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The Pros and Cons of U.S. Trusts for Foreign Persons — The Movement Onshore

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OVERVIEW

This article explains a fairly recent development[1] of interest to international estate planners, trust companies and wealth managers: the use of trusts subject to the laws of one of the states of the United States and administered by a U.S. trust company but considered ''foreign'' for federal income tax purposes.[2] These trusts are sometimes called ''hybrid'' trusts, ''foreign U.S.'' or ''U.S. foreign'' trusts. We will use the first term and will refer to ''hybrid trusts'' during the rest of this article. Also, we will assume that the settlor and his family are mostly non-U.S. persons, so that the emphasis will be on truly hybrid and not ''domestic'' trusts. However, as will be explained below, a hybrid trust can be easily converted into a domestic trust if it will benefit the grantor and the beneficiaries.

BACKGROUND

Foreign individuals invest significant sums in the United States, mostly in portfolio investments but also in real estate and other assets.[3] By ''foreign'' I mean an individual who is neither a citizen nor a tax resident of the United States.[4] The term ''resident'' is specifically and objectively defined in detail for income tax purposes in §7701(b), but that definition does not apply for purposes of the gift and estate tax. For the latter, the definition of resident is the same as the concept of common law ''domicile.''[5]

Non-citizen non-residents of the United States are usually referred to in tax parlance as ''non-resident aliens'' or ''NRAs.'' However, given the difference in the definition of residency for income versus estate and gift tax purposes (the former being based on an objective standard — either presence in the United States or an immigrant visa — whereas the latter depends on whether the individual has changed its ''domicile'' to the United States, a fact intensive test), individuals who are neither citizens nor residents for both income and gift and estate purposes are usually referred to as ''non-domiciliary aliens'' or ''NDAs.''

If the foreign person's U.S. investments are titled in his or her personal name and he or she dies, the heirs will not be able to obtain title to the assets unless a

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[1] While ''hybrid trusts'' have previously been discussed in the legal literature, it was more in terms of a forecast given the change in the definition of a ''foreign trust.'' *See* Rozlyn L. Anderson, *The New Era of the Hybrid Trust*, 2006 Fall CLE Meeting, Income and Transfer Tax Planing Group (Oct. 20, 2006), available at http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2006/547200610056.authcheckdam.pdf.

[2] The subject of this article was the substance of a power point presentation by the author at a Society of Trust and Estate Practitioners, Miami Branch (STEP) Lunch Forum on November 16, 2016, in Miami Florida.

[3] *See* ''Foreign Portfolio Holdings of U.S. Securities, as of June 30, 2015,'' Department of the Treasury, Federal Reserve Bank of New York, May, 2016, available at https://www.treasury.gov/press-center/press-releases/Documents/05.31.16%20TIC%20Final%20Report%20on%20Foreign%20Portfolio%20Holdings%20of%20U.S.%20Securities.pdf.

[4] Section 7701(a)(30) defines who is a ''United States person,'' so a foreign person is any person who does not come within the definition of a United States person. All section references herein are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder, unless otherwise stated.

[5] Reg. §20.0-1(b)(2).

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"probate" proceeding is commenced, an executor or personal representative appointed, and the probate judge enters an order of distribution.[6] Moreover, if the particular asset held individually is an asset that is subject to the U.S. federal estate tax,[7] an estate tax return must be filed, the estate tax paid,[8] and the asset will not be received free and clear until the IRS issues a closing letter.[9]

Therefore, if properly advised, the NDA will interpose an entity, usually a foreign company, to own assets situated in the United States. By doing so, the NDA will avoid the U.S. estate tax because the shares of the foreign company are not deemed "property situated within the United States."[10] However, if that entity is located in a common law or another jurisdiction that requires judicial intervention to pass title from a decedent to his heirs,[11] the same succession problem will arise.

On the other hand, if the investment is made through an entity formed and subject to the laws of the NDA's resident country, it is probably best that the succession of the entity's ownership be organized pursuant to local law. Moreover, in many civil law jurisdictions that provide for forced heirship it may not require much to organize the succession of a person's property because all it may take is to go before a notary and prove your status as a legitimate heir.

Because traditionally, foreign investors did not use entities of their residence country to make their U.S. investments, but rather tax-neutral entities formed in tax haven jurisdictions, the appropriate advice was for the NDA to put the shares or ownership interests of the holding company directly[12] or indirectly owning the U.S. assets in a trust. A trust would avoid probate and pass the ownership of the company shares in a confidential and efficient manner.

The reason tax haven entities were used rather than local entities did not necessarily involve nefarious motives of evasion of tax or exchange control laws. Investment outside the individual's country (other than the case of a very stable country with organized capital markets such as the United States) is generally prompted by a desire to diversify a person's estate, avoid the consequences of political instability, and generally not to keep "all of one's eggs in the same basket."

However, it is important that an investment structure for an NDA be tax efficient, and to the extent legally possible, avoid or minimize the two significant federal taxes (income and transfer taxes). As far as the income tax is concerned, our tax system is very favorable to foreign persons with portfolio investments because two of the most important sources of investment income, trading gains (whether short or long term) and interest, are not subject to tax if received by them.[13] Thus, not only the company interposed as a "blocker" to avoid the U.S. estate tax, but also the trust created to hold its shares, would have to be considered to be a "foreign person." Were the trust to be taxed as a U.S. person, it would pay tax on its income that is not distributed to the beneficiaries, which will mean that such a trust could not accumulate income, something that often is either intentionally planned by grantors of trusts or that may result from unforeseen events such as when the parent beneficiary dies leaving a minor child.

