Report 12

A complete listing of the proceedings and speakers is available on **the Institute's Web site**

Thursday, January 8, 2004 (Continued)

Reporter: John Warnick Esq.

10:45 - 11:30 a.m.
Trust Classification Times Four
Robert C. Lawrence, III

Mr. Lawrence started out explaining that his talk will really be an overview, because of the time limitations, and that the real substance will be discussed during the workshop.

Reporter's Notes: The afternoon workshop really applied, in much greater detail, the rules which Mr. Lawrence touched on duriing his general session. Therefore, we are posting the afternoon session as part of these general session remarks.

Mr. Lawrence then asked why the foreign trust rules should be important to you if your practice is primarily a domestic practice. You may think it has no relevance to your practice. That is a mistake. The globalization trends are so strong that Mr. Lawrence believes in the coming years you will be faced with clients that have multinational holdings or multinational families.

Mr. Lawrence went back to the Roman empire to trace the development of "trusts" or entities similar to trusts. . He noted that these concepts have developed independently in Teutonic culture, Gallic culture and Anglo-Saxon culture. At the time of the French revolution they abolished their trust equivalent and when the Napoleonic code spread throughout Europe it contained no statutory form of trust. Instead the "usufruct" developed under French law. But starting in Liechtenstein after the First World War the trust concept has been recognized as the "treuhand".

So it is likely that when you first deal with the client that has an interest in one of these foreign trusts you will be dealing with a treuhand or some other hybrid arrangement. You will then have to put that foreign entity under the microscope of U.S. law and determine how it will be classified for U.S. tax law and apply our principles of law to tax them.

What is the U.S. tax definition of what is a "trust"? Under the Regulations the term "trust" refers to "an arrangement created under will or inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." The emphasis here is on the function of the trustee in protecting or conserving the property for the benefit of the beneficiaries.

What happens if your foreign entity doesn't meet the definition of a trust. You need to go back to the check the box regulations. If
you don't check the box, when that entity is analyzed 10 or 15 years later and the foreign entity is not regarded as a trust, then the default provisions for entity classification become applicable and it would be treated as a partnership if it had more than one member and at least one member does not have limited liability, or as an association taxable as a corporation if all members have limited

liability, or disregarded as an entity separate from its owner, if it has a single owner that does not have limited liability.

The existence of associates and the objective to carry on a business are the two attributes which case law has identified as being present in associations and partnerships. The absence of either attribute will cause an entity to be classified as a trust for U.S. tax purposes.

Mr. Lawrence noted that it is unusual to see a trust drafted in the U.K. that won't have powers clauses that permit the carrying on of business and that it is there mere existence of the power rather than whether it is actually being used to conduct a business that matters.

Once we determine that we are dealing with a trust we have to move to the second classification: whether the trust is a foreign trust or a U.S. trust. That classification will depend on whether we are dealing with pre-1996 or post-1996 law. The pre-1996 law had a totally useless definition and the courts ended up using a facts and circumstances test.

The post-1996 law requires that a trust meet two requirements to qualify as a U.S. trust: (1) a court within the U.S. must be able to exercise primary supervision over the trust's administration (the "Court Test"); and (2) one or more U.S. persons must have the authority to control all substantial decisions of the trust (the "Control Test"). If a trust fails to meet either of these requirements, it is a foreign trust for U.S. tax purposes.

Mr. Lawrence pointed out that having an arbitration clause in your trust will result in the trust being classified as a foreign trust because the Court Test would not be satisfied if a U.S. court wouldn't be able to exercise primary jurisdiction.

The regulations provide a safe harbor for satisfying the Court Test. A trust will satisfy the Court Test if (i) the trust instrument does not direct the trust be administered outside the U.S.; (ii) the trust is in fact administered exclusively in the U.S. and (iii) the trust is not subject to a flee provision. Bob Lawrence also pointed out that the flee cause doesn't flunk the Court test if it is limited to a foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S.

Mr. Lawrence pointed out that the regulations provide a list of substantial decisions for purposes of the Control Test. But that list doesn't include approvals of accountings, decisions to migrate, to borrow or lend, or to guarantee a loan to a beneficiary. And you have to be very careful that you don't lodge any substantial decision in anyone that isn't a U.S. person.

Mr. Lawrence feels this Control Test is a great thing from the U.S. point of view. The only problem is that the U.S. wanted an objective test and the Control Test can be very subjective. From a U.S. Trust company perspective this is a great marketing opportunity to foreign individuals because they can offer the stability and advantages of administration in the U.S. and so long as there is just one substantial decision lodged in a non U.S. person, the trust will be treated as a foreign trust for U.S. tax purposes.

