Article-Foreign Trusts and U.S. Estate Planning: A Client-Centered Analysis

by Michael W. Galligan

I. INTRODUCTION

In 1996, with a series of amendments to the Internal Revenue Code regarding the tax treatment of U.S. grantors and U.S. beneficiaries of foreign trusts,[1] the U.S. Congress fundamentally altered the uses of foreign or "off shore" trusts in U.S. estate planning and dramatically increased the reporting that is required of most U.S. grantors and U.S. beneficiaries of off shore trusts. Regulations issued by the Treasury Department since 1996 have provided extensive detailed rules for implementing the new criteria and restrictions imposed by Congress. The 1996 amendments therefore substantially modify the considerations that must be taken into account in deciding whether to adopt an off shore trust strategy as a means of benefiting U.S. persons. Legal and financial advisors to foreign persons intending to benefit U.S. persons, as well as advisors to U.S. persons deciding whether to establish off shore trusts, must be familiar with these still relatively new and untested rules in order properly to advise their clients.

The following discussion begins with a consideration of the criteria for determining whether a trust is a U.S. trust or a foreign trust -- a matter that itself was fundamentally altered by the 1996 legislation and subsequent regulations -- and a brief explanation of the differences that flow from being a U.S. trust rather than a foreign trust. The balance of the discussion attempts to summarize the key features of the U.S. off shore trust rules from the perspective of each of the following classes of clients who may have reason to consider establishing off shore trusts and who may seek advice about them:

- A foreign client who wishes to benefit foreign persons only, but who wishes to invest in U.S. assets.

- A foreign client who does not plan to immigrate to the United States, but who wishes to benefit U.S. persons.

- A foreign client who plans to immigrate to the United States and wishes to benefit persons who may be U.S. or foreign.

- A U.S. client who wishes to benefit foreign persons only.

- A U.S. client who wishes to benefit U.S. persons.

Before considering the key features of the U.S. offshore trust rules as they affect each of these groups, we should first consider the threshold question of what
constitutes a foreign trust for U.S. tax purposes, and why, from a U.S. perspective, it matters to be a foreign trust rather than a U.S. trust.

II. DETERMINING WHETHER A TRUST IS A FOREIGN OR U.S. TRUST

One of the most significant innovations of the 1996 legislation was the introduction of a meaningful statutory test for determining the situs, for U.S. tax purposes, of a trust. While not free from ambiguity, this provision, amplified by the subsequent implementing regulations, has added a relatively clear test for determining whether the I.R.S. will view a trust as U.S. or foreign, especially when compared with the facts and circumstances approach that predated the 1996 legislation. The new provision establishes two essential criteria for a trust to be a U.S. trust. If a given trust fails either of the following criteria, it is deemed for U.S. income tax purposes to be a foreign trust, regardless of what other contacts the trust may have with the United States: (1) a United States court must be able to exercise primary supervision over the trust; and (2) one or more U.S. persons must have the authority to control all substantial decisions of the trust.[2]

A. The Court Test.

A United States court must be able to exercise primary supervision over the trust. This means that a United States court must have the authority to determine substantially all issues about the administration of the trust.[3] "United

States" here means only the fifty states and the District of Columbia.[4] Thus, trusts subject to the primary jurisdiction of the courts of Puerto Rico, the American Virgin Islands, or Guam are considered foreign trusts.

The "court test" means that a trust governed by an agreement that attempts to give a foreign court exclusive jurisdiction over the trust will ordinarily not qualify as a U.S. trust, even if U.S. citizens control all the major decisions of the trust. Of course, if the normal jurisdictional tests were met (such as location of trust property in a United States jurisdiction, or presence of a trustee in the relevant jurisdiction), it is possible that a U.S. court would exercise jurisdiction notwithstanding a trust provision choosing a foreign forum, especially in the interests of justice. The final regulations issued in February 1999 implementing the new law provide that a trust will not meet the "court test" if the trust instrument contains a provision causing the trust to migrate from the United States if a U.S. court attempts to exercise jurisdiction over it.[5] Whether a U.S. court would honor such a provision when the regular jurisdictional predicates were otherwise satisfied is doubtful, but the inclusion of such a provision would ensure that the exercise of jurisdiction over the trust by a U.S. court, even if a majority of trustees were U.S. citizens or residents, would not change the foreign tax situs of the trust for U.S. tax purposes.

The final regulations provide a "safe harbor" for compliance with the "court test." Thus, a trust will be deemed to satisfy the "court test" if (1) the trust instrument does not direct that the trust be administered outside the United States, (2) the trust is administered exclusively in the United States, and (3) the trust is not subject to an automatic immigration provision.[6] The requirement that the trust be administered in the United States means all steps necessary to carry out the terms of the trust and applicable law (including maintaining the records of the trust, filing tax returns, managing and investing trust assets, defending the trust from suits by creditors, and determining the amount and timing of distribution) must be performed in the United States.[7] It is important to note that failure to meet the second requirement does not mean that a trust thereby fails to meet the "control test." For example, if trust assets are managed abroad but the trust agreement directs that U.S. law govern the trust and confers primary jurisdiction over the trust on one or more U.S. courts, the trusts would not necessarily be deemed a foreign trust. If both a U.S. court and a foreign court can exercise primary supervision over the trust (for example, because the trust has assets located in the United States and abroad), the trust can still meet the requirements of the "control test."[8]

The final regulations provide for three situations in which a trust would be deemed to have satisfied the "court test": (1) when a trust is registered by an authorized fiduciary or fiduciaries within the United States pursuant to a state statute similar to Article VII of the Uniform Probate Code; (2) when a trust created under a Will is admitted to original probate within the United States, if all trust fiduciaries have been qualified as trustees by a U.S. court; and (3) when fiduciaries or beneficiaries of a trust take steps to cause the administration of the trust to be subject to the primary supervision of a U.S. court.[9] At the present time, New York does not have a registration scheme similar to that of the Uniform Probate Code.[10] Under EPTL §7-19, if all of the beneficiaries of an irrevocable trust are adults and the settlors of the trust are living, the beneficiaries and settlors could validly amend the trust to remove any provisions that would cause the trust to fail to meet the "court test" and to confer primary jurisdiction over the trust on a U.S. court.