THE CHANGE IN THE DEFINITION OF A FOREIGN TRUST

For the foregoing reasons, foreign families have traditionally used foreign trusts to hold their U.S. assets. However, before 1996, in order for a trust to be considered foreign under U.S. tax law it was impor-

[6] For a general discussion as to why and when there must be probate to pass title of an asset situated in the United States, see Bekerman, 804 T.M., *Probate and Administration of Decedents' Estates* at IV.

[7] §2101(a) and §2103. Property of an NDA "situated" in the United States is subject to the federal estate tax unless specifically exempted. The exemption has often been expressed by providing that the property is not considered situated in the United States.

[8] §2102(b). The exemption amount (actually a credit of $13,000 against the tax) for an NDA decedent is only $60,000, as opposed to that of citizens and domiciliaries, which is $5,490,000 in 2017.

[9] *See* Peebles and Janes, 822 T.M., *Estate, Gift, and Generation-Skipping Tax Returns and Audits* at VIII.F. Note that the IRS will no longer issue closing letters unless the estate asks for a closing letter. Further, pursuant to Notice 2017-12, 2017-5 I.R.B. 742, the receipt of an account transcript with the transaction code of "421" and an explanation "Closed examination of tax return" will also confirm completion and closing of an IRS examination of an estate tax return.

[10] Section 2104(a) expressly provides that shares of stock owned by an NDA shall be deemed property within the United States only if issued by a domestic corporation. So shares of stock of a foreign corporation are deemed situated outside the United States and thus not includible in the U.S. estate of the NDA.

[11] For instance, Panama is a civil law jurisdiction but it generally requires a judicial succession proceeding to pass title of a Panama company's shares registered in the name of a decedent. The proceeding would be required unless there has been a judicial order entered in the country where the decedent's shares are deemed situated at the time of death. Panama counsel consulted by the author refer us to Article 52 of Law 61 of October 7, 2015 and Article 1508 of the Judicial Code, which applied in tandem will require the Panama judicial proceeding in most cases.

[12] It would be possible to invest directly through a trust that is "estate tax protected." Such would be a trust in which the NDA had not reserved any of the powers that deem the trust property to be includible in his estate. Most NDAs are not comfortable with such a trust as they want to exercise control over the trust assets.

[13] §871 and §881.

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tant that the trust be settled with a ‘‘foreign’’ trustee and for such trustee to be situated outside the United States. Moreover, the definition of a foreign trust was quite complex and difficult to apply.[14] Former §7701(a)(31) provided that a foreign trust was a trust ‘‘the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.’’ This definition assumed that for non-U.S. source income not to be taxed the trust must not be a U.S. ‘‘resident,’’ which left open the question as to when a trust was a U.S. ‘‘resident.’’ Accordingly, the courts came up with a six-factor test[15] that gave some additional guidance but was difficult to apply because it was not always clear that all of the factors applied. However, in the case of foreign families, if at least three of the factors — the country under whose laws the trust was created, the nationality and residence of the trustee, and the situs of administration were outside the United States — the trust was almost surely foreign because in most cases the grantor and the beneficiaries were foreign.

Given the pre-1996 definition, almost all trust business for foreign families was directed to foreign trust companies located in ‘‘offshore’’ trust jurisdictions. In fact, many U.S. banks and trust companies that conducted important wealth management and/or trust business in the United States obtained licenses in many of the common law trust centers in the Caribbean to offer ‘‘foreign’’ trusts to their high net worth foreign clients. In addition to the fact that trusts settled and administered in these offshore jurisdictions were not subject to tax either in the residence country or in the United States as to most investment income, these jurisdictions offered other advantages that were attractive to many foreign families for the situs of trusts. The trust laws were very protective of the trust property, particularly from creditors, spouses and heirs of the grantor. Even more important in the world of tax evasion,[16] these jurisdictions have very strong confidentiality (secrecy) ordinances that in many cases made it a criminal offense for a trust company to divulge information.

[14] See Heimos, 854 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* at III.C. for a good discussion of the case law and difficulties that the pre-1996 definition caused.

[15] The six factors were: (1) the country under whose laws the trust was created, (2) the situs of the corpus of the trust, (3) the nationality and residence of the trustee, (4) the situs of the trust administration, (5) the nationality and residence of the grantor, and (6) the nationality and residence of the beneficiaries. *Id.* at III.C.1.

[16] *See* Robert T. Kudrle, *Tax Havens and the Transparency Wave of International Tax Legalization*, 37 U. Pa. J. Int’l L. 1153 (2016).

Given the difficulty of applying the definition of a foreign trust, in the Small Business Job Protection Act of 1996[17] Congress came up with a new definition as to the status of trusts, not as ‘‘resident’’ or ‘‘non-resident’’ but as a ‘‘United States person’’ or a non-U.S. person. The new definitions are most definitely more objective and easier to apply because they did away with the more subjective fact intensive examination of factors. As we will see, the definitions tilt in favor of a ‘‘foreign’’ trust. This is important because as stated before, a foreign trust is taxed as if it were a non-resident alien subject to certain adjustments.

Under the new §7701(a)(30)(E), a trust is considered a ‘‘United States person’’ and thus ‘‘domestic’’[18] if:

(i) A court in the United States is able to exercise primary supervision over the administration of the trust, and

(ii) One or more United States persons have the authority to control all substantial decisions of the trust.