Once the grantor dies, you may not want the trust to continue as a foreign trust. So if you have a U.S. trustee, you can easily migrate that trust into the U.S. upon the grantor's death if that is desirable. Bob Lawrence pointed out that there is a distinct advantage to having a U.S. trustee in these circumstances in terms of being able to migrate the trust into the U.S. His experience in transitioning a trust from a foreign trustee to a U.S. trustee indicates you need plenty of lead time to get this accomplished. He has seen it take up to two year time to migrate that trust into the U.S. upon the grantor's death. Since there are many potential tax consequences during this period, it may prove very advantageous to already have a U.S. trustee in place.

But Mr. Lawrence pointed out that out that what you need to take away from this is to be very careful of what powers you have in your trust instruments and to whom you give those powers, whether in a fiduciary capacity or in a non-fiduciary capacity. You have got to be very careful in drafting your domestic trusts and monitor the status of powerholders because they may leave the U.S. and it may change. You have a 12 month change in which you can cure an inadvertent change but if you don't cure that change then there may well be a change in the trust classification and the trust may become subject to the § 684 tax on transfers or there may be a different tax result.

The third area of classification is whether the trust is grantor or nongrantor. The grantor powers are found at § 673 to § 677. Prior to 1996, Rev. Rul. 69-70 provided that if you had a foreign grantor trust and there was no U.S. income in the trust, then the income of the trust would be taxable to the foreign grantor and there would be no tax on distributions to U.S. beneficiaries. The IRS didn't like this. The 1996 legislation changed all of this. We were successful in carving out a few exceptions. One of these is for a foreign trust that is revocable. The revocation has to be in the control of the foreign grantor and not in the control of the beneficiaries. The second exception is for a trust where the only distributions during the grantor's lifetime are to the grantor or the grantor's spouse. This exception permits an irrevocable trust and can provide assurances to the ultimate beneficiaries that the trust won't be subject to further change.

There is an important grandfather exception for trusts which were in existence in September 1995 but the trusts had to be classified as a grantor trust under § 676 and § 677(a)(1) and (2). There isn't symmetry between the grandfather provisions and what the current law is. To preserve grandfather status you have to be very careful about future contributions that are made to a grandfathered foreign grantor trust and make sure that is accounted for separately and in Mr. Lawrence's opinion segregated from the balance of the trust assets.

You also need to be aware of § 679 and 684. These will be covered in greater detail in the workshop.

Next he discussed the taxation of U.S. Beneficiaries of foreign non-grantor trusts. The beneficiary will be taxed on these distributions and there will need to be a return filed on Form 3520. One difference between the foreign non-grantor trust and domestic trust is that there is the possibility that the U.S. beneficiary will be taxed on realized capital gain in the foreign trust. DNI for the foreign grantor trust is enhanced by realized capital gains. If not all the income is distributed out in the year it is earned then we have UNI (undistributed net income). But it is important to note that the capital gain if it doesn't get completely distributed in the year of realization will be treated as UNI and there is a conversion of its character from capital gain to ordinary income so that in the year when it is distributed eventually to the U.S. beneficiary it will no longer be treated as capital gain but will be taxed as ordinary income to the U.S. beneficiary.

Mr. Lawrence also noted that in addition to the income tax imposed on UNI distributions made to a U.S. beneficiary, there is also a nondeductible interest charge imposed. A weighted average method is used to determine the period for which interest is charged with a different rate charged for accumulations through 1995 and a floating rate determined under § 6621 applied to accumulations after 1995.

Mr. Lawrence also noted that it is important to plan and draft for the possibility that the foreign trust could receive a step-up in basis upon its assets upon the death of its grantor. This will significantly reduce what the tax might be if that trust is converted to U.S. trust status after the grantor's death. Some people think that it is useful to keep the foreign trust offshore after the grantor's death. But it doesn't provide much flexibility if you don't have distributions for a long, long time. You have to be very careful if you have a client that is a beneficiary of a foreign trust and there are accumulations. You have to plan for the distribution of those accumulations. It is a rather complicated exercise because often these accumulations.

Mr. Lawrence mentioned that he wanted to briefly mention the problems associated with ownership of foreign corporations held by foreign trust. You have to look to see what your entity structure is and how you will migrate this trust and/or deal with the accumulations in the trust or the corporation.

Mr. Lawrence concluded with a summary of the usufruct, the treuhand, the stiftung and the anstalt. The treuhand is not a testamentary document. It has to be intervivos but it can extend beyond the death of the transferor. It is a third party beneficiary form of ownership. There is no third party beneficiary form of enforcement. The stiftung is primarily for charitable purposes. The anstalt is used for commercial purposes. You still have to go through the same classification routines with these entities where you will first have to determine if it is a trust or an association, then presuming you find it is a trust you will have to determine if it is foreign trust or a U.S. trust, then you will have to consider whether it is a grantor trust or a non-grantor trust. Finally, once you have identified what you are dealing with then you will have to analyze the income and transfer tax consequences of the arrangements and what reporting requirements it is subject to.