B. <u>The Control Test</u>.

United States persons must exercise control over all major decisions affecting the trust. United States citizens and United States residents qualify as United States persons for purpose of this requirement. In a departure from the definition of "United States Trusts" under the Treasury regulations governing qualified domestic trusts (trusts for surviving non citizen spouses that qualify for the estate tax marital deduction), a U.S. citizen who resides outside the United States qualifies as a "United States person" for purposes of the control test.[11] Domestic corporations and partnerships may also qualify as U.S. persons.[12] Major decisions include, but are not limited to, all types of non-ministerial decisions that trustees are generally required to make under the trust agreement or under applicable law.[13] Thus, the U.S. persons serving as trustees of a trust must be able to control all discretionary decisions as to distributions, investment of the trust, allocation between income and principal, and so forth. Delegation of investment decisions by a trustee to a foreign investment advisor would not cause the trust to fail the "control test" as long as a U.S. person can terminate the investment advisor's power to make investment decisions at will.[14]

In considering whether U.S. persons have the requisite control, it is important to focus not only on the persons who have the technical title of trustee but anyone who may have the authority to make or affect decisions about the trust.[15] Thus, a power by a foreign person to veto a decision that is deemed to be "substantial" by the final regulations, could cause the trust to fail the "control test." Conferral on a foreign person of a power to direct the disposition of trust property under a general power of appointment would clearly cause the trust to fail to satisfy the "control test." It is difficult to conceive of any form of limited power of appointment that would not lead to the same result.[16] The authority of any person named as protector, even if the authority is very narrowly circumscribed, must

also be considered in this light. The final regulations also provide that the trust will not meet the "control test" if the trust instrument contains a provision forcing one or more substantial decisions of the trust to no longer be controlled by U.S. fiduciaries if an attempt is made by any governmental agency or creditor to collect information from or assert a claim against the trust.[17] In what could easily become a trap for the unwary, the I.R.S. has decided that the power to appoint a successor trustee, even if the power to make such a decision does not include the power to remove the trustee, constitutes a substantial decision for purposes of the "control test," unless the power to make such a decision is limited to preclude an appointment that would change the trust's status as a U.S. or foreign trust.[18] Thus, if a foreign person has unrestricted authority to appoint a successor trustee, that authority would cause the trust to fail the "control test" and to be deemed a foreign trust, even if all other substantial decisions were controlled by U.S. persons and the trust complied with the "court test¡¨ and even if a foreign person were never actually named as successor trustee."

III. WHY IT MATTERS WHETHER A TRUST HAS A U.S. OR FOREIGN TAX SITUS

A. U.S. Tax Treatment of a U.S. Trust.

If a trust is determined to be a U.S. trust, it will be treated as a U.S. resident for federal income tax purposes, and will therefore be subject to the federal income tax on U.S. resident trusts. In addition, it is likely that the trust will be considered a resident of a particular state of the United States, and therefore be subject to that state's income tax as well.

U.S. resident trusts are generally subject to U.S. income tax on their worldwide income, including the tax on capital gains.[19] This is true regardless of the source of the income, with the result, for example, that a U.S. trust completely invested in non U.S. bonds and securities will be taxable on all interest, dividends, and gains from these investments, even though none of them is itself a U.S. asset. It is important to note that a U.S. resident trust is not eligible for any of the special exemptions from U.S. income tax that are available to foreign trusts, such as the exemption for income from U.S. bank deposits and for portfolio source income from most U.S. bonds and other debt instruments. If the accounting income of a trust is required to be distributed at least annually to at least one beneficiary or if the trustee actually distributes the trust's accounting income to the income beneficiary during the trust¡¦s taxable year, the trust will receive a distribution deduction for the income payable or paid to the income beneficiary and the income beneficiary rather than the trust will be subject to the tax on that income.[20]

If the trustees are permitted to accumulate the income and do not pay all income on a current basis, the trust is subject to income tax on the accumulated income as well as capital gains.[21] The key factor to be noted here is that the marginal income tax rates for trusts accelerate faster than those for individual taxpayers, with the result that as of 2003, all accumulated trust income in excess of approximately $9,350 in a given year is taxed at the highest Federal marginal income tax rate, currently 38.6%. [22]

Whether a U.S. trust is simple (all income must be paid annually) or complex (income may be accumulated), a U.S. trust is subject to the U.S. tax on capital gains regardless of whether the assets sold are domestic or foreign. As with capital gains on which an individual U.S. taxpayer is taxed, the rate of tax depends on the length the asset has been held, with gains on assets held for less than one year taxed at the same rates as ordinary income, gains on art and other tangible assets held for one year or longer taxed at twenty-eight percent[23] and gains on intangible assets held for one year and one year or longer taxed at twenty percent.[24]

B. U.S. Tax Treatment of a Foreign Trust.

A foreign trust, by contrast, is only subject to U.S. income tax on U.S. source income and income effectively connected to an active U.S. business in which the trust has an ownership interest.[25] U.S. source income of a "fixed" or "periodic" nature is generally subject to a U.S. withholding tax of thirty percent.[26] Effectively connected income is taxed at the regular rates imposed on U.S. taxpayers.[27] Deductions are generally not available in connection with fixed or periodic income, whereas they are available for "effectively connected income". There are special exemptions from U.S. income tax on income from U.S. bank deposits and most U.S. portfolio interest paid to foreign persons, which exemptions are available to foreign trusts as well as other foreign taxpayers.[28] Thus, if a foreign trust's only U.S. assets are U.S. bank deposits and eligible portfolio debt instruments, the trust will not pay any U.S. income tax on its U.S. source income. In cases in which a foreign trust has a situs in a jurisdiction with which the United States has an income tax treaty, the trust may be eligible for lower withholding tax rates on dividend income (often fifteen percent rather than thirty percent) from U.S. companies.[29]

Perhaps even more significantly, foreign trusts are completely exempt from the U.S. tax on capital gains on intangible assets. Even if a foreign trust maintains some form of active presence in the United States for 183 days or more in a given year, which would ordinarily subject a foreign individual to the U.S. tax on capital gains, the foreign trust will not be subject to such tax.[30] Thus, gains on the sale of U.S. stocks as well as bonds and other debt instruments will ordinarily be completely exempt from U.S. tax. This exemption, however, does not apply to holdings of U.S. real property.

