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ASSET PROTECTION JOURNAL

Planning for Wealth Preservation Worldwide

FEATURE ARTICLES

WHEN YOUR CHILD'S MARRIAGE GOES BAD, SO MIGHT YOUR CHILD'S TRUST: SPOUSAL AND CHILD SUPPORT EXCEPTIONS TO SPENDTHRIFT TRUST PROTECTIONS
Daniel S. Rubin

SCHEFFEL V. KRUEGER: USING STATUTORY SPENDTHRIFT TRUST PROTECTION TO ENHANCE ESTATE PLANNING
Christopher M. Riser and Steven J. Oshins

THE VIABILITY OF ASSET PROTECTION AFTER *BILZERIAN, BRENNAN, HAVOCO,* AND *WEESE:* SUCCESS—BUT AT GREAT COST
Howard S. Fisher

HOW TO PROPERLY FUND AND ADMINISTER AN INTEGRATED ESTATE PLAN
John R. Garland and Patricia A. Barron

DEMYSTIFYING TAXATION OF THE FOREIGN TRUST: THE WORKINGS OF INTERNAL REVENUE CODE SECTIONS 679 AND 684
Elizabeth M. Schurig

TAX PLANNING WITH PRIVATE PLACEMENT LIFE INSURANCE: PRACTICAL CONSIDERATIONS AND REAL WORLD USES TO ACHIEVE TAX-FREE INVESTMENT RETURNS
David S. Neufeld and Grant R. Markuson

COLUMNS

FROM THE EDITOR

FOCUS ON JURISDICTION: NEVIS
Agatha Jeffers-Gooden

PRACTITIONER'S FORUM: BOOKS IN BRIEF
Alexander A. Bove, Jr.

LEGAL DEVELOPMENTS
Lynn A. Buskey and Robert H. Ryan

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Demystifying Taxation of the Foreign Trust:

The Workings of Internal Revenue Code Sections 679 and 684

BY ELIZABETH M. SCHURIG

Before deciding how to structure estate and business relationships, it is important for clients to understand how the United States taxes foreign trusts and transfers to foreign trusts. This article uses a case structure to discuss foreign trusts having one or more United States beneficiaries and recognition of gain on certain transfers to certain foreign trusts and estates, with relevant examples, to explain the workings of Internal Revenue Code Sections 679 and 684.

FACT PATTERN

The client is a U.K. citizen, but is resident in the U.S. His spouse and children are U.S. citizens. The client's parents reside in and are citizens of the Isle of Man (IOM).

The client's worldwide assets exceed USD100M. He would like to create an inter vivos structure to benefit his Manx parents and other beneficiaries who are U.S. citizens. He would also like to gift assets to a friend's children who are U.K. citizens and enter into business relationships with several individuals who are nonresident aliens. He is also considering moving back to England. Before he decides how to structure his estate and his business relationships, he would like to understand how the United States taxes foreign trusts and transfers to foreign trusts.

PLANNING STRATEGIES[1]

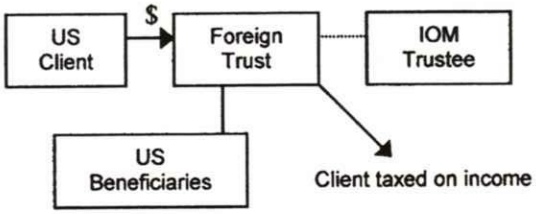
IRC § 679—Foreign Trusts Having One or More United States Beneficiaries

IRC § 679 taxes the U.S. transferor as the owner of any portion of a foreign trust (as that term is defined in IRC § 7701(a)(31)(B)) that is attributable to the property transferred by the U.S. transferor for any year in which the trust has a U.S. beneficiary [Treas. Reg. § 1.679-1(a)]. The rules of this section apply without regard to whether the U.S. transferor retains any power or interest described in IRC §§ 673-677. Indeed, even if a U.S. transferor would be treated as the owner of the trust assets pursuant to IRC § 679 and another person would be treated as the owner of the trust assets pursuant to IRC § 678, then the U.S. transferor is treated as the owner of the trust assets under IRC § 679 and the other person is not treated as the owner. [Treas. Reg. § 1.679-1(b)].

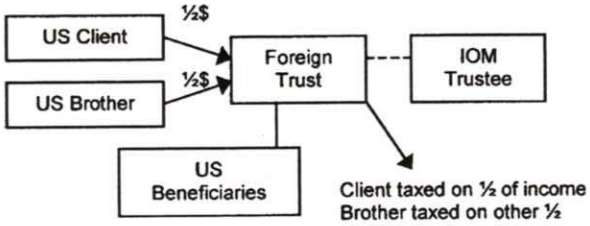
1. U.S. Transferor. A U.S. transferor is a U.S. person who makes a transfer of property to a foreign trust. A U.S. person is a person defined as such in IRC § 7701(a)(30), a nonresident alien individual who elects to be a resident of the United States under IRC § 6013(g), and an individual who is a dual resident taxpayer within the meaning of Treas. Reg. § 301.7701(b)-7(a) [Treas. Reg. §§ 1.679-1(c)(1) and (2)].

    a. The client creates and fully funds a trust that is situsued in the Isle of Man for his benefit and for the benefit of his U.S. family. The trust is a "foreign trust" as that term is defined in IRC § 7701(a)(31)(B). Because the client is a U.S. resident, he is a "U.S. person," and

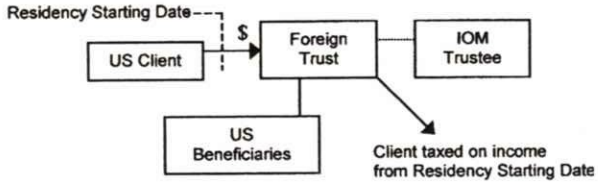
because the trust has U.S. beneficiaries, he is taxed as the owner of the entire trust pursuant to IRC § 679. [Treas. Reg. § 1.679-1(a)].



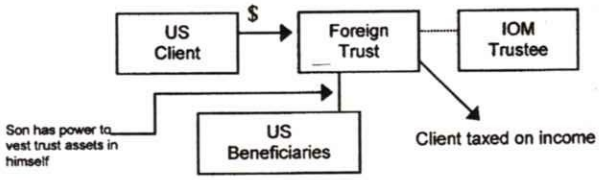
- If, under the same facts, the client contributes half of the trust assets and the client's U.S. brother contributes the other half of the trust assets, then each will be taxed as the owner of one-half of the trust assets [IRC § 679(a)(1); Treas. Reg. §§ 1.679-1(a) and (d) Example 2].