The first is referred to as the ‘‘court test’’ and the second, as the ‘‘control test.’’ Both of these requirements must be met for a trust to be ‘‘domestic.’’

The trusts that I typically examine will, without exception, meet the court test and fail the control test (which is very easy to fail). The trust instrument can be (except for some provisions typical of foreign trusts) very similar to those of trusts settled by U.S. persons, i.e., with a U.S. trustee, and the governing law and courts exercising primary jurisdiction being one of the states of the United States. The only difference will be that a foreign person is given the power to consent to one or more of the substantial decisions of the trust.

The regulations tell us what constitutes ‘‘substantial’’ decisions. Reg. §301.7701-7(d)(1)(ii) includes 10 of those decisions but it leaves open the door for others. Among them are typically important decisions such as making amendments, replacing the trustee, directing distributions, and adding or excluding beneficiaries. However, there are others that may be more infrequent and not commonly applied. For instance, one of those is ‘‘whether to compromise, arbitrate, or abandon claims of the trust.’’ Including a requirement that a certain foreign person must give her consent to that decision will make the trust foreign.

REASONS FOR/CHARACTERISTICS OF HYBRID TRUSTS

In retrospect, there is no doubt that the change in our Code definition of a foreign trust has been a pow-

[17] Pub. L. No. 104-188, §1907.

[18] The Code does not use the word ‘‘domestic’’ when referring to a trust but rather the term ‘‘United States person.’’

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erful incentive for the increasing popularity of the hybrid trust. However, there are many other reasons for this development.

Changes in the Global Legal Landscape

Even after the definition changed, foreign high net worth families continued settling trusts with trustees in offshore ''secrecy'' jurisdictions, such as the Cayman Islands, Bahamas, and BVI. Particularly in Latin America, but also in Europe and Asia, there were many fortunes that were not declared to the tax authorities of the residence countries where the owners wanted total confidentiality.

While important for many, avoidance of tax, exchange control, and other residency country laws were certainly not the primary reasons these jurisdictions were chosen. After many years in the ''offshore'' trust business, many trust companies in these jurisdictions were quite expert in the settling and administration of trusts for foreign families and U.S. tax planners, and banks felt comfortable in using them.

However, because of the pressure by tax authorities and organizations in the United States and Europe, laws in both the grantors' countries and offshore centers began to change. In many countries, tax laws now make it more difficult and costly to defer taxes; and tax haven countries that were popular trust jurisdictions have been pressured to provide more disclosure through treaties and international agreements.[19] The 2008 prosecution of UBS by the U.S. Department of Justice probably had more influence in the emphasis on the need for home country tax compliance than most of the other institutional pressures because it resulted in dealing a heavy if not fatal blow to bank secrecy.[20] Accordingly, secrecy is no longer a significant element.

Many countries have so-called ''Black Lists'' in their tax laws[21] that include most tax havens. An entity of a black-listed jurisdiction will be generally subject to reporting and ''look through'' treatment. The United States is not a Black List country in most countries.[22]

As discussed in more detail later in this article, international treaties on disclosure, such as the OECD Common Reporting Standard (CRS), apply in almost all foreign trust centers but not in the United States.[23] Thus, the United States is a more confidential trust venue than many of the offshore centers that used to dominate the international trust business.

Foreign Trusts that Need to Become Domestic Trusts

''Globalization'' has also prompted the use of the hybrid trust because there are more children of wealthy foreign families who are now studying and staying to work in the United States.[24] Many of them marry U.S. citizens or decide to stay themselves and become ''United States persons.'' While a foreign trust is not necessarily detrimental to a U.S. beneficiary, the preferred approach, particularly when a foreign family has more than one such child or descendant, is for the trust of such beneficiaries to be domestic. Because of the accumulation distribution problem that applies to foreign, but not domestic, trusts resulting in a Throwback Tax[25] on distributions in excess of trust income if there is ''undistributed net income'' from prior years, in most cases, most U.S. international tax planners advise that a trust for a U.S. beneficiary be domestic and not foreign when the trust becomes a non-grantor trust.[26]

Given the need for a transition from foreign to domestic trust in the case of a foreign family with several U.S. beneficiaries, the hybrid trust is particularly

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[19] *See* Kudrle, *Tax Havens and the Transparency Wave of International Tax Legalization*, above.

[20] *See* Eric Victorson, *United States v. UBS AG: Has the United States Successfully Cracked the Vault to Swiss Banking Secrecy?* 19 Cardozo J. Int'l & Comp. L. 815 (2011). *See also* Deferred Prosecution Agreement, *United States v. UBS AG*, No. 09-60033-CR-COHN (S.D. Fla. Feb. 18, 2009), available at https://www.justice.gov/sites/default/files/tax/legacy/2009/02/19/UBS_Signed_Deferred_Prosecution_Agreement.pdf.

[21] In the 1990s Mexico enacted new income tax laws that required disclosure by its residents of income earned through entities located in a low or zero tax jurisdiction. The regulations provided a list of these jurisdictions that included most of the tax havens of the world and many of the popular offshore trust jurisdictions. The Mexican law was copied by Venezuela and in the last decade Argentina, Colombia, Peru and Ecuador have come up with similar laws that penalize the use of tax haven jurisdictions.

[22] *See* Marshall J. Langer, Langer Treaty Notes, ''Blacklisting Tax Havens'' available at http://www.offshoreinvestment.com/media/uploads/714Langer.pdf.

[23] *See* http://www.oecd.org/tax/automatic-exchange/common-reporting-standard/.

