Morgan Stanley

INTERNATIONAL WEALTH MANAGEMENT

Succession Planning for Global Clients with US Citizen and Resident Descendants

INTERNATIONAL STRATEGIES

Executive Summary

Global clients that are not residents of the United States and are not US citizens with US beneficiaries may consider creating trusts as part of their succession plan.[1] Trusts may provide benefits including preventing costly and lengthy probate proceedings in the US, the client's home jurisdiction, or in the jurisdiction in which the assets are located.

Problems with Direct Succession

Families with members living abroad or with different nationalities should consider the legal framework in any relevant jurisdiction (including ownership, family, succession and taxes) for the transfer of assets to the next generation. This analysis should include any jurisdiction in which a family member is a citizen or resident or in which any of the assets are located. Often assets are inherited by the beneficiaries as provided in the valid will of the decedent, or to the heirs under the intestate rules applicable to the decedent. A probate process may be necessary to effectuate a transfer of the assets. When the assets are in different jurisdictions, conflicts of law could occur and probate may need to be opened in multiple jurisdictions.

In addition, the immediate inclusion of the assets into the patrimony of the heirs (that is, distributed directly to the heirs and held in their own name) may lead to some inefficiencies or contingencies that could be minimized if the assets are held in trust after the lifetime of the decedent. Examples of such issues include divorce, alimony, assets inherited by minor children or by children who may not be mature enough to manage the assets, assets subject to lawsuits or other claims against the beneficiary/heir and assets subject to tax in the hands of the beneficiary/heir. The tax treatment of the gifts and bequests can vary from jurisdiction to jurisdiction.

From the perspective of a US beneficiary, receiving the assets in one's personal name might not be the most efficient manner to inherit as it could (i) create the need for probate proceedings in the country of the decedent or the location of the asset, (ii) immediately be subject to claims of creditor, and (iii) be included in the estate of the beneficiary upon the death of the beneficiary and potentially be subject to US estate tax.

Issues of Estate Taxes

A global client's assets located outside the United States are normally not subject to the US estate tax if the global client is not a US citizen and is not a US resident. Only assets located in the US (so-called "US situs" assets) are subject to US estate taxes.[2] Thus, the transfer of wealth located outside the US from the global client to the US beneficiaries upon death would not be subject to the US estate tax.

US Persons are subject to federal gift and estate tax on their worldwide assets. They are afforded a generous lifetime exemption ($12.92mm for 2023). Upon the death of a US person, federal estate tax is imposed on the US person's worldwide estate to the extent that it exceeds the person's federal estate tax exemption, including any assets received from a global client.

Consequently, a Global client should consider:

1. How US situs assets are titled during the global client's life

2. How best to minimize the US federal estate tax impact to US beneficiaries.

A Trust Could be an Efficient Solution to Minimize These Problems

A trust is a legal arrangement involving three parties: a grantor (a/k/a the donor or settlor), a trustee, and a beneficiary or beneficiaries. The grantor transfers property to the trustee, who holds legal title to the assets. The trustee must prudently administer the trust and the assets – for example, by investing, maintaining, or distributing the assets – for the beneficiaries.

A trust could take different forms and contain different provisions. Revocable trusts can be amended from time to time by the grantor and the grantor has access to the trust funds during the grantor's lifetime. Irrevocable trusts cannot be amended or modified by the grantors. Revocable trusts become irrevocable upon the death of the grantor. If properly planned, a "Dynasty Trust" could be created to maintain the assets in trust for the benefit of more than one succeeding generation.

For purposes of this paper, we will consider the case of revocable trusts during the lifetime of the settlor. Parents interested in creating an efficient plan for their US beneficiaries may benefit from the use of a revocable trust. The grantor will retain access to the assets and control over the assets during the grantor's life and the trust instrument will include provisions that govern how the assets will be distributed after the grantor's death. The trust instrument could direct that the US situs assets be held in trust for the benefit of the US beneficiaries. These US situs assets would be used to benefit the US beneficiaries but would not be included in a US probate estate or in the beneficiary's estate for US federal estate tax purposes.

The assets held in a revocable trust at death will likely be deemed owned by the foreign person for US tax purposes. Planning is important since US situs assets owned by the trust may be subject to US federal estate tax. (See: our white paper on Taxation of global clients.)

US Income Tax Treatment

The federal income tax treatment of the assets in a revocable trust is different during the lifetime of the grantor compared to after the grantor's death. For US federal income tax purposes, a revocable trust is a grantor trust and the settlor may be considered the owner of the assets held in the trust. The income of the assets held by a grantor trust is income attributed to the grantor. During the lifetime of the grantor, the trust will generally not be subject to US income tax. Therefore, it is more important to understand the implications of the trust under the income tax laws applicable to the grantor in the grantor's country of residence. Upon the death of the grantor, a revocable trust will become irrevocable and thereafter will be a non-grantor trust. The treatment of a non-grantor trust from a US perspective varies depending on whether the trust is a foreign or a domestic non-grantor trust. It is important to note the difference and plan accordingly because the taxation and reporting obligations of the trust and the US beneficiaries vary significantly between foreign and domestic trusts.

