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The intentionally defective grantor trust: a strategy for Swiss resident US persons engaging in US gift tax exemption planning

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ABSTRACT

US Persons (including foreign residents) should prepare for the reduction in the US estate and gift tax lifetime exemption scheduled for 2026. A common planning strategy is to set up irrevocable trusts to divest themselves of part of their wealth. However, for US Persons living abroad, a transfer into trust can result in double taxation of income with no treaty relief. An intentionally defective trust can thread this needle, constituting a completed gift for US lifetime exemption purposes while allowing the application of mechanisms to prevent double taxation of income.

US Persons[1] who are tax residents of Switzerland often find themselves running a regulatory gauntlet to remain compliant with Swiss and US reporting rules. Switzerland follows a residency-based tax regime, grounding in one's locality the obligation to pay cantonal and federal income tax, cantonal wealth tax, and (in some regions) cantonal gift and inheritance taxes. Residents of Switzerland, whether or not US Persons, are subject to Swiss reporting requirements. The USA on the other hand (along with North Korea and Eritrea) has adopted a worldwide system of taxation, imposing informational and income tax reporting, and gift and estate tax liability, on US Persons regardless of their place of residency. As a result, Swiss residents who are US Persons (let us call them "SRUSPs) serve two sovereigns. As such they are frequently subject to duplicative tax reporting requirements, and potentially to a double tax burden.

Both countries have taken steps designed to make life easier for the hapless SRUSP. To avoid the spectre of double taxation, Switzerland and the USA are parties to a tax treaty for the avoidance of double taxation on income,[2] but it does not protect SRUSPs … . even though the two countries also concluded a treaty for the avoidance of double taxation on estates and inheritance.[3] The US tax code offers foreign income exclusions and foreign tax credits that SRUSPs may apply to reduce their tax bills. Despite these avenues of apparently available relief, however, each sovereign reserves the right to tax its own—known colloquially as the "savings clause". The result may be the imposition of additional burdens on the taxpayer that are unique to the dual national/Swiss resident status. An SRUSP, for example, may face liabilities originating in one jurisdiction with no available offset from the other—the Swiss wealth tax being one instance of a tax for which there is no US equivalent. Even when the two countries align as to tax policy—special treatment to incentivize retirement savings, for example, there may be materially different rules as to timing or eligibility that can result in extra tax cost and additional bookkeeping requirements.[4]

Despite these potential setbacks, every now and then inconsistencies and mismatches between the Swiss and US tax systems can create opportunities. One such area of opportunity is in the realm of gift, trust, and estate tax planning. The USA and Swiss have differing approaches to the bifurcation of income tax from estate and gift tax liability. The inconsistent

1 Meaning US citizens, permanent residents, US tax residents for other reasons (see I.R.C. § 7701(a)(30)).
2 Convention between the Swiss Confederation and the USA for the avoidance of double taxation with respect to taxes on income with Protocol of 2 October 1996.
3 Convention between the Swiss Confederation and the USA for the avoidance of double taxation with respect to taxes on estates and hereditary shares of 9 July 1951
4 For example, retirement pension schemes that are tax deferred in Switzerland, such as Pillar II and III contributions, are taxable upon receipt in the USA. A SRUSP contributing to such Swiss pensions must pay annual US income taxes on Pillar or pension contributions, which in practice wipes out the advantages of tax deferral in Switzerland. In addition, the SRUSP must keep careful records of those taxes paid in connection with fund contributions so as not to face double jeopardy from the IRS later when withdrawing his Swiss pension fund.

treatment of these concepts allows a dual taxpayer to engage in tax-efficient US gift tax planning without triggering double taxation under the Swiss taxation system.

By way of review, under current US federal law taxpayers may give away during their lifetime, or at death, the federal exemption amount of $13.61M to anyone they wish (this amount will be increased annually for inflation). However, the law is scheduled to "sunset" in 2026 resulting in the decrease of the federal estate tax exemption to approximately $6M, as adjusted for inflation. Under current federal estate tax law, the unused federal exemption amount of the first spouse to die of a married couple may be transferred to the surviving spouse, who may then use the predeceased spouse's unused federal exemption amount for gift and estate tax purposes; this concept is called portability. Thus, a married couple who are both US Persons currently has a combined federal estate tax exemption amount of $27.22M.

The pending "sunset" of the expansion of US gift and estate tax exemption amounts under the Tax Cuts and Jobs Act of 2018 (from $13.61M to approximately $6M in 2026) creates both a planning challenge and an opportunity for high-net-worth US Persons. One such challenge is that there is no guarantee that the US Congress will maintain the current rules. Indeed, Congress has historically shown an aversion to allowing scheduled tax cuts to lapse.[5] So long as current law calls for material reduction in the exemption amounts, however, estate and financial planners counselling US Persons who are high-net-worth individuals have been encouraging their clients to consider "locking in" or fully and irrevocably funding these higher estate and gift tax exemptions available under current US law. Such an exemption funding strategy calls for the transfer of the maximum permitted amounts (of $13.61M per person in 2024) before the scheduled reversion to an estimated $6M per person in 2026. A typical strategy is to create and fund an irrevocable trust in favour of relatives. This allows the taxpayer to remove a significant amount from his or her estate (using the current federal exemption), while deferring the actual transfer of the estate to the relatives.