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Special Sessions IV Workshop - Thursday afternoon.

Session IV-D - Foreign Trusts

Robert C. Lawrence, III
Jane Tse
Dina Kapur Sanns
Cadwalader, Wickersham & Taft

Note: The examples are shown in italics.

Ellen, a U.S. citizen, lives in London with her husband, Jean-Marc. Ellen and Jean-Marc have three adult children who are U.S. citizens. Ellen is the sole shareholder of a U.K. corpo*ration which is in the business of exporting textiles, El- Jean Holdings. On August 10, 1999, sells her El-Jean Holdings shares to Jean-Marc for cash. At the time of the sale the shares are valued by an independent appraiser at $100,000. On Sept. 19, 1999, Jean-Marc creates and funds a trust with the El-Jean Holdings shares known as the El-Jean Holdings Trust. On February 5, 2000, the El Jean Holdings Trust sells the shares to an unrelated corporation for $200,000. At the same time that Jean-Marc created the El Jean Holdings Trust he creates a second foreign trust, called the Last Resort Trust, with a nominal amount of cash from his personal bank account. The Last Resort Trust is an irrevocable, discretionary, sprinkle trust for the adult children. The El-Jean Holdings Trust is an irrevocable discretionary trust for the benefit of Ellen and Jean-Marc but it provides that upon the first to occur of the death of Jean-Marc or the divorce of Jean-Marc and Ellen, the trust will terminate and be distributed to the Last Resort Trust. Until such triggering events, however, the trustee may, in its sole and absolute discretion, pay or apply the income or principal of the El-Jean Holdings Trust to or for the benefit of Jean-Marc and/or Ellen, to the exclusion of either one of them.*

The trustee of both trusts is a foreign trust company but Jean-Marc may replace the trustee with any other trustee.

1 (A) *What is the classification of the El-Jean Holdings Trust and the Last Resort Trust for U.S. income tax purposes? Are they a grantor or non-grantor trust as to Jean-Marc or Ellen?*

Jane responded to this question by analyzing whether Jean-Marc would be treated as a grantor of the trust. Let's assume the August 10, 1999 sale was made for adequate and full consideration and that Jean-Marc is really the sole contributor of assets to the El-Jean Holdings Trust. Will Jean-Marc be treated as the owner of the El-Jean Holdings Trust for Subpart E of Subchapter J of the Internal Revenue Code. Jean-Marc won't be treated as a grantor/owner of the El-Jean Holdings Trust under § 672(f)(2) of the IRC because it doesn't fit within any of the three exceptions. Jean-Marc can't revoke and revest the assets of the trust in himself, either by himself or with anyone else's consent. It is also possible that income or principal could be distributed during Jean-Marc's lifetime to his children if he and Ellen divorced. Distributions from the trust won't be taxable as compensation to Jean-Marc. So none of the three exceptions apply and the trust isn't subject to the grandfathering rule either since it was executed after September 19, 1995.

Dina responded to this question by analyzing whether Ellen would be treated as a grantor of the trust. Ellen could be viewed as the grantor under IRC § 679 of the El-Jean Holdings Trust if she were viewed as having made an "indirect" contribution to the trust through Jean-Marc if the fair market value exception were not made. So if the shares were really worth $200,000 at the time Ellen sold her shares to Jean-Marc, then she would be treated as the owner of 50% of the El-Jean Holdings Trust because she will be viewed as having made an indirect contribution through Jean-Marc for the portion of the value for which she didn't receive adequate consideration. It should be pointed out that these transfers took place prior to August 8, 2000, the effective date of the regulations that introduced the intermediary rule under § 679. Those intermediary rules have a very broad application. They basically provide that if a U.S. person transfers property to a foreign trust through an intermediary with a tax avoidance purpose then § 679 applies. But because these transfers took place prior to August 8, 2000 the only way that Ellen can be deemed to be the grantor in our example would be if in fact the shares were worth more than the consideration she received from Jean-Marc.

Mr. Lawrence pointed out, however, that there was an independent appraisal. It would appear that this appraisal should hold up. But there could have been some intervening event between the initial sale and the second sale that is responsible for the appreciation. If that were the case, then Ellen would not be the grantor.

Mr. Lawrence pointed out that transfers between family members frequently take place informally and without the benefit of an independent appraisal which makes it troublesome to be able to rely on the adequate consideration exception.