[24] *See* Rosanna Xia, *Number of International Students in U.S. Colleges at All-Time High, and California Is Their Top Destination*, L.A. Times, Nov. 25, 2016.

[25] This term is not in the Code but is generally used to describe the income tax to be paid by a U.S. beneficiary of a foreign trust who receives an accumulation distribution pursuant to the rules set forth in §665–§667.

[26] An extensive discussion of the problems of accumulation distributions to a U.S. beneficiary of a foreign trust is beyond the scope of this article. For a detailed analysis, see Knickerbocker, 856 T.M., *Subchapter J — Throwback Rules*, Heimos, 854 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* at V.E., and Bissell, 903 T.M., *Tax Planning for Portfolio Investment into the United States by Foreign Individuals* at VII.C.

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useful. This is because it is easier to convert a hybrid trust to a domestic trust than a foreign trust settled in one of the British jurisdictions since, in the first case, the trust converts almost automatically at the foreign grantor's death, particularly if there is no foreign Protector or other foreign person acting as advisers and there is no need to sever the trust into foreign/domestic.

If the trust is to continue for the beneficiaries, either in whole or in part, and not distribute out upon death of the foreign grantor (e.g., a dynasty trust), the hybrid trust will avoid a change of trustee from a foreign organization to a domestic one and the amendment of the instrument to conform it to the requirements of the new law. Even if there is already a ''stand-by'' trust in effect designed to be domestic for U.S. beneficiaries, the change of trustees may very well involve delays because the retiring and receiving trustees will almost always involve their legal counsel in the negotiation of the indemnities.

A word of caution here is in order. While in many instances the conversion from foreign to domestic is automatic when the grantor dies because the trust was foreign due to the fact that the grantor had the power to revoke and amend the trust, if the trust was a non-grantor trust and was foreign due to the fact that a Protector or other adviser with power over a substantial decision was foreign, the trust may continue to be foreign and it may be difficult for the family to substitute the foreign advisers with equally trusted and close U.S. persons. This is something that the grantor and family members should plan in advance so that the trust does not continue as foreign when the grantor's intention was for the trust to seamlessly convert to domestic upon her death.

Moreover, the automatic conversion of the hybrid trust from foreign to domestic will avoid decanting, which sometimes may create tax problems, particularly when the transferring foreign trust is substantially different from the domestic standby or newly created domestic trust.[27]

The hybrid trust is efficient for foreign families with both U.S. and foreign beneficiaries. After becoming a domestic trust (other than where the portfolio is concentrated in U.S. stocks paying qualified dividends unless the foreign beneficiary resides in a treaty country that reduces U.S. withholding), there should be no adverse income tax consequence on the foreign beneficiary's share of the income if it is of the type that is not subject to tax for non-residents. This is because the character of the income at the trust level is the same when received by the beneficiaries.[28]

Other than the fact that a hybrid trust is a foreign trust that may convert into a domestic trust after the grantor's death because it has U.S. persons as beneficiaries, there are no particular differences in its tax characteristics. The hybrid trust will be either ''simple'' or ''complex,'' a ''grantor trust'' or a '' non-grantor trust,'' estate tax protected or not, and may or may not need an offshore company interposed, depending on whether there could be inclusion in the foreign grantor's U.S. estate.

A ''simple'' trust is one that requires the distribution of all of its income currently, whereas any other trust would be a ''complex'' trust.[29] Even though the Code does not use the terms, federal tax law uses the term ''grantor'' trust to define a trust described in §671–§679, which is ignored for income tax purposes so that all the income is taxed to the grantor; and a ''non-grantor'' trust, which may be considered a separate taxpayer from its grantor and beneficiaries. Even though the income of a grantor trust is taxed to the grantor, its assets may be considered outside and separate from the grantor's estate. However, in most cases the trust assets of a ''grantor'' trust will also be considered part of the grantor's estate. Any trust where the grantor has retained none of the rights that the tax law considers to result in the trust property being in her estate will be considered to be ''estate tax protected.''

Modern U.S. Trust Laws — The ''Directed Trust''

U.S. trust laws are much more flexible than those of the British offshore centers. Unless the foreign jurisdiction has a special regime that permits the grantor or her family to retain control and local counsel agrees, the English doctrine regarding a ''bare'' or ''sham'' trust[30] may require significant trustee involvement that would not only restrict grantor control but also increase fees. Special trust legislation designed to give the family more control and avoid trustee responsibility such as the VISTA regime in BVI[31] and the STAR Trust[32] in the Cayman Islands fall short of providing the needed flexibility and continuity, particularly when there are U.S. beneficiaries.

[27] *See* Notice 2011-101, 2011-52 I.R.B. 932. See also ''Report on Notice 2011-101 and Trust Decanting,'' New York State Bar Association, Tax Section Report 1265 (Apr. 26, 2012), where some of the problems are discussed.

[28] §652(b) and §662(b).

[29] §651.

[30] A good summary of the doctrine of sham or bare trusts can be found at http://www.collascrill.com/documents/factsheets/tf-sham-trusts/, a blog written by Kellyann Ozouf a partner of the Jersey law firm, Collas Crill.

[31] Virgin Islands Special Trusts Act, 2003 (No. 10 of 2003).

[32] The Special Trusts (Alternative Regime) Law 1997.

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VISTA Trusts subject to this law permit the trustee to hold shares of a BVI company and delegate all management decisions to the grantor or his designee(s) absolving the trustee of responsibility. VISTA Trust are limited in that the only assets that they may hold are shares of a BVI company.