It is important to note, however, that the limited impact of the U.S. income tax on a foreign trust does not necessarily apply to the U.S. beneficiaries of such a trust, because the U.S. beneficiaries of foreign trusts (like U.S. trusts themselves) are generally subject to U.S. income tax on their worldwide income. This includes distributions from foreign trusts, which are taxed in much the same way as they would be if they were coming from a domestic trust with some added disadvantages. As with domestic trusts, for U.S. tax purposes, each foreign trust with a U.S. beneficiary to whom income or principal is distributed is deemed to earn each year a certain amount of income known as the trust's "distributable net income," which may approximate but is not necessarily the same as the trust's income for accounting purposes.[31] Distributions to the U.S. beneficiaries by a foreign trust, like domestic trusts, carry out to U.S. beneficiaries their pro rata share of the distributable net income of the trust, which the beneficiaries must report and on which they must pay U.S. income tax.[32] But distributions to U.S. beneficiaries by a foreign trust may also carry out capital gains and various interest charges, which would not occur if the distributions were from a domestic trust.

The United States is acutely aware that many grantors of foreign trusts established in "tax haven" jurisdictions would prefer that foreign trusts accumulate income in the year in which it is earned, hoping thereby to escape tax not only in the jurisdiction of the trust (because it presumably does not impose an income tax on trusts established for this purpose) but also in the jurisdiction of the beneficiary. As explained in more detail below, the U.S. effectively requires a U.S. beneficiary of a delayed income distribution or accumulation to pay the U.S. income tax the beneficiary would have paid on the income had the income been distributed to the U.S. beneficiary on a current basis, with interest for the period of the deferral. This is an especially important consideration in evaluating the use of foreign trusts by foreign grantors to benefit persons who are U.S. citizens or residents.

IV. APPLICATION OF THE U.S. FOREIGN TRUST RULES

A. Foreign Client Who Wishes to Benefit Foreign Persons Only but Who Wishes to Invest in U.S. Assets.

At first blush, it would appear that the U.S. tax rules about trusts should have very little to do with a foreign trust established by a foreign national for the benefit of foreign persons. The main concern of a foreign person establishing a foreign trust of U.S. investments for foreign beneficiaries, it would seem, would be the U.S. tax treatment of these investments. As mentioned above, investments held by foreign trusts in U.S. securities will be subject to the thirty percent U.S. withholding tax (possibly lower if a treaty applies) but no capital gains tax. Thus, the tax cost of an investment in a U.S. security that has a low yield but very high potential for appreciation is quite low. If it is desired that the trust invest to maximize income, the trustee still has the option of investing in U.S. portfolio debt instruments (including U.S. Treasury securities) and U.S. bank deposits. These investments will be exempt from all forms of U.S. income and gains tax.

There is, however, one trap for the unwary foreign person who uses a foreign trust to conduct investments in the United States. This concerns the U.S. estate tax. The fact that the U.S. assets are held by a foreign trust will not immunize the foreign person's estate from U.S. estate tax on the U.S. assets if the foreign person was the creator of the trust and, at the time of his death, retained certain interests in or authority over the trust.[33] Thus, if a foreign person creates a trust and retains an enforceable right to receive distributions from the trust or to direct the beneficial enjoyment of the trust assets, U.S. estate tax law "looks through" the trust to the foreign grantor.[34] A similar situation develops if the foreign person retains the right to revoke the trust or has more than a de minimis reversionary right in the trust.[35] To avoid this potential exposure to U.S. estate tax, it is important that the trust assets be held by a foreign corporation owned by the trust rather than directly by the trust. As explained below, however, holding assets of a foreign trust in an off shore corporation can pose potential tax problems for U.S. persons who are trust beneficiaries.

One may wonder how the I.R.S. would learn that a foreign person has an interest, through a trust, in U.S. securities when or after the grantor dies, assuming that the grantor has no other assets in the United States that would require the filing of an estate tax return. If the trust continues after the grantor's death, there may be little way for the I.R.S. to find out about the decedent's taxable interest. But if the trust terminates and distributions of U.S. securities are made, the transfer agent may inquire about the circumstances once it becomes obvious that the transfer is part of a

distribution and not part of a sale. Also, if any beneficiaries are U.S. persons, the I.R.S. may learn about the situation through an audit of one or more tax returns of a U.S. beneficiary. It should be remembered that the beneficiaries of an estate have a so called "transferee liability" with respect to the taxes on any property that they have inherited that were not properly taxed in the estate.[36]

B. Foreign Client Who Does Not Plan to Immigrate to the United States but Who Wishes to Benefit U.S. Persons.

1. Circumstances under Which U.S. Beneficiaries Do Not Have to Pay Tax on Foreign Trust Distributions.

Ordinarily, a trust is a separate taxpayer under U.S. tax concepts. However, the situation can be different if the person who establishes a trust retains beneficial interests in the trust, the right to direct the beneficial enjoyment of the trust, or certain other powers such as the right to exchange personal assets for assets of the trust.[37] Under the so called "grantor" trust rules, persons with these forms of retained benefits or rights in trusts they have established are deemed to continue to own the trust assets directly for U.S. income tax purposes as if the trust property was never placed in trust. The converse is that the beneficiaries of the trust are not taxed on trust distributions. Also, a person who has broad rights to withdraw property from a trust, without the consent of a person who would be adversely affected by such withdrawal, can also be treated as the owner for income tax purposes of the property subject to such withdrawal.[38]

Until the 1996 legislation, these so called "grantor trust rules" created an excellent tax planning opportunity for foreign persons establishing trusts to benefit U.S. persons because, if the foreign person retained a relevant power or right in the trust, the foreign person would be treated as the owner of the property for U.S. income tax purposes. Assuming that the property would not be subject to U.S. income tax if it were owned by the foreign person directly (which would be the case, for example, if the trust were completely invested in foreign assets), not only would the foreign person and the trust not pay any U.S. income tax on the trust income but all distributions and payments to U.S. persons would be free of any U.S. income tax. If the foreign grantor were also exempt from tax in his or her home country, there would be an effective "triple dipping" of tax savings no tax to the grantor by either the home jurisdiction or the United States and no tax to the U.S. beneficiaries.