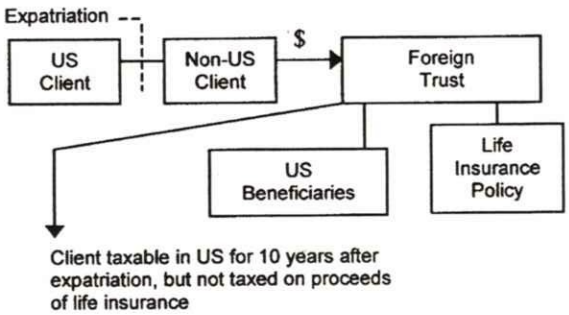
- If the client created the same trust less than five years before becoming a U.S. resident, then he will be deemed to have made the transfer to the trust on the residency starting date [IRC § 679(a)(4)(A); Treas. Reg. §§ 1.679-2(a)(3)(i) and (ii) Example 1]. The residency starting date is determined under IRC § 7701(b)(2)(A) [IRC § 679(a)(4)(c)].



- If, under the same facts, the client's U.S. resident son is given the power to vest the trust assets in himself within the meaning of IRC § 678(a)(1), the client is nonetheless treated as the owner of the trust assets and his son is not treated as the owner [Treas. Reg. §§ 1.679-1(b) and (d) Example 1].

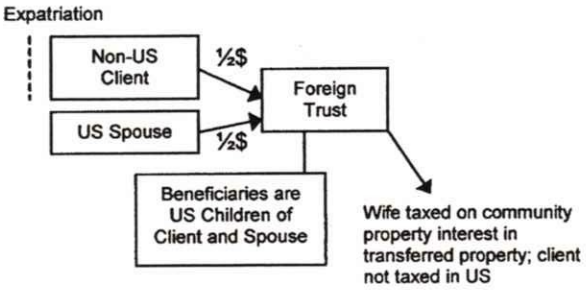


b. The client is planning to expatriate, and he creates a foreign trust for his benefit and for the benefit of the other U.S. family members. The trust income will not be taxable to him in his new tax home. The trustee purchases a life insurance policy with trust assets. Though IRC § 679 will cause the trust income to be taxable to him, even after expatriation for 10 years under IRC § 877, there will be no trust income that is actually taxed to him. Loan proceeds against policy cash values can be used to benefit the grantor and other beneficiaries without an income tax consequence.

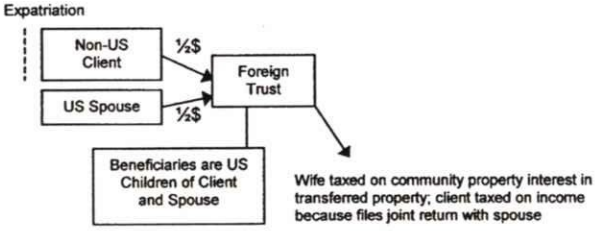


- After expatriation, if the client transfers property in which his U.S. spouse has a community

property interest to a trust for the benefit of the children, IRC § 679 will apply to treat the spouse as a grantor of the trust to the extent of her community property interest in the transferred property.

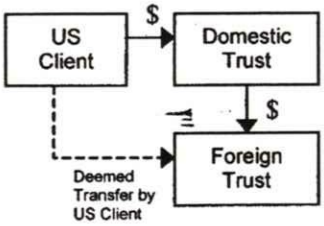


- After expatriation, if the client elects to be treated as a U.S. resident under IRC § 6013(g) for purposes of filing a joint U.S. federal income tax return with his spouse, then he will also be defined as a U.S. person for purposes of IRC § 679 [Treas. Reg. § 1.679-1(c)(2)].

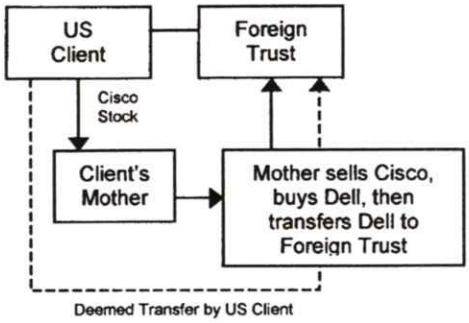


2. Transfer. It is clear from even a cursory reading of the Regulations and the examples contained therein that the Service intends IRC § 679 to apply to any transfer that can be or could be traced back to a U.S. person. The Regulations state that "[a] transfer means a direct, indirect, or constructive transfer" [Treas. Reg. § 1.679-3(a)].

   a. The client creates a domestic trust over which he retains a general power to appoint the assets to himself. The domestic trustee later settles the trust assets in a foreign trust. The client is the deemed transferor of the assets settled in the foreign trust [Treas. Reg. § 1.679-3(b)(2)].

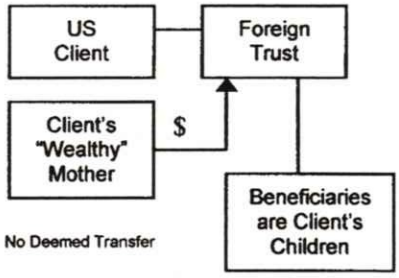


   b. The client creates a foreign trust for the benefit of his children. He later transfers stock in Cisco Systems to his mother, who is a nonresident alien. His mother sells the Cisco Systems stock and purchases Dell Computer stock. The client's mother then transfers the Dell Computer stock to the foreign trust. Unless the client is able to demonstrate that his mother acted independently, the client will be deemed to be the transferor of the Dell Computer stock and his mother will be treated as the client's agent and not a transferor to the trust [Treas. Reg. §§ 1.679-3(c)(1), (3), and (5) Example 2].

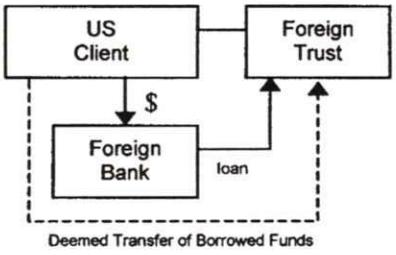


- If, however, the client's mother has independent wealth of her own and transfers assets to a foreign trust for the benefit of the client's children, the client will not be deemed to be the

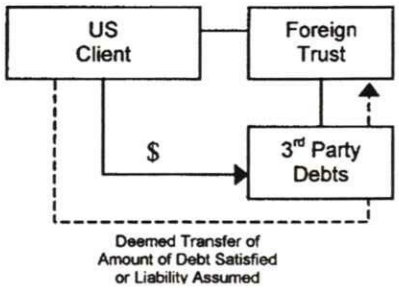
transferor of such assets because the transferred assets did not indirectly come from the client [Treas. Reg. § 1.679-3(a)].



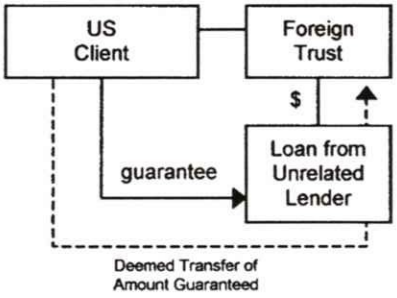
c. If the client deposits assets with a foreign bank and the bank subsequently loans funds to the foreign trust created by the client for the benefit of his children, the client will be deemed to be the transferor of the loan proceeds. This will be done unless the client can demonstrate that the foreign bank acted independently [Treas. Reg. §§ 1.679-3(c)(1), (3), and (5) Example 3].