1 (B) *Assume the same facts but with the modification that the transactions all take place a year later*.

Dina explained that in this variation of the facts the transfers have fallen on the other side of the effective date of the § 679 regulations which will bring the intermediary rules into play.

Mr. Lawrence asked Jane to explain why the $100,000 gift tax exclusion under 2503(b) as some bearing on the first example. Jane noted that there is an exception to § 672(f)(5) for gifts which are covered by the annual exclusion under 2503(b). Thus, if there was a gift transfer to Jean-Marc and the fair market value exception did not apply, this transaction still wouldn't be covered by § 672. Jane also pointed out that the annual exclusion is increased to $100,000 (adjusted for inflation now to $114,000 if I understood her correctly) if the donee spouse is not a U.S. citizen.

Dina, however, noted that the annual exclusion exception does not apply to § 679. So in the second variation where the transfer by
Jean-Marc took place after August 7,2000, the annual gift tax exclusion would not keep the transaction from being covered by the intermediary rules.

Mr. Lawrence: What are the U.S. income tax reporting requirements applicable to Jean Marc or Ellen upon the creation of the trust, if any?

Dina: Ellen would be the grantor/owner of 50% El-Jean Holding Trust. She would have to report the transfer to the trust on Form 3520. If the intermediary rule applied then she would be deemed to have made the transfer to the trust when Jean-Marc made the transfer. The Trust would also have to annually file a form 3520A and provide Ellen with a Foreign Grantor Trust statement so she could properly report 50% of the income from the trust on her income tax return. If she failed to do so, the penalty would be 5% of the assets deemed to be owned by her. She would also have to make sure that the trust provided each U.S. beneficiary with a Foreign Grantor Trust beneficiary statement so they could properly report as well.

Jane: On the other hand, if under the first set of facts Jean-Marc were treated as the sole contributor to the Foreign Trust there is no reporting requirement for Jean-Marc upon the formation and funding of this trust. However, if the trust subsequently makes distributions to Ellen the trust will have to furnish her with a Foreign Trust beneficiary statement and Ellen would have to report the income which she received as a result of the distributions to her. If she fails to report, there would be a penalty as to 35% of the gross distribution.

Mr. Lawrence: If the sale of the El-Jean Holding Company shares to Jean-Marc were for fair market value, there would have been no reporting requirement for Ellen in our first variation. Likewise, if But if Ellen were required to report the transfer to the trust on a Form 3520 and she failed to report, there is a penalty of 35% of the initial value of the assets transferred.

Mr. Lawrence: What the analysis change if Ellen sold the shares to Jean-Marc for a note payable in three years. This gets into the qualified obligation issues.

Jane: § 679(a)(3) But the regulations say that you take any obligation from a grantor/owner or beneficiary of the trust shall not be taken into consideration unless it is writing and the term is for less than five years and it is denominated in U.S. Dollars and the yield is not more than 130% of the AFR. If it meets the "qualified obligation" then it will be taken into consideration. Jane pointed out that if there is a valuation problem, the qualified obligation would only work as to 50% of the transaction and would still leave Jane being treated as the owner of 50% of the trust.

Question: In the example it states that Jean-Marc can remove and replace the trust. Isn't it conceivable that he could thereby appoint himself as trustee and make a distribution to himself or Ellen of all the assets of the trust. Wouldn't this cause a problem.
Jane: This is a very good question and you have picked up on one of the important points in our

example. However, as to a foreign person the revocation power has to be held by Jean-Marc. It isn't sufficient that he can remove and replace the trustee. Even if he holds the power and it is subject to the consent of an independent trustee, who he can remove and replace, that will not be enough. He must hold the power to revoke or hold it subject only to the consent of a related or subordinate party.

Mr. Lawrence: And who is in fact subservient to him.

Dina: The point here is that what is sufficient under 676 for domestic trusts doesn't work under 672 (f) for foreign trusts.

Question: If under governing law Jean-Marc's creditors could reach the trust, even that wouldn't be tantamount to a general power of appointment.

Panel: True.

Question: These penalties are quite severe and up until a year ago we had been successful in getting the IRS to abate these penalties where CPAs are overlooked the reporting requirements.

Mr. Lawrence: I haven't seen any change particularly. The IRS seems to be relatively understanding especially when there is an intent to comply and the taxpayer is coming forward voluntarily and saying Mea Culpa.

Question: What happens if the foreign spouse, because of laws in their own jurisdiction, gives property to the U.S. citizen who then contributes it to a foreign trust that was grandfathered.