The 1996 legislation now permits this very favorable device to be used, for practical purposes, only when the creator of the trust retains the right to revoke the trust.[39] In that case, the U.S. beneficiaries can still claim that the trust grantor is the owner of the trust, even though the creator pays no U.S. income tax on trust income and gains, and thereby avoid having to report any distributions they receive from the trust as taxable income. The old approach also still works if the only beneficiaries of the trust are the grantor and the grantor's spouse,[40] but this would have a beneficial planning effect only if the foreign grantor were planning for distributions to a spouse who was a U.S. citizen or resident.

Expecting some "creative" techniques for avoiding the payment of U.S. income tax by U.S. beneficiaries of foreign trusts that were previously treated as being owned for tax purposes by foreign grantors, the IRS has issued new rules to prevent the "laundering" of foreign trust distributions to U.S. persons through foreign intermediaries to hide the fact that the distributions have come from foreign trusts. Thus, a distribution to a U.S. person from another foreign person, foreign partnership or foreign corporation will be treated as being made directly to the U.S. person if the foreign intermediary is related to the U.S. beneficiary of the trust and the foreign intermediary transfers to the U.S. beneficiary property initially transferred from the foreign trust. The same result will occur if the foreign intermediary would not have transferred the property but for the fact the intermediary received the property from the foreign trust or made the distribution with a principal purpose of avoiding U.S. income tax.[41]

2. Circumstances in Which the U.S. Beneficiaries Become Subject to U.S. Income Tax on Distributions.

The U.S. beneficiaries of a foreign irrevocable trust are subject to special tax rules that do not apply to beneficiaries of domestic trusts. These fall into the following categories: (1)additional components of ¡§distributable net income"; (2) "partial tax" on accumulation distributions; (3) special interest charge on such partial taxes; (4) potential liability for taxes on income of closely held corporations owned by foreign trusts; and (5) potential tax liability on loans from foreign trusts.

(a) *Distributable Net Income*. U.S. beneficiaries are generally taxed on distributions of income from trusts. However, even in the case where all of the net income of a trust is paid to the beneficiary each year, the taxable income, as noted in Part IIIB above, is not necessarily the same as the net accounting income paid to or due the beneficiary. The taxable income is based on the "distributable net income" of the trust that is deemed to flow through

to the beneficiary in the form of payments from the trust. In general, capital gains are not a component of distributable net income of a trust, with the result that the gains are taxed to the trust and not the beneficiary.[42] But in the case of irrevocable foreign trusts, capital gains are a component of distributable net income,[43] which means that U.S. beneficiaries of a foreign trust will likely pay tax with respect to these gains when the beneficiary calculates his or her "partial" tax on distributions from the trust. Any such tax will be paid at ordinary income tax rates rather than at capital gains tax rates.

(b) "*Partial Tax*." Many irrevocable off shore trusts are intended to accumulate income for the benefit of a class of beneficiaries or for a particular beneficiary until that beneficiary has reached a certain age or life stage. The U.S. tax rules are structured to prevent foreign trusts from accumulating income for the benefit of U.S. beneficiaries in order to defer payments of income and thereby avoid the U.S. tax on distributions of income. Thus, in any year in which a U.S. beneficiary receives a distribution of income from an irrevocable foreign trust that was earned in a prior year, the taxpayer must perform a special calculation to compute the "partial tax" (also sometimes called the "throwback tax"), which is designed to recapture the tax that would have been paid if the income had been distributed to the beneficiary in the year it was earned rather than accumulated in the trust.[44] The distribution is deemed to have been a payment of the earliest income accumulation and is taxed as a rate designed to replicate the beneficiary's tax rate over the years the distribution of the income was deferred.

(c) *Interest Charge*. In addition to the "partial tax" itself, there is also an interest charge, again designed to replicate the interest on a late payment of tax by the beneficiary of a domestic trust.[45] This interest rate, which used to be capped at six percent, is set for all years after December 31, 1995 at the same rate that applies to other underpayments of U.S. income tax and is based on a weighted average of the years in which income accumulations have occurred.

(d) *Closely Held Companies Owned by Trusts*. Special problems arise in the case of irrevocable, foreign trusts where the beneficiaries are not limited to the grantor and the grantor¡¦s spouse (see Part IVB(1) above) and which hold significant interests in closely held investment corporations. This will frequently be the case if a grantor has established a foreign trust with the intent that the trust invest in U.S. assets. If the grantor has retained any powers over the trust that could make the assets subject to U.S. estate tax at the grantor's death (see the discussion at Part IVA above), the grantor, in order to avoid the U.S. estate tax on these assets, may direct that the assets be held by an off shore corporation, whose stock is usually owned by the trust. Such corporations almost always qualify as "passive foreign investment companies"[46] and frequently as "controlled foreign corporations"[47] or as "foreign personal holding companies"[48] under the U.S. tax rules designed to discourage the use by U.S. taxpayers of foreign corporations to defer tax. Under these rules, if a U.S. person is a beneficiary of an irrevocable foreign trust, the trust is disregarded and the U.S. beneficiary is deemed to have a direct ownership interest in the corporation.[49] This would mean that a U.S. beneficiary could have phantom income, on which the beneficiary would owe U.S. income tax, even though the beneficiary may have only a future interest in the trust that is subject to defeasance and may not have any right to require the trust to contribute the funds required to pay the taxes. Regulations regarding this very difficult subject have been promised for several years, and it is possible that these regulations will allow the corporate tax to be deferred to the time the U.S. beneficiary actually receives a trust distribution, subject to the payment of interest on the deferred payment. If some relief is not offered to U.S. beneficiaries of irrevocable foreign trusts who do not have enforceable present interests in such trusts, it may become impossible for a foreign trust in which the foreign grantor has retained a beneficial interest or discretionary power to invest in U.S. assets at all, since by interposing a foreign corporation to avoid exposure to U.S. estate tax, the grantor may be creating an adverse income tax situation for U.S. beneficiaries. Alternatively, protectors and trustees of trusts where the grantor has a potential exposure to the U.S. estate tax may have to determine whether they can segregate the interests of U.S. beneficiaries from non U.S. beneficiaries in separate trust shares and, ironically though it may seem, invest only the shares of the non U.S. beneficiaries in U.S. assets with an off shore corporation as an intermediary.

