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The Impact of Asset Transfers by U.S. Citizens Living Abroad

In international trust and estate planning, there are often inescapable details to address in order to both minimize tax implications and maximize the financial health of families with feet both in the United States and overseas.

By Rekha Rao | November 27, 2017

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For the large number of U.S. citizens living abroad, there is a significant concern about the transfer of wealth and proper succession planning to minimize or reduce the estate tax liability upon the death of that U.S. citizen. As a trusts and estates attorney of Indian origin practicing in Princeton, it is only natural that a portion of my clientele is Asian Indians. This article focuses on the approximately 700,000 or so U.S. citizens living in India. Many of these individuals or couples have either amassed significant wealth of their own or could stand to inherit assets from their parents and/or grandparents adding to their overall net worth. Proper planning for these estates becomes critically important for such individuals and their families so that they do not run afoul of their annual reporting and compliance obligations. Moreover, succession planning strategies implemented to reduce or minimize their estate tax obligations should be carefully structured so as to not trigger adverse tax consequences down the road.

Introduction to U.S. Estate/Gift Tax Structure

The U.S. tax structure is unique in that it subjects its citizens to a transfer tax on their worldwide assets whether or not a citizen is residing in the U.S. Except for special rules applicable to expatriates, green-card holders are treated the same as U.S. citizens for transfer taxation; the main difference here is that transfers to non-U.S. citizen spouses do not get the benefit of the unlimited marital deduction available to U.S. citizen spouses.

A federal estate tax of roughly 40 percent is imposed on assets over and above $5.49 million (individual); $10.98 million (married couple) — this exemption amount is called the lifetime unified credit and is scheduled to increase to $5.6 million and $11.2 million respectively in 2018. This $5.49 million can either be gifted during lifetime *gift-tax free,* or individuals can transfer the amount (minus any prior taxable gifts made) to their beneficiaries upon death, *estate-tax free.* There is also an annual exclusion of $14,000 per year ($15,000 in 2018) to any individual or $149,000 per year for transfers to a non-U.S. citizen spouse ($152,000 in 2018), over and above the lifetime gift. New Jersey does not have a gift tax, but New Jersey residents are subject to a state estate tax for estates over $2 million. However, this tax will be repealed next year, although some discussions seem to suggest that this will not happen. Additionally, if the Trump Administration's Nov. 2 proposed bill called the Tax Cuts and Jobs Act is approved, even the federal estate tax regime is expected to undergo a sea change.

Establishing Trusts with Foreign Assets

A common technique to reduce or minimize estate taxes in the U.S. is to set up irrevocable trusts. This technique removes assets out of the U.S. citizen's estate for gift and estate tax purposes. When such irrevocable trusts are established in India though, they need to be vetted thoroughly to ensure that the foreign reporting obligations are met both for the U.S. citizen settlor of the trust as well as for any beneficiaries receiving distributions from the trust. More importantly, trust provisions need to be drafted in such a way that the assets do not fall prey to the devastating throwback tax on accumulated income.

U.S. citizens residing abroad should be careful not to try and set up structures or entities solely for the purpose of evading U.S. income taxes.

A *grantor* is any person (foreign or U.S.) who either (a) creates a trust or (b) directly or indirectly makes a gratuitous transfer of property into the trust. Frequently (but not always), the Grantor is treated as the *owner* of the income and property and is responsible for any income tax liability attributable to the trust assets. In the context of a foreign grantor trust where a non-U.S. citizen sets up a trust for the benefit of U.S. beneficiaries, the IRS limits the circumstances in which the foreign grantor can be considered an owner (thereby escaping U.S. income taxation on trust income). Instead the IRS will pass the income tax liability to the U.S. beneficiary by triggering the Special Foreign Grantor Trust Rules. In other words, where a non-U.S. person is transferring assets to a foreign trust, the U.S. beneficiaries, not the foreign grantor, must pay U.S. income tax on the trust income unless certain exceptions apply (Code §672(f)):

> (a) The foreign Grantor has the absolute right to revoke the trust or re-vest title to property to himself or herself either unilaterally or with the consent of a related non-adverse party (in other words, the trust is fully revocable by the Grantor); or

(b) The Trust requires the amounts distributed from the trust during the Grantor's life only to be distributed to the Grantor and the Grantor's spouse.