Mr. Lawrence: First, the U.S. spouse will have certain reporting requirements once they receive a gift from their foreign spouse. Second, the U.S. spouse would be a grantor as to that portion of the foreign trust which is attributable to the contribution by the U.S. spouse. If that property were commingled and there isn't separate accounting, that would taint the trust and destroy the grandfather status of the foreign trust.

Question: If it was separately accounted for, could you preserve the grandfather status?

Mr. Lawrence: I would actually keep it separate. But you must account for it separately. But I would advise the trustee to keep it entirely separate.

Question: Would this be a U.S. trust or a foreign trust.

Dina: You are going to have to go back to the Court Test and the Control Test to make that determination.
Question: If the trust is amendable by the trustee during the lifetime of the U.S. citizen and the foreign spouse but by its express terms its income can only be paid to the U.S. citizen and the foreign spouse, is there a problem?

Mr. Lawrence: Yes, there is a problem. The second exception is a mandatory requirement. It doesn't permit any possibility of alternation.

Dina: The way to get around this problem is to limit the power to amend in the trustee's hands to provide that it can only be amended to benefit the U.S. citizen and the foreign spouse.

Jane: U.K. Trusts almost always have that power in the trustee.

Question: In Canada it is fairly typical to have the trust established not by the family itself but by a family friend who puts in $100. I feel that the family friend is merely a nominee.

Mr. Lawrence: The initial seed funding would leave that person as a grantor and owner as to their contribution but if the family then contributes $1,000, that person would not be grantor as to that additional contribution. This desire for confidentiality drives this. Sometimes the institution can be the grantor.

1 (C) *Assume the facts as above except that Ellen sells the shares to Jean Marc on August 10, 2000 and then Jean-Marc, rather than the trust, sells them on February 5, 2001 to a third party for $200,000. Jean-Marc then purchases marketable securities which he contributes to the El-Jean Holdings Trust two years later. Would there be any change in the outcome or analysis.*

Jane: It doesn't matter that Jean-Marc is contributing other assets to the trust other than the assets which were originally transferred to him by Ellen. The analysis under 679 doesn't change.

Mr. Lawrence: Another problem we might focus on is what happens if Jean-Marc purchases U.S. stocks with the proceeds of the sale of the El-Jean Holdings stock. That raises a very serious problem. Under § 2104 if the asset is situated in the U.S. at the time of transfer or time of death, then § 2036 or § 2038 applies and those assets will be taxable in the estate of Jean-Marc. If Jean-Marc contributes assets to the trust which are subject to § 2036 or § 2038, then that puts a taint on that trust as to those assets and if they grow to be worth $20,000,000 15 years later that $20,000,000 would be included in Jean-Marc's estate and § 2104(b) would apply. The only way around it is to terminate the trust and start over. I'm not aware of any other way to solve that problem.

1 (D) *Assume the same facts except that Ellen sells the shares to Jean-Marc on August 10, 2000 and he contributes them to the trust on September 19, 2000 and the trust sells them on February 5, 2001 for $100,000 rather than $200,000. Also, assume that Jean-Marc can revoke the trust but only with the consent of the trustee and the trustee would consent to the revocation because otherwise Jean-Marc would remove the trustee. Does the analysis change?*

Dina: Even though the transfer takes place after the effective date of the § 679 intermediary rules, we are assuming that the fair market value exception is met. So here it is clear that Ellen is not the grantor but that Jean-Marc is the grantor of the trust. The issue is whether the trust is a grantor trust as to Jean-Marc. As Jane explained earlier, there is a chance that the trust could terminate during Jean-Marc's lifetime and be distributed to the Last Resort Trust. So the question here is whether the revocable trust exception is met. Even though Jean-Marc can revoke the trust it is subject to the consent of the trustee and the trustee's powers are not attributed to Jean-Marc. Therefore, the revocable trust exception is not met.

The next example asks if the analysis would change if Jean-Marc removed the trustee and appointed a trustee who is related and subordinate to Jean-Marc. The answer is no because there is a special rule under the revocable trust exception regulations which says that once a trust is tainted for purposes of the revocable trust exception it is tainted for all other years. So even though now the trustee is related and subordinate it is still tainted and will continue to be tainted.

Mr. Lawrence The next example asks if the analysis would change if Jean-Marc names a related or subordinate trustee at the outset. And here the answer is yes, the analysis does change. Because in this example from the outset the trustee is a related or subordinate trustee so it would constitute a grantor trust as to Jean-Marc trust.

