Transformation and Transparency - The Current State of the Offshore Trust

U.S. Issues

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1. Introduction

Due to increased reporting obligations, virtually every activity relating to the remittance or holding of assets overseas must be reported by U.S. citizens and residents to the Internal Revenue Service. Furthermore, such reporting, in virtually every case, is coincident with enhanced tax liabilities. The reporting obligations are designed to counter the effectiveness of foreign secrecy and confidentiality laws, and to penetrate offshore institutions to obtain information on U.S. account holders.

2. Objectives

The typical objectives sought to be achieved include:

2.1 Income tax minimization considering both U.S. and foreign income tax exposure;

2.2 Estate and gift tax mitigation, again keeping in mind both U.S. and foreign tax exposure;

2.3 Flexibility and ease of operations;

2.4 Asset protection;

2.5 Confidentiality;

2.6 Estate planning.

In each case the relative weight to be afforded for each of these objectives will vary. That is, each client's needs will differ in this regard depending on his or her individual objectives.

3. Jurisdictional Alternatives — The appropriate jurisdiction must also be considered for planning purposes. For example, one must consider if it is necessary to take advantage of a tax treaty country or if it is preferable to base operations in some other offshore jurisdiction.

4. Individual Residency Rules

4.1 U.S. citizens and resident alien individuals (“U.S. Persons") are generally subject to U.S. income tax on their worldwide income.[1]

4.2 Resident Aliens: Under Code §7701(b) a foreign national who is either a lawful permanent resident of the United States or who satisfies the substantial presence test generally will be treated as a resident alien.

4.2.1 Lawful permanent residence ("green card test"): A foreign national is a resident if he holds a "green card"; i.e., a permanent residency permit issued by the U.S. Immigration and Naturalization Service.

4.2.2 Substantial Presence Test: The Substantial Presence Test is a mechanical test determined on a calendar year basis:

4.2.2.1 Under the Substantial Presence Test one is a resident if:

4.2.2.1.1 Such individual is present in the United States for 183 days or more during the calendar year in question or

4.2.2.1.2 Such individual is present in the U.S. for at least 31 days during the calendar year in question and the sum of the days spent in the U.S. during the current calendar year plus one-third of the days in the immediately preceding calendar year plus one-sixth of the days in the second preceding calendar year equals or exceeds 183 days.

The test is applied on a year-by-year basis.

4.2.2.2 Days excluded from formula: Certain individuals are exempt: e.g., certain teachers and trainees (J Visa), students engaged in a full course of study (F Visa), professional athletes present in the U.S. to compete in a charitable sports event, foreign government-related individuals, and those unable to leave the U.S. because of a serious medical condition that arose while present in the U.S. The right to exclude days of physical presence in the United States for a teacher, trainee, student or foreign government-related individuals extends to the individual's immediate family.[2]

[1] Code §61(a); Treas. Reg. §1.1-1(b).

[2] Code §7701(b)(3)(D)(i) and (b)(5).

4.2.2.2.1 Specifically, in this regard, a professional nonresident alien athlete can exclude the days present competing in a charitable sports event in the U.S.[3] Note that not all charitable sporting events qualify under the rule. In order to qualify, the event organizers must: (1) have organized the event for the primary purposes of benefiting an organization qualified under Code §501(c)(3); (2) contributed all of the net proceeds to that organization, and (3) provided volunteers to perform substantially all of the work. In addition, days of practice time and travel time are not excluded even if the practice time is devoted to promoting the event.[4]

4.2.2.2.2 This exemption applies only to professional athletes and does not apply to amateurs. Also, members of an immediate family of a professional athlete present in the U.S. during a period of exemption for the athlete, are not themselves exempt.

4.2.2.3 Exceptions to the substantial presence test:

4.2.2.3.1 Closer connection exception: An individual present in the U.S. less than 183 days during the calendar year in question can avoid residency status if it can be established that the individual has a closer connection with a foreign country than the U.S., a tax home in a foreign country, and does not have an application pending for residency status in the U.S. or taken any steps to apply for such permanent residency. Code §7701(b)(3)(B).

4.2.2.3.2 Treaty Relief: When an alien individual would be classified as a resident by two countries party to a treaty, the individual will usually find that the applicable treaty applies so-called tie-breaker tests so as to make him or her a resident in only one of the two countries for treaty purposes.

Generally, if the individual has a permanent home available to him in only one of the countries, that individual will be deemed resident only in that country in which he has the

[3] Code § 7701(b)(5)(A)(iv).

