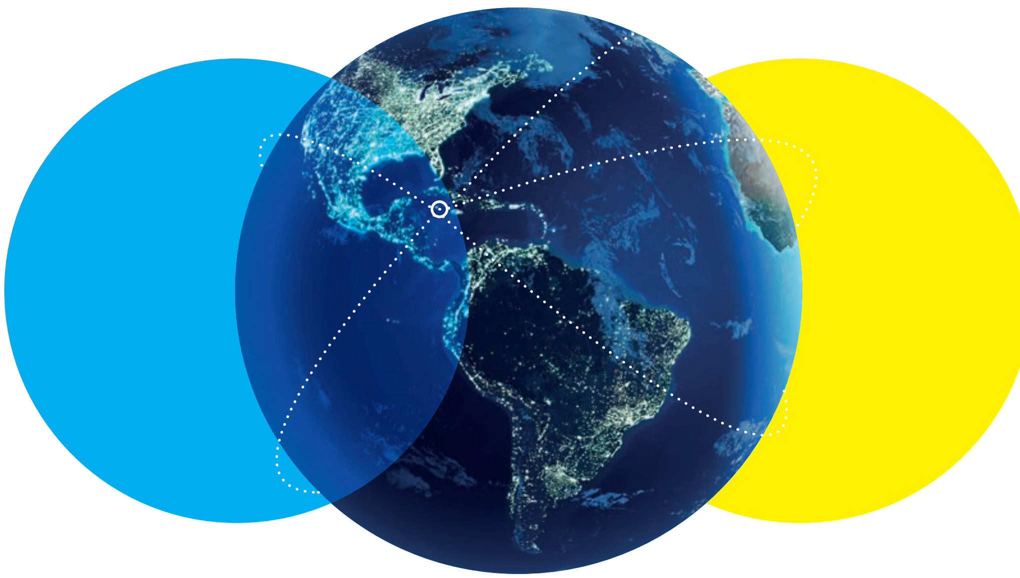

Cayman in the middle

Cayman trusts can be a hugely helpful wealth-planning vehicle for multinational families with US connections. **Myriam Soto** and **Joan K Crain** explain why

It is not uncommon for professionals and entrepreneurs to move to the US to make their fortunes. These successful, first-generation Americans often leave behind wealthy relatives in their native countries. This can lead to a number of wealth-planning challenges, but there are ways to protect family wealth from US gift and estate taxes.

To implement an effective wealth-transfer strategy for a multinational family, it is critical to understand how the US Internal Revenue Service (IRS) treats various types of wealth transfer by non-resident aliens.

The classification by the IRS of assets as 'US *situs*' or 'non-US *situs*' is key to whether the assets will incur gift or estate tax. A US-*situs* asset is one located within the jurisdiction of the US, either physically (for tangible assets, such as real estate or jewellery) or legally (for brokerage accounts, or shares of stock in US companies). An applicable gift- or estate-tax treaty may modify the types of assets classified as US-*situs* (see table overleaf).

For example, the estate-tax exemption for transfers of US-*situs* assets is only USD60,000 for non-resident aliens, and there is no exemption from gift tax. There is also a common misconception that gift tax will be imposed on wealth transferred to someone in the US by a relative living abroad. In fact, such a transfer may often be made tax-free (although there may be some reporting requirements, depending on the size of the transaction).

The various IRS rules around such transfers can be difficult to navigate, particularly now that the US government is being more diligent about tracking the flow of foreign wealth. Too often, families act on incorrect information. The consequences can be significant.

Use of irrevocable US trusts

Setting up a US-based trust is perhaps the most effective means of making gifts to family members who reside in the US. For example, if a non-US person were to simply transfer their non-US-*situs* assets to a child living in the US, the child would be taxed on all future income from those assets. And, at the child's death, those assets would be part of their taxable estate. But, if an irrevocable trust were set up in a state like Delaware or Florida (which do not impose income tax on trusts and no longer have the traditional rule against perpetuities), assets transferred into the trust could grow without ever being subject to US gift, estate or generation-skipping transfer taxes.