(e) *Loans from Foreign Trusts*. Loans to U.S. beneficiaries from irrevocable foreign trusts are generally treated as distributions and are therefore potentially subject to U.S. income tax.[50] For purposes of this rule, loans to persons related to a U.S. beneficiary (such as siblings, ancestors, lineal descendants and spouses) are treated as if they were made to the beneficiary.[51] Also, when an irrevocable foreign trust makes a loan to a U.S. beneficiary, it must be treated as a complex trust, which raises the possibility of the imposition of the "partial tax" even if the trust otherwise pays all of its net income to trust beneficiaries on a current basis.[52] Pursuant to authority conferred on it by the 1996 amendments, the IRS has announced that certain loan transactions can be structured in such a way as to avoid being treated as deemed distributions: they must be in writing; the term must not exceed five years; all payments must be denominated in U.S. dollars; the yield to maturity of the obligation must not be less than one hundred percent and no more than one hundred thirty percent of the applicable Federal rate; the U.S. beneficiary

must agree to extend the period for assessment on income attributable to the loan, and the U.S. person must report the loan to the IRS for each year the obligation is outstanding.[53]

3. Circumstances in Which U.S. Beneficiaries Become Subject to U.S. Income Tax Reporting Requirements.

The United States does not intend to cede the determination of whether a U.S. beneficiary has to pay income tax on distributions from a foreign trust to an honor code. Whether the foreign trust is or is not entitled to be treated for U.S. income tax purposes as owned by its foreign grantor (see Part IVB(1) above), a U.S. person who receives any distribution from a foreign trust in a given tax year must file a return on Form 3520 together with the U.S. person¡¦s income tax return for that year, reporting such information as the name of the trust, the distributions received from the trust during that year, and either a "Foreign Grantor Trust Beneficiary Statement" or a "Foreign Non-grantor Trust Beneficiary Statement," issued by the trust.[54] If the beneficiary cannot obtain the relevant statement, the distribution will be treated as a taxable accumulation distribution, subject to the partial tax and the related interest charge. If, however, the beneficiary can provide information about trust distributions for the prior three years, only that portion of the distribution that exceeds the average of distributions from the prior three years will be treated as an accumulation distribution.[55] The U.S. beneficiary return is filed on Form 3520 and there is a penalty for failing to file the return equal to thirty-five percent of the distributions for that year.[56]

C. Foreign Client Who Plans to Immigrate to the United States and Wishes to Benefit Persons Who May be U.S. or Foreign.

A foreign person who becomes a U.S. permanent resident, for immigration purposes, automatically qualifies as a U.S. tax resident and therefore subjects his worldwide income to U.S. income tax.[57] Becoming a U.S. permanent resident is very probative, although not conclusive evidence, that the person has also become a resident or domiciliary for purposes of the U.S. gift and estate taxes, thus subjecting all transfers of property by gift or by reason of death after the U.S. domicile begins to U.S. transfer taxes. It therefore behooves a person contemplating becoming a U.S. resident to consider steps to reduce his or her exposure to these taxes.

Irrevocable transfers of property made before a donor becomes a U.S. citizen will not be subject to U.S. gift or estate tax as long as the donor does not retain an interest in or power over the property that would cause it to be treated as if the person were the owner under U.S. transfer tax concepts. Thus, if a person contemplating immigration to the United States establishes a foreign trust before immigrating to the United States, regardless of whether the beneficiaries will be U.S. or foreign persons, and does not retain any relevant interest in or power over the trust, that trust will escape U.S. transfer taxation. In such circumstances, it is prudent to allow a reasonable period of time between the establishment of the trust and immigration. The Service could argue that visits made to the United States shortly before the person formally became a U.S. permanent resident were part of a plan to change residence and that the U.S. domicile of the person began before the first date on which the person is considered to be a resident for immigration or U.S. income tax purposes.[58]

A U.S. taxpayer who establishes a foreign trust with U.S. beneficiaries is deemed to be the tax owner of the trust for income tax purposes, even if the taxpayer has no interest in or power over the trust.[59] Until the 1996 foreign trust legislation was enacted, a foreign person who wished to establish an off shore trust for the benefit of U.S. persons could completely avoid this rule by making the contemplated transfer to the off shore trust at any time before commencing status as a U.S. permanent resident. The 1996 foreign trust legislation now requires that any person who establishes a foreign trust and becomes a U.S. resident within five years thereafter will be taxed as the owner of the trust property after commencing U.S. residence.[60] This means that only a far sighted person who may eventually plan to become a U.S. resident, but does not plan to do so for at least five years, can derive any U.S. income tax benefits from establishing a foreign trust to benefit U.S. beneficiaries before commencing U.S. residence. For those persons who expect to have substantial wealth and income after becoming U.S. residents but who establish a trust within the five-year period before commencing U.S. residence, establishing an off shore trust will still have the transfer tax advantage discussed in the preceding paragraph.

D. U.S. Client Who Wishes to Benefit Foreign Persons Only.

A U.S. person who establishes an off shore trust to benefit only foreign persons does not have to be concerned about being taxed on the income of the trust property after the property is transferred abroad simply because he has established a foreign trust. Of course, if the U.S. grantor retains an interest in or power over the trust that would otherwise cause the grantor to be the owner of the trust for U.S. income tax purposes under the ¡§grantor trust¡¨ rules,

the fact that the trust is a foreign trust is irrelevant and the grantor will continue to be taxed as the owner of the trust property.

