RECENT LEGISLATION INVOLVING FOREIGN TRUSTS AND GIFTS

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I. INTRODUCTION

1. RICH IMMIGRATING FOREIGNERS - THE "NEW VILLAIN"

   a) For decades, foreign citizens who were planning to become permanent U.S. residents, engaged in sophisticated tax planning to keep their wealth outside the grasp of the U.S. tax authorities.

   b) Under prior law, a foreign person could create a grantor trust under IRC Sec. 671-677, usually reserving the power to revoke the trust (a revocable trust is a grantor trust under IRC Sec. 676). The beneficiaries would be U.S. citizens or residents, usually the grantor's children. These trusts are sometimes called "intentionally defective grantor trusts."

      (1) The result: Income from the trust would be taxed to the grantor (usually no actual tax would be paid, thereby allowing these trusts to grow tax-free) and distributions to the children would be tax-free as a gift.

      (2) The trust would become a non-grantor trust upon the grantor's death and the U.S. beneficiaries would then be taxed on their distributions, but if a corporate grantor was used, the grantor trust would become perpetual, since corporations cannot die.

      (3) Congress started policing this area by enacting IRC Sec. 672(f) (now designated Sec. 672(f)(5)) which prevented a foreign person who planned to become a U.S. resident or citizen, from avoiding the grantor trust rules by first transferring property to a relative or friend, who then transferred the property to a trust for the grantor's benefit.

   c) In a search for revenue, these intentionally defective grantor trusts were suddenly deemed "abusive loopholes." The essence of these changes is to convert grantor trusts to non-grantor trusts and tax the U.S. beneficiaries on the distributions.

      (1) Note: The legislation may work in some straightforward instances, but the well-advised taxpayer will be able to circumvent most of these changes.

   d) Proposed Regulations 301.7701-7 for foreign trusts were issued on June 4, 1997.

2. FOREIGN GIFTS - NEW REPORTING REQUIREMENTS

   a) Beneficiaries receiving gifts from foreign donors must now report those gifts, if the amount of foreign gifts received totally more than $10,000 per year.

      (1) IRC Notice 97-34, 1997-25 IRB (6/23/97) relaxed these reporting requirements for gifts made by individuals. Only gifts in the aggregate that exceed $100,000 per year must be reported, and the identity of the donor, in most circumstances, is not subject to disclosure.

b) Except for this new reporting requirement, the receipt of foreign gifts which were not taxable under old law will remain non-taxable.

3. REPEAL OF IRC SEC. 1491.

a) The 35% excise tax under IRC Sec. 1491 was repealed under the Taxpayer's Relief Act of 1997 (Act Section 1131(a)) for transfers to foreign entities after August 4, 1997. Also, the penalties for failure to report transactions under IRC Sec. 1494(c) were repealed.

b) Transfers occurring between the effective date of the trust law changes, generally August 6, 1996 and the repeal of IRC Sec. 1491, should still be subject to IRC Sec. 1491.

c) Domestic trusts which become foreign trusts, and transfers to foreign trusts will be treated as sales and exchanges, and taxed as such, rather than a transaction which was subject to a 35% excise tax under IRC Sec. 1491.

II. FOREIGN TRUSTS

A. Foreign Non-Grantor Trusts

1. INTEREST ON ACCUMULATION DISTRIBUTIONS

a) The interest rate applicable to the accumulations of income within these trusts was 6% simple. This interest rate applied to accumulations through tax year 1995.

b) The interest rate has now been changed to the compounding interest rate charged for underpayments of tax under IRC Sec. 6621(a)(2).

c) Effective date: Distributions made after August 20, 1996.

(1) Planning Note: If possible, use a foreign corporation to accumulate income tax-free, then pay dividends to a foreign trust in the year in which distributions to beneficiaries will occur. Also, accumulated distributions might be paid to non-U.S. beneficiaries.

(2) Carefully structured trust agreements may also avoid this interest on accumulations. The accumulations apply to a trust's "distributable net income" ("DNI") and the definition of DNI under IRC Sec. 662 does not include a "specific sum of money or specified property" which is ascertainable at death and paid to a beneficiary in 3 or fewer installments.