[4] Treas. Reg. §1.7701(b)-3(b)(5).

home. If the individual has a home available to him in both countries, or in neither country, a series of other tests are applied.

It is important to remember that relief from classification as a U.S. resident under a treaty tie-breaker test applies only for treaty purposes. The extent of relief therefore depends, in part, on the individual treaty in question. Where non-income tax items are at issue, the individual will generally be regarded as a resident for U.S. tax purposes. Thus, for example, even when an individual is deemed a non-resident for treaty purposes, that person must nevertheless file a Form 3520 if a foreign trust is established and the individual is otherwise required to file the form. In addition, the individual may be regarded as a U.S. shareholder in deciding whether a particular foreign corporation is a controlled foreign corporation, but, depending on the treaty, the individual may not be taxable on his or her share of the corporation's income that would otherwise be taxable.

4.2.2.4 Election to be Taxed as a Resident: An individual may have the option to "elect" to be treated as a U.S. resident in certain cases.

4.2.3 Starting and Ending Dates for Residency

4.2.3.1 Green Card Test. The starting date for an alien who becomes a U.S. resident by operation of the green card test begins residency on the first day of physical presence in the U.S. after obtaining the green card provided the individual was not a U.S. resident during the prior year. The ending date is the first day during the year that the individual is no longer a lawful permanent resident, provided that the individual is able to establish a closer connection to a foreign country during the remainder of that year and the individual is not a resident of the U.S. in the succeeding year.[5]

4.2.3.2 Substantial Presence Test. The residency starting date is the first day the individual is physically present in the U.S. during the calendar year in question, provided the individual was not a resident in the prior year. Presence in the U.S. for ten days or less is disregarded, however, if the individual can establish that during such period he had a closer connection with a foreign country.

[5] Code §7701(b)(2)(B).

4.2.3.3 If both the substantial presence test and the green card test apply, the earlier starting date and the later termination date are used.

5. Foreign Trusts Established by Non-U.S. Persons for the Benefit of U.S. Persons:

5.1 A trust is generally regarded as a separate taxable entity for U.S. tax purposes. The grantor of a trust will be treated as the owner of trust assets for income tax purposes, however, where the grantor retains certain rights with respect to the assets of the trust. These rules are referred to as the "grantor trust rules".[6] If the grantor is treated as the owner of the assets of a trust under the grantor trust rules, distributions from the trust to a beneficiary may, in appropriate circumstances, be regarded as nontaxable gifts from the grantor to the recipient rather than as taxable distributions from trust income.

5.2 Subject to certain exceptions, Section 672(f) of the Internal Revenue Code provides that the grantor trust rules can only be applied to cause a person to be regarded as the owner of a trust to the extent such application results in an amount being currently taken into account in computing the income of a citizen or resident of the U.S. Thus, under the general rule, the grantor trust rules will not apply to a foreign person who sets up a trust. An exception is provided, however, for trusts which are revocable, either by the grantor alone or by the grantor with the consent of a person who is regarded as related and subordinate to the grantor.[7] Trusts which may make distributions only to the grantor or the grantor's spouse during the grantor's lifetime may also be regarded as grantor trusts with respect to a foreign person.[8]

5.2.1 Thus, any income from a trust which fails to meet one of the exceptions will be subject to U.S. tax if paid to a U.S. person. In addition, an interest penalty will be imposed at market rates (currently 9%) on the undistributed income which is earned in prior years and accumulated in the trust. The Service is given broad authority in this area, to prevent attempted avoidance of these rules by means of indirect distributions from another beneficiary or deemed distributions from corporations and partnerships.

[6] Code §§ 671 through 679.

[7] The grantor's power of revocation will be respected if the grantor has such power for a period or periods aggregating 183 days or more during the taxable year of the trust.

[8] The Act also contains grandfather rules excepting certain foreign trusts which were in existence as of September 19, 1995, provided that such trusts were either revocable or previously regarded as owned by the grantor because the income of the trust could be distributed to the grantor or the grantor's spouse without the consent of an adverse party.

5.2.2 A U.S. person who receives a distribution, directly or indirectly, from a foreign trust is required to report the distribution on Form 3520. A U.S. beneficiary who fails to report the receipt of such a distribution will be subject to a 35% penalty on the gross amount of the distribution.[9] A distribution from a foreign trust for this purpose includes any gratuitous transfer of money or property from a foreign trust, whether or not the trust is owned by another person.