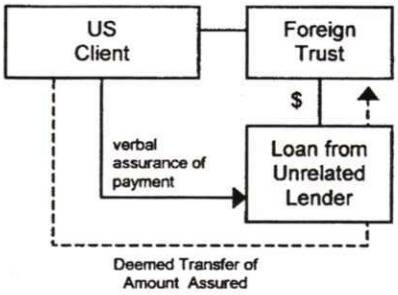
d. The client creates a foreign trust for the benefit of his U.S. children and subsequently satisfies debts that the trust has outstanding to unrelated third parties or assumes the trust's liabilities to an unrelated third party. The client is deemed to have transferred property to the trust equal to the debt satisfied or the liabilities assumed [Treas. Reg. §§ 1.679-3(d)(1) and (2) Examples 1 and 2].



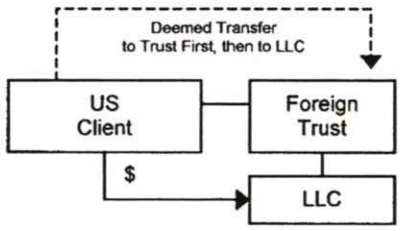
e. The client guarantees a loan made to the foreign trust from an unrelated lender. Because the client is a related person to the trust within the meaning of Treas. Reg. § 1.679-1(c)(5), he is deemed to have transferred the guaranteed portion of the adjusted issue price of the obligation [within the meaning of Treas. Reg. § 1.1275-1(b)] plus any accrued but unpaid qualified stated interest [within the meaning of Treas. Reg. § 1.1273-1(c)] [Treas. Reg. §§ 1.679-3(e)(1), (2), (3), and (5) Examples 1 and 2].



- If, in the same example, instead of a formal guarantee, the client simply assures the bank that the loan will be repaid without entering into any type of legally enforceable obligation, the client will nonetheless be deemed to be the transferor of the amount that he assured would be paid [Treas. Reg. § 1.679-3(e)(4)(iii)].



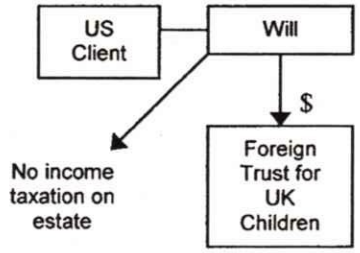
- If, in the same example, the client transfers property to an entity owned by the foreign trust, then the client will be deemed to have transferred the property to the foreign trust first with a subsequent transfer to the entity owned by the trust. This will take place unless the client can demonstrate that the transfer to the entity is properly attributable to the U.S. person's ownership interest in the entity [Treas. Reg. §§ 1.679-3(f)(1) and (2) Examples 1 and 3].



3. Transfer Exceptions. IRC § 679 can apply if a U.S. person makes a direct or indirect transfer to a foreign trust. There are exceptions to this rule. IRC § 679 does not apply to (i) transfers "by reason of the death of the transferor"; (ii) any transfer to a foreign trust described in IRC §§ 402(b), 404(a)(4), or 404A; (iii) any transfer to a foreign trust described in IRC § 501(c)(3) [without regard to the requirements of IRC § 508(a)2]; or (iv) a transfer made for fair market value [Treas. Reg. § 1.679-4(a)].

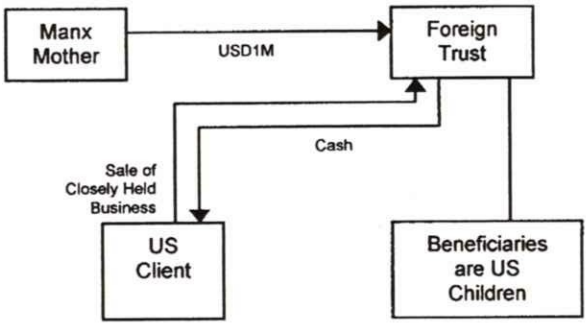
a. *Testamentary Transfer Exception.* IRC § 679(a)(2)(A) excludes transfers by reason of the death of the transferor from the application of IRC § 679(a)(1).

- The client wants to gift assets to a friend's children who are U.K. citizens but, in order to avoid current transfer tax, he decides to make a gift under his will to Manx trusts for their benefit. At his death, the transfer to the foreign trusts will not cause the client's estate to be taxable on the income derived by the foreign trust [Treas. Reg. § 1.679-4(a)].



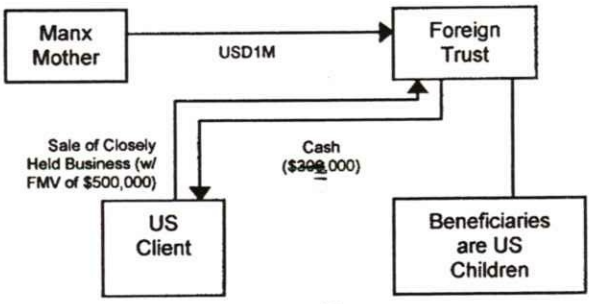
b. *Fair Market Value Exception.* IRC § 679(a)(2)(B) excludes transfers of property to a trust in exchange for consideration of at least the fair market value of the transferred property from the application of IRC § 679(a)(1). Consideration other than cash (for example, real property, entities, art, rights to property, leaseholds, etc.) shall be taken into account at its fair market value [IRC § 679(a)(2)(B); Treas. Reg. § 1.679-4(b)(1)]. When determining fair market value for rents, royalties, interest, compensation, and so forth, transfers of such amounts are for fair market value only to the extent that such payments reflect an arm's length price for such payments [Treas. Reg. § 1.679-4(b)(1)].

- The client's mother (a Manx citizen) creates a foreign trust for the benefit of the client's children (her grandchildren) and settles USD1 million in the trust. There is no question that the funds belonged to her and did not come from the client in any type of a step transaction. If the client sells an interest in his closely held company for the fair market value of the interest (presumably pursuant to an appraisal of such interest) and the trust either pays cash for such interest or distributes assets with a fair market value equal to the value of the interest, then the client will not be deemed to be a transferor to the trust for purposes of IRC § 679. If the interest in the client's closely held business generates income or increases in value and is later sold, neither the income nor the gain will be taxed to the client [Treas. Reg. § 1.679-4(b)(1)].



No Deemed Transfer by US Client

- If, under the same facts, the client transfers an interest in his company with a fair market value of $500,000 but receives cash or other assets from the trust with a fair market value of $300,000, the client will be deemed to have transferred the $200,000 difference to the foreign trust [Treas. Reg. § 1.679-4(b)(2)].