1 (E) *Assume the same facts as above except that Ellen sells the El Jean Holdings shares to Jean-Marc on August 10, 2000; he contributes them to the trust on September 19, 2000; and the trust sells them on February 5, 2001 for $100,000 (not $200,000). Assume further that the trustee of the El Jean Holdings Trust may exclude and add beneficiaries in its complete and absolute discretion. In 2004, Ellen and Jean-Marc move to New York City but leave their children behind. Prior to such move the trustee executes a deed excluding Jean-Marc and Ellen as beneficiaries of the El Jean Holdings Trust and adding their adult children as beneficiaries. October 30, 2004, Ellen and Jean-Marc move to New York City and in the process Jean-Marc obtains a green card.*

Jane: Here we are trying to illustrate the preimmigration rules of § 679(a)(4). Because Jean-Marc's immigration starting date is within five (5) years of the transfer to the El Jean Holdings Trust, he would be treated as the owner of the trust under § 679.

Mr. Lawrence. If there is accumulation income inside of this trust on the starting date of his immigration status, that income will be attributable to him and treated as being a portion of the trust owned by Jean-Marc but it would not be immediately taxable to him in that year.

Would the analysis change if the adult children were nonresident aliens?

Jane: It wouldn't change the analysis under these facts because the trustee still has the power to add beneficiaries and could add U.S. beneficiaries at any time.

Mr. Lawrence: There were a lot of abuses in this area. There would be an arrangement there would be no U.S. beneficiary during the lifetime of the grantor. Then miraculously after a year the trustee would add the grantor's children as beneficiaries. Mr. Lawrence was never comfortable with this but now it is absolutely clear this won't work.

Would the analysis change if the adult children were nonresident aliens and at the same time the trustee excluded Jean-Marc and Ellen as beneficiaries, it irrevocably released its powers to add future beneficiaries?
Would the analysis change if Ellen and Jean-Marc move to New York City on October 30, 2005?

Jane: Yes, the analysis would change because now the residency starting date would be more than five years after the transfer by Jean-Marc to the El Jean Holdings Trust.

1 (F) *Assume the same facts as in E except that after moving to New York City, Ellen and Jean-Marc stay for a period of time and then return to London on November 1, 2007.*

Would the analysis change if the trustee exercises its power to add Ellen and Jean-Marc as beneficiaries and exclude their adult children as beneficiaries and at the same time irrevocably releases it powers to add or exclude beneficiaries prior to Nov. 1, 2007?

Dina: This is illustrating the application of § 684. The only reason Jean-Marc was treated as the owner of this trust while he was in the U.S. was because § 679 applied. But when he moves out of the U.S. and becomes a foreign person again, § 679 will no longer apply. This would create a § 684 event and he would be treated as transferring all of the assets to the trust in a taxable sale immediately prior to becoming a foreign person.

Would the analysis change if the trustee distributes the trust fund to another trust which is created by Jean-Marc for the same beneficiaries but over which Jean-Marc retains the power to revoke prior to Nov. 1, 2007?

Dina: Yes, this would change the analysis because the second trust would meet the revocable trust exception and would be treated at all times as a grantor trust. Thus, when the transfer takes place prior to Jean-Marc leaving the U.S. we have a grantor trust to grantor trust transfer and this will avoid the § 684 problem. But note that this technique is only available before 2011. § 684 has now been amended for years starting after 2010 to only apply if the grantor/owner is a U.S. person.

Question: We have had a couple of sessions dealing with the five U.S. jurisdictions which offer asset protection. Do you feel there is a continuing advantage to going offshore strictly from an asset protection trust.

Mr. Lawrence: I think you are really talking about creditor protection trusts. I consider true asset protection trusts the types of trusts which were created to protect assets in the event of invasion such as those we created for Kuwaiti citizens before the Iraqis invaded Kuwait in the early 1990s. I find the idea of trying to avoid your creditors morally repugnant. But in terms of analysis, you have to look first at your local law. I don't think that there is any reason to take a domestic trust and tainting it "foreign". When you are dealing with a foreign jurisdiction there are more hurdles to overcome than when you are dealing with a domestic jurisdiction. You have the full faith and credit clause. You don't have those issues with a foreign jurisdiction.

The questioner responded to the moral issue by discussing what he perceived to be a "tort crisis" in the U.S. and pointed out the example of the Rhode Island nightclub fire where any deep pocket is being pulled into the litigation on a joint and several liability basis even though many of them have no moral culpability for the tragedy.

Mr. Lawrence agreed that the proliferation of contingent fee litigation has gotten out of hand.

Question: If you have a problem getting the form 3520A out of the foreign trustee, does the U.S. beneficiary have any standing to file a 3520A on their initiative to avoid the penalties. Bob Lawrence responded that you have a major problem on your hands and the IRS can determine that any distribution is all ordinary income. Jane pointed out that the penalty is actually imposed on the U.S. owner so ultimately the U.S. owner has significant incentives to cause the foreign trustee to act.