5.2.3 With regard to distributions, the following additional rules must also be considered:

5.2.3.1 If a U.S. beneficiary uses a credit card, and charges on that credit card are paid or otherwise satisfied by a foreign trust or guaranteed or secured by the assets of a foreign trust, the amount charged will be treated as a distribution to the U.S. beneficiary and must be reported.[10]

5.2.3.2 If a beneficiary receives a payment from a foreign trust in exchange for services rendered to the trust, and the fair market value of the payment received exceeds the fair market value of the services rendered, such excess will be treated as a distribution to the U.S. beneficiary and must be reported.[11]

5.2.3.3 If a foreign trust directly or indirectly makes a loan of cash or marketable securities to a U.S. beneficiary of the trust, the amount of the loan will be treated as a distribution to that beneficiary except in certain limited circumstances.[12]

5.2.3.4 Any distribution from a foreign trust, whether from income or corpus, to a U.S. beneficiary, will be treated as an accumulation distribution includable in the gross income of the distributee and subject to the interest penalty applicable to accumulations if adequate records are not provided to the Service to determine the proper treatment of the distribution.[13] A U.S. beneficiary will not be required to treat the entire distribution as an accumulation distribution, however, if the beneficiary obtains from the foreign

[9] Notice 97-34.

[10] *Id*. at Section V.

[11] *Id*.

[12] *Id*, Section V(A).

[13] Code § 6048(c)(2).

trust either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement with respect to the distribution.[14] If a U.S. beneficiary cannot obtain such a beneficiary statement from the trust, the U.S. beneficiary can avoid treating the entire amount as an accumulation distribution if the U.S. beneficiary can provide information regarding actual distributions from the trust for the prior three years.[15]

5.2.3.5 If a U.S. beneficiary receives a complete Foreign Grantor Trust Beneficiary Statement with respect to a distribution during the taxable year, the beneficiary should treat the distribution as a gift from the owner of the trust and therefore generally nontaxable although the filing is nevertheless required. This would include, for example, a distribution from a revocable trust.

5.2.3.6 The Regulations describe the circumstances under which a payment that is derived directly or indirectly by a U.S. person from a foreign trust through an intermediary will be deemed to have been paid directly by the foreign trust to the U.S. person.[16]

5.2.3.7 In computing the income of the beneficiaries of certain irrevocable trusts, where a trust owns the shares of a closely-held corporation, under certain circumstances, the ownership of shares of such a corporation may be attributed to the beneficiaries of the trust. Where those beneficiaries are U.S. persons, such beneficiaries could be regarded as the owners of the shares of the corporation directly, and, as such, subject to tax on the income of the corporation irrespective of any distributions. This can be a significant problem given the large number of offshore trusts which hold their assets in a corporate entity for administrative convenience. It has been reported that the Service is, at this time, considering how to apply the attribution of ownership rules in the context of discretionary trusts. Although some have argued that there may be no attribution of share ownership from such trusts, from other guidance issued by the Service in similar circumstances, I believe that they may look to historic patterns of trust distributions, letters of wishes, and the relationship of the beneficiary in question to the grantor of the trust. This is something that must be considered in every foreign trust structure.

[14] Notice 97-34 Section V(B).

[15] *Id*.

[16] Treas. Reg. § 1.643(h)-1.

6. Foreign Trusts Established by US Persons

6.1 Description of Trust

6.1.1 Considerable flexibility can be employed in the design of the trust. The planner must consider the particular assets, distribution desires and administration needs of each grantor.

6.1.2 The trust is typically established with the following basic features:

6.1.2.1 The initial governing law must be determined and the "protector" is generally given the authority to change the jurisdiction of the trust.

6.1.2.2 The directions to the trustee regarding investments and distributions are set forth in the trust deed. The trustee may make distributions during the term of the trust to beneficiaries and for expenses incident to management of the trust.

6.1.2.3 The trust may name one or more protectors to scrutinize the actions of the trustee.

6.1.2.3.1 In some circumstances the protector may serve in an advisory role. For example, the consent of the protector may be required in order for the trustee to make certain investments. The consent of the protector may also be necessary in order for the trustee to exercise its discretionary powers over distributions.

6.1.2.3.2 At other times the protector may act independently. For example, a protector may change the governing law of the trust or the situs of trust administration. Further, the protector may, in certain circumstances, remove and replace the trustee.

6.1.2.4 The grantor transfers property to the trust at the time of its establishment and may make additional transfers at later times. It is typically best not to have multiple grantors with respect to the same trust.

6.1.2.5 The grantor will generally be regarded as the owner of the trust property for federal income, estate and gift tax purposes.