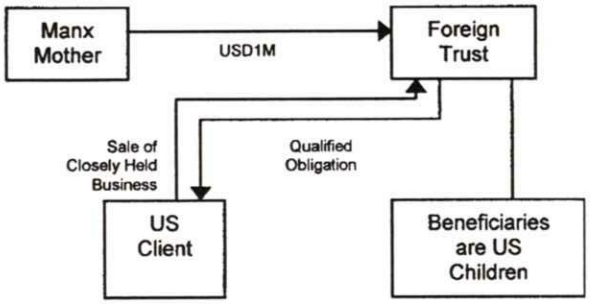
Deemed Transfer by US Client of $200,000

- If, under the same facts, the client receives a note back from the trust, instead of cash or other assets, the note will be taken into account. It is valued at its fair market value as consideration received in exchange for the transferred asset only if it is a "qualified obligation" since the foreign trust is a "related person" to the client as that term is defined in Treas. Reg. § 1.679-1(c)(5) [Treas. Reg. § 1.679-4(c)]. An obligation will be qualified only if the following criteria are met:

  * The obligation must be in writing.
  * The term of the obligation must be for no more than five years.
  * All payments on the obligation must be denominated in U.S. dollars.
  * The yield to maturity must be not less than 100 percent of the Applicable Federal Rate and not more than 130 percent of the Applicable Federal Rate in effect under IRC § 1274(d) for the day on which the obligation is issued.

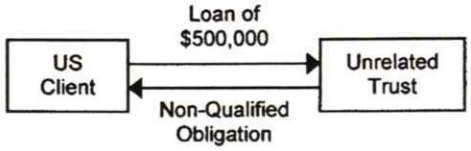
* The U.S. transferor must extend the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax charges for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation.
* The U.S. transferor must report the status of the loan, including principal and interest payments, on Form 3520 for every year that the loan is outstanding.

[Treas. Reg. § 1.679-4(d)(1)]



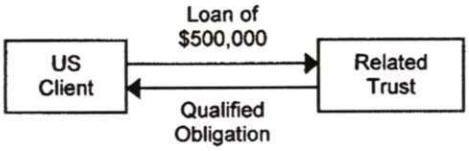
No Deemed Transfer by US Client If All Qualified Obligation Criteria Are Met

- The client loans $500,000 to a trust that is not a "related person" within the meaning of Treas. Reg. § 1.679-(c)(5) in exchange for an obligation that is not a qualified obligation. The client is not a related person with respect to the foreign trust. Because of this fact, the fair market value of the obligation received by him is taken into account for purposes of determining whether his transfer is eligible for the fair market value exception [Treas. Reg. §§ 1.679-4(c) and (d)(7) Example 3].



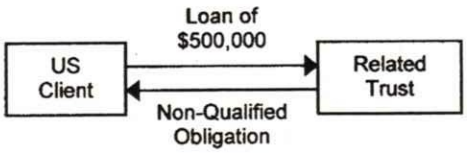
No Deemed Transfer If FMV Of Obligation Is Equal to Amount of Loan

- If, under the same example, the client loans $500,000 to a foreign trust that is a related person within the meaning of Treas. Reg. §1.679-1(c)(5), then the loan must be a qualified obligation to qualify for the fair market value exception [Treas. Reg. §§ 1.679-4(c) and (d)(7) Example 5].



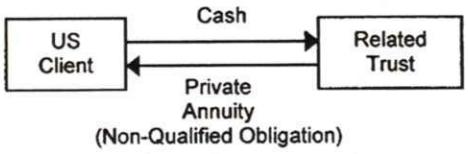
No Deemed Transfer If FMV Of Obligation Is Equal to Amount of Loan

- If, under the previous example, the obligation ceases to be qualified (e.g., renegotiation of the note causes the total term to exceed five years), then the client will be treated as making a transfer to the foreign trust in an amount equal to the original obligation's adjusted issue price [within the meaning of Treas. Reg. § 1.1275-1(b)] plus any accrued but unpaid qualified stated interest [within the meaning of Treas. Reg. § 1.1273-1(c)] as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation [Treas. Reg. § 1.679-4(d)(3)].



Deemed Transfer of Obligation's Adjusted Issue Price
Plus Accrued but Unpaid Stated Interest
As of Date of Disqualification of Obligation

- If, under the same facts, the client transfers cash to a foreign trust that is a related person to the client in exchange for a private annuity that will pay an annual sum to the client for the client's lifetime, this obligation does not qualify as a qualified obligation. This is because the obligation to the client could remain outstanding for more than five years. Therefore, the fair market value exception does not apply to this transfer and the client is deemed to be the transferor of all of the cash paid to the foreign trust [Treas. Reg. § 1.679-4(d)(7) Example 2].

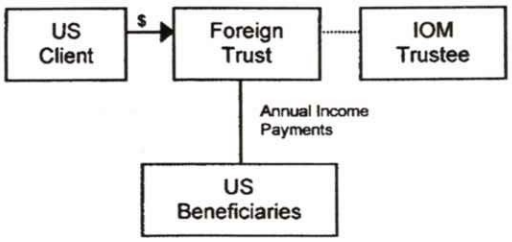


Deemed Transfer of Cash

4. U.S. Beneficiary. For IRC § 679 to apply, there must be a transfer by a U.S. transferor to a foreign trust, and the trust must have a U.S. beneficiary [IRC § 679(a)(1)]. All foreign trusts are presumed to have a U.S. beneficiary unless the taxpayer can establish that . . .

   - under the terms of the trust, no part of the income or principal of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person; and
   - were the trust to be terminated at any time during the taxable year, no part of the income or principal of such trust could be paid to, or for the benefit of, a U.S. person [IRC § 679(c)(1); Treas. Reg. § 1.679-2(a)(1)].

   a. The client creates a foreign trust for the benefit of his U.S. children. The trust document mandates that all income be paid annually to his children. The trust is treated as having a U.S. beneficiary [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Example 1].



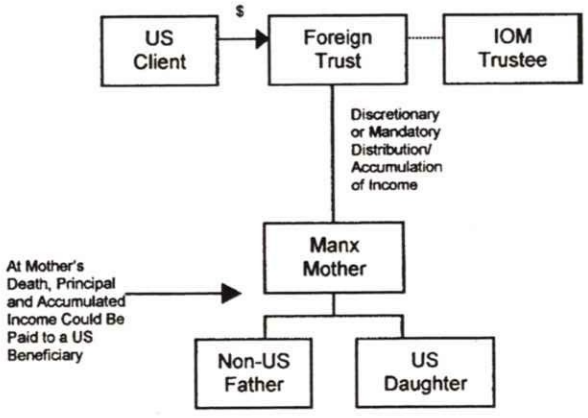
Trust with a US Beneficiary

   b. The client creates a foreign trust for the benefit of his mother, a Manx citizen and resident, and directs that the income be distributed or accumulated for the benefit of his mother at the trustee's discretion. At his mother's death, the trust will terminate and the assets will be distributed in equal shares to such of his father (a Manx citizen and resident) and his daughter (a U.S. person) as are then living. Because it is possible that income may be accumulated in each year, and that the principal and accumulated income may be ultimately distributed to the client's daughter, who is a U.S. person, the trust is treated as having a U.S. beneficiary during each of the tax years prior to his mother's death.