The STAR trust can be established for a purpose or purposes and/or beneficiaries. A STAR trust relieves the trustee from responsibility to any beneficiary, as the trust provisions can only be enforced by an ''Enforcer'' named in the trust instrument. This absolution is limited because the Enforcer can always bring an action and thus, as will be discussed later, are much weaker than the exculpation of a directed trustee under the strongest directed trust legislation of some U.S. states.

A hybrid trust may be created as either a ''living trust'' if for a limited purpose, or with an institutional trustee. Living trusts, possible in many U.S. states, are trusts declared by the grantor who also acts as trustee during his or her lifetime. These trusts are not considered valid trusts in the U.K. trust jurisdictions because of the ''bare trust'' doctrine previously mentioned, or due to trustee residency/licensing requirements. Living trusts are a cost effective practical solution to avoid probate and organize an orderly succession for specific investment structures, such as for U.S. residences if the top holding company shares can only be transferred through a probate proceeding. If the trust is substantial, has various asset classes, and will not distribute out at the grantor's death, an institutional trustee should instead be chosen.

''Directed trust'' legislation in many states[33] (e.g. Delaware, Florida, South Dakota) gives the family more control and results (or generally results) in lower trustee fees. The grantor can appoint an advisor for many of the decisions that the trustee was responsible for under traditional trust law such as distributions, investments, amendments, appointment and removal of trustees and other advisers. They are particularly useful where the trust is to consist of shares of an operating company, which most trust companies have been reluctant to accept, except for very high fees, since the grantor can appoint an adviser or an advisory committee that has sole responsibility for the management of the company business, including the appointment of directors, officers and other management personnel, thus absolving the trustee of responsibility.

Some of the states with strong directed trust legislation, such as Delaware and South Dakota,[34] also have very modern trust laws designed to make the jurisdiction attractive for the location of trusts with a trust company licensed in that state. These legal attractions include ''asset protection'' trust legislation, liberal non-judicial modification statutes, and no rule against perpetuities, among others.

The directed trustee under the laws of some states can remain in the role of an ''administrative trustee'' and have another person chosen by the grantor to act as co-trustee with many of the traditional trustee powers. In effect, the local trust company acts very much like a custodian with back office functions such as record keeping and tax filings. Nevertheless, the legislation protects the trustee from liability, even from monitoring the actions of the co-trustee if the document clearly defines the power of the administrative versus the fully empowered trustee. The alternative to the co-trustee arrangement is the appointment of a ''Protector'' with many of the traditional trustee powers or the division of those powers among various ''advisers'' or advisory committees. The new concept in the directed trust legislation is not the division of powers or functions that has existed in practice for years, but the protection of the trustee from liability even if it does not monitor the actions of the advisers. The degree of protection varies from state to state, particularly in states where the law has been recently enacted as there has been no court tests of the trustee exculpation. In this connection, the early adopting states, such as Delaware, have a slight advantage in that their courts have had an opportunity to have the law tested in court.[35]

Other Uses of the Hybrid Trust

A hybrid non-grantor trust may be the most efficient vehicle for a substantial real estate investment in the United States. The trust may start as foreign by giving the foreign grantor the right to change the trustee with a U.S. trust company located in a state with legislation that permits the grantor to be a discretionary beneficiary without subjecting the trust property to inclusion in the grantor's estate[36] and later change to a domestic trust if there is going to be a disposition of the

[33] Directed trust legislation has been widely discussed in the legal literature. See, for instance, Charles A. Redd, *Tips From the Pros: Directed Trusts—Who is Responsible*, available at http://wealthmanagment.com/print/estate-planning/tips-pros-directed-trusts-who-responsible (Aug. 27, 2015); Richard W. Nenno, *Directed Trusts: Making Them Work*, 38 Tax Mgmt. Est., Gifts and Tr. J. 159 (Mar. 2013); David A. Diamond & Todd A. Flubacher, *The Trustee's Role in Directed Trusts*, 149 Tr. & Est. No. 11, p. 24 (Dec. 2010).

[34] For a list of states with directed trust legislation of varying degree of protection see Nenno, above, n. 33.

[35] *Duemler v. Wilmington Trust Company*, No. 20033 NC, 2004 BL 31983 (Del. Ch. Oct. 28, 2004).

[36] These are states such as Alaska (covered in the article cited here), Delaware (12 Del. Code §3570 *et seq.*) and South Dakota (S.D. Codified Laws §55-16 *et seq.*), among others, which protect

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real property, thus avoiding FIRPTA.[37] If the foreign trust will have rental income effectively connected with its U.S. trade or business, it may be lowered by a loan with a relatively high interest payment and §163(j) interest stripping may not apply. In addition, the trust may be structured as a grantor trust by making the grantor's spouse the sole beneficiary of income and principal during her lifetime so that the trust would be entitled to the ''step-up'' in basis under §1014(b)(2).[38]

DRAWBACKS OF USING A HYBRID TRUST

Some drawbacks to consider when a foreign investor uses a hybrid trust are: (a) possible limitation on SEC foreign-targeted investments; (b) no assurance in fending off forced heirship attacks as ''foreign elements'' type legislation of many offshore trust centers has not been adopted in most states; (c) if grantor needs an asset protection trust (APT), he may be better advised to go offshore because a domestic APT is not as protective given the full faith and credit constitutional dictate; (d) possible requirement of filing a Foreign Bank Account Report or ''FBAR''; and (e) confusion on the part of financial institutions' compliance departments as to the correct classification of the trust.