The challenge of this approach for the SRUSP is that this may create double taxation of income (and wealth) between Switzerland and the USA. In the USA, in principle, when a non-grantor irrevocable trust is set up, the burden of income tax passes from the grantor (settlor) to the trust itself. In Switzerland, in contrast, the grantor (the settlor) remains liable for income and wealth tax (irrevocable non-grantor trusts as such are not recognized under the Swiss taxation system). In other words, if an SRUSP establishes an irrevocable non-grantor trust, then there is double taxation of income as the grantor pays Swiss income (and wealth) tax and the trust pays US income tax. The domestic and international mechanisms for eliminating double taxation only apply if the same person is taxed in two different countries on the same taxable event. They are, however, ineffective when there are two separate taxpayers (in this case, the grantor and the trust) that are taxed in two different countries on the same taxable event.

Most clients—along with their advisors—are reluctant to generate a possibly unnecessary double tax liability by setting up irrevocable trusts in anticipation of a US statutory scheme that might be revised or even eliminated within the next 2 years. Moreover, even among those whose asset base permits such substantial gifts, completing a transfer of nearly $30M US dollars by a married couple might generate some anxiety about future sources of support, should the assets they retain after the gift prove to be insufficient.

The irrevocable grantor trust is a potential solution to this conundrum. The irrevocable grantor trust is a ubiquitous tool for US planners, and exemption planning is frequently undertaken via a transfer to a vehicle known as an intentionally defective grantor trust (IDGT). Under principles of Anglo-American law, a properly drafted grantor trust is a distinct legal entity, widely recognized under principles of US property law as having legal personhood, capable of holding title to property, contracting with others, pursuing claims, and capable of being held to a legal duty.[6] A critical distinction is made, however, between its status as a legal entity and its status as a taxpayer. A grantor trust is a disregarded entity for income tax purposes,[7] and taxable activity at the entity level flows through to the grantor. The advantage of this tax treatment is that it is aligned with the Swiss tax treatment of irrevocable trusts. As the grantor remains taxable on trust income in both countries, he or she can take full advantage of the mechanisms for preventing double taxation of income.

So long as the grantor trust can be amended or revoked by the grantor, it remains an asset of the grantor, and available to his or her creditors (including tax authorities). Where a grantor trust is irrevocable, however, while it remains disregarded for income tax purposes, it need not be disregarded for US estate and gift tax purposes. This possibility—to create a trust with dual or hybrid status—allows the planner to bifurcate the instrument for tax planning purposes, treating it as a nullity for income tax purposes and yet also setting it up as a separate entity from the grantor for estate planning purposes. As a result, assets held inside a properly structured IDGT, and any appreciation of those assets, remain outside of the grantor's US taxable estate. Property contributed to a properly structured IDGT is reportable as a completed gift, and the disposition of the property is governed thereafter by the terms of the trust and not the grantor[8] though all income activity within the trust, including capital gains or losses, continues to flow through to the grantor.[9]

5 Federal gift and estate tax rates have been modified most recently in 2001, 2003, 2010, 2017, and 2020, frequently with the so-called "sunset" clauses envisioning a snap back or reversion to higher prior rates. The successive legislation was drafted with the cynical expectation that successor Congresses would take subsequent action to avoid the scheduled reversion to the historical, higher tax rates, out of concern that allowing rates to rise as scheduled would be viewed politically as a "tax increase" and toxic to their re-election prospects.

6 (see Restatement (Third) of Trusts § 2, comment a (2003)).

7 A trust can be deemed a grantor trust if certain powers or benefits are reserved to the grantor (or, if properly crafted, a non-adverse party or related or subordinate party (as defined under I.R.C. § 672(c)). Such powers and benefits are discussed under Sections 673–679 of the Internal Revenue Code. Some of the most common powers and benefits found under properly drafted grantor trusts include (i) the power to reacquire assets of the trust by substituting assets of equivalent value, (ii) naming the grantor's spouse as a permissible income beneficiary of the trust, and (iii) the power to borrow assets from the trust without adequate consideration.

8 While the grantor may retain certain rights and powers under an IDGT (such as the grantor trust powers enumerated under Sections 673–679 of the Internal Revenue Code as well as certain investment powers), it is important that the grantor ceases all "dominion and control" (see 26 CFR § 25.251102) of the property contributed to the trust for the gift to be complete and not included in the grantor's estate for federal estate tax purposes.