This treatment takes place even though no U.S. person may receive distributions from the trust during the client's mother's lifetime [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Examples 2 and 4].

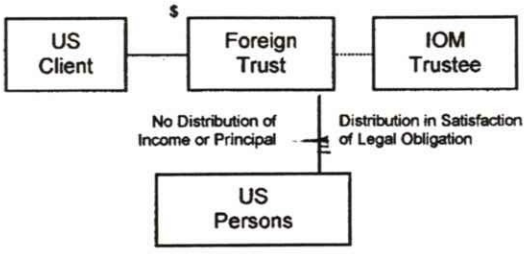
- Under the same facts, the trust is deemed to have a U.S. beneficiary even if the trust document requires that all the income be distributed to the client's mother because trust principal is being held for possible future distribution to a U.S. person [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Examples 3 and 4].

- Under the same facts, the trust is deemed to have a U.S. beneficiary even if the trust document provides that the trust will not have a U.S. beneficiary until one year after the death of the client [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Example 5].



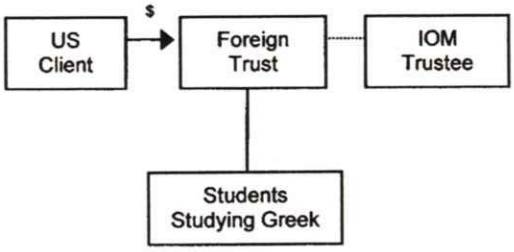
Trust with a US Beneficiary for Entire Term of Trust

c. The client creates a trust that specifically excludes distributions of income or principal to a U.S. person, but allows distributions for the benefit of, or to satisfy the legal obligations of, U.S. persons. This foreign trust is treated as having a U.S. beneficiary [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Example 6].



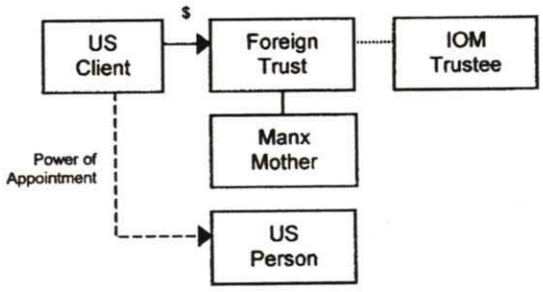
Trust with a US Beneficiary

d. The client creates a foreign trust, and the trust document gives the trustee discretion to distribute the assets to any person who is pursuing an education in the study of ancient Greek. This foreign trust is treated as having a U.S. beneficiary because it is possible that a U.S. person will receive distributions at some point [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Example 10].



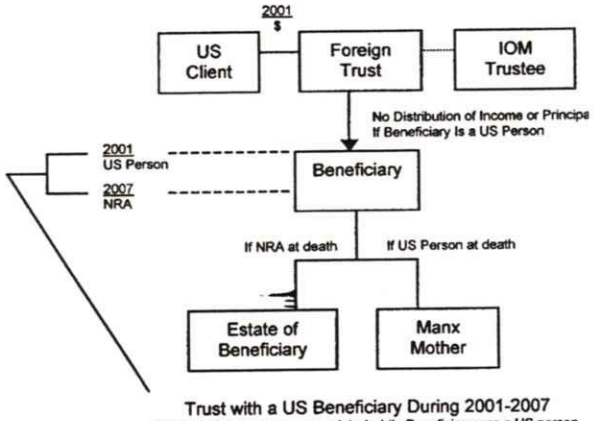
Trust with a US Beneficiary

e. The client creates a foreign trust for the benefit of his mother (who is a Manx citizen and resident) but retains the power to appoint the trust assets to other beneficiaries at his mother's death. This foreign trust is treated as having a U.S. beneficiary because it is possible that a U.S. person could be named as a remainder beneficiary [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Example 11].



Trust with a US Beneficiary

f. In 2001, the client creates a foreign trust that provides that as long as the beneficiary is a U.S. resident, no distribution of income or principal will be made to the beneficiary. If the beneficiary becomes a nonresident alien, distributions of income and principal may be made to him. The trust will terminate upon the beneficiary's death and will be distributed to his estate if he is a nonresident alien. If the beneficiary is a U.S. person at his death, then the trust assets will be distributed to the client's mother who is a nonresident alien. In 2007, the beneficiary becomes a nonresident alien. Because income may be accumulated during the years 2001 to 2007 for the benefit of a person who is a U.S. person during those years, the trust is treated as having a U.S. beneficiary during each of those years. This is true even though the beneficiary cannot receive distributions from the trust during the years he is a U.S. person and even though he may never be entitled to any distribution from the trust. After 2007, the trust will not be treated as having a U.S. beneficiary [Treas. Reg. §§ 1.679-2(a)(2)(i) and (iii) Example 13].



Trust with a US Beneficiary During 2001-2007
(because income was accumulated while Beneficiary was a US person even though no distributions were made to the Beneficiary)

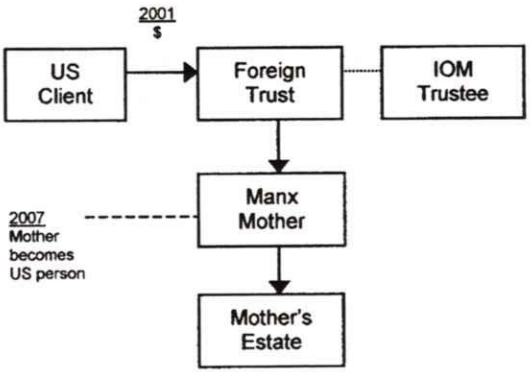
g. The client creates a foreign trust for the benefit of his mother, a nonresident alien, which will pass to her estate at her death. The mere possibility that she could become a U.S. person will not cause her to be treated as a U.S. person. If she does actually become a U.S. person, then the trust assets will be treated as owned by the client, unless his mother becomes a U.S. person more than five years after the time the client transferred the assets to the trust [Treas. Reg. §§ 1.679-2(a)(3)(i) and (ii) Examples 1 and 2].

In determining whether a foreign trust has a U.S. beneficiary, the Service will look to the following in addition to the terms of the trust document:

- all written and oral agreements and understandings relating to the trust;
- memoranda or letters of wishes;
- all records that relate to the actual distribution of income and corpus; and
- all other documents that relate to the trust, whether or not of any purported legal effect.

