I. Introduction to an Irrevocable Trust

An irrevocable trust is a legal arrangement recognized under the applicable trust laws of the state of formation and a taxable entity for U.S. tax purposes. Generally, the grantor/settlor of the trust transfers property to the trust; thus, splitting the legal and equitable title of the property. The trustee of the trust holds the legal title of the property for the benefit of the beneficiaries. The beneficiaries hold the equitable title in the property. Once the property has been transferred to the trust, the grantor/settlor no longer has legal or economic rights over the property or trust. The trustee is now regarded as the legal owner of the property and will be person responsible to manage the property for the benefit of the beneficiaries. Upon termination of the trust, the beneficiaries acquire full ownership interest in the property.

II. Trust is a Legal Person

a. The Internal Revenue Code (Sec. 641(a)) provides that a trust is a taxable person subject to taxation on its taxable income. Thus, it is not a disregarded or transparent entity for U.S. tax purposes.

b. Article 3(1) of the U.S. – Mexico Tax Treaty states that a trust is a legal person for treaty purposes and eligible for tax benefits and obligations. The maximum tax rate of the trust is 37%.

c. Chapter 14 of the United States – Mexico – Canada Agreement (USMCA) provides that a trust is a legal entity eligible for the full protection and benefits of the USMCA.

III. U.S. Tax Aspects

a. Income Tax: a trust is a separate taxable entity for U.S. income tax purposes if it is an irrevocable trust and the grantor/settlor does not retain unallowed powers. In other words, the trust is not a transparent flow through entity for U.S. tax purposes.

b. U.S. Estate Tax: The grantor/settlor is exempt from the U.S. estate tax if the grantor/settlor does not have control of the trust or property owned by the trust or his powers as trustee are limited by an “ascertainable standard.” IRC § 2036. For U.S. tax purposes, a grantor/settlor may also be a trustee if their powers to distribute are limited by an ascertainable standard. This means that during the grantor/settlor’s life, only distributions subject to an ascertainable standard i.e., for the health, education, maintenance, and support of the beneficiaries will be allowed.

c. U.S. Residency: A trust is deemed to be a foreign trust if it is controlled by a foreign person, in other words, if the trustee or protector are foreign persons. A foreign trust has special income tax treatment and is only taxed on the U.S. sourced passive income. IRC § 7701.

VI. Asset Protection

a. Spendthrift Clause: a spendthrift clause is a provision in the trust that protects the trust property from creditors and contingencies. The beneficiaries are prohibited from selling, giving away, or otherwise transferring the beneficiary’s interest. The spendthrift clause also prevents the beneficiary’s creditors from reaching the beneficiary’s interest in the trust.

b. USMCA Treaty: Under the newly enacted USMCA Chapter 14, a trust is protected as an investment. The treaty prohibits a party (Mexican government) from directly expropriating an investor’s investment in a host country.

V. Conclusion

An irrevocable trust is a legal and tax person for U.S. income tax purposes, U.S.-Mexico Tax Treaty, and the USMCA protection provisions. Further, a foreign government cannot attack or pierce the legal veil of a U.S. trust since it is seen as a separate entity under U.S. law and protected under the USMCA.