Any U.S. person establishing a foreign trust must be aware that there is a deemed capital gains tax on the transfer of appreciated property to a foreign trust that becomes applicable when there are no U.S. beneficiaries of the trust to which the transfer is made.[61] This tax will be in addition to any gift taxes that may be imposed on the transfer, and any deduction for one tax against the other will be limited to an adjustment to the cost basis of the property based on the portion of the gift tax attributable to the net appreciation since the donor acquired the property.[62]

A U.S. person who transfers property to any foreign trust, whether or not the trust is a grantor trust, must notify the Internal Revenue Service of the transfer.[63] The statute contemplates that such notice be given within ninety days after the transfer. However, the instructions to Form 3520, on which it appears such notice must be given if the U.S. person will not be deemed to be the owner of the trust under the grantor trust rules, permits the notice to be filed by the due date for the U.S. person's income tax return for the year in which the transfer took place. The executor of the estate of a deceased U.S. grantor of a foreign trust must make a similar notification to the I.R.S. when a transfer to a foreign trust is made by reason of the decedent's death and also when a foreign trust ceases to be a grantor trust for U.S. income tax purposes by reason of the grantor's death.[64] Failure to file such notice can lead to a penalty equal to thirty-five of the value of the property transferred to the trust.[65]

Assuming that the U.S. grantor does not retain any interest or power over the foreign trust and that there are no U.S. beneficiaries, no annual reporting should be required. The circumstances will likely change, however, if a foreign beneficiary became a U.S. resident. Then, as discussed in Part IVE below, the U.S. grantor must file an annual report about the trust with the I.R.S. and the new U.S. beneficiary would also be required to file an information return in any year in which he or she receives a distribution from the trust.[66] Thus the most secure way to ensure that the U.S. grantor of a foreign trust need never be concerned about seeing that annual information returns are filed for the trust would be to provide in the governing instrument that no U.S. citizen or tax resident can be a beneficiary of the trust. By regulation the Treasury has determined that the interest of any beneficiary who becomes a U.S. resident more than five years after property was transferred to the trust will be disregarded for this purpose.[67]

E. U.S. Client Who Wishes to Benefit U.S. Persons.

1. Income Tax Treatment of Foreign Asset Protection Trusts Established by U.S. Grantors for U.S. Beneficiaries

Unfortunately, U.S. persons interested in establishing foreign trusts to benefit U.S. persons get the worst of virtually all possible worlds. A U.S. person establishing a trust to benefit a U.S. beneficiary is treated as the owner of the trust for U.S. income tax purposes even though the U.S. person has not retained any interest in or power over the trust.[68] In this context, it is important to note that, under the new rules defining a U.S. trust, it is distinctly possible that a trust that was initially a U.S. trust could unintentionally become a foreign trust. For example, there could come a time when a majority of trustees are not U.S. persons and therefore the trust will have become a foreign trust because the trust no longer meets the "control test." (See the discussion at Part IIB above.) When this happens, the U.S. grantor will begin to be treated as the owner of the trust for U.S. income tax purposes, to the extent the assets of the trust are attributable to the property the U.S. grantor initially transferred to the trust.[69]

A U.S. grantor of a foreign trust who is treated for income tax purposes as the owner of the trust must notify the I.R.S. of the transfer of property to the foreign trust. The U.S. grantor of such a foreign trust must also designate a U.S. agent, who can be the grantor, for service of process upon the foreign trustee or the I.R.S. will reserve the right to determine the U.S. grantor's taxable income with respect to the trust.[70] The notification and designation must be made on Form 3520 A, which must be filed on the fifteenth day of the third month after the end of the trust's tax year. Similar information must also be reported on Form 3520, which must be filed each year in which the grantor is treated as the owner of the trust on the same day that the grantor's income tax return for that year is due.[71]

A U.S. grantor of a foreign trust who is considered the owner of the trust must also ensure that the trustee files a return each year which includes a complete accounting of all trust transactions and furnishes any required information forms, such as a "Foreign Grantor Trust Beneficiary Statement" or a "Foreign Non-grantor Trust Beneficiary Statement,¡¨ to each U.S. and beneficiary.[72] This must be done on Form 3520 A, which must be filed by the fifteenth day of the third month after the end of the trust's tax year.[73] Failure by a trustee to file annual returns can lead to a penalty on the U.S. grantor equal to five percent of the value of the trust's assets.[74]

Since the U.S. grantor of a foreign trust with U.S. beneficiaries is taxed on the trust as if the grantor owned it, the U.S. beneficiaries will not have to pay income tax on any distributions during the grantor's lifetime. But, if the trust continues after the grantor's death, the beneficiaries will have to pay, in the year of the grantor's death or any year thereafter in which they receive trust distributions, U.S. income tax on the current year's distributable net income[75] and also the "partial" tax and the related interest charge on distributions of accumulated income and gains that were accumulated after the grantor's death, just as if the trust had been established as of the grantor's death by a foreign grantor as discussed in Part IVB(2) above.[76] Similarly, the beneficiaries will have to report information about the trust to the I.R.S. in each such year[77] and failure to file the required return incurs a penalty equal to thirty-five percent of the trust distribution.[78]

Since capital gains form part of the distributable net income of a foreign trust, U.S. beneficiaries of a foreign trust that continues after the death of a U.S. grantor will eventually have to pay a "partial" or throwback tax on capital gains realized after the grantor's death at ordinary income tax rates as well as on trust income accumulated after the grantor's death. The only silver lining with respect to the capital gains of foreign trusts is that, as long as the grantor of a foreign trust is deemed the owner of the trust because of the U.S. beneficiaries, there will be no deemed capital gains tax on the unrealized appreciation attributed to the property transferred to the trust. If in the future, however, there should come a time while the U.S. grantor is still alive when the only beneficiaries are foreign persons, a deemed transfer would then occur, at which time the U.S. grantor would be liable for capital gains tax on the unrealized appreciation of the trust. Assuming that the grantor does not have to pay any deemed capital gains tax during his lifetime, the trust would cease to be a grantor trust upon the grantor's death and the tax on deemed capital gains would then be due, unless the trust property were included in the grantor's taxable estate. Treasury regulations make clear that foreign trust property includible in the U.S. grantor's taxable estate would be eligible for a "step up" in cost basis and thus eliminate any such gains tax liability.[79]

Significantly, in the 1996 amendments Congress also made it much more difficult to use debt obligations of an offshore trust issued to a U.S. person who transfers a foreign trust as a means of preventing the U.S. person from being treated as the U.S. tax owner of the trust when the trust has U.S. beneficiaries. A note or other debt obligation issued by any of the offshore trust itself, the grantor, owner or a beneficiary of the trust, or anyone related to any of the foregoing or to that person's spouse (including siblings, spouses, ancestors and lineal descendants) will not qualify as a bonafide form of consideration.[80]

