Foreign grantor trusts, US Situs Assets and 'Check the Box' Planning under the US Tax Reform Act

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Foreign Grantor Trusts, US Situs Assets and *'Check the Box'* Planning under the US Tax Reform Act

The recently enacted US Tax Reform Act has repealed an exemption that may affect the way foreign grantor trusts (*'FGTs'*) hold US situs assets potentially benefiting US (and also possibly non-US) family members. In view of this change, trustees of FGTs should re-visit their strategies for protecting US situs investments from US estate tax on the eventual passing of the trust's non-US grantor.

Under pre-2018 law, trustees of FGTs generally could use non-US holding companies to provide estate tax protection for US situs assets and then, following the grantor's death, effectively eliminate those holding companies (via so called 'check the box' elections) within 30 days after the grantor's death without triggering adverse income tax consequences for US trust beneficiaries under the CFC tax provisions. This is because under pre-2018 law, there would not be CFC tax to US trust beneficiaries on appreciation in the value of holding company assets as long as the check the box election was effective within 30 days after the date of the grantor's death. But the US Tax Reform Act has repealed this 30-day CFC exemption for tax years beginning after 2017. From now on, a post-death check the box election on a trust's non-US holding company, even effective the day after the death of the grantor, could cause US tax and reporting to US beneficiaries of the trust with respect to the historical appreciation in value of the holding company's assets.

Trustees of FGTs who are holding US situs assets via non-US holding companies should reconsider whether to and how to hold US situs assets and how to manage those assets from year to year and in anticipation of the grantor's death. Considerations would include weighing US estate tax exposure on underlying US investments versus US income tax exposure on historical US asset portfolio appreciation versus practical considerations of implementing new investment strategies and structures for US market exposure.

Traditional FGT Planning

FGT Status

Traditional FGT planning typically involves a non-US person settling a non-US trust for the current or eventual benefit of US (and also possibly non-US) family members. The trust is structured in a manner which generally treats the non-US grantor as the tax owner of trust assets for US purposes, so there generally is no US income tax on non-US source income of the trust. Further benefits accrue to the US beneficiaries after the death of the grantor when the trust also may provide an automatic 'basis step-up' on the grantor's death. Favourable grantor trust and step-up classification is frequently achieved by the grantor having the power to revoke the trust and to receive or direct annual income, but there are a number of other options. Upon the grantor's death, the trust's status automatically converts to so-called 'foreign non-grantor trust' status.

Estate Tax Position

If the trust directly held US investments, US estate tax generally would apply on the grantor's death at the rate of 40% of the assets' actual value. To eliminate this US estate tax exposure, FGTs often make their US investments via a properly managed and administered non-US holding company. This way, the grantor is generally treated as owning a non-US asset (the holding company) rather than the underlying US investments, meaning that no estate tax should apply on the grantor's death.

Income Tax Exposure from Underlying Investments Following Grantor's Death

Following the grantor's death, when the trust ceases to qualify as a grantor trust, the ongoing existence of the holding company would potentially create tax and information reporting issues for the US beneficiaries of the trust. Generally, under complex CFC through-trust attribution rules, US beneficiaries who in the aggregate are deemed to have more than a 50% proportionate interest in the trust or the company could be taxed directly on income and gain in the company.

Check the Box Elections and the CFC 30 Day Rule under Prior Law

Under the tax law that applied prior to 2018, to address the CFC tax issue created by the grantor's death, trustees generally could cause a so called 'check the box' election to be filed for the holding company effective within 30 days after the grantor's death, triggering a deemed liquidation of the holding company for US tax purposes. Under prior law, this worked well from both an estate and income tax perspective. On the estate tax front, as the liquidation takes effect after the grantor's death, there should not be any US estate tax on the underlying US assets (as the non-US situs holding company is treated as existing as of the time of the grantor's death). This estate tax element of the planning is still preserved under the new law. But on the income tax front, under the prior law, the deemed liquidation within the 30 day time frame did not create any CFC 'subpart F' income for those US beneficiaries. This is because, under prior law, a special rule provided that US shareholders of a CFC (including indirect shareholders through a trust) would not be taxable on CFC subpart F income unless the holding company was classified as a CFC for more than 30 days during the year.

US Tax Reform Act impact on the 'Check the Box' elections going forward

The US Tax Reform Act eliminates the CFC 30 day exception. This rule previously allowed trustees to safely eliminate subpart F income tax exposure for their US beneficiaries following the grantor's death by implementing 'check the box' deemed liquidations of their underlying holding companies (for US tax purposes) effective within 30 days of the grantor's death. Going forward, the same check the box election could now create potential CFC subpart F income tax liabilities for the US beneficiaries. This subpart F income would generally be measured by reference to the amount of unrealized appreciation inherent in the investments held by the non-US holding company pro-rated over the company's final year (likely the year of the grantor's death and check the box election). US person beneficiaries of the trust who are considered attributed sufficient ownership of the CFC through the trust would be subject to this CFC subpart F tax and reporting.

How FGTs Can Plan for US Situs Assets Going Forward

FGT trustees that desire exposure to US situs assets must now consider that it will not be quite as easy to minimize estate tax, income tax and complication by simply forming and maintaining a non-US holding company and resolving to check the box on it within 30 days after the grantor's death. Some useful but non-exhaustive ideas and planning considerations are outlined below.

The single company estate tax blocker for US situs assets should continue to be effective against the US estate tax, but if there are substantial US beneficiaries of the trust, one will need to plan for the income tax and reporting on historical appreciation of assets that would eventually be recognized subsequent to the grantor's death. A critical consideration here is an examination of the makeup of the beneficiary class after the grantor's death in order to assess the risk of whether indeed the holding company will have sufficient proportionate US person beneficial ownership to even qualify as a CFC. However, if it is likely to qualify as a CFC, then the trustee should consider strategies to possibly minimize taxable appreciation subsequent to the death of the grantor. For example, selling and purchasing back, or_ 'churning'_, assets of the holding company periodically while the trust is still a FGT can have the effect of minimizing eventual taxable gain on a check the box deemed liquidation in the year the company becomes a CFC. In such a case there should be no CFC tax on asset appreciation that occurred prior to the calendar year of the death of the grantor.

Furthermore, with a slightly more complex multiple tier holding company structure, it should be possible to own US situs assets, maintain the corporate estate tax blocker at the grantor's death, and perform successive check the box elections or liquidations during the calendar year of the grantor's death to minimize post death taxable gain to only that appreciation that occurs between the date of death and the day or two after death that the final check the box election is effective.

The trustee can also consider achieving US asset exposure via other investment vehicle means. For example, it may be possible to replicate the desired US market exposure by investing in non-US publicly available investment funds that invest in US stock and securities. Such funds structured as corporates for US tax classification purposes, should be considered non-US situs assets not subject to US estate tax, but the fact that they are widely held rather than wholly owned by the FGT should prevent them from qualifying as CFCs. Even though these funds would qualify as passive foreign investment companies (PFICs) after the death of the FGT's grantor, a sale of the fund shortly after the grantor's death should not generate taxable gain to the US beneficiaries beyond appreciation from the date of death to date of the sale, as long as the FGT was drafted with basis step-up language.

A trustee can also obtain US asset exposure without the estate tax exposure by investing in certain types of private placement life insurance policies which invest in the US assets. As the investments in a properly structured and qualifying life insurance contract would be the property of the insurance company the death proceeds would not be considered a US situs asset subject to US estate tax and the proceeds should not be taxable to trust beneficiaries if properly structured.

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