Dina: The 3520A is only relevant if you have a U.S. owned foreign grantor trust. If it is a true foreign grantor trust or foreign non-grantor trust then it doesn't have to file the 3520A but it does have to provide the U.S. beneficiary with a beneficiary statement.

II. After moving to the U.S. and obtaining a green card, Jean-Marc learns of the death of his aunt. At the same time Jean-Marc and his siblings learn of a Cook Islands trust established for their benefit by their deceased aunt during her lifetime. Assume that the trust is, and has always been, a foreign non-grantor trust which provides for the division of the trust funds into equal shares on a per stirpital basis for the grantor's nieces and nephews. Each share is held in a separate sub-trust for the individual for whom it was set apart and such individual's lineal descendants. The separate sub-

trusts are discretionary, sprinkle trusts and the trustee may, in its sole and absolute discretion, pay or apply the income and/or principal of the sub-trust to or for the benefit of any of all of the beneficiaries thereof to the exclusion of any one of them. Jean-Marc has a sister and a brother. The brother has been physically present in the U.S. for several years and is treated as a U.S. resident for U.S. federal income tax purposes. The sister is a French resident living in London. The brother has three children, who were born in the U.S. and are U.S. citizens. None of Jean-Marc nor any of his siblings were aware of the existence of the trust prior to their aunt's death. none of them of any of their issue have ever received distributions from this trust. The trust's sole asset is shares of a New Zealand holding company valued at $38 million and the trust has a $0 basis in those shares. The New Zealand holding company has accumulated earnings and profits of $12 million and has never declared a dividend. The New Zealand holding company declares a dividend of its accumulated earnings and profits.

(A). Analyze the U.S. federal income tax consequences and reporting requirements, if any, applicable to the U.S. beneficiaries of the trust as a result of the receipt by the trust of such dividend.

Jane: There is a two level analysis here. First we to determine if the New Zealand holding company is a CFC, a FPHC or a PFIC.
Here there are three separate trusts. Two of these trusts are for the benefit of U.S. persons: Jean-Marc and his brother. We reach that conclusion through attribution. But since 50% of either the vote or value of the New Zealand holding company is owned (through attribution) by U.S. shareholders, this company meets the definition of a CFC. The New Zealand holding company would also be a FPHC because more than 50%, by vote or value, of the outstanding stock is owned by or for not more than five individuals who are U.S. citizens or residents. Again by attribution we would have Jean-Marc and his brother both treated by attribution as owning more than 50% of the stock. The test for the PFIC doesn't look to ownership but rather to the source of the company's income. In our example we are assuming that all of the sources of income of this holding company are passive. Therefore, we meet all three of the definitions.

Mr. Lawrence: That is not a good result. Is there some sort of prioritizing.

Jane: In this case Jean-Marc and his brother don't own this stock directly but rather through discretionary trusts. The rules are not very clear on whether the beneficiaries are actually taxed on the income of the companies where there is a discretionary trust.

Dina: I think the CFC rules take precedence over the rules. Under the CFC rules you look not only to direct and indirect ownership but also to constructive ownership. But for CFC income purposes, the constructive ownership rules are ignore. For purposes of CFC income you look only at direct and indirect ownership. If we look at indirect ownership we have two trusts, each of which owns 33.3% of the New Zealand holding company. There are four beneficiaries of each trust. Each beneficiary would be deemed to own approximately 8.2% of the company through indirect ownership. However, that assumes that each of these beneficiaries have fixed entitlements under the trust. And as Jane pointed out these are fully discretionary trusts and there have been no distributions made to date. So it would be very hard to determine which of the beneficiaries is stuck with CFC income so we would argue that for income inclusion purposes it would be inequitable to tax any beneficiary until there has been a pattern of distributions established. But it isn't clear-cut how you allocate income when you are dealing with a discretionary trust.

Mr. Lawrence: If there is a fixed interest trust, on the other hand, I think there is a much more difficult argument to be made. Think about this. This is really unfair. The income that is being earned at the lower corporate level is being imputed up to the beneficiaries and taxed to them even they don't get the income nor have any right to the income. The position that our government is taking under the regulations is really unfair. I wonder if a court could be persuaded that the equities here are being overlooked and that the regulations should be upheld.

Question: This is more of a clarification but in the example it doesn't indicate that the New Zealand holding company has any related party "trading" or "service" income nor does indicate that it has personal holding company passive income, so we don't know whether the company has any so-called "bad" Subpart F income. The questioner pointed out that it is clear that it is a CFC. But if it doesn't have Subpart F income then you still have to deal with the PFIC rules. You do have the QEF election but my question is if this is a foreign nongrantor trust and there are no distributions, then how does the QEF election interface with the throwback rules when the trust finally makes a distribution?