2. Transfer Tax Issues Regarding Foreign Asset Protection Trusts Established by U.S. Grantors for U.S. Beneficiaries

It should be kept in mind that the major reason why a U.S. person would consider establishing a foreign trust to benefit U.S. beneficiaries would be to secure the assets from creditors.[81] If there is a serious concern about exposure to claims, the inconvenience and extra expense associated with the tax treatment of off shore trusts may seem a small price to pay to ensure that there are assets to pass on at all. If a U.S. grantor of an off shore asset protection trust, however, retains a non discretionary right to receive the income of the trust, the income will likely be subject to the claims of the grantor's creditors and, in addition, the trust property will be includible in the grantor's taxable estate.[82] Thus, to be completely effective for asset protection purposes, a trust must usually be irrevocable and the grantor must have no right to compel any payment from the trust.[83]

Unless the U.S. grantor retains a limited power of appointment over the trust or the right to substitute the assets of the trust for the same value, however, the establishment of the foreign trust will likely be subject to U.S. gift tax. Even if a prospective U.S. grantor is willing to pay the U.S. gift tax to achieve his or her asset protection goals, he or she may wish to have some ability to rely on the trust as a form of "safety net." It is not uncommon for asset protection trusts to include the grantor as a member of a class of permissive "sprinkle" beneficiaries. In many jurisdictions, the mere possibility of receiving a distribution from the trust, as long as there is no right to compel such distribution, will not cause the grantor's interest in the income to be considered part of the grantor's estate in bankruptcy. Also, under U.S. estate tax concepts, as long as the discretion of the trustee is unlimited by any definite standards, the trust will not automatically be considered a part of the grantor's taxable estate.[84]

V. CONCLUSION

The 1996 changes in U.S. tax law regarding off-shore trusts have fundamentally altered many considerations regarding the uses of such foreign trusts in U.S.-related estate planning. For example, great care must be taken in considering whether off-shore trusts can meet the estate planning needs of families with U.S. beneficiaries even if there are foreign persons eager to assist U.S. beneficiaries for whom off-shore trusts may be established with no local tax cost. Also, U.S. persons interested in establishing off-shore trusts must seriously consider the reporting

burdens, income and possible capital gains taxes, and the eventual tax cost to U.S. beneficiaries of these types of entities, even if their asset protection features seem particularly compelling or attractive.

Appendix

Under IRS Notice 96 61, a trust that qualified as a U.S. trust under the criteria in effect before the establishment of the 1996 Amendments was able to elect to remain a U.S. trust by beginning to take steps to conform to the new criteria of a U.S. trust by the 15 April 1998 due date for the trust's 1997 income tax return (or authorized extension deadline), completing the necessary steps by two years thereafter, and making an election to remain a U.S. trust on the trust's income tax return. In 1997, Congress enacted legislation establishing a simpler method for a U.S. trust to remain a U.S. trust.[85] This can be accomplished if the trust filed a tax return on Form 1041 for the period including 19 August 1996 (and did not file Form 1041 NR for the same year), the trust had a reasonable basis under prior law to be considered a U.S. trust under prior law, and the trust files an election to remain a U.S. trust with the trust's Form 1041 income tax return for the 1997 or 1998 tax year.[86] The last date for making the election is the date on which the trust's 1998 income tax return is due, with extensions.[87] The final regulations should be consulted regarding situations in which a trust was or is not required to file an income tax return in a relevant year.[88]

The final regulations also provide a measure of relief for trusts created after August 19, 1996 and before April 3, 1999 that do not satisfy the "control test" formulated in the regulations.[89] This would apply, for example, in the case of a trust that permits a foreign person to appoint a successor trustee without regard to whether the appointment effects the trust's status as domestic or foreign. The trust must be modified to conform to the "control test" by December 31, 1999 in order to be considered a U.S. trust for any taxable year beginning after December 31, 1996. If the trust would, save the relevant modification, fail to qualify as a U.S. trust for a taxable year ending after August 20, 1996, the trust must also make an election to remain a domestic trust under the procedures set forth in IRS Notice 96-61.

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**Earlier versions of this article were published in 1999 in the International Law Practicum and the Journal of Asset Protection.

[1] The amendments were enacted as Sections 1901 to 1909 of the Small Business Job Protection Act of 1996. ¡§Foreign" or "off shore trusts,¡¨ as used in this article, refers to trusts that do not have situs in a state of the United States or the District of Columbia. See the discussion at Part II A below.

[2] IRC 7701(a)(30)(E).

[3] Reg 301.7701-7(c)(3)(iv).

[4] Reg. 301.7701-7(c)(3)(ii).

[5] Reg. 301.7701-7(c)(4)(ii).

[6] Reg. 301.7701-7(c).

[7] Reg. 301.7701-7(c)(3)(v).
[8] Reg. 301.7701-7(c)(4)(i)(D)
[9] Reg. 301.7701-7(c)(4)(i)(A)-(C).

[10] The Committees of the New York State Bar Association on International Estates and Trusts and on International Estate Planning have drafted proposed legislation to provide for such a registration scheme in New York.

[11] Compare Reg. 301.7701-7(d)(1)(i) with Reg. 20.2056A-2(d)(2).
[12] See Reg. 301.7701-7(d)(1)(i) referring to IRC 7701(a)(30).
[13] Reg. 301.7701-7(d)(1)(ii).
[14] Reg. 301-7701-7(d)(1)(ii)(J).
[15] See Reg. 301.7701-7(d)(iii).

[16] See the Treasury Department comments under "Control Test Issues", 64 Federal Register 4967 (Feb. 2, 1999).
[17] Reg. 301.7701 7(d)(3). See the appendix regarding elections that may be made to preserve the U.S. tax situs of

trusts that were in existence when the 1996 amendment became effective.

18 Reg. 301-7701-7(d)(1)(ii)(I).

19 IRC 641.

20 IRC 651. Trusts that are required to pay all of their income to the beneficiaries at least annually are denominated "simple" trusts under the Internal Revenue Code. If an income beneficiary is a foreign person, the foreign person will be taxed only on the trust income that is U.S. source income and U.S. "effectively connected. income, and would be eligible for the nonresident exemption from tax on most U.S. portfolio debt and bank account income.

21 See IRC 661 and 662.

22 IRC 1(e).

23 IRC 1(h)(4).

24 IRC 1(h). It should be noted that the eighteen-month holding requirement for the twenty- percent capital gains tax rate on the sale of intangible assets imposed by the Taxpayer Relief Act of 1997 was reduced to twelve months by the IRS Structuring and Reform act of 1998.

25 IRC 641(b) and 871.

26 871(a).

27 871(b).