When seeking to establish a US-based trust, multinational families may benefit from the advice of a US advisor, who is likely to be familiar with the various protections and tax benefits in different US jurisdictions. A US-based trust can provide better access to assets, more direct contact with the trustee and, in many cases, a greater feeling of security.

To avoid the estate tax on US-*situs* assets, a trust must be irrevocable. This means the ability to change aspects of the trust in future is very limited. Otherwise, the transfer will be considered incomplete until the grantor dies, when the IRS will assess the estate tax as though there had been no trust at all. Non-US-*situs* assets can be transferred to the trust with no gift-tax implications.

PROPERTY TRANSFERRED BY NON-RESIDENT ALIENS

(Note that situs rules might be varied by treaty)

US *SITUS* VERSUS NON-US *SITUS*

TYPE OF ASSET	GIFT TAX	ESTATE TAX
Real property in US	Yes	Yes
Tangible personal property in US	**Yes**	**Yes**
Stock in US corporation	No	Yes
Stock in foreign corporation	**No**	**No**
American depositary receipts	No	No
Shares of US mutual fund	**No**	**Yes**
US business interests (including partnerships)	No	Yes
Deposits in US banks	**No**	**No**
Special deposits (brokerage accounts)	Yes	Yes
Deposits in foreign banks	**No**	**No**
Cash or property in a safety deposity box in US	Yes	Yes
Debt obligations of US persons	**Yes**	**Yes**
Debt obligations of US government	No	No
Life-insurance proceeds	**No**	**No**

Case study one

Mr Patel, an Indian citizen, has a son, John, who works in New York and has a green card. Mr Patel wishes to leave USD10 million to John's young children, who were born and live in New York. If Mr Patel were to wait until death to pass this money to his heirs, some or all of it may be subject to US estate and generation-skipping transfer tax, depending on the type of assets and their *situs*.

If Mr Patel were to make an outright gift to his son during his lifetime, he may avoid gift tax on some or all of the assets, but John's children would receive significantly less, as the full amount would be subject to US estate tax on John's death. Further, Mr Patel may not be willing or able to gift the full amount in one lump sum, as India's exchange controls may limit the amount of money he can transfer out of the country in a given year.

In this situation, Mr Patel could create an irrevocable life insurance trust (ILIT) in Delaware or Florida. The trust's only asset would be a US-compliant life-insurance policy on John's life, acquired by the trustee. Each year, Mr Patel would transfer non-US-*situs* assets into the trust to cover the insurance premiums. As the insurance policy would be the only asset in the trust, there would be no income taxes during Mr Patel's life and no transfer taxes on his death. If Mr Patel were to transfer more than USD100,000 into the trust in a given year, the ILIT would need to file Form 3520 with the IRS.

'Regardless of the type of trust that a non-US resident selects, it will be important to pay special attention to the choice of trustee, to maximise value'

When John dies, the death benefit would be payable to the trust, which could then make distributions to John's children or retain the funds for future generations.

Lifetime or posthumous funding?

Depending on the type of assets transferred, it may be more advantageous for Mr Patel to fund this trust or make gifts to John and his children during his own lifetime, rather than waiting to leave them the assets after his death.

As a non-US person, Mr Patel would only be assessed for gift tax on lifetime transfers if he were to give his son tangible property (such as US real estate or cash in a US bank account). But he could fund the trust or make outright gifts with US-*situs* intangible assets (such as stock in US companies) without any gift tax.

Were Mr Patel to die owning more than USD60,000 of US-*situs* intangible personal property, John's inheritance would be reduced by US estate tax, as the rules are different for transfers on death and during life.

There is another way for Mr Patel to transfer US real estate without incurring gift tax. If he wanted to transfer a US vacation home to John, he could establish a non-US corporation to buy the home, thus converting the real estate into an intangible asset. Instead of giving John the home, Mr Patel could give him shares in the corporation. Such an arrangement would also help Mr Patel if he preferred to wait until death to transfer those assets. However, there are some income-tax drawbacks to this strategy and Mr Patel would be wise to first consult with an expert.

