

Drafting Revocable Trusts Which Have Non-Citizen Beneficiaries

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This article will address some of the concerns particular to drafting a revocable trust for a client whose trust will benefit one or more non-citizen beneficiaries. The paper will consider the choice and removal of trustees, judicial supervision and applicable law, distribution provisions and the use of an “escape clause”.

Choice and Removal of the Trustee

The choice of an original or successor trustee for a revocable trust is limited to a U.S. citizen or resident so as to avoid the risk of converting the trust into a foreign trust at some time after the death of the settlor. When the trust becomes a foreign trust, each asset in the trust is subjected to a capital gains tax on the excess of the fair market value of such asset over its adjusted cost basis.² Other negative tax consequences, such as a special tax on accumulation distributions of undistributed net income when distributed to the beneficiaries, will also result.³

Upon the death of the settlor, the trustee can be a non-citizen surviving spouse residing in the U.S. since the spouse will qualify as a U.S. person while a U.S. resident taxpayer.⁴ However, if the surviving spouse ceases to be a U.S. resident taxpayer, the trust will become a foreign trust with the negative consequences set out above. To avoid these negative consequences, the trust terms must require that the trustee can only serve during such time as he or she is a U.S. resident taxpayer (U.S. person). In the alternative, the trust should name a U.S. citizen or U.S. corporate institution as trustee.

If the revocable trust contains provisions for the creation of a Qualified Domestic Trust (QDOT) for the benefit the surviving spouse, the trustee of the QDOT must be a U.S. person. If the net value of the QDOT exceeds Two Million

Dollars (\$2,000,000), the trustee must be a U.S. bank or the trust must furnish a bond or letter of credit.⁵ For this reason it is most advantageous to have a U.S. bank named as an alternate trustee of at least the Marital trust portion of the revocable trust which may become a QDOT.

It is common that the revocable trust gives some individual the power to remove the trustee and appoint a successor trustee. If this is the case, the power to remove must be reserved only to U.S. Citizens or residents in order to avoid transforming the trust into a foreign trust.⁶ This can be a trap in those trust documents which give the beneficiaries, by majority or unanimous vote, the right to remove a trustee and appoint a successor. The provision must limit such power to beneficiaries who are U.S. persons in order to avoid the conversion of the trust to a foreign non-grantor trust following the death of the settlor. If one of the beneficiaries is a non-U.S. person having veto power over the removal and appointment of a trustee by reason of a unanimous vote requirement, the trust becomes a foreign trust with all the negative consequences.

Judicial Supervision and Choice of Jurisdiction

In order for the trust to be a U.S. trust instead of a foreign trust, the trustee must at all times be under the primary supervision of the courts of one of the states of the U.S.⁷ To insure that this is the case, the trust should require that the trustee at all times reside in the U.S. and appoint a U.S. corporate trustee to serve in the event that an individual trustee moves out of the U.S.

If the trust gives the trustee the power to change the jurisdiction of the trust, a power which may be useful if all of the beneficiaries move out of Ohio following the death of the client, the document should preclude the trustee from moving the trust to a foreign jurisdiction. This move will immediately cause the trust to become a foreign trust. The incorporation of a “flight clause” in the trust powers, which would move the jurisdiction of the trust to a foreign country upon a challenge from a governing authority, will also cause the trust to be a foreign trust.

Distribution Provisions

For optimal tax planning, the provisions of the trust should contain a series of options.

First, the surviving spouse should have the authority to remove all assets from the trust upon the death of the client. This will provide the surviving non-citizen spouse with the option to take all the assets outright if the client's estate is below the exemption equivalent amount,⁸ and the assets will not be subjected to U.S. estate tax at the death of the surviving spouse since he or she is no longer living in the U.S. Having the assets in his or her own name will allow the surviving spouse to fund his or her own grantor QDOT after the death of the client with a portion of the funds distributed from the trust.

The trust should allow the surviving spouse to disclaim assets to a "spousal trust" to benefit the surviving spouse. Although it must require the payment of all income to the surviving spouse, the terms of the spousal trust should limit access to principal. This allows for the option to treat the spousal trust as a "qualified terminable interest property" (QTIP) trust or a by-pass trust by not electing to QTIP the trust.

