

**U.S. TRUST LAW &
INCOME TAXATION**

**SANTIAGO, CHILE
TRUST TAXATION PROGRAM
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**Objectives in this
Presentation**

- 1) U.S. trust law (common law, except Louisiana) principles (state law rules).
- 2) Fundamentals of U.S. income taxation of trusts & U.S. estate taxation
- 3) U.S. taxation of U.S. inbound trust investment
- 4) Relevance of U.S. income tax treaties to U.S. trust taxation

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**What is a Trust?
U.S. Trust Law Concepts**

**Trust - (1) a separate legal entity;
(2) ownership of assets held by the entity;
(3) managed by a fiduciary (the trustee) for another (the beneficiary);
(4) pursuant the terms of the trust (the manifestation of the settlor's intent concerning the holding and distribution of the assets held by the trust).**

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Trust Definition for U.S. Tax Purposes

Reg. § 301.7701-4(a) specifies that a “trust” is “an arrangement created whether by will or by an intervivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.”

continued

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Trust Definition for U.S. Tax Purposes, continued

Reg. § 301.7701-4(a) further provides that “an arrangement will be considered as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.”

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Types and Uses of Trusts Multiple Applications

- 1) Personal wealth trusts – revocable; irrevocable; lifetime; testamentary
- 2) Business trusts – equipment leasing (e.g., airplanes); property ownership
- 3) Investment trusts
- 3) Trusts for holding deferred compensation funds
- 4) Law suit settlements
- 5) Charitable trusts

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Categorization of the Trust for U.S. Tax Purposes

Trust vs. Business Association (Corporate or Partnership) Status

- 1) Does the entity have (a) associates and (b) a profit motivation- only a corporation or a partnership.
- 2) Is the entity only holding passive investment assets – can be a trust.

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Personal Wealth Trust Structuring

Trust objectives:

- 1) Conserve assets
- 2) Protect beneficiaries from creditors, ex-spouses, etc.; cf. spendthrift trusts
- 3) Multi-generational transfers, e.g., a “dynasty trust” (subject to rule against perpetuities – but repealed in some states)
- 4) Tax planning – income deflection
- 5) Coordinated money/investment management
- 6) Choice of law – another jurisdiction?

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Governing Law for Trusts

- 1) State law, e.g., Texas Property Code, §112.001 – specifies the methods for creating a trust.
- 2) Trust as defined for federal tax purposes – Reg. §301.7701-4(a)
But, cf., special types of trusts: pension trusts, equipment leasing trusts, special needs trusts, real estate investment trusts – each having special U.S. tax treatment.

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Personal Wealth Trusts - Testamentary Trusts

Created under decedent's "last will and testament."

Activated for federal income tax purposes when actually funded.

A possible receptacle for non-probate assets (e.g., insurance proceeds and pension benefits).

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Intervivos Revocable Trusts/Living Trust

Creation during lifetime by a contract.

Enabling avoiding probate/estate administration process for assets held at death.

Funded or unfunded (minimum corpus)?

Enables privacy/protection from disclosure for assets held (but, disclosure for tax).

"Seasoning" of the trust during lifetime - to frustrate challenges about the last will?

Also, a receptacle for assets after death.

"Grantor trust" status during life - §676.

Inclusion in gross estate - §§2036 & 2038

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Structure of the Trust Document

Transfer to the trust

Designation of the trustee & successors

Dispositive provisions (next slide)

Spendthrift clause?

Powers clauses - trustee authority

Distribution to minors provisions

Performance bond/security?

Trustee's fee - compensation

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Trust Dispositive Provisions - Income

Types of income distribution structures for beneficiaries:

- Mandatory distributions
- Ascertainable standard (e.g., health, support, education & maintenance)
- Spray & sprinkle power
- Discretionary income distributions

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Trust Dispositive Provisions - Corpus

Corpus distributions

- Mandatory distributions – multiple distributions at various ages
- Ascertainable standard
- Spray & sprinkle power
- Discretionary distributions
- Generation skipping trust
- Power of appointment – special?

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Trust as a Source of Estate Tax Payment

Cf., revocable vs. irrevocable (i.e., no estate tax inclusion when irrevocability)

A source of liquidity for death transfer taxes:

- 1) buy illiquid assets from, or
- 2) loan funds to the probate estate

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Trustee's Responsibilities

- 1) Exercise of discretion concerning income/corpus distributions
- 2) Investment management of the assets/prudent investor
- 3) Record-keeping/tax returns, etc.

Other choices for trust supervision:

- Special trustee
- Advisory committee
- "Trust Protector"

Duty of Impartiality

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Federal Tax Issues and Planning

A. Federal taxes on wealth transfers –

- Federal estate tax/death tax
- Federal gift tax – asset transfers during life
- Generation skipping transfer tax

B. Federal income tax –

- Who is the taxpayer on income received? The trust creator, the trust itself, or the trust beneficiaries?