(a) If the trust is considered a foreign non-grantor trust, the trust would be considered a foreign person for US tax purposes and subject to US federal income tax only on certain types of US source income (See: our white paper on Taxation of global clients). Other types of income would not be taxed in the US in the year generated unless the income is distributed to a US beneficiary. US beneficiaries are subject to federal income tax upon receiving income distributions from the foreign non-grantor trust. It will be vital for the trust to keep proper accounting and to differentiate between the distributable net income (DNI) for the current tax year, the undistributed net income (UNI) from previous tax years and the corpus. Taxation for the US beneficiaries will differ for each case:

1. The DNI (income distributed to a beneficiary in the tax year in which it was generated) distributed to the US beneficiary would be included in the taxable income of the US beneficiary and would maintain its character (for example, long term capital gains, qualified dividends, or ordinary income) in the hand of the beneficiary.

2. UNI, (income that is distributed after the tax year in which it was generated), is includable in the taxable income of the US Beneficiary but with a less favorable treatment than DNI: First, all UNI is taxed as ordinary income rates (thus other types of income are stripped of their character and

their reduced tax rates), and an interest charge is imposed for each year that the income was accumulated before being distributed, and

3. Principal distributions are not subject to federal income tax for the US beneficiary.

(b) If the trust is a US non-grantor trust, the trust will be taxed in the US on the income generated during the tax year that is not distributed to the beneficiaries in that year. Any income that is distributed to the beneficiaries will be included as taxable income for the beneficiary. The ordinary income of US non-grantor trusts is taxed as the same tax rates as individuals, except that the trust will reach the top marginal rate with $14,451 of income in 2023. Income that was previously taxed at the level of the trust is not taxed as income to the beneficiary upon distribution.

The benefit of a US non-grantor trust is that there are no penalties for accumulating income at the trust level. The income is taxed in the year it was generated but there are no penalties or adverse tax consequences for the US beneficiary when accumulated income is distributed. On the other hand, income accumulated in a foreign non-grantor trust may not be subject to US federal income tax until it is distributed, but the tax imposed at that time may be significantly higher than the tax that would have been imposed if the income had been distributed in the year in which it was generated.

Special considerations when receiving shares of foreign entities

US persons holding shares or an equity interest in a foreign company treated as a corporation for US federal income tax purposes may be subject to complex and adverse tax consequences when the entity is controlled by US persons and meets the requirements of a controlled foreign corporation (CFC). The CFC rules could be triggered if the estate of a global client includes ownership of a foreign entity and US persons inherit the shares. Prior to the 2017 Tax Cuts and Jobs Act, a US person that inherited a foreign entity could prevent that entity from being treated as a CFC by filing, within 30 days, a "check-the-box" election, which is treated as a deemed liquidation of the entity for US federal income tax purposes. The 2017 Tax Reform eliminated this "30-day rule," so even if a check-the-box election is made immediately after the US person inherits the shares, the interest is still treated as a CFC for the short period of time from inheritance until the election is made. The deemed liquidation of the CFC that occurs when the check-the-box election is made may now have adverse US federal income tax consequences to the US beneficiary, including potential US federal income tax on a portion of the appreciation in value of the assets of the CFC above their original cost.

Global client's holding US-situs assets through a non-US entity should consider reviewing the strategy to understand the impact on the US beneficiary (or beneficiaries).

Reporting Obligations

In addition to the payment of US federal income tax, there are reporting obligations for the US beneficiaries of trusts. Trustees may also be required to prepare and file certain reports. For example, US beneficiaries must file, among other forms, Form 3520 to report transactions with foreign trusts or the receipt of certain foreign gifts, Form 8938 to report specified foreign financial assets, FBAR to report an interest in, or signature or other authority over, certain foreign financial accounts and Form 1040. On the Trustee side, a Trustee of a Foreign Non-Grantor Trust should (i) provide the US beneficiary with a beneficiary statement reporting any distribution and whether it represented DNI (character of income), UNI or corpus and, (ii) file Form 1040-NR if US source or effectively connected income was received by the Trust and (iii) comply with FATCA (Foreign Account Tax Compliance Act) reporting.

For US Non-Grantor Trusts, the trustee must (i) provide the US beneficiary with Form 1041, Schedule K-1 to report each distribution and whether it represented income (including the character of the income) or corpus, and (ii) file Form 1041.This list is not exhaustive and there may be additional reports and filings that are as relevant and important as the ones described above.

Important

There are many planning alternatives available. The one described herein may not be appropriate or efficient in all cases. Clients should consider all relevant circumstances with their legal and tax advisors to plan efficiently.

1 In this paper, "US beneficiaries" refers to descendants who are US citizens or US residents. "Residents" for the purposes of this paper mean residents for US federal income tax purposes. That is, those who are lawful permanent residents of the United States ("green card" holders) or those substantially present in the United States for the requisite period of time.

2 US situs assets include real property located within the US, stocks in United States based corporations, certain bonds, personal property located in the United States, cash held in a brokerage account, for instance, in a safety deposit box, but not cash held in bank deposit accounts, and intellectual property. The rules for whether an asset is a US situs asset are different for federal gift tax purposes.

3 This number is indexed for inflation.

4 Any use of the gift tax exemption by the US person during life will cause a corresponding reduction in the amount of federal tax exemption available at death.

Important Disclosure

Morgan Stanley Smith Barney LLC does not accept appointments, nor will it act as a trustee but it will provide access to trust services through an appropriate third-party corporate trustee.

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