Dina and Jane: The U.S. beneficiary, rather than the trust, makes the QEF election. Once the QEF election is made the company doesn't have to make a distribution the income is deemed to be distributed.

Jane: In our example it is to late to make a QEF election because that QEF election has to be made in the first year of the U.S. shareholder's holding period.

(1) *Assume the same facts as above except that the trust is a discretionary sprinkle trust for the grantor's nieces and nephews and their lineal descendants instead of three separate sub-trusts.*

Bob Lawrence: If you move from separate trusts to a pot trust, if you do have UNI up at the trust level you can make a stripping distribution to foreign beneficiaries of the UNI and then in later years make distributions in later years to the U.S. Beneficiaries. I see nothing in the regulations which would prohibit that.

Jane: In this variation we were trying to illustrate if the trust is a discretionary trust it is even more difficult to determine if the New Zealand holding company are a CFC, PFIC or FPHC. There would be better arguments that the New Zealand holding company is not a CFC or FPHC and there is no income inclusion.

(B) *Assume the same facts as above except that the New Zealand holding company does not declare a dividend and instead the trustee sells its shares to a third party.*

Dina: If we take the position that we have a 10% shareholder of a CFC, the sale to the third party would be an indirect disposition under the PFIC rules. But in our example the 10% ownership only through constructive ownership, so while the statute seems to capture this it isn't clear and even if PFIC did apply the similar facts and circumstances test is used to ascertain the ownership and we would argue it is not ascertainable.

1. *Would the analysis change if local law requires capital gains of the trust to be allocated to principal and the trust only provides for discretionary income distributions for the next one hundred years?*

Dina: The argument would be even more compelling if the capital gain were allocated to principal and the trust only provided for income distributions for the next 100 years because the beneficiaries would have no prospect for ever receiving any of the capital gains from that sale.

(C) *Assume the same facts as in (B) above except that after such sale, the trustee reinvests the sales proceeds of the trust through an underlying holding company*.

1. *Analyze the U.S. federal income tax consequences and reporting requirements, if any, applicable to the U.S. beneficiaries as a result of the trustee reinvesting the sales proceeds through another holding company wholly-owned by the trust.*

Jane: In (C) we are assuming that the CFC, PFHC and PFIC rules do not apply and that the beneficiaries are not subject to tax under those regimes. In this case the trust would realize the gain at the trust level and it would be DNI that year and in subsequent years if not distributed it will be UNI. If the trustee continues to reinvest the sales proceeds through an underlying holding company they will continue to be problems with CFC, PFHC and PFIC. So we don't recommend that. Instead, we would suggest the new holding company make an election to be a disregarded entity for U.S. tax purposes. In that case we would eliminate the problems with PFHC, PFIC and CFC. Nevertheless if not distributed there will still be a problem for the beneficiaries down the line. So we prepared these charts in the supplement to illustrate the difference between distributing 50% of the income annual with catch up distributions in year 10 and 20 versus making distributions of 100% of the income annually

Would the analysis change if the new holding company had an election in effect to be treated as a disregarded entity for U.S. tax purposes?

Would the analysis change if the holding company distributes 50% of its current earnings to the trust each year, and the trust in turn distributes the same to its beneficiaries an din years 10 and 20, the holding company distributes all of its current and accumulated earnings to the trust and the trust in turn distributes the same to the beneficiaries.

Jane: There is a rule under 665 that there can never be an accumulation distribution in a year where the distribution does not exceed fiduciary accounting income. If the company makes a distribution of $26.8 million to the trust in the tenth year, even though that amount exceeds the DNI for that year the beneficiary will not be treated as receiving an accumulation distribution but rather will only be taxable on the DNI distribution in that tenth year which is $5.8 million.

Dina: So this rule lets you transfer more than $26 million of value to the beneficiary with the beneficiary only being subject to tax on the $5.8 million of DNI.

Jane: What we are basically doing in this example is allowing the trust to accumulate income and then permitting the trustee to distribute that accumulated income to the beneficiaries without any tax consequences.

Mr. Lawrence: It is much more favorable then if there would general distributions of all DNI ever year. Obviously this foreign stuff is very complicated. It is like multi-dimensional chess.

Would the analysis change if the holding company distributes 100% of its current earnings to the trust each year, and the trust, in turn, distributes the same to the beneficiaries? The chart illustrates the superiority of the 50% distribution.

Analyze the U.S. Federal income tax and reporting requirements, if any, applicable to U.S. beneficiaries who receive distributions of the earnings (current and accumulated) of the holding company which are distributed to the trust. The panel ran out of time and didn't cover this.

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