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IRREVOCABLE TRUSTS – Avoiding Estate Tax

Transfer assets to irrevocable trust during lifetime –

- Save estate tax (but possible gift tax, at 35% lower rate during 2010, §2502(a))
- Transfer asset management responsibility
- Reduce exposure to creditors' claims

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Federal Tax Planning – Lifetime Objectives

- 1) Minimize gift tax on transfers, e.g., exclusions (including \$1 million credit equivalent) and discounts
- 2) Reduce federal income tax by spreading income among multiple taxpayers (cf., grantor trust rules)
- 3) Eliminate estate tax exposure for transferred assets

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Grantor (Owner) Trust Income Tax Rules

Subchapter J, §§ 671-678, including:

- 1) Power to revoke trust - §673
- 2) Power to withhold corpus distributions - §674(b)(5) –
- 3) Power to withhold income distributions - §674(b)(6)
- 4) Power to retrieve trust property

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Federal Income Tax – Non-grantor Trusts

What income tax treatment of a “true trust” – income allocation between: (1) the trust, and (2) the beneficiaries (and not the grantor)?

What allocation between the several beneficiaries?

These questions relevant (1) during grantor’s life (irrevocable trust, assuming no “grantor trust” status) and (2) after death (e.g., “testamentary trust”).

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Remembering Trust Distribution Options

- 1) Distribute income currently
- 2) Accumulate trust income
- 3) Ascertainable standard (HSEM)
- 4) Trustee's total discretion
- 5) Spray or sprinkle power to multiple beneficiaries

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Considering the Trust U.S. Income Tax Rates

Maximum 35% rate reached at very low level for trust – US \$11,200 in 2010.

- Consider:
- (1) Incentive to distribute income;
 - (2) Investment policy (e.g., capital gain assets)
 - (3) Incentive for flexible structuring of trust instrument

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When Does Trust Tax Existence Commence?

An income tax question:

- (1) Intervivos trust – when irrevocable and funded
- (2) Testamentary trust – when funded from the probate estate (and other sources)

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Options for Allocating True Trust Income

- 1) All to the beneficiary (simple trust)?
- 2) Between the trust and the beneficiary (complex trust)?

But, first, what is the trust's "income" to be distributed? Cf., capital or corpus.
 Cf., rights of (1) income beneficiary and (2) remainderman – owner when trust ends

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Defining Distributable net Income ("DNI")

Definition in Code §643(a).

Purpose of the DNI concept?

Note differences between (1) trust law accounting and (2) U.S. (federal) income tax accounting for trusts.

Consider: (1) Relevance of capital gains and losses (i.e., income or corpus?);

(2) Note: "total return" investment policy

(3) Treatment of trust administration expenses

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Simple Trust Tax Treatment - §§ 651-652

Deduction to trust for amount required to be distributed. §651

Income inclusion is required of beneficiary for amount required to be distributed; even if not distributed? Yes, because entitled to income. §652(a)

Tax character of income items is retained in the hands of the beneficiary. §652(b)

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"Complex Trust" Tax Treatment - §§ 661-664

- Deduction to the trust only for amounts (1) required to be distributed and (2) actually distributed. §661(a)
- Income inclusion required of beneficiary for this amount (1) required to be distributed (even if not distributed) and (2) actually distributed. §662(a)
- Excess retained by trust is taxed to trust.
- Character of income items is retained in hands of the beneficiary. §662(b)

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Multiple Tiers Distribution & Deduction Concept

- Ordering rules: 1st tier beneficiary – receives amount required to be distributed.
- 2nd tier beneficiary – receives discretionary distributions.
- Allocation of DNI first to the 1st tier beneficiary.
- Planning: How direct 1st tier distributions?
What if financial circumstances of some beneficiaries change?

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Separate Share Rule - §663(c)

- Each trust created under one trust agreement is treated as a separate trust for Subchapter J income allocation rules.
- Objective of this rule? Only one agreement but multiple “trusts.”
- What if the trust has a “spray or sprinkle” power?

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Income Distributions Made "In Kind"

The interrelated income tax elements:

- (1) built-in gain (loss) in the distributed property, and
- (2) the income distribution (DNI) rules.

Does gain realization/recognition occur on the distribution when tax basis is less than the fair market value at time of the distribution?

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Trust "Throwback" Rules, i.e., income averaging

Accumulate income at trust level (low tax) and later pay (as tax-paid) to beneficiaries (i.e., after year-end).

Domestic trusts are exempt (since trust income tax rate higher than individual tax rate & no incentive to accumulate).

Rules are applicable to distributions received into U.S. from foreign trusts (since assumption that no prior tax paid on the trust income).