(a) Example: If a trust with $2,000,000 states that its sole beneficiary will receive the sum of $3,000,000 payable in 5 years, 10 years and 15 years after the death of the grantor, none of the payments should be considered DNI, even though the additional $1,000,000 was generated by trust accumulations.

d) The Treasury is directed to issue regulations to prevent abusive transactions in this area.

2. LOANS FROM FOREIGN TRUSTS

a) To prevent indirect distributions to a beneficiary, a loan of cash (including foreign currency and cash equivalents) or marketable securities from a foreign non-grantor trust to a U.S. grantor or beneficiary will be treated as a distribution to that person.

(1) This rule applies to loans made to persons related to a U.S. grantor or beneficiary, but will not apply to loans to a tax-exempt entity.

(2) This rule will not apply to arm's-length loan transactions.

(3) Note: Congress had considered treating any use of property, such as rent-free use of a trust's condominium by a beneficiary, as a taxable distribution. The final legislation did not contain this provision.

b) Effective Date: Loans made after September 19, 1996.

B. Inbound Foreign Grantor Trust Rules

1. NON-APPLICABILITY OF THE U.S. GRANTOR TRUST RULES

a) To prevent foreign grantors from setting up foreign grantor trusts (taxed to the foreign person) with U.S. beneficiaries receiving the income tax-free, the grantor trust rules have been modified. IRC Sec. 6651(d)(2).

(1) Under the new law, the grantor trust rules will not apply if the grantor is a foreign person.

(2) The grantor trust rules will only apply when computing the income of a U.S. person or entity.

(3) If this new law applies, then the foreign trust will be considered a non-grantor trust and the U.S. beneficiaries will be taxed on their distributions and the new interest rules on accumulated distributions will apply.

b) Under IRC Sec. 672(f), the old grantor trust rules will continue to apply when —

(1) The grantor retains the power to revoke the trust and that power is not conditioned upon the approval or consent of anyone else;

(a) Note: Approval or consent by a non-adverse related party who is subservient to the grantor under IRC Sec. 672(c) is permitted.

(i) If the consent of the grantor's child is necessary for the grantor's actions and the child does not have a beneficial interest in the trust, IRC Sec. 677 will usually treat the grantor as the owner of the trust.

(b) The grantor's power to revoke the trust and revest the principal must be exercisable at least 183 days per year in the aggregate. Prop. Reg. 1.672 (f)-3.

(i) This rule prevents the potential abuse of limiting the grantor's right to revoke to 1 day per year.

(2) Income or corpus during the grantor's lifetime is solely distributable to the grantor or the grantor's spouse;

(a) Legal obligations to support minor children under age 24 or those with disabilities are considered distributions solely to the grantor under Prop Reg 1.672(f)-3.

(3) A trust is established to pay compensation for services rendered; and

(4) Trusts owned by the grantor or another person under IRC Sec. 676 or 677 [other than IRC Sec. 677(a)(3)] that are in existence on September 19, 1995.

c) Planning note: A foreign grantor trust naming a U.S. beneficiary which is revocable by the grantor, or in which the income is distributable only to the grantor or the grantor's spouse, will continue to be treated as a grantor trust.

(a) Under such an arrangement, the trust's income will continue to be taxable to the grantor (or spouse) and distributions of that income to the U.S. beneficiary will be tax-free.

(b) The U.S. beneficiary will become taxable on the distributions of income only when the grantor (or the grantor's spouse) dies.

d) The grantor trust rules will apply to CFC's (controlled foreign corporations) which are treated as grantors.

(1) Under prior law, use of a foreign corporation as the grantor of a revocable trust could have resulted in a perpetual grantor trust.

2. TRANSFERS BY U.S. BENEFICIARIES

a) Under IRC Sec. 672(f)(5), when a U.S. beneficiary makes a gift to a foreign grantor and the beneficiary retains an interest in the property, the trust is recast as a grantor trust in which the U.S. person is the grantor as to the transferred property.

(1) IRC Sec. 672(f)(5)(A) provides that the U.S. person will be considered the grantor of the trust even if the foreign grantor would otherwise be considered the grantor of the trust.