6.1.2.6 The trust may make its investments through an intermediate underlying structure such as a limited partnership or a limited liability company.

6.1.3 Income Tax Matters:

6.1.3.1 Recognition of the Trust. Although the grantor will be given an opportunity to advise the trustee on trust investments and distributions, the grantor can have no legal right to participate in trust administration directly. The beneficiaries, on the other hand, have no role in the activity of the trust. Thus, the trust should typically be respected as a "trust" for federal income tax purposes.

6.1.3.2 Classification as a "grantor trust".

6.1.3.2.1 As stated previously, trusts are generally regarded as separate taxable persons for federal income tax purposes. As such, a trust must report all items of income, gain, loss, deduction and credit for a given taxable year. Because trusts, like partnerships, are meant to be conduits which do not give rise to double taxation, a trust is given a deduction for all income which it, in turn, distributes to its beneficiaries.

6.1.3.2.2 If the trust is a "grantor trust", however, the foregoing rules are inapplicable.

6.1.3.2.3 Trusts are treated as "grantor trusts" if they meet certain requirements contained in Subpart E of the Code (Code sections 671 through 679). If a trust is a "grantor trust", the grantor of the trust is treated, for federal income tax purposes, as the owner of all (or a portion) of the trust assets, with the result that the trust is a conduit with respect to the grantor of all items related to such assets.

6.1.3.2.4 A "grantor trust" is one over which the grantor retains a "prohibited" control over the trust property, resulting in the grantor being regarded as the owner of the trust assets for <u>income tax purposes</u>. That is, the transfer to a grantor trust may, nevertheless, be fully effective and respected for gift tax, estate tax or other purposes (such as creditors' rights).

6.1.3.2.5 If a U.S. person makes a transfer to a foreign trust with U.S. beneficiaries, the trust will be regarded as a grantor trust irrespective of any control over the trust retained by the grantor. Code section 679.

6.1.3.3 Classification of the trust as a "United States" trust.

6.1.3.3.1 Section 7701(a)(30) and (31) of the Code provides that a "trust" is a "domestic trust" if the following requirements are met:

6.1.3.3.1.1 A court within the U.S. is able to exercise primary jurisdiction over the trust administration ("Court Test"); and

6.1.3.3.1.2 One or more U.S. Persons have authority to control all substantial decisions of the trust ("Control Test").

6.1.3.3.2 Under the Regulations, substantial decisions include, whether or when to distribute corpus or income, amount of distributions and the recipient, allocation of receipts between trust principal and income, whether to terminate the trust, whether to litigate claims for or against the trust, whether to add or remove a trustee, and whether to appoint successor trustee with limitations such that the power cannot be exercised to change the trust's residency.[17]

6.1.3.4 Taxation of transfer of assets to the trust. The transfer will not constitute a sale or exchange within the meaning of Section 1001 because the grantor is regarded as the owner.

6.1.4 Gift Tax Matters:

6.1.4.1 Code section 2501 imposes a tax on the transfer of property by gift during a calendar year. Under Code section 2511, the tax is imposed "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible..."

6.1.4.2 There is no gift, however, unless the transfer is complete; i.e., the donor has parted with dominion and control over the property which is the subject of the gift. The Regulations provide:

> "As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave him no power to

[17]Treas. Reg. § 301.7701-7.

> change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case."[18]

6.1.4.3 Specifically, in this regard, a gift is incomplete if the donor retains the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by an ascertainable standard.[19] Even if such a power is held jointly with the trustee, it will render the transfer incomplete. That is, the grantor is considered as himself having a power if it is exercisable in conjunction with any person not having a substantial adverse interest in the exercise of that power, and a trustee, as such, is not regarded as a person having an adverse interest in the disposition of the trust property or its income.[20]

6.1.4.4 Accordingly, if, under the terms of the trust deed, the grantor, with the consent of the trustees, has the power to add as beneficiaries persons or entities other than the grantor, the grantor's estate, the grantor's creditors, and creditors of the grantor's estate, the transfer should be regarded as incomplete for gift tax purposes.[21]

6.1.4.5 Additionally, the gift should be regarded as incomplete if the grantor, together with the trustee, is given the power to vary the interests of the beneficiaries by deletion of a beneficiary. With such a power there is no certainty that any beneficiary, absent the death of the grantor, would receive any distribution from the trust.

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[18]Treas. Reg. § 25.2511-2(b).

[19]Treas. Reg § 25.2511-2(c).

[20]Treas. Reg. § 25.2511-2(a).