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Estate Tax Risks to Trust Grantor

- 1) Grantor retains beneficial interests
- 2) Retained powers concerning (a) income & (b) corpus distributions from trust to others
- 3) Certain administrative powers retained

Estate tax provisions: §§2036, 2037 & 2038; cf. §2035; income tax & estate tax different.

Cf., no tax issue if these powers are held by an "independent trustee"

How create a "supertrust"?

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Beneficial Enjoyment by the Trust Grantor

Estate tax - Code § 2036(a)(1) – retained life interest causes gross estate inclusion.

What is the amount of inclusion in the gross estate?

What relevance/applicability of a “reciprocal trust doctrine,” e.g., “cross-trusts” between spouses?

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Situations where a “Retained Interest” Exists

What rights of creditors when property is transferred into trust for grantor & a discretionary power to distribute to grantor (i.e., a “protective trust”)?

A state law issue re creditor’s rights?

Cf., support obligations (*next slide*)

See state law provisions re satisfaction of support obligations.

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Beneficial Powers Retained by Grantor

What choices for trust income/corpus distribution provisions:

- 1) Mandatory distributions
- 2) Discretionary distributions
- 3) Standard: health, support, education and maintenance

Code §§ 2036(a)(2) and 2038.

Cf., independent trustee vs. grantor as the trustee

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Effect of "Ascertainable Standard" Provision?

Does an "ascertainable standard" exist (where grantor as trustee)?

Cf., "support and education" – no estate tax inclusion

Distributions as "advisable" – required estate tax inclusion

What is an "ascertainable standard" & how determined?

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Administrative Powers Clauses – Examples

- 1) Classification of an extraordinary corporate dividend
- 2) Creation of a depreciation or depletion reserve
- 3) Power to distribute high tax basis property to one beneficiary
- 4) Power to substitute property of equal value

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Trustee Replacement Power – Estate Tax

Example: Independent trustee; discretionary power re distributions.

But, power to remove a corporate trustee and to replace with another (corporate) trustee – not a retained §2036(a)(2) or §2038 power. Is the retained power to change trustees important?

Cf., power to substitute oneself as trustee.

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Closely-held Business & Retained Power

Note Byram case – U.S. Supt. Ct. that retention of voting power over trust shares not a power (§2036(a)(1)) causing estate tax inclusion.

When should inclusion be required (under §2036(b)) – majority position; minority position?

Note: transfer of closely held stock to partnership and the transferor was the GP of the partnership.

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Cross Border (International) Income Tax Elements

Trust investment into the U.S. –

-Investment in stocks, bonds – withholding at source on outbound payment; 30 percent statutory rate; reduced under bilateral tax treaty; possible statutory exemption (e.g., portfolio interest).

- Investment in business (still a trust, or a business entity?) Tax on U.S. business profits at U.S. trade or business (or P.E. profits if tax treaty)

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Outbound Investment from the United States

U.S. trust - immediate worldwide income taxation to (i) the trust or (ii) the U.S. beneficiaries of the foreign income.

Income allocation depends on the simple trust or complex trust analysis.

Possible foreign tax credit for foreign tax paid on income received.

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What is a "foreign trust" (for U.S. income tax)?

No U.S. court has primary supervisory jurisdiction over administration of the trust; and,

No U.S. person has authority to control the substantial decisions of the trust.

§7701(a)(31)(B).

Beyond U.S. tax jurisdiction on a "person" but not "income source" basis.

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Foreign Trust with U.S. Beneficiaries

U.S. person who transfers property to a foreign trust is owner of trust's income if any U.S. person who is a trust beneficiary.

§679 – grantor trust treatment. Assumption of a U.S. beneficiary unless showing otherwise.

Special problems for (1) foreign grantor who becomes U.S. person; (2) foreign trust that later acquires a U.S. beneficiary.

Loan of trust property (including cash) treated as payment. §643(i) and 679(c)(6).

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Income Tax Treaty Trust as a "Person"?

U.S. Model Treaty, Article 3(1) – A "person" eligible for benefits under the treaty includes a "trust" (and an "estate").

Further specifies that the "fiscally transparent" entity attributes are attributed to the U.S. resident owner (similar to Code § 875(2)). But, cf., treatment of "true trusts."

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Income Tax Treaty - Fiscal Transparency

U.S. Model Treaty, Article 1(6) –

Fiscally transparent entities – the income treated as derived by the resident of the country when taxed to that resident under local country tax law.

But, U.S. has a “savings clause” with residual taxation in the U.S. - but question concerns who is the person subject to tax?

Savings clause in Chile-U.S. treaty protocol.

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Income Tax Treaty Real Property Income

U.S. Model Treaty, Article 13(1) – real property gains may be taxed at location.

Article 13(2) - the trust is fiscally transparent for determining whether U.S. real property ownership exists (and in U.S. the FIRPTA tax is applicable on real property gains).

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