[Treas. Reg. § 1.679-2(a)(4)(i)]

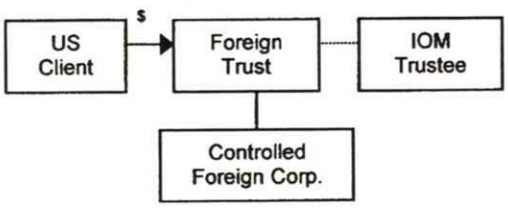
The Service will also take into account the ability of the trust to be amended to benefit a U.S. person, the ability of foreign law to cause payments to a U.S. person, and whether the parties to the trust agreement have ignored, or there is a reasonable expectation that they will ignore, the terms of the trust agreement so that U.S. persons will actually benefit from the trust [Treas. Reg. § 1.679-2(a)(4)(ii)].



Trust with No US Beneficiary

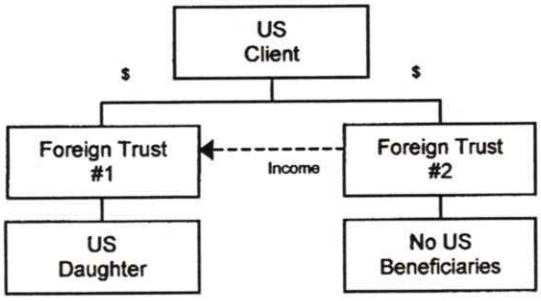
5. Indirect Beneficiaries. In addition to direct beneficial ownership, U.S. persons who indirectly benefit from a trust will be deemed to be U.S. beneficiaries for purposes of IRC § 679(a)(1).

   - The client creates a foreign trust for the benefit of a foreign corporation that is a controlled foreign corporation [as that term is defined in IRC § 957(a), after the application of IRC § 958(a)(2)]. The trust is deemed to have a U.S. beneficiary [Treas. Reg. §§ 1.679-2(b)(1) and (3) Example 1].



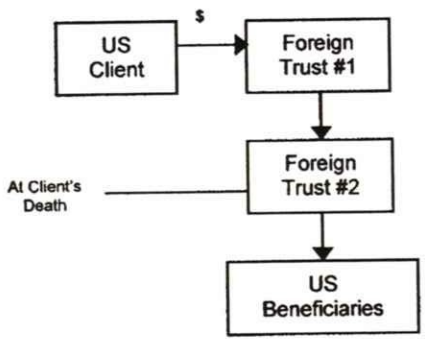
Trust with a US Beneficiary

- The client creates two foreign trusts. Foreign Trust #1 is for the benefit of the client's U.S. daughter. Foreign Trust #2 specifically prohibits distributions of either income or principal to U.S. persons but permits current distributions of income to Foreign Trust #1. Because Foreign Trust #2 can distribute income to Foreign Trust #1 and thereby benefit a U.S. person, it, as well as Foreign Trust #1, has a U.S. beneficiary [Treas. Reg. §§ 1.679-2(b)(2) and (3) Example 2].



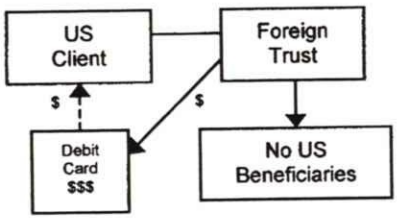
Both are Trusts with a US Beneficiary

- The client creates a foreign trust, and the trust document requires that all income be accumulated during his lifetime. In the year after his death, a share of the foreign trust will be distributed to another foreign trust for the benefit of a U.S. person. The foreign trust created by the client is treated as having a U.S. beneficiary beginning with the year of the client's transfer to the foreign trust because a U.S. person will ultimately benefit from the trust assets [Treas. Reg. §§ 1.679-2(b)(2) and (3) Example 3].



Foreign Trust #1 Is Immediately Treated As a Trust with a US Beneficiary

- The client creates a foreign trust, and the trust document specifically excludes U.S. persons from being beneficiaries, but the client uses a debit card issued by a foreign bank to make withdrawals from the trust funds. The foreign trust is deemed to have a U.S. beneficiary because it benefits the client who is a U.S. person [Treas. Reg. §§ 1.679-2(b)(2) and (3) Examples 4 and 5].

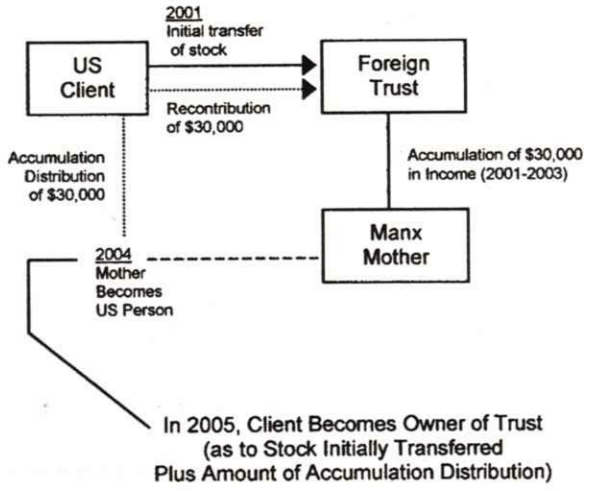


Trust with a US Beneficiary

6. Tax Consequences of the Acquisition or Loss of U.S. Beneficiary. If a foreign trust with a U.S. transferor and no U.S. beneficiary subsequently acquires a U.S. beneficiary, the U.S. transferor becomes immediately taxable on all of the trust's undistributed net income (as defined in IRC § 665(a)) on hand as of the close of the U.S. transferor's immediately preceding taxable year. Such income is subject to an interest charge on accumulation distributions in accordance with IRC § 668 [Treas. Reg. § 1.679-2(c)(1)]. This interest charge is currently 6 percent.

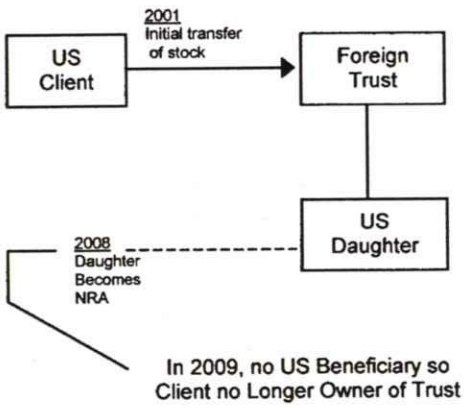
- In 2001, the client transfers stock with a fair market value of $100,000 to a foreign trust. The stock has an adjusted basis of $50,000. The beneficiary of the trust is the client's mother, who is a Manx citizen and resident. The client is not treated as the owner of any portion of the trust under IRC § 679. The trust accumulates $30,000 of income in the taxable years 2001 through 2003. The client's mother becomes a resident of the United States in 2004 (less than five years after the initial transfer to the trust). In 2004, the client is treated as receiving an accumulation distribution of $30,000 and immediately transferring that amount back to the trust. In addition to the income tax on the deemed distributed amount, the accumulation distribution is subject to an interest charge under IRC § 668. Beginning in 2005, the client is treated as the owner of the portion of the trust attributable to the stock transferred in 2001 and the accumulated income that is deemed to be recontributed by him in 2004 [Treas. Reg. §§ 1.679-2(c)(2) and (3) Example 1].