[21]Compare, however, Rev. Rul. 76-275, 1976-2 C.B. 299 and Rev. Rul. 77-328, 1977-2, C.B. 347. Those rulings, however, did not directly concern the reservation of a power by the grantor to add beneficiaries or to change their interests, which powers cause the gift to be incomplete notwithstanding the value (or lack of value) of any reversionary interest.

6.1.4.6 To the extent the trust distributes income or corpus to a beneficiary, there will be a completed gift at the time of such distribution.[22] This gift may not be reportable or taxable if it is excluded by virtue of the $12,000 annual exclusion[23] or if the gift is excluded under the qualified transfer rules for certain educational or medical expenses[24] (unless reporting is required due to a gift-splitting election).

6.1.5 Estate Tax Matters:

6.1.5.1 Because there is no completed gift upon the transfer of assets to the trust, it follows that the assets in trust are part of the grantor's estate for federal estate tax purposes. Further, a transferor of property who retains certain powers over the transferred property will have that property included in his or her gross estate.[25] If, for example, the grantor retains the power to add beneficiaries to the trust, it has been held that the assets of the trust will be included in the gross estate of the grantor.[26]

6.1.5.2 To minimize the incidence of estate tax, the trust should be drafted to include all of the estate planning provisions that are typically included in a will or "living trust".

6.1.6 Income Tax on the Death of the Grantor (Code Section 684):

6.1.6.1 Under Code section 684, for income tax purposes, the transfer of property by a U.S. person to a foreign trust will be treated as a sale or exchange for an amount equal to the fair market value of the property transferred, and the transferor will recognize gain on the excess of the fair market value over the adjusted basis of the property in the hands of the transferor.

6.1.6.2 Under Code section 684(b), the income tax under Code section 684(a) is made inapplicable to transfers to a foreign trust to the extent that any person is treated as the owner of the trust under Section 671 (the grantor trust rules).

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[22]Treas. Reg. § 25.2511-2(f).

[23]IRC § 2503(b).

[24]IRC § 2503(e).

[25]IRC §§ 2036 and 2038.

[26]*Estate of Craft v. Commissioner*, 68 T.C. 249 (1977).

6.1.6.3 The Service takes the position that Code section 684 can apply to impose a tax on the death of a U.S. person who was the grantor of a foreign grantor trust if the assets are not included in the estate of the grantor.

6.1.7 Selected Federal Reporting Requirements:

6.1.7.1 Form 709 - United States Gift Tax Return. Even though the contribution of assets to the trust is an incomplete gift, the grantor must file a gift tax return for the year of the trust's creation, disclosing all relevant facts (including a copy of the trust).[27]

6.1.7.2 Form 1040 - U.S. Individual Income Tax Return of the Grantor. The grantor must report the transfer (Part III, Schedule B), and each year the grantor must report all of the income of the asset protection trust on his or her individual Form 1040 for federal income tax purposes.

6.1.7.3 Form 3520 - Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. The grantor is required to file Form 3520 by the due date for the grantor's individual tax return. The penalty for failure to report the transfer on the Form 3520 is 35% of the gross value of any property transferred to the foreign trust.

6.1.7.4 Form 3520-A - Annual Return of Foreign Trust With U.S. Beneficiaries. This form must also be filed annually. A Foreign Grantor Trust Owner Statement and Statement of Foreign Trust Income Attributed to U.S. owner must be attached to this form.

6.1.7.5 Form 1040NR - U.S. Nonresident Alien Income Tax Return. This form must be filed annually by the trustee.

6.1.7.6 Form 56 - Notice Concerning Fiduciary Relationship. The trustee of an asset protection trust may notify the Service of the creation of the trust.

6.1.7.7 Form SS-4 - Application for Employer Identification Number. The trust will need a tax identification number.

6.1.7.8 Form TD F 90-22.1 - Report of Foreign Bank and Financial Accounts. If at any time during the term of the trust, the bank

[27]Treas. Reg. § 25.2511-2(c).

account(s) , securities account(s) or other financial instrument accounts of the trust have an aggregate value that exceeds $10,000, the grantor must file this Department of Treasury Report. The filing is required even though the grantor has no signatory power over the account.

6.1.7.9 Customs Form 4790 - Report of International Transportation of Currency or Monetary Instruments. This applies if more than $10,000 cash has been physically transferred out of the U.S.

6.1.7.10 Form 8858 – Information Return of U.S. Persons With Respect To Foreign Disregarded Entities. This form is required of all U.S. persons who are the tax owners of foreign disregarded entities. Because these trusts frequently have underlying entities, this form may be required.