Limitation on SEC Foreign-Targeted Investments

If the client wishes to invest in ''foreign targeted'' securities that are not registered with the SEC based on the foreign exemption available when the securities are not offered to U.S. persons,[39] the hybrid trust presents some obstacles because a U.S. trustee is considered a U.S. person for SEC purposes. However, there are two ways to get around the problem: (i) interpose a foreign corporation (which is ''principally'' formed to avoid the estate tax on U.S. equities) to own the investment account, or (ii) if the trust does not use an underlying foreign company, add a foreign co-trustee with ''sole or shared investment discretion with respect to trust assets.'' The latter exception also requires that ''no beneficiary of the trust. . . is a U.S. person.''[40] Since there is a dearth of interpretive precedents regarding the applicable regulation, it is unclear, however, that a ''contingent'' U.S. beneficiary counts as a beneficiary for purposes of this exception. If one analogizes this rule to those dealing with the exemption for family offices, it would appear that only present vested beneficiaries, and not contingent ones, would count as ''beneficiaries'' for purposes of this provision. Nevertheless, in practice and in this author's own experience, financial institutions take the position that even when the account is in the name of a foreign corporation, such corporation cannot purchase foreign targeted securities, if the corporation's shares are owned by a hybrid trust that manages the corporation through one of its agents.

Forced Heirship Attacks as ''Foreign Elements''

Most U.S. trust states have not adopted the conflicts of law rule found in many of the traditional British trust jurisdictions,[41] which expressly provide that a trust that is valid under the laws of the chosen jurisdiction is valid notwithstanding marital or succession laws of another country (usually the grantor's domicile) that may be violated by the creation of the trust. This is important because the traditional conflicts of law rule has been that the devolution of personal property is to be determined by the law of the domicile of the decedent.[42] So, in the absence of appropriate legislation, it is not clear that a foreign grantor is free to vary the disposition of her estate in violation of her domicile's forced heirship laws.

Need for Asset Protection Trust

While the asset protection rules in place in the states that offer asset protection trusts are generally adequate compared to the rules in place in such foreign asset protection trust havens as the Cook Islands and Nevis, one of the major deficiencies of an asset protection trust governed by a U.S. state law is the requirement of the U.S. Constitution that a state give ''full faith and credit'' to the judgments of sister states. Thus, in theory rather than in practice, because even in the states that have had asset protection trust legislation the longest such as Delaware, the issue has

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self-settled trusts against the claims of the grantor's creditors. *See* Gideon Rothchild, Douglas J. Blattmachr, Mitchell M. Gans & Jonathan G. Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate*, 37 Est. Plan. 3 (Jan. 2010).

[37] The well-known abbreviation for the Foreign Investment in Real Property Tax Act of 1980 codified in §897 and §1445 requiring 15% withholding on the amount realized by a non-U.S. person on the disposition of a U.S. Real Property Interest.

[38] *See* PLR 201245006.

[39] The exemption from registration is contained in SEC Regulation S.

[40] 17 C.F.R. §230.902(k)(2)(iii).

[41] *See, e.g.,* Cayman Islands Trusts Law (Foreign Element) 1995 Amendment; Nevis, The Nevis International Exempt Trust Ordinance 1994, as amended, §48.

[42] Restatement (Second) of Conflict of Laws §260 (1971).

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not squarely come up before the courts,[43] if a creditor obtains a judgment against the grantor of an asset protection trust in another state, it could very well have to be enforced by the courts of the trust state. There is a lack of meaningful case law analyzing the enforcement of judgments of non-asset protection jurisdictions against asset protection trusts under the Full Faith and Credit Clause.[44] However, the consensus of scholarly opinion is that the Full Faith and Credit Clause would require a court to enforce a valid judgment of a sister state, even if this judgment was inconsistent with the general public policy of the enforcing state.[45] The same would not be true with a Nevis asset protection trust because the Nevis court would not be bound to enforce the judgment, unless there is a treaty in effect, and even in such a case the Nevis court will always be able to avoid enforcement on the grounds that it violates public policy of protecting the assets of Nevis' trusts.

Possible Requirement of Filing an FBAR

The FBAR is required to be filed under the Bank Secrecy Act of 1970 (BSA)[46] by all U.S. persons at the same time they file their income tax return (whether they have to file or not) who have signature authority in any financial account outside the territory of the United States if the account had a balance of $10,000 in any day during the tax year. The filing must be done on FinCEN Form 114[47] and sent online to the Treasury Department. Because it is not a requirement under the Code (Title 31 of the United States Code instead of Title 26), many of the Code concepts do not apply under the BSA. In particular the definition of ''U.S. person''[48] includes ''a trust formed under the laws of the United States. . . .'' The term ''laws of the United States'' includes the laws of the various states. Accordingly, it is clear that it would apply to a hybrid trust governed by the laws of one of the states of the United States. Be that as it may, in the author's experience it is not usual for a hybrid trust to possess a financial account outside of the United States and even if it does, it is not the type of information that is either burdensome or would likely be exchanged with other countries pursuant to an exchange of information treaty.

Confusion as to the Correct Classification of the Trust

I mention confusion by compliance departments of banks and financial institutions as a possible drawback anecdotally because the author has often experienced it. However, it is not a serious issue and it is becoming less frequent as institutions become more familiar with the hybrid trust.