While the defective grantor trust creates a desirable alignment in terms of income taxation between Switzerland and the USA, it creates a gap in terms of estate and gift taxes, and an opportunity for arbitrage. As mentioned earlier, the whole point of this trust, from the US point of view, is that the event triggering gift tax is funding of the irrevocable trust.

By way of background, in Switzerland, there is no federal gift, inheritance, or estate tax. It is up to the cantons to levy such taxes. Most do, with the exception of a few cantons in central Switzerland (Obwalden, Schwyz, Zug, and Lucerne). In all cantons, gifts and inheritances between spouses are exempt. In most cantons, the same applies to transfers to descendants (with the exception of Vaud, Neuchâtel, Appenzell Innerrhoden, and Lucerne at the municipal level). The rates only become more significant as the degree of kinship between the deceased and the beneficiary becomes more distant. Thus, in most cases, where a trust is set up in favour of a spouse or direct descendants, there will be no taxation in Switzerland at the time of the grantor's death (and not when the trust is created either), and therefore no double taxation with the USA.

The Swiss planner will of course need to consider the degree of consanguinity that the beneficiary bears to the grantor. However, this issue only becomes critical at the time of the death of the grantor. Attention must also be paid to Swiss forced heirship rules, but there are various strategies for reducing or eliminating their impact.[10]

In short, the defective grantor trust on the Swiss side can act as a will substitute, while if properly structured under US estate and gift rules, a transfer to an IDGT is a completed gift on the US side. The neutral impact generally achieved on the Swiss side allows the US taxpayer to mitigate the feared loss of exemption per the 2026 "sunset" on the US side without negative Swiss tax consequences. The SRUSP is essentially arbitraging the differential between the US and Swiss tax systems as to when the gift is deemed to have been made.

THE MANY USES OF AN INTENTIONALLY DEFECTIVE GRANTOR TRUST

A planner engaged in this strategy will need to take note of several facets of Swiss federal and cantonal laws that will determine the success of the outcome. It will generally be advisable to submit the trust project to the local tax authorities for prior approval to ensure that its tax treatment will be as expected. Strategies will also have to be devised for navigating through the restrictive rules of Swiss inheritance law, such as forced heirship rules.

Having taken due care to satisfy the cantonal requirements, the SRUSP will discover broad flexibility in planning using the IDGT structure. One surprising option includes the prospect of making transfers in gifts that might still benefit—directly or indirectly—the transferor. A grantor might create an IDGT, for example, whereby the primary beneficiary is his or her spouse (this is sometimes called a "Spousal Limited Access Trust" or "SLAT"). By designating the spouse as the sole or primary beneficiary of an SLAT, so long as the household remains intact, distributions to the spouse can be used to enhance the living standards of the family unit, such that practically nothing has been sacrificed in making the transfer.[11] Alternatively, the IDGT can be deployed as a dynastic planning tool to benefit multiple generations.

The benefits on the US side of making a transfer to an IDGT are clear: estate taxation on trust assets used to fund the trust, and any subsequent appreciation, are excluded from the grantor's taxable estate. On the Swiss side, the efficacy of the planning is subject to concurrence as applicable by the cantonal tax authorities as to the degree of transparency of the trust instrument and whether the indenture functions as a will substitute. It will also, depending on the identity of the beneficiaries and the distributive provisions, need to be the subject of a duly executed waiver of forced heirship rights by beneficiary heirs. At best, however, the Swiss outcome is neutral, a solution that permits the SRUSP to plan around the US exemption rules without incurring double taxation of income or premature gift taxation.

US Persons resident of Switzerland can frequently encounter frustration in navigating two imperfectly synchronized tax systems. Registering for schools, banking, accessing healthcare, obtaining permits for work, navigating the Pillar systems, and even mastering the waste and recycling patterns in various townships can pose obstacles. In the meantime, looking homeward, the ex-pat's US tax reporting obligations, maintaining US domestic banking and brokerage relationships, voting, and managing social security and Medicare benefits—to name a few—if managed from a permanent Swiss residence, can prove quite daunting. Yet, not all of the cross-border and cross-cultural contradictions, inconsistencies, and antinomies encountered in the quotidian need to result in setbacks. For those high-net-worth individuals contemplating exemption planning, transfers to IDGTs can be beneficial in the extreme to the US planning calculus and neutral on the Swiss side.

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10 As to forced heirship, a grantor would be well-advised—prior to funding the trust—to seek a valid waiver from any beneficiary whose forced heirship property rights might be impacted by the distributive scheme.

11 Grantors of SLAT's who fear the loss of access in the event that their spouse may predecease them or that the marriage could end prematurely might consider organizing the IDGT under the laws of Delaware and including a role for a Trust Protector empowered to expand the class of eligible beneficiaries to include the grantor herself—thus resulting in enjoyment of a beneficial interest in assets that have been afforded status of a completed gift.

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