  * Practice Point: Had all of the accumulated income been distributed to the client's mother prior to her establishment of residency in the U.S., or if the trust assets had been paid in as premium on an insurance policy so that there was no trust income generated, the client would have been spared the income tax and accumulation distribution charge on the $30,000 accumulated income.



If a foreign trust with a U.S. beneficiary ceases to have a U.S. beneficiary, then the U.S. transferor ceases to be treated as the owner of the trust beginning in the first taxable year following the last taxable year in which the trust had a U.S. beneficiary [Treas. Reg. § 1.679-2(c)(2)].

- In 2001, the client transfers stock with a fair market value of $100,000 and a basis of $50,000 to a foreign trust that benefits his daughter who is a U.S. person. In 2008, the client's daughter ceases to be a U.S. person. Beginning in 2009, the trust will not be treated as having a U.S. beneficiary and the client will not be treated as the owner of the trust [Treas. Reg. §§ 1.679-2(c)(2) and (3) Example 2].



IRC § 684—Recognition of Gain on Certain Transfers to Certain Foreign Trusts and Estates

1. Historical Background. The United States government has always been concerned about the transfer of appreciated assets to foreign entities where the U.S. tax on gain could be subsequently avoided. The Revenue Act of 1932 imposed an excise tax on these types of transfers "to prevent avoidance of tax by transferring stock or securities appreciated in value of foreign corporations to foreign trusts prior to the sale thereof. . . ."[3] The tax was limited to transfers of securities, but it was not clear whether the excise tax applied to deferred payment transactions (such as installment sales or private annuities).

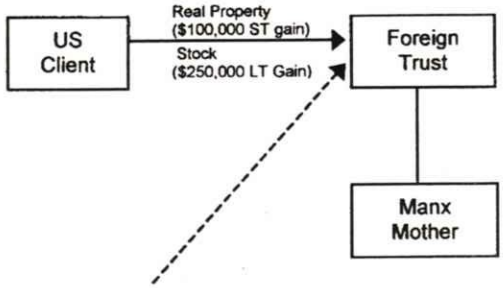
The Tax Reform Act of 1976 increased the tax rate from 27.5 percent to 35 percent and extended the application of the tax to cover transfers of all types of appreciated assets, instead of just securities. The 1976 Act also made it clear that the excise tax applied to deferred payment transactions. It imposed the 35 percent excise tax on the excess of the fair market value of the transferred property over the sum of the transferor's adjusted basis and any gain recognized at the time of the transfer. Therefore, any gain deferred was ignored in determining the appreciation to which the IRC § 1491 excise tax applied.

The IRC § 1491 excise tax did not apply, however, if all of the gain on the transfer was otherwise recognized or if the transfer was to a grantor trust [see Rev. Rul. 87-61 1987-2 C.B. 219]. Revenue Ruling 87-61 did not state whether the IRC § 1491 excise tax would be imposed upon the estate of a grantor who died, since the trust would cease to be a grantor trust at the grantor's death, causing a transfer to a nongrantor trust. Many commentators believed that an IRC § 1491 excise tax should apply at the grantor's death, but many practitioners believed otherwise in situations in which the assets were

included in the estate of the grantor. If the assets were included in the grantor's estate for federal estate tax purposes, then the basis in the assets would be stepped up to fair market value, and, even if the excise tax applied, there would be no gain to tax. The question was what happened first, the inclusion of the assets in the grantor's estate or the transfer offshore. The Treasury informally stated that it did not intend to impose an estate tax and an IRC § 1491 excise tax to the same assets transferred to a foreign nongrantor trust as a result of the grantor's death.

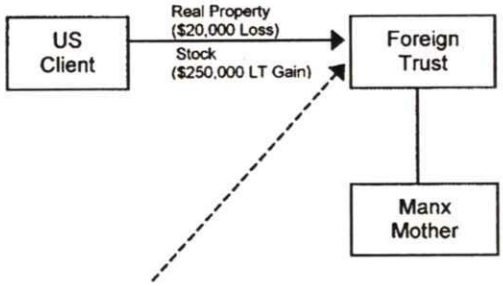
2. IRC § 684. The Taxpayer Relief Act of 1997 repealed the IRC § 1491 excise tax and substituted a requirement under new IRC § 684 that gains be recognized on transfers by U.S. persons of appreciated property to foreign trusts after August 4, 1997. IRC § 684 treats transfers of property by a U.S. person to a foreign trust, estate, or nonresident alien as a sale or exchange of such property for an amount equal to the fair market value of such property. The U.S. person must immediately recognize his or her gain in the property transferred [IRC § 684(a), Treas. Reg. § 1.648-1(a)(1)]. The amount of gain is determined on an asset by asset basis [Treas. Reg. § 1.684-1(a)(1)].

   a. In 2001, the client creates a foreign trust for the benefit of his mother, who is a Manx citizen and resident. He transfers real property that he purchased two months earlier in the Isle of Man, with a basis of $100,000 and a fair market value of $200,000, and stock that he purchased in 1997, with a basis of $50,000 and a fair market value of $300,000, to the trust. The client must recognize short-term gain on the transfers of the real property and long-term gain on the transfer of the stock [Treas. Reg. §§ 1.684-1(a)(1) and (d) Example 1].



Recognition of Short-Term Gain on Transfer of Real Property; Recognition of Long-Term Gain on Stock Transfer

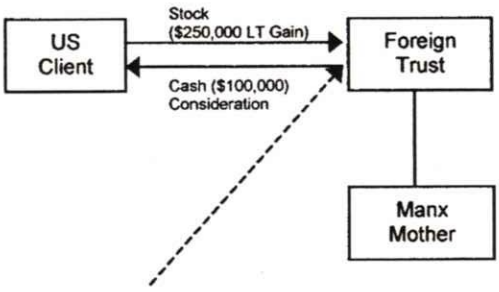
   b. The client creates a foreign trust for the benefit of his mother, who is a Manx citizen and resident. He transfers real property with a basis of $100,000 and a fair market value of $80,000 and stock with a basis of $50,000 and a fair market value of $300,000. The client must recognize the $250,000 gain on the transfer of the stock but he may not recognize the loss on the transfer of the real property or offset this loss against the gain on the stock [Treas. Reg. §§ 1.684-1(a)(2) and (d) Example 2]. U.S. persons may not recognize loss under IRC § 684 on the transfer of assets to a foreign estate or trust. They may not offset gain realized on the transfer of an appreciated asset to a foreign trust or estate by a loss realized on the transfer of a depreciated asset to a foreign trust or estate [Treas. Reg. § 1.684-1(a)(2)].