Use of Cayman grantor trusts

Non-US grantor trusts such as those set up in the Cayman Islands allow family members living outside the US to retain control of and use the funds in the trust during their lives, and then transfer their wealth to US family members on their death.

If structured properly, these trusts are tax-efficient for the US family members who receive distributions. Remember, though, that transfers to a Cayman grantor trust do not shelter US-*situs* assets from the US estate tax.

For a Cayman trust to be considered a grantor trust for the purposes of US income tax, the grantor must have the power to revoke the trust or restrict distributions to either the grantor or their spouse. All of the income and deductions attributable to a grantor trust are treated as those of the grantor, regardless of whether they receive any income from the trust. This allows for tax-free growth in the trust and tax-free distributions to beneficiaries.

Case study two

Mr Patel has changed his mind. He now wishes to retain control over the USD10 million during his lifetime, with the aim of passing it to John on death. In this situation, a Cayman grantor trust could serve his needs.

Depending on the type of assets he wishes to hold in the trust, Mr Patel may need to set up an offshore private investment company (PIC) in the Cayman Islands to hold the assets of the trust fund – e.g. US equities and real estate are subject to US estate tax when held by a non-US person, while US Treasury bonds, other US bonds and non-US equities are not.

The trust would own the shares of the Cayman PIC. Any distributions to John (or to a US trust for his benefit) during Mr Patel's life would not be subject to US gift tax, and, on his death, would avoid any US gift or estate taxes.

Mr Patel's family should immediately consult with a tax advisor on his death. The advisor may recommend that the PIC be liquidated within 30 days of Mr Patel's death to avoid application of the onerous US rules on controlled foreign corporations and passive foreign investment companies to John. If that is not possible because 30 days have elapsed, steps can still be taken to ensure the PIC is treated as a disregarded entity.

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A Cayman trust can ensure safe passage of family wealth

Use of Cayman non-grantor trusts

In contrast to a grantor trust, a non-grantor trust is treated as a separate taxpayer for tax purposes. The income of the trust is taxed either to the trust, the beneficiaries, or partly to both. The allocation of taxable income is achieved by permitting the trust a deduction for distributions of current income to beneficiaries of the trust. Trusts established in the Cayman Islands will have no tax liability.

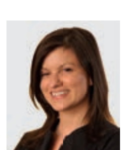
However, distributions to US beneficiaries will be subject to tax and reporting. Any distribution will carry out trust income (interest, dividends and capital gains) and will be taxable to the beneficiary receiving it. Beneficiaries will be obliged to report distributions received on their individual income-tax returns, in accordance with US tax laws. The trustee chosen should understand these reporting requirements and provide the relevant reportable information.

Distributions of income accumulated in prior years from non-grantor non-US trusts are subject to the so-called 'throwback rules', the aim of which is to negate any tax-deferral benefit to a US person from the accumulation of income in such a trust. Advisors and trustees can avoid these onerous rules by carefully structuring and administering the trust.

Choice of trustee

Regardless of the type of trust that a non-US resident selects, it will be important to pay special attention to the choice of trustee, to maximise value. While family involvement may be appropriate, there are many advantages to having a corporate trustee or co-trustee of long-term trusts. Besides avoiding problems of mortality, a corporate trustee can provide the objectivity, experience and empathy that are the keys to a successful partnership with a family over generations.

Where a non-US trust is determined to be the best vehicle, it will add great value down the road if the corporate trustee is a 'global' trustee, has experience with US and non-US trusts, and has capabilities in both foreign and domestic jurisdictions. This can greatly assist in a seamless transition should there be a need to domesticate trusts in the US for US beneficiaries. Such trustees will also have a firm understanding of the rules applicable to US beneficiaries of non-US trusts.



Myriam Soto is Managing Director of International Wealth Management for BNY Mellon Wealth Management and President of BNY Mellon Trust Company (Cayman) Ltd. **Joan K Crain** is Senior Director and Global Family Wealth Strategist at BNY Mellon Wealth Management