GLOBAL INFORMATION EXCHANGE — WHY THE U.S. APPEARS ATTRACTIVE

The discussion that follows should be prefaced by the proposition that first and foremost the United States is attractive to investors worldwide because it is a recognized investment haven given its investment opportunities, legal protections, and political stability. In addition, it should be pointed out that the following treatment of global information exchange is general and limited to an explanation of why these information exchange developments are one more reason,[49] among the many others previously mentioned, to consider the United States as a useful trust jurisdiction. I want to make it very clear that there is no suggestion here that foreign investors whose financial accounts have not been reported to their home country tax authorities consider a hybrid trust to continue their nondisclosure. Rather, it is a simple recognition based on experience in dealing with foreign high net worth families that for varied and legitimate reasons they always seek financial privacy. There are many foreign prominent and wealthy families that are fully tax compliant in their home country and, particularly if they live in Latin America, for security reasons do not

[43] *See* Todd A. Flubacher, *Planning to Avoid Pitfalls — Asset Protection Trusts Thirteen Years After Enactment*, 6 Delaware Banker 20 (Winter 2010) (''there have been no published court decisions in any state in which the validity of a domestic asset protection trust has been challenged'').

[44] *Id.*

[45] *See* John Paul Parks, *Evaluating the Alaska Trust's Ability to Shield Assets from the Claims of Creditors*, Ariz. Att'y, Nov. 1998, at 28, 29–30 (''If the [Arizona] Court has jurisdiction over the parties and the subject matter, it might decide, without regard to the validity of the trust, that a transfer to the Alaska trustee, permitted under Alaska law, but having a significant relationship to Arizona, is a fraudulent transfer under Arizona law and order appropriate relief in favor of the settlor's creditors. The Alaska court would be required to enforce such a judgment pursuant to its obligations under the Full Faith and Credit Clause''). For a contrary opinion, see Nenno and Sullivan, 868 T.M., *Domestic Asset Protection Trusts*, at IV.G. (Obstacle 6: Domestic APT Court Might Not Have to Give Full Faith and Credit to Judgment of Non-DAPT Court).

[46] 31 U.S.C. §5311 *et seq.*

[47] 31 C.F.R. §1010.350(b)(1).

[48] 31 C.F.R. §1010.350(b).

[49] For a thorough discussion of why the United States is an attractive jurisdiction for those foreign investors concerned with automatic exchange of information, see Peter A. Cotorceanu, *Hiding in Plain Sight: How Non-US Persons Can Legally Avoid Reporting Under Both FATCA and GATCA*, Tr. & Trustees (Oct. 2015).

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want their financial accounts disclosed in the manner required by the automatic exchange of information of the new global scheme known as the ''Common Reporting Standard'' (CRS).[50]

A full and accurate discussion of CRS or GATCA and its U.S. predecessor, the Foreign Account Tax Compliance Act (or FATCA),[51] enacted in 2010, are beyond the scope of this article; but they will be briefly discussed so we can explain why hybrid trusts have become more attractive in the brave new world of global automatic information exchanges.

With FATCA, the United States was able to get most substantial foreign financial institutions (FFIs) throughout the world to report the accounts of U.S. taxpayers. However, while a very potent tax transparency law for the IRS, since it is enforceable by withholding and practically every FFI of substance cannot afford to avoid the U.S. financial system, the legislation and the Intergovernmental Agreements (IGAs) signed with over 100 countries, are notoriously nonreciprocal with the important ultimate beneficial owner disclosures going only to the United States. Thus, unless the foreign investor has a financial account in his own individual name, something that most properly advised high net worth individuals do not do, she need not be concerned that her U.S. financial account will be reported to the tax authorities of her home country.

The OECD countered with Global FATCA (or GATCA) with rules very similar to FATCA set forth in the CRS, but with an important difference: GATCA/CRS as opposed to FATCA is truly multilateral and reciprocal in its approach and to date 101 jurisdictions have committed to CRS.[52] However, there is one big hole in the scheme: the United States has not committed and, given that it has a very strong weapon in FATCA, it will probably not join in the foreseeable future.

As in FATCA, CRS divides entities into *financial institutions* or ''FIs'' and *non-financial entities* or ''NFEs.'' In simple terms, the former are required to report ''Reportable Accounts''[53] of ''Reportable Persons''[54] resident in a counterparty country, whereas the latter do not.

Going through the CRS definitions, we know that a trust located in a CRS jurisdiction is an FI required to report information regarding its Reportable Account(s) (the debt or equity interests in the trust) to the ''Competent Authority'' of its jurisdiction, which will in turn report to those CRS jurisdiction(s) of which the Reportable Person(s) is (are) resident(s) pursuant to the applicable bilateral agreement with its counterparty. On the other hand, as we know, most trusts invest through underlying companies and such a company, even if incorporated in a CRS jurisdiction, will not be required to report if it is not an FI.

Why is it important for a foreign family that the United States is not part of CRS? Because if the trust, or ''private interest'' foundation[55] that is the basic family estate planning structure for foreign assets is settled with a U.S. trustee and the financial assets are in the United States, it is assured, at least for the foreseeable future, that such part of the family fortune will not be disclosed to their government if the grantor is a resident of a CRS jurisdiction.