The trust should provide that the assets not passing outright to the spouse are to pass to a "Spousal Trust." "Qualified Terminable Interest Property" (QTIP) assets retained in a trust as to which no QTIP election is made will avoid estate tax upon the death of the surviving spouse if he or she remains in the U.S. Retaining the assets in a trust will also avoid U.S. estate tax on U.S. shares, or U.S. real estate which the surviving spouse wishes to retain, since these U.S. situs assets, if owned outright, will be taxable in the surviving spouse's estate even if he or she moves out of the U.S. Furthermore, the country to which the surviving spouse moves may tax the assets more favorably if retained in trust rather than being held outright by the surviving spouse.⁹ Following the death of the surviving spouse, the "Spousal Trust" will direct the trustee to distribute the assets to other beneficiaries.

The terms of the spousal trust should provide the trustee with the flexibility to elect QTIP treatment for all or a portion of the trust. This will allow the trustee of a trust to take advantage of the "exemption equivalent" amount for federal estate tax purposes, and to elect Ohio QTIP treatment for assets exceeding \$338,000 (the "Ohio QTIP Trust"). By doing so, the trustee can defer the Ohio estate tax on the Ohio QTIP Trust until the death of the surviving spouse. It is important to note the Ohio marital deduction does not depend upon the citizenship of the surviving spouse.¹⁰

Finally, the "Spousal Trust" should contain provisions that allow the trustee to qualify all or a portion, a QDOT. To provide this flexibility, the document should give the trustee the authority to amend the trust to contain the required QDOT provisions and the discretion to make the QDOT election as to all or some of the "Spousal Trust". The document may also contain the QDOT provisions within the "Spousal Trust". The QDOT election provisions will give the trustee flexibility to elect QDOT treatment where the value of the "Spousal Trust" exceeds the "exemption equivalent", thereby deferring the federal estate tax on such assets for the life of the surviving spouse, if the assets remain in the QDOT. By deferring the tax on these assets, the trustee can maximize the income earned on the assets. This income, payable to the surviving spouse, is not subjected to federal estate tax.

Escape Clause

The use of a trust protector, or special trustee to authorize principal distributions to the surviving spouse, will facilitate the distribution of all assets from the "Spousal Trust" if the surviving spouse leaves the U.S. and wants to take all of the assets out of the U.S. investments. A trust protector also allows the surviving spouse to unwind the trust if it no longer serves a purpose. This will be particularly important for the non-QTIP portion of the trust as to which no QDOT election is made. Where the surviving non-citizen spouse intends to remain in the U.S. upon the death of the client, or is not certain of future plans, the assets can remain in the non-

QTIP trust to preclude inclusion in the estate of the surviving spouse. However, the terms of the trust should allow a special trustee or a trust protector, each of whom must be a U.S. citizen or resident, to distribute all assets outright from the trust to the surviving spouse if he or she does not remain in the U.S. after the death of the client. As long as the surviving spouse remains in the U.S., holds a U.S. permanent residence visa, or wishes to retain U.S. shares or real estate or other U.S. situs assets, the trustee should retain the assets in the by-pass trust.

Conclusion

There are any number of issues raised when creating trusts with non-citizen beneficiaries. This article has briefly summarized some provisions to consider when drafting a revocable trust which will distribute assets to or give powers to such beneficiaries. ❖

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² I.R.C. § 684.

³ I.R.C. §665.

⁴ I.R.C. § 7701(a)(30)(A).

⁵ I.R.C. Reg. § 20.2056A-2(d). This \$2,000,000 threshold is not linked to the exemption equivalent and therefore will not increase unless done so by regulatory amendment.

⁶ I.R.C. § 7701(a)(30).

⁷ I.R.C. § 7701(a)(30)(E)(i).

⁸ Be aware that the transfer tax treaties with certain countries such as Canada and Germany provide a limited marital exemption equal to the applicable exemption equivalent, in which case the non-citizen spouse can receive outright up to twice the exemption equivalent without incurring U.S. estate tax.

⁹ This is particularly true if the client's surviving spouse will return to the United Kingdom or to France.

¹⁰ R.C. § 5731.15.

^a The Kentucky Supreme Court requires us to advise that Kentucky does not certify specialties in legal fields.