(2) Transfers by family members of property to a foreign grantor will not cause the U.S. beneficiary to become the grantor of a U.S. grantor trust.

3. FOREIGN TAX CREDITS

a) The Secretary of Treasury may devise regulations to account for any taxes paid by the foreign grantor on the income from the trust and allow a credit under the foreign tax credit limitations.

4. EFFECTIVE DATE

   a) These rules will take effect on August 20, 1996.

   b) If a domestic trust becomes a foreign trust or assets are transferred to a foreign trust before January 1, 1997, then no tax will be imposed under IRC Sec. 1491. (Note: IRC Sec. 1491 has been repealed for transactions after August 4, 1997).

C. Outbound Foreign Grantor Trusts

1. PRIOR LAW

   a) If a U.S. person transferred property to a foreign trust, he was treated as the owner of the property in any year in which the trust had U.S. beneficiaries ("ownership rule"). Also, sales to a trust for fair market value were exempted from IRC Sec. 679(a)(1), even when the trust paid for the property with an obligation.

2. CHANGES IN THE LAW

   a) If the trust pays fair market value for the property transferred by a U.S. beneficiary, then the transferor will not be treated as the owner of the trust. IRC Sec. 679(a)(2).

      (1) Obligations issued by the trust, grantor or beneficiaries or parties related thereto, containing arm's-length terms and conditions will qualify for this exception to the ownership rule as well.

   b) Transfers to charitable trusts are exempted from the ownership rule.

   c) A foreign grantor who transfers property to a trust who then becomes a U.S. **resident** within 5 years of the transfer is now brought within the ownership rule. IRC Sec. 679(a)(4).

      (1) The ownership rule will apply retroactively to the first date the person became a U.S. resident.

         (a) Note: This ownership rule applies when residency is acquired under IRC Sec. 7701(b)(2)(A), the physical presence test (as modified by the closer connection test).

      (2) The amount transferred includes the non-distributed income arising between the time of the property transfer to the trust and the date of residency.

      (3) Although the grantor is subject to U.S. income taxes, the assets might not be part of his estate for estate tax purposes.

   d) If a foreign person becomes a U.S. resident more than 5 years after the transfer, the ownership rules will not apply.

3. PRE-U.S. RESIDENCY ISSUES

   a) IRC Sec. 679(a)(1) applies to trusts with U.S. beneficiaries. Therefore, if a non-U.S. grantor creates an irrevocable trust naming only non-U.S. beneficiaries, these new rules will have no impact.

   b) Also, IRC Sec. 679(f)(5) will not apply to transfers made by a non-U.S. grantor to a relative who then creates a trust, provided the grantor is not a beneficiary of the newly formed trust.

   c) Finally, a non-U.S. grantor who creates a trust, then waits 5 years before becoming a U.S. resident, will not be affected by these new rules.

      (1) Apparently, a spouse is not considered a grantor under these rules, so if one spouse plans on becoming a U.S. resident and the other does not, the non-U.S. spouse may create the trust without running afoul of the 5 year rule. The U.S. resident spouse should not be a beneficiary or grantor of the trust.

      (2) Note: If a person creates a trust primarily as an accommodation for another, the other person will be considered as the grantor of the trust. Stern v. Cm., 77 TC 614 (1981), rev'd on other grounds, 747 F 2d 555 (9th Cir. 1984).

4. OUTBOUND TRUST MIGRATIONS

   a) A transfer of property by a U.S. person to a domestic trust, which subsequently becomes a foreign trust while the beneficiary is still alive, will be considered a transfer to a foreign trust on the date of migration.

      (1) The transferor, under IRC Sec. 679(a)(1), is treated as the grantor to the portion previously transferred to the trust and the reporting requirements will apply.

5. DISTRIBUTIONS BY FOREIGN TRUSTS THROUGH NOMINEES

   a) Amounts paid or derived from a foreign trust, directly or indirectly, to a U.S. "person" will be considered a direct payment to that person. Note: The payee is supposed to be a U.S. beneficiary of the foreign trust, according to the legislative history, not just any "U.S. person."

