International Estate Planning

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I. Asset Protection Trusts

A. Background

The stated purpose of asset protection trusts is to shelter assets in an off-shore trust from future claims of potential creditors. They are almost always designed to be "tax-neutral" so that no gift tax is incurred on their creation and any income earned by the trust continues to be fully subject to the U.S. income tax.

Asset protection trusts (APTs) have been publicized enough to receive congressional attention. Representative Gibbons explained that once their attention had been focused on the "billionaire's expatriation loophole," in 1995, he found that "many other wealthy individuals, while retaining their citizenship in this country, are abusing our tax laws by hiding their assets in offshore trusts . . . located in tax havens with bank secrecy laws designed to facilitate tax evasion."[1] He estimated that over $644 billion had been transferred by U.S. persons to the Cayman Islands, Luxembourg, and the Bahamas, and that only $1.5 billion (in 1993) had been reported to the IRS.[2] In response to this suspicion that most APTs are not reporting (or paying) their U.S. income tax, several new reporting requirements, and penalties, were added.

B. New Reporting Requirements

The approach of H.R. 3448 (Pub. L. No. 104-188), the Small Business Job Protection Act of 1996, signed into law on August 20, 1996, is to require new reporting about APTs. The new "reportable events" (which must be reported within ninety days) are:

i. the creation of any foreign trust by a U.S. person;

ii. the transfer of any money or property (directly or indirectly) to a foreign trust by a U.S. person, including a transfer by reason of death (sales at fair market value are excluded); and

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1. Federal Register, Sept. 19, 1995, p. E1804.

2. *Id.*

iii. the death of a U.S. person who was the owner of, or whose estate included, any portion of a foreign trust.[3]

The report must be filed by the grantor, the transferor, or the executor. It must include the amount of the transfer and the identity of the trust, each trustee, and each beneficiary or class of beneficiaries.[4] The U.S. taxpayer-owner must ensure that an annual return is filed for the trust, that includes a complete accounting of transactions during the year and the name of the U.S. agent for the trust.[5]

C. Penalties

Failure to file, or incomplete information, can result in a penalty tax of thirty-five percent of the gross reportable amount; a failure that continues more than ninety days after notice incurs an additional $10,000 per month.[6]

D. Effective Date

This applies to all reportable events that occur after August 20, 1996.[7]

II. Foreign Grantor Trusts

A. Background

Until this change in the law, it had been possible for a foreign grantor to create a foreign trust for a U.S. beneficiary that would incur no U.S. income tax. This was because the grantor trust rules treat the grantor as the owner for income tax purposes, and in fact no (U.S.) income tax would be payable by a foreign grantor, with respect to a foreign trust with non-U.S. assets. Thus trust distributions to a U.S. beneficiary would not carry out taxable income.

B. New Law

H.R. 3448 (see above APT discussion), signed into law on August 20, 1996, changed that. Section 1904 is titled "Foreign Persons Not to Be Treated as Owners Under Grantor Trust Rules." The legislation allows treatment as the owner only to the extent that there is U.S. taxable income.[8] There are two narrow exceptions: (1) a trust wholly revocable by the grantor (without requiring consent of an adverse party); and (2) a trust that permits distributions (during the grantor's life) only to the grantor or the grantor's spouse.[9]

C. Effective Date

This has an effective date of August 20, 1996, except that amounts in trusts as of September 19, 1995, are excluded.[10]

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3. Pub. L. No. 104-188, Sec. 1901(a) (amending I.R.C. § 6048).
4. *Id.*
5. *Id.*
6. *Id.* Sec. 1901(b) (amending I.R.C. § 6677).
7. *Id.* Sec. 1901(d).
8. *Id.* Sec. 1904(a) (amending I.R.C. § 672(f)).
9. *Id.*
10. *Id.* Sec. 1904(d).

D. Foreign Trusts—General

Several new rules apply to all foreign trusts. One is a definition of "foreign trust," which had been a test based on all relevant factors. Now a foreign trust is: "[A]ny trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more United States fiduciaries have the authority to control all substantial decisions of the trust."[11]

Another new rule will apply to the tax due on transfer to a foreign trust (I.R.C. § 1491) to a domestic trust when it "migrates" into becoming a foreign trust.[12] Also accumulation distributions from a foreign trust had been subject to a six percent interest rate; that has been increased to correspond to the current rate for underpayment of tax.[13] Another planning strategy, of borrowing from a foreign trust, has been eliminated. The new law will treat loans of cash or marketable securities to U.S. beneficiaries (or related persons) as distributions from the trust.[14] (Proposals to also tax the use of trust property did not pass.) Also, the frequently used pre-immigration creation of a foreign trust will not receive the favorable tax treatment if the grantor becomes a U.S. person within five years.[15] Finally, as mentioned below, any distribution to a U.S. person must now be reported, by the U.S. person.[16]

III. Receipt of Foreign Gifts

A. Background

Many relatives in the United States receive gifts and inheritances from foreign persons. There has never been a requirement to report those gifts and bequests, since the receipt does not cause a U.S. transfer tax.