Code §672(f)(2).

However, the above exceptions are overridden by a provision that requires that in the event the property transferred by the foreign grantor was actually received as a gift from a U.S. donor, the U.S. donor will be considered the grantor of the trust with respect to that portion of trust property. Code §672(f)(5). In essence, what the IRS is trying to avoid is a scenario where a U.S. citizen transfers by gift some or all of his foreign assets to a non-U.S. citizen who then turns around and sets up a trust with those very assets for the benefit of the U.S. citizen. The provision ensures that the U.S. citizen will be subject to U.S. income tax arising from those transferred assets that he or she initially owned.

Tax Compliance for Spousal Transfers

It is extremely important for U.S. citizens with non-U.S. citizen spouses *not* to transfer assets between themselves without being aware of the ramifications. A simple act of establishing a joint account with assets of both spouses in excess of the annual exemption of $149,000 (e.g., where assets were earned by the U.S. citizen only) could trigger an immediate taxable gift reportable on a Form 709 gift tax return. Lifetime gifts in excess of $5.49 million are subject to a gift tax of 40 percent. If a U.S. citizen uses up his lifetime gift exclusion, then upon his death (assuming he predeceases his non-U.S. citizen wife), his estate will be subject to an immediate federal estate tax unless the assets pass to a qualified domestic trust (QDOT). A QDOT does not avoid tax but defers taxation to after the death of the survivor.

Tax Compliance for Non-Spousal Transfers

Any U.S. citizen receiving distributions from a foreign trust is required to file a return for the taxable year of distribution setting forth the name of the trust and the aggregate amount of distributions received from the trust during the taxable year. Form IRS 3520/3520A. In addition, he or she must disclose *indirect* distributions from trusts to avoid running afoul of §672(f). Finally, care must be taken that under the terms of the trust(s) that no part of the income or corpus is to be paid or accumulated during the taxable year to, or for the benefit of a U.S. person; and if the trust is terminated at any time during the taxable year, then no part of the income or corpus of the trust can be paid to, or for the benefit of a U.S. person (even if the interest is contingent on a future event). Since the primary focus here is to ensure that a trust not be treated as having a U.S. beneficiary at any time, the following measures should be taken:

- no written or oral agreements, memos or letters of wishes or any records or documents relating to the actual distribution of income and corpus should be retained;
- trust provisions should not have any discretion to distribute to a U.S. person;
- avoid any agreements or understandings involving U.S. persons who directly or indirectly transfer property into the trust, which are to be paid or accumulated for the benefit of a U.S. person;
- avoid loans directly or indirectly to or by any U.S. grantor or beneficiary that are for less than fair market value; and

- trust provisions should provide for an override to liquidate the trust assets and terminate the trust in the event any one of the non-U.S. citizen beneficiaries becomes a U.S. person.

Conclusion

Under the Special Foreign Grantor Trust rules described above, the overarching concern is that the IRS would question the primary objective of setting up these structures and whether they were set up to avoid US income and estate taxes. In such a case, the IRS would uncross the trusts and, subject the trust assets to the appropriate taxation. On the other hand, if there were other non-tax avoidance reasons for the setting up trusts that would address this concern, then a U.S. citizen taxpayer may have a better, more defensible argument in front of the IRS or the Tax Court.

In international trust and estate planning, there are often inescapable details to address in order to both minimize tax implications and maximize the financial health of families with feet both in the United States and overseas. By understanding and acting on the multiple needs and complexities of those families' situations, trust and estate attorneys would be better equipped to help such families fulfill their estate planning objectives while remaining compliant with the law.

Rao is founder of the Rao Legal Group in Princeton. She concentrates her practice in the areas of estate planning, estate and trust administration, elder law, guardianships and special needs.