      (1) Intermediaries or nominees interposed between the foreign trust and the U.S. beneficiary are disregarded. Under Prop. Reg. 1.643(h) -1, an intermediary may be disregarded, if —

         (a) The intermediary is related to either the U.S. person or the foreign trust and transfers property received from the trust to the U.S. person;

         (b) The intermediary would not have transferred the property, unless he received it from the trust; or

         (c) The intermediary received the property from the trust pursuant to a plan, one of the principal purposes of which was to avoid U.S. taxes.

(2) These rules do not apply if the intermediary is the grantor of the portion of the trust from which the amount is distributed. This exception may be used to effectively circumvent the preceding intermediary rules.

(a) Example: Father, a foreign citizen, forms a foreign trust naming foreign daughter as the beneficiary. Foreign daughter is expected to transfer 50% of her distribution to U.S. daughter (although she is not a U.S. beneficiary).

(i) Query whether foreign daughter would be a intermediary for U.S. daughter, if U.S. daughter is not a U.S. beneficiary?

(b) Assuming these rules reach all U.S. persons, whether or not they are U.S. beneficiaries, then if the trust states that foreign daughter has a power to withdraw her distribution from the trust and she failed to exercise that right, foreign daughter will become the grantor of those funds.

(i) See: Private Letter Rulings 8142061 and 8545076 (an individual who permitted a withdrawal power to lapse with respect to a trust was treated, for income tax purposes, as having withdrawn the assets subject to the power and recontributed those assets to the trust as a grantor).

(c) In year two, if foreign daughter withdraws the "lapsed" funds from the trust then distributes those funds to U.S. daughter, the intermediary rules will not apply, since foreign daughter is now the grantor over those funds.

(3) An intermediary is disregarded if it is an agent of either the foreign trust or the U.S. beneficiary under general agency principals as set forth in Cm. v. Bollinger, 485 U.S. 340 (1988). Prop. Reg. 1.643(h)-1.

(4) There is a de minimus rule for distributions that do not exceed $10,000 per year in the aggregate.

(5) To prevent a potential abuse under the check-the-box regulations, a single owner entity will be treated as a corporation; therefore, a gift will be made by the entity and not the individual owner of the entity. Prop. Reg. 301.7701-2(c)(2)(iii).

b) These rules do not apply to a withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person (whether or not that person is a U.S. beneficiary).

(1) Planning points: If a foreign grantor has children living in the U.S. and other countries, the grantor should withdraw the income from the trust and make a gift to the U.S. beneficiary, rather than causing a trust distribution.

(a) Also, consider excluding the U.S. children as beneficiaries of the foreign trust. Gifts can be made to the U.S. children from the grantor or non-U.S. beneficiary children (subject to the

application of the intermediary rules to U.S. persons who are not U.S. beneficiaries).

(b) A non-U.S. beneficiary may be added to the foreign trust as an extra grantor, as a precaution against the original grantor's death, since the new grantor may continue to withdraw funds and pay them to U.S. persons as tax-free gifts.

6. EFFECTIVE DATE

a) The ownership rules will apply to transfers of property after February 6, 1995.

D. Residence of Foreign Trusts

1. PRIOR LAW

a) Under prior law, there was not an objective test to determine whether a trust was domestic or foreign.

2. CHANGES IN THE LAW

a) Under IRC Sec. 7701(a)(30) and (31), there is a two-part objective test to determine the residency of a trust. A trust is considered domestic if —

(1) A U.S. court can exercise primary supervision over the administration of the estate or trust ("court test"); and

(2) One or more U.S. fiduciaries have the authority to control all substantial decisions of the trust ("control test").

(a) These decisions include: (1) whether and when to distribute income or corpus; (2) the amount of distribution; (3) the selection of the beneficiary; (4) the power to make investment decisions; (5) allocation of receipts to income or principal; (6) whether to terminate the trust; (7) whether to compromise, arbitrate, or abandon claims of the trust; (8) whether to sue on behalf of the trust or defend suits against the trust; and (9) whether to remove, add, or replace a trustee. Temp Reg. 301.7701-7(e)(1)(ii)(A).