B. New Reporting Requirements

Now, as part of H.R. 3448, signed into law on August 20, 1996 (Pub. L. No. 104-188), whenever a U.S. person receives more that $10,000 in the aggregate during any one calendar year from foreign persons or estates, those gifts must be reported.[17] Note: There is also a new requirement to report any amount received from a foreign trust (the report must include the name of the trust and the total received that year).[18]

D. Penalty

Failure to report can result in a penalty tax equal to five percent of the amount for each month, up to a maximum of twenty-five percent.[19]

11. *Id.* Sec. 1907(a) (amending I.R.C. § 7701(a)).
12. *Id.* Sec. 1907(b) (amending I.R.C. § 1491); *see also* I.R.S. Notice 96-56 (Dec. 6, 1996).
13. Pub. L. No. 104-188, Sec. 1906(a) (amending I.R.C. § 668 (a)).
14. *Id.* Sec. 1906(c) (amending I.R.C. § 643).
15. *Id.* Sec. 1903(c) (amending I.R.C. § 679(a)).
16. *Id.* Sec. 1905(a) (adding I.R.C. § 6039F).
17. *Id.*
18. *Id.* Sec. 1901(a) (amending I.R.C. § 6048).
19. *Id.* Sec. 1905(a) (adding I.R.C. § 6039F).

E. Effective Date

This applies to gifts (or bequests) received after August 20, 1996.[20]

IV. Expatriation

A. Background

There had been many proposals to impose some sort of "exit tax" to collect from those who give up their U.S. citizenship. Because the U.S. estate and gift tax apply to all assets, wherever located, for anyone who is a U.S. citizen, the only way to avoid this tax has been to own no U.S. assets, give up U.S. residency, and give up U.S. citizenship. During 1995 this "billionaire's loophole" received substantial attention in Congress.

B. New Laws

None of the "exit tax" proposals passed. Instead, there are new reporting requirements, some modifications to the existing tax rules, and a very surprising addition to the Immigration Act that may exclude expatriates from reentering the United States.

First, the modifications to the existing ten-year continuing taxation on U.S. source income, at U.S. person rates, which apply whenever tax avoidance was "a" principal purpose of expatriation, include that it will automatically apply to the "wealthy," who are those with a net worth of $500,000 or more or a five-year average net income tax over $100,000.[21] The exceptions from this are those who: (1) became dual citizens at birth and continue to be citizens of the other country; (2) become citizens of the country where they were born, or their spouse or either parent was born; (3) were present in the United States less that 31 days in each of the prior ten years; or (4) renounce prior to age 18½.[22] Persons meeting one of those qualifications must also submit a ruling request within one year.[23]

For the first time certain permanent residents (e.g., "green card" holders) who lose that status will be treated for tax purposes the same as those who renounce citizenship. This applies to those who were permanent residents in at least eight of the prior fifteen years.[24]

The new reporting requirement is that a statement must be filed in connection with the actual loss of citizenship (and that agency is required to give a copy, or the names of those who refused to give a report, to the Treasury Department) providing:

1. the taxpayer's identification number,
2. the mailing address of the principal foreign residence,
3. the foreign country of residence,
4. the foreign country of citizenship, and
5. for the "wealthy" (those with a net worth of $500,000 or more) a detailed statement of assets and liabilities.[25]

20. *Id.* Sec. 1905(c).
21. Pub. L. No. 104-191, Sec. 511(a) (amending I.R.C. § 877(a)).
22. *Id.* Sec. 511(b) (adding I.R.C. § 877(c), striking (d), and renumbering former (c) as (d)).
23. *Id.* Sec. 511(a) (amending I.R.C. § 877(a)).
24. *Id.* Sec. 511(f) (adding I.R.C. § 877(e), and changing former (d) to (f)).
25. *Id.* Sec. 512(a) (adding I.R.C. § 6039F).

The names of those who renounce citizenship will be published in the Federal Register each quarter.[26] Those who lose permanent resident status are required to attach the above report to their income tax return.[27]

C. Penalty

The penalty for failure to file is five percent per year of the income tax required under Section 877 (minimum $1,000).[28]

D. Effective Date

The effective date continues to be (as it was with the "exit tax" proposals) Feb. 5, 1995.[29] The changes were included in the Health Insurance Portability and Accountability Act (Pub. L. No. 104-191), signed into law on August 21, 1996, and were intended to be a source of revenue. Note that the Treasury is also directed to submit a report on measures to improve tax compliance by Americans residing abroad.[30] Reentry to the United States may be denied. Surprisingly, an expatriation provision was added to the Illegal Immigration Reform Act that was signed on September 30, 1996, stating:

> Any alien who is a former citizen of the United States who officially renounces U.S. citizenship and who is determined by the Attorney General to have [done so] for the purpose of avoiding taxation . . . is excludable.[31]

This provision applies only to those who renounce citizenship after September 29, 1996.[32]

E. Trends and General Comments

It appears that all wealthy individuals who "use" another jurisdiction for tax-planning will continue to be scrutinized by the U.S. Congress. As a result of the publicity generated by the expatriation controversy, we will probably see additional legislation in this area.

26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.* Sec. 512(c).
30. *Id.* Sec. 513.
31. Pub. L. No. 104-208, Sec. 352.
32. *Id.*