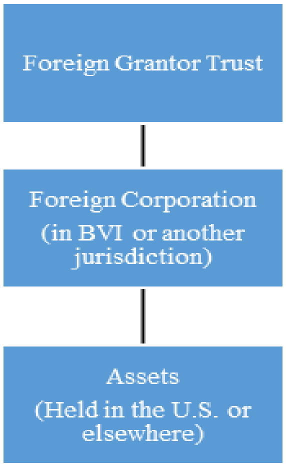
The Foreign Grantor Trust

An important consideration in establishing an Inbound Dynasty Trust is the timing of the funding. If the trust is to be funded upon the death of a foreign parent, when the U.S. child might otherwise be inheriting assets from his or her parent outright, there is no U.S. income tax disadvantage to funding the trust. The trust will pay federal income taxes on the income it generates each year, just as the U.S. child would pay income tax on the same income if he or she received it. Indeed, as noted previously, the Inbound Dynasty Trust funded at death offers an income tax *advantage* by escaping state and local income taxation of its income.

However, what if the foreign parent wishes to fund a trust for his or her child in the U.S. while the parent is living, so the child can use and enjoy the asset currently? Once assets are transferred to the Inbound Dynasty Trust, the income generated from these assets will be subject to federal income tax in the U.S. If the same assets are simply held by the foreign parent while he or she is alive, there might be little or no U.S. income tax. How do you create a trust for a U.S. child, but at the same time avoid U.S. income taxes while the foreign parent is living?

The solution is to create the trust for the U.S. child as a *Foreign Grantor Trust* while the foreign parent is living. This simply means that, during the lifetime of the foreign parent, the trust is fully *revocable* by the foreign parent. By giving the foreign parent the right to revoke the trust during his or her lifetime, the trust is treated as "owned by" the foreign parent under U.S. tax rules. This enables the trust to take advantage of the favorable U.S. income tax rules that apply to foreign persons, and continue to enjoy the same tax treatment it would have enjoyed if the foreign parent still owned the trust assets.

In spite of the word "foreign" in the title, the trust is created under U.S. law in a state like Delaware, and the trust is only "foreign" in the sense that it is considered to be owned for U.S. tax purposes by a foreign person. Except for provisions enabling the trust to be revoked by the foreign parent during his or her lifetime, the form of the trust tends to be very similar to that of an Inbound Dynasty Trust. Indeed, upon the death of the foreign parent, the Foreign Grantor Trust effectively becomes an Inbound Dynasty Trust and it is treated the same way. In this sense, a Foreign Grantor Trust is just a variation of an Inbound Dynasty Trust that offers income tax advantages during the lifetime of the foreign parent who creates the trust. However, the U.S. child must keep in mind that there is a tradeoff for this tax advantage—the trust can be revoked by his or her foreign parent at any time. Depending upon the family, the revocability of the trust may or may not be a concern.



Another point to mention about Foreign Grantor Trusts is that, depending upon the specific case, it may be appropriate for the trust to hold its assets through a foreign corporation created in a jurisdiction like the British Virgin Islands (BVI). The main reason for this is to avoid U.S. estate tax upon the death of the foreign parent on certain assets (such as stock of U.S. companies) that may be deemed to have a U.S. situs for estate tax purposes. The foreign corporation, in effect, serves as a "blocker" that prevents U.S. estate tax from being imposed on the underlying assets. In considering whether the Foreign Grantor Trust makes sense for a particular family, the cost of maintaining this underlying entity and the related U.S. tax reporting needs to be taken into account.

Conclusion

Appropriate structuring for the transfer of wealth to the U.S. child of an international family involves weighing many different factors, and every family is unique. Fortunately, the Inbound Dynasty Trust and the Foreign Grantor Trust are highly customizable, and they can be modified to suit almost every situation. International families with children in the U.S. should work with their advisors in the U.S. and in their home countries to take advantage of the powerful planning opportunities presented by these structures, which can have a positive impact on the family's future prosperity and security in the U.S. for generations to come.

Our experienced team of wealth planning advisors at HPM Partners is available to assist with any questions you may have about this or other wealth planning techniques.

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