(b) The control test cannot be met if a trust is subject to automatic migration provisions in which fiduciary decisions would no longer be controlled by U.S. trustees if a governmental agency or creditor asserted rights against the trust. Temp Reg. 301.7701-7(e)(3).

b) A trustee may elect the application of these objective tests for the trust's tax year after the date of enactment. Notice 96-65 , 1997-52 IRB 28 contains the requirements for existing domestic trusts to retain their status. These requirements include —

(1) Modification of the trust to confirm to the new domestic trust criteria which must be initiated by the due date of the tax return for tax year ending after December 31, 1996 and must be completed within two years after that date; and

(2) Attaching the statement required under Notice 96-65 stating that the trustee is relying on the Notice and, in general, outlining the steps being taken to conform the trust to the new domestic trust criteria.

c) A trust which has automatic migration rules cannot meet the court test and, therefore, will be considered a foreign trust. This will occur when the trust instrument provides that if a U.S. court attempts to exercise jurisdiction over the trust, the trust will migrate from the United States. Prop. Reg. 301.7701-7(d)(2)(v).

3. OUTBOUND MIGRATION OF DOMESTIC TRUSTS

a) If a domestic trust changes its situs and becomes a foreign trust, there will be a deemed outbound taxable transfer of assets which occurs on the date of migration. IRC Sec. 679(a)(5).

(1) Note: The 35% excise tax under IRC Sec. 1491 which used to apply to the deemed transfer, has been repealed under the Taxpayer's Relief Act of 1997 for transactions after August 4, 1997.

(2) The U.S. grantor is required to report the transaction under the newly-enacted reporting requirements.

b) If a trustee, through an election, changes a domestic trust's situs to a foreign trust, the deemed outbound transfer will occur on the date of election.

4. EFFECTIVE DATE

a) The residency provisions are applicable to tax years beginning after December 31, 1996. A trust may make an irrevocable election to apply the provision to tax years ending after August 20, 1996.

b) The imposition of IRC Sec. 1491 to transfers to foreign trusts is effective on or after August 20, 1996. (IRC Sec. 1491 has been repealed for transactions after August 4, 1997).

E. Reporting Requirements

1. REPORTABLE EVENTS

a) A "responsible party" must file certain information reports when the following reportable events under IRC Sec. 6048(a)(3) occur —

(1) The creation of a foreign trust by a U.S. person;

(2) The transfer of money or property (either directly or indirectly) to a foreign trust by a U.S. person; and

(3) The death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules, or a portion of the foreign trust was includable in the decedent's gross estate.

b) Reportable events do not include transfers of assets to foreign trusts for fair market value, transfers involving deferred compensation or transfers to charitable trusts.

c) A responsible party includes the grantor of an inter vivos trust, the transferor of money or property (except at death) and the executor of the decedent's estate.

(1) Written notice of a reportable event must be given on or before the 90th date after the event.

d) Notice 97-34 contains lengthy requirements regarding the information to be reported. Generally, revised Form 3520-A will be used to report IRC Sec. 6048(a) transfers to foreign trusts.

2. GRANTOR TRUST REPORTING

a) A U.S. person treated as the grantor of a foreign trust under the ownership rules is responsible under IRC Sec. 6048(b) for ensuring that the trust —

(1) Files a return containing a full and complete accounting of trust activities, the name of the U.S. agent for the trust, and any other information the Secretary prescribes; and

(2) Furnishes other information that the Secretary of the Treasury may require regarding U.S. grantors or beneficiaries.

b) A U.S. agent needs to be appointed for accepting service of process for an IRS summons or request.

(1) If a U.S. agent is not appointed, then the Secretary of the Treasury, at his sole discretion, may determine the amounts of income under the grantor trust rules.

(2) The judicial review standard of the Secretary's discretion is "arbitrary and capricious," which gives the Secretary great latitude in exercising his discretion.

c) U.S. beneficiaries must report any distributions received from a foreign trust and the name of the trust.