Recognition of Long-Term Gain on Stock Transfer; No Recognition or Offset of Loss on Transfer of Real Property

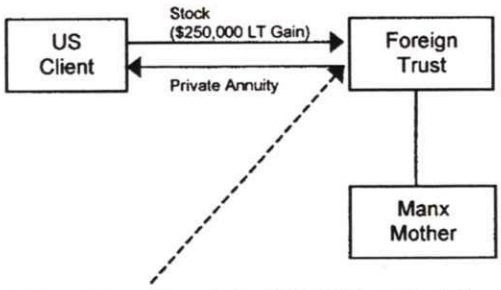
   - If, under the same facts, the client receives cash of $100,000 in exchange for his transfer of the

stock to the foreign trust, he must recognize $250,000 as his gain on the transfer [Treas. Reg. § 1.684-1(d) Example 3]. The gain that must be recognized is the difference between the fair market value and the transferor's basis, not the difference between the consideration received in exchange for the transfer (if any) and the basis.



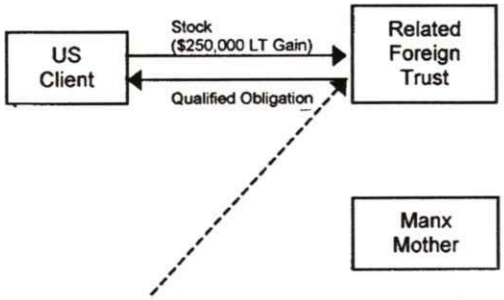
Recognition of Long-Term Gain ($250,000) on Stock Transfer

- If, under the same facts, the client receives a private annuity in exchange for the transfer of the stock, he must immediately recognize the $250,000 gain on the transfer [Treas. Reg. § 1.684-1(d) Example 4]. A transfer to a foreign trust in exchange for a private annuity will not defer the gain.



Recognition of Long-Term Gain ($250,000) on Stock Transfer

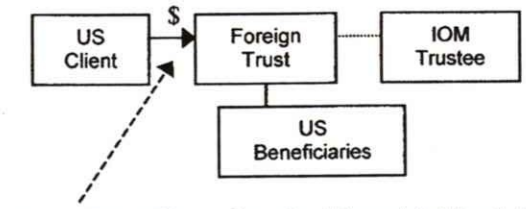
- If, under the same facts, the client receives a qualified obligation in exchange for his transfer of the stock to the foreign trust, his gain of $250,000 must be immediately recognized on the transfer of the stock to the trust because the trust is related to the client within the meaning of Treas. Reg. § 1.679-1(c)(5) [Treas. Reg. § 1.684-1(d), Example 5]. A transfer to a foreign trust that is related to the transferor in exchange for a qualified obligation within the meaning of Treas. Reg. § 1.679-4(d) will not defer the gain.



Recognition of Long-Term Gain ($250,000) on Stock Transfer

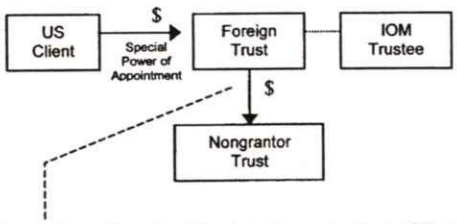
3. Exceptions to the Operation of IRC § 684. IRC § 684 states that transfers made before December 31, 2009, to grantor trusts (trusts as to which the transferor is treated as the owner under IRC § 671) will not trigger gain recognition [IRC § 684(b)]. For transfers made after December 31, 2009, transfers to grantor trusts and lifetime transfers to nonresident aliens will not trigger gain recognition (IRC § 684(b)). In addition to these statutory exceptions, the Regulations contain additional exceptions. Transfers to charitable trusts, certain transfers at death, transfers for fair market value to an unrelated trust, transfers to which IRC § 1032 applies, and certain distributions to trusts will also not trigger gain [Treas. Reg. §§ 1.684-3(a)-(f)].

- The client creates a foreign trust for the benefit of his family and transfers appreciated assets to it. Because his children are U.S. persons, the client is treated as owning the trust under IRC § 679 and, therefore, he does not recognize gain on the transfer [IRC § 684(b); Treas. Reg. §§ 1.684-3(a) and (g) Example 1].



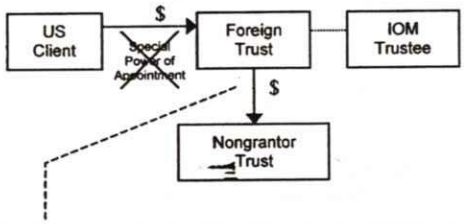
No Gain Recognition on Transfer of Appreciated Assets to Trust

- If, under the same facts, the client retains a special power of appointment over the trust assets, thereby making the initial gift to the trust incomplete and resulting in the inclusion of the trust assets in the client's gross estate for federal estate tax purposes, the subsequent deemed transfer of the assets to a trust that is now treated as a nongrantor trust at his death does not cause the client (or his estate) to recognize gain under IRC § 684 because the basis of the property in the foreign trust is determined under IRC § 1014(a) [Treas. Reg. §§ 1.684-3(c) and (g) Example 2].



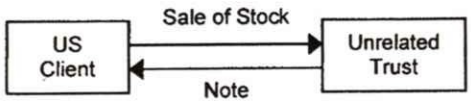
No Gain Recognition on Transfer of Assets to Nongrantor Trust at Client's Death

- If, under the same facts, the client releases his special power of appointment, making the gift to the trust complete, the assets will not be included in his estate for federal estate tax purposes. Therefore, the trust's basis is carried over from the basis in the hands of the client and is not determined under IRC § 1014(a). Because basis is not determined under IRC § 1014, the client is treated as having transferred the assets to the trust immediately before his death and he must therefore recognize the gain on the transfer made as a result of his death on his final income tax return [Treas. Reg. §§ 1.684-3(c) and (g) Example 3].



Recognition of Gain on Transfer of Assets to Nongrantor Trust at Client's Death

- If the client sells the assets to an unrelated trust [as defined in Treas. Reg. § 1.679-1(c)(5)] for their fair market value and receives a note back in exchange for the transfer of the assets, IRC § 684 will not apply to cause immediate recognition of gain [Treas. Reg. §§ 1.684-3(d) and (g), Example 4].



No Recognition of Gain If FMV of Note Is Equal to FMV of Assets

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ENDNOTES

1. Internal Revenue Code Sections 679 and 684 deal only with foreign trusts. In order to avoid the application of these Code sections, the trust could be constructed in such a fashion so that it qualifies as a U.S. person under IRC § 7701(a)(30).
2. Although the proposed Treasury Regulations required foreign trusts to obtain a ruling or determination letter from the IRS recognizing the charitable trust tax exempt status under IRC § 501(c)(3), the final Regulations do not contain this requirement. The preamble to the final Regulations cautions that the U.S. transferor must report the transfer to the charitable trust on Form 3520 unless the trust has received a ruling or determination letter recognizing the trust's tax exempt status under IRC § 501(c)(3).
3. Act of June 6, 1932, Ch. 209, §901-904, 47 Stat. 159.