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“Foreign Grantor Trust” – a Primer

The purpose of this primer is to briefly explain the concept of the foreign grantor trust (“FGT”). A FGT is typically used when a non-U.S. Person individual (i.e., an individual who is a non-U.S. citizen, not a “green card” holder, or otherwise not considered a U.S. income tax resident) wishes to benefit U.S. Persons through a trust. For example, a Singaporean resident wishes to create a trust to benefit her grandchildren who are U.S. Persons.

This primer explains the characteristics of FGT planning, the tax advantages of the FGT during the settlor’s lifetime, and the pitfalls of the FGT after the settlor’s demise. When engaging in cross border trust planning, it is important to not only consider the U.S. tax aspects for the U.S. Person beneficiaries, but also the tax laws of the settlor’s and other non-U.S. beneficiaries’ jurisdictions. FGT planning may be extremely attractive for U.S. Person beneficiaries of the FGT, but may prove to be a tax disaster for the settlor or other non-U.S. Person beneficiaries of the FGT, *e.g.*, a German resident establishing a FGT may trigger up to a 50% German tax charge. Given the complexity of considering the tax consequences for the settlor, beneficiaries, and trustees of the FGT, it is critical that we consider the cross – jurisdictional aspects of the trust planning and confer with qualified in-country tax counsel.

What is a “Foreign Grantor Trust”?

The term “foreign grantor trust” is a U.S. term meaning that a trust satisfies a particular tax status under the U.S. tax rules. “Foreign” (i.e., non-U.S.) means that the trust is not considered a U.S. domestic trust, so neither the trust nor its trustees are not liable to U.S. taxation. “Grantor” (the U.S. term for “settlor”) means the non-U.S. Person individual who for U.S. tax purposes funded the trust.

source income, such as portfolio interest income, U.S.-source capital gains (excluding U.S. real property gains), usually are exempt from U.S. taxation. If the FGT does not invest in any U.S.-situs assets, then the FGT/settlor will not suffer U.S. tax. In short, without any U.S.-source assets held in trust, the FGT/settlor will not be liable to any U.S. taxation.

What are the advantages of a FGT?

The ideal scenario to take advantage of FGT planning is when a non-U.S. Person establishes a trust with U.S. Person beneficiaries in mind. The advantages typically are as follows:

- Settlor/FGT: The settlor will only suffer U.S. taxation on certain defined categories of U.S.-source income, such as U.S.-source dividends (*e.g.*, Apple, Google). Other categories of U.S.-

- U.S. Person Beneficiaries:

Option 1 (Revocable Trust): The U.S. Person Beneficiary may benefit tax free from the FGT during the lifetime of the settlor. The U.S. Person Beneficiary need only report the distribution from the FGT to the Internal Revenue Service (the “IRS”).

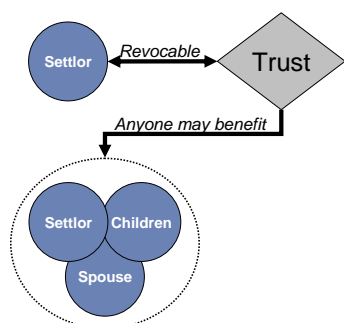
Option 2 (Irrevocable Trust): The U.S. Person beneficiary may not directly

benefit from the FGT during the lifetime of the settlor however they may receive unlimited gifts from the settlor or settlor’s spouse without any U.S. tax. Unlike Option 1, the U.S. Person Beneficiary need only report to the IRS a gift of over 100,000 USD per calendar year though the gift usually is not subject to U.S. taxation (this is an area that needs to be carefully reviewed, several tax traps abound here).

Revocable Versus Irrevocable Trust?

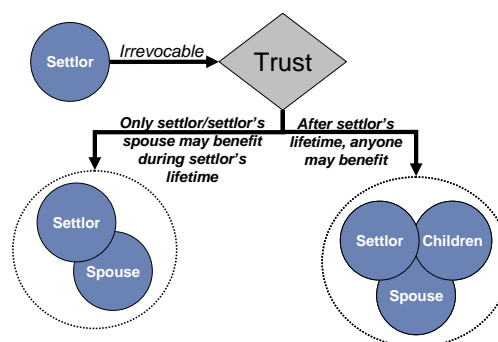
Any trust that is properly drafted can qualify as a FGT. A non-U.S. Person wishing to establish a FGT must choose either:

Option 1 (Revocable Trust): very flexible because anyone in the class of beneficiaries may benefit. The settlor has the power to revoke the funds, which provides a higher level of comfort to the settlor in some cases. In many jurisdictions, however, a settlor may be encouraged by the local tax rules where he is resident to make a complete gift and not a revocable gift (*i.e.*, an irrevocable trust, Option 2). Thus, in some cases a settlor may not be able to use Option 1 to create a FGT because of the rules in his country of residence.



Option 2 (Irrevocable Trust): To qualify as a FGT under this option the trust must be irrevocable and only the settlor or the settlor’s spouse may benefit from the FGT

during the settlor’s lifetime. Option 2 is often confusing to families because of this restriction, however, it is allowable from the U.S. tax side to have the FGT firstly make a distribution to the settlor, and then have the settlor make a gift to the U.S. Person beneficiary. Similar to Option 1 however, one must consider the local tax consequences for the settlor making a gift and/or creating an irrevocable trust.



What are the disadvantages of a FGT?

Unfortunately, the advantages of the FGT do not last forever: when the settlor of the FGT dies the ideal U.S. tax treatment also ends. Upon death, the FGT became a foreign non grantor trust (the “FNGT”). It is important to also to plan for the FNGT phase of the trust. Families often only consider the FGT period (*i.e.*, the tax advantageous period), but fail to consider the U.S. tax consequences to the U.S. Person beneficiaries of a FNGT. It is therefore critical that we consider a plan for both FGT and FNGT periods.

What are the solutions for U.S. Person Beneficiaries of a FNGT?

After the settlor’s demise, careful planning is required to ensure the U.S. Person beneficiaries do not suffer substantial U.S. taxation when benefiting from the FNGT.

Some common strategies to mitigate onerous U.S. taxation are the following:

- *Scenario A:* The FNGT makes distributions to a U.S. Person beneficiary of income and realized capital gains arising annually. Under this Scenario, the FNGT will ensure that the trust’s income and realized capital gains are distributed to the U.S. Person beneficiary annually and thereby avoid a serious U.S. tax problem of accumulating income and gains.
- *Scenario B:* As a variation of Scenario A, the FNGT could establish a U.S. resident trust (which would be treated as a U.S. Person for U.S. tax purposes) and make annual distributions of income and realized capital gains to the newly created U.S. resident trust.
- *Scenario C:* The FNGT may wish to redomesticate the trust so that it is no longer a “foreign” trust, and becomes a U.S. resident trust. No annual distributions are then necessary.
- *Scenario D:* In some cases, it may be easier to simply terminate the FNGT soon after the death of the settlor, and make distributions to the U.S. Person beneficiaries.
- Further scenarios may be possible depending on the situation.

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