3. PENALTIES FOR FAILURE TO FILE THE APPROPRIATE RETURNS

a) The penalty for failing to provide the required notice or return in cases involving the transfer of property to a foreign trust or the distribution from a foreign trust to a U.S. beneficiary is 35% of the gross reportable income.

b) If this information is not filed within 90 days of receipt of a notice to file from the IRS, an additional $10,000 penalty for each 30-day period is imposed.

c) If a U.S. grantor fails to ensure proper trust reporting, the penalty is 5% of the gross reportable income.

d) There is a reasonable cause exception to these penalties. Reasonable efforts to comply with the reporting requirements will constitute reasonable cause.

(1) This exception should apply when probate estates, or successor trustees, discover foreign trust assets after the 90-day period.

e) In no event will the total penalty amount exceed the gross reportable income.

4. EFFECTIVE DATE

a) The reportable events provision is effective for events occurring after August 20, 1996.

(1) The grantor reporting provisions apply to tax years after December 31, 1995.

(2) The beneficiary reporting provision apply to distributions received after August 20, 1996.

III. FOREIGN GIFT REPORTING

A. Prior Law

1. GIFTS WERE NOT TAXABLE OR REPORTABLE

a) Gifts of non-U.S. property by a foreign donor to a U.S. donee were not taxable nor reportable. The same was true for bequests from foreign sources.

B. Change in Law

1. GIFTS IN EXCESS OF $10,000 PER YEAR

a) U.S. persons (other than charities) that receive foreign gifts during the tax year totaling more than $10,000 may now be required to provide information to the IRS. IRC Sec. 6039F.

(1) Note: The draft legislation provided for the reporting of gifts in amounts over $100,000. This reduction to $10,000 will affect many donees. However, the IRS has retained the $100,000 threshold for gifts from individuals, but not from entities.

b) A U.S. person is a citizen or resident of the United States, a domestic partnership or corporation or any estate or trust (other than a foreign estate or trust). IRC Sec. 7701(a)(30).

c) The definition of a gift excludes qualified tuition or medical payments under IRC Sec. 2503(e)(2).

d) Also excluded are amounts distributed to a U.S. beneficiary of a foreign trust if such amounts are properly disclosed under the new reporting requirements.

e) The $10,000 annual limitation is adjusted for inflation for tax years after December 31, 1996.

2. DEFINITION OF A GIFT

a) A gift is any amount received from a donor who is not a U.S. person that is treated as a gift or bequest by the recipient.

(1) Note: Focus on the **donor**, not the location or source of the gift. The term "foreign gift" is deceptive.

b) Apparently included in this definition would be the creation of a joint tenancy in stock, although the creation of the tenancy must be treated as a gift by the recipient.

(1) Query: Would the creation of a joint tenancy by a non-resident alien who owns U.S. real property with his U.S. person daughter be a reportable transaction under this provision? In such a case, the donor made a taxable gift of U.S. real property and has the obligation to report it.

(2) Apparently, the creation of joint tenancies with foreign persons in which the U.S. person has received more than $100,000 in value are reportable transactions.

(a) For instance, if W, a non-U.S. resident or citizen, places real property in Country X worth $200,002 in joint tenancy with H, a U.S. citizen, the transaction is reportable as a foreign gift.

(b) Unlike real estate, usually the creation of a joint bank account is not considered a gift until the donee actually withdraws funds.

3. FAILURE TO PROVIDE INFORMATION

a) If the donee fails to provide the proper information, the IRS may determine the tax consequences of the transfer, subject to judicial review under the "arbitrary and capricious" standard (which provides a high degree of deference to the determination), and may impose a penalty of 5% of the gift amount for each month the information is not furnished.

(1) The penalty cannot exceed 25% of the gift amount.

(2) There is a good cause exception to these penalties.

4. REPORTING FOREIGN GIFTS

a) In Notice 97-34, the IRS announced that Form 3520 will be used to report foreign gifts on an annual basis.

(1) Generally, the identity of the donor will not be required, unless the donor is a partnership, corporation or a nominee for such an entity. A brief description of the property will be required.

(2) Foreign trust distributions to U.S. beneficiaries are reported under IRC Sec. 6048(c) and not as foreign gifts.

(3) Also, reporting is not required unless the U.S. donee knows, or has reason to know, that the donor is a foreign person.

5. EFFECTIVE DATE

a) These provisions apply to amounts received after August 20, 1996, in tax years ending after that date.