28 871(h), 871(i).

29 See, e.g., United States-France Income Tax Treaty, Article 10 (maximum withholding rate of five percent for certain closely-held companies and fifteen percent for all others).

30 See 871(a)(2), expressly limited in the case of foreign trusts by Reg. 7701(a)(3), consistent with the provisions of IRC 641(b) (foreign trust, for purposes of the taxation of trusts, to be treated as a nonresident alien individual who is not present in the United States at any time).

31 IRC 643(a).

32 IRC 652 and 662.

33 IRC 2104(b).

34 IRC 2036.

35 IRC 2037, 2038.

36 IRC 6901.

37 See IRC 673-677.

38 IRC 678.

39 IRC 672(f)(2)(A)(i).

40 IRC 672(f)(2)(A)(ii). Payments to a dependent, as defined in IRC 152(a)(1), of the grantor or the grantor¡¦s spouse, to which the grantor or the grantor¡¦s spouse has a legal obligation of support are deemed to be payments to the grantor or the grantor¡¦s spouse, if the dependent person is permanently disabled or, in the case of a child, under the age of twenty-four years. Prop. Reg. 1.672(f)-3(b)(2).

[41] Reg. 1.643(h)-1(a).

[42] See IRC 643(a).

[43] IRC 643(a)(6)(C).

[44] IRC 667. Domestic trusts used to be subject to similar rules. However, U.S. trusts must pay income tax on accumulated income in the year the income wee earned and the marginal tax rates for trusts accelerate at a much higher rate than for individuals, with the result that any tax deferral possibility has been virtually wrung out of the system. Most off shore trusts do not owe the United States any tax, save the withholding tax to which they might be subject on certain forms of U.S. investments.

[45] IRC 668.

[46] IRC 1297. A "passive foreign investment company" is any foreign corporation whose "passive income¡¨ for the taxable year represents seventy-five percent or more of such corporation's gross income, or whose average percentage of assets which produce "passive income¡¨ during the taxable year is fifty percent or more of such corporation's total assets.

[47] IRC 957. A "controlled foreign corporation" is any foreign corporation in which more than fifty percent of the total combined voting power of all classes of stock of the corporation or the total value of the stock of the corporation is owned by U.S. shareholders.

[48] IRC 552. A "foreign personal holding company" in general is any foreign corporation whose ¡§foreign personal holding company income¡¨ is sixty percent or more of such corporation ¡¥s gross income, and fifty percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote or fifty percent or more of the total value of the stock of such corporation is owned by or for not more than five individuals who are citizens or residents of the United States.

[49] 1298(a)(3) PFIC; 554(a) FPHC.

[50] IRC 643(i)(1).

[51] IRC 643(i)(2)(B).

[52] IRC 643(i)(2)(D).

[53] See IRS Notice 97-34, Section V(A).

[54] IRC 6048(c) and Notice 97-34. It should be noted that a foreign trust filing either form of Statement must agree that the trust will permit the I.R.S. to inspect and copy the trust¡¦s permanent books and records and relevant trust documents.

[55] See Notice 97-34.

[56] IRC 6677(a).

[57] IRC 7701(b).

[58] A person can, independently of his or her immigration status, become a U.S. tax resident based solely on the number of days spent in the United States. Thus, if a person has made visits to the United States prior to becoming a permanent resident in the same year in which residence is commenced, the person¡¦s tax residence may be deemed to commence on one of the visits, which would strengthen an argument that the domicile also commenced at that point.

[59] See IRC 679.

[60] IRC 679(c)(4).

[61] IRC 684(a).

[62] IRC 1015(d)(6).

[63] IRC 6048(a).

[64] IRC 6048(a)(4)(C).

[65] IRC 6677(b).

[66] IRC 6048(c).

[67] Reg. 1.679-2(a)(3).

[68] IRC 679.

[69] IRC 679(a)(5).

[70] IRC 6048(b)(2).

[71] See Forms 3520 and 3520-A.

[72] IRC 6048(b)(1).

[73] See also IRS Notice 97-34.

[74] IRC 6677(b) The IRS has provided penalty relief to U.S. owners of foreign trusts for failing to file a timely 1997 Form 3520 A, Annual Information Return of Foreign Trust With a U.S. Owner, provided the form is filed by the later of (i) the 15th day of the seventh month following the end of the trust's taxable year beginning in 1997, or (ii) the extension date granted under Form 2758, Application for Extension of Time to File Certain Excise, Income, Information and Other Returns. See IRS Announcement 98 30, IRB 1998 17 at 38. The reason for the relief is that the Form was not available in time for foreign trusts to meet their filing requirements. The same relief was provided for the 1996 Form. See IRS Notice 97 34, 1997 1 C.B. 422.

[75] IRC 652 and 662.

[76] IRC 667.

[77] IRC 6048(c).

[78] IRC 6677(a).

[79] Prop. Reg. 1.684-3(c) (relieving property transfers by reason of death if basis of property in hands of foreign trust is determined under IRC 1014(a) and Example 2 (property transferred to foreign trust over which deceased grantor retained power to revoke, which was therefore includible in grantor¡¦s taxable estate, was not subject to tax under IRC 684 because basis of contributed property was determinable under IRC 1014(a).

[80] IRC 679(a)(3).

[81] See William P. Streng, U.S. International Estate Planning, 16.03.

[82] IRC 2036.

[83] See William P. Streng, n. 72 supra, (1996) 16.04[2].

[84] See, e.g., Armata v. U.S., 494 F.2d 1371 (C1. Ct. 1974); Estate of Green v. C.I.R., 64 T.C. 1049 (1975); Estate of Gartland v. C.I.R., 34 T.C. 867 (1960). Of course, if many distributions to the U.S. grantor are made, the I.R.S. may conclude that there was an understanding between the trustee and the grantor at the time the trust was established that such distributions would be made, and this may cause the trust to be included in the grantor's taxable estate, even if gift tax was paid when the trust was funded.

85 Taxpayer Relief Act Section 1161(a).

86 Reg. 301-7701(7)(f)(3).

87 Reg. 301-7701(7)(f)(3)(ii).

88 Reg. 301-7701(7)(f)(2)(ii) and 301-7701(7)(f)(3)(ii)(B).

89 Reg. 301-7701(7)(e)(2).