The information to be disclosed under CRS is fairly detailed, including names, place of birth, residence, tax ID numbers of ''Reportable Persons,'' names of FI's where accounts are held, account numbers, balances, and the gross amounts of different types of income.[56]

While an underlying company located in a CRS jurisdiction (e.g., BVI) with a discretionarily managed financial account in the United States may itself be required to report as it is classified as an FI of a CRS country, no one really knows who will be charged with the reporting obligation. Presumably, the person(s) in charge of the management of the company (directors, officers or managers) will be under that obligation although it will be hard to police and enforce if they do not reside in a CRS jurisdiction. We will need to wait for and examine local legislation in each

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[50] Organisation for Economic Co-operation and Development [OECD], *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (OECD Publishing 2014). The Common Reporting Standard is only part of a series of legal documents binding countries which have joined the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters which as of October 2016 had been signed by 105 countries (the ''Multilateral Convention''). Based on the Convention, a Model Competent Authority Agreement (MCAA) was developed for countries committed to global automatic exchange of information between their tax authorities. The MCAA is followed by the Common Reporting Standard which contains the due diligence rules and information to be obtained and reported, and various Annexes and Commentaries on the MCAA and CRS. Given that CRS is only part of the entire scheme for information exchange under the MCAA, authors such as Mr. Cotorceanu, refer to the commitment not as ''CRS'' but as ''Global FATCA'' or ''GATCA.'' *See also* John J. Ryan, Jr., *A Crash Course in the CRS*, 14 T. Q. Rev. 24 (Mar. 2016).

[51] Pub. L. No. 111-147, now codified in §1471–§1474.

[52] The United States signed the Multilateral Convention and the amending Protocol but Congress has never approved it.

[53] CRS, Section VII. D.1.

[54] CRS, Section VII. D.2.

[55] These are statutory entities in jurisdictions such as Liechtenstein, the Netherlands and Panama (not to be confused with U.S. private foundations used for charitable purposes) that are generally considered the equivalent of common law trusts for federal tax purposes. *See* AM 2009-012 (Oct. 7, 2009).

[56] CRS, Section I.A.

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CRS jurisdiction to determine, practically, how the FI will be obligated to report. Except for that unknown, the generally accepted interpretation is that if the trust and its trustee are not in a CRS jurisdiction,[57] no reporting is required to the CRS country of the Controlling Persons'[58] residence, even if the underlying company is in a CRS jurisdiction with its Resident Office and Agent provided by a local trust company and even if a corporate nominee director is provided. That is, as long as neither the trust nor the financial account are in a CRS jurisdiction. The author understands, however, that some trust companies in CRS jurisdiction take the view that reporting would be undertaken by the companies whose registered offices they provide if the trust companies provide nominee directors.

As a result of CRS, foreign families residing in CRS jurisdictions with trusts or foundations in CRS jurisdictions,[59] both "early adopters" required to report by September 30, 2017 (i.e., Barbados, Bermuda, BVI, Cayman, Curaçao, Gibraltar, Guernsey, Isle of Man, Liechtenstein, Jersey, Malta, Netherlands, Turks and Caicos Islands, and U.K.) and jurisdictions reporting in 2018 (i.e., Aruba, Bahamas, Belize, Cook Islands, Marshall Islands, Mauritius, New Zealand, Nevis, Panama, Saint Lucia, Saint Vincent and the Grenadines, and Switzerland) who have not moved or terminated them in 2015 and 2016,[60] respectively, should be preparing for the information to be sent to the tax authorities of their country. Nevertheless, the exact date for the reporting of a trust on the books of a trust company located in a CRS jurisdiction may depend not only on the CRS rules but also on the implementing legislation of the particular jurisdiction.[61] Therefore, there is no substitute for checking with the compliance department of the trust company and local counsel to determine the specific effective date.

To take a practical example close to home, if a Latin American high net worth investor is planning to settle a trust for his family, and, for purely privacy reasons, wants to avoid reporting to his residence CRS country,[62] he would learn that there are no reliable trust jurisdictions left as practically all of the traditional ones (listed above) are CRS jurisdictions. This makes the United States "the last person standing" as a non-exchanging trust jurisdiction, leaving alone all other trust benefits we have detailed and purely from a confidentiality standpoint.

CONCLUSION

There is no question that we are seeing more hybrid trusts — either living trusts governed by the laws of the state where trust assets are located or trusts with institutional trustees. It behooves international tax and estate planning counsel, as well as accountants, trust officers, bankers, investment advisers and other U.S. professionals to become familiar with the concept so that the international high net worth family can be provided with optimal estate planning strategies. Finally, to the extent that the family has a trust with a trustee resident in a CRS jurisdiction and the grantor and beneficiaries also reside in a CRS jurisdiction, they should be prepared for the upcoming disclosure of the trust details to their home country's tax authority.

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[57] *See* Peter A. Cotorceanu, *Hiding in Plain Sight: How Non-US Persons Can Legally Avoid Reporting Under Both FATCA and GATCA*, Tr. & Trustees (Oct. 2015).

[58] CRS, Section VII.D.6., gives the following definition, "The term 'Controlling Persons' means the natural persons who exercise control over an Entity." It goes on to cover trusts and *other* entities very broadly.

[59] I have listed only jurisdictions known for providing offshore trusts and/or private interest foundations.

[60] Reporting is required if the trust/foundation information is available on January 1st of the year prior to the year in which reporting is required. CRS, Section II.A.

[61] See Chapter 4.5, paragraph 180 of the CRS Implementation Handbook which permits an "alternative reporting period" instead of the calendar year. Accordingly, if the particular jurisdiction has provided for a reporting period other than the calendar year a trust moved after January 1st of the first reporting year but before the beginning date could possibly avoid reporting,

[62] As of January 1, 2017, the following Latin American countries had committed to CRS: Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Panama and Uruguay.

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