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I. Asset Protection Trusts

A. Background

So-called asset protection trusts (APTs) are trusts established in offshore jurisdictions for the purpose of thwarting claims of creditors. They are usually created without incurring gift tax, which means that they are fully taxed by the United States at the death of the U.S. settlor. They are also fully subject to U.S. income tax.

B. 1999 Cases

1. *Ninth Circuit Looks Through Protector Agreement*

As a general rule, creditors are able to reach assets that the debtor can access. Accordingly, the hallmark of APTs has been the purported legal inability of the settlor to have access to trust assets in the event of a claim by a creditor. This assumption was severely undermined in *Federal Trade Commission v. Affordable Media, LLC.*[1] In *Affordable Media*, the U.S. Court of Appeals for the Ninth Circuit affirmed the district court's injunction against the settlors of an APT; the injunction required the defendants to repatriate any assets held for their benefit outside of the United States.

Affordable Media arose on the filing of a complaint by the Federal Trade Commission (FTC) charging Denyse and Michael Anderson and Affordable Media with violations of the Federal Trade Commission Act relating to their telemarketing activities that amounted to, according to the district court, a "classic Ponzi scheme."[2] The Andersons had established an irrevocable trust in the Cook Islands in 1995, naming themselves as trustees along with a local trust company. In response to the preliminary injunction issued by the district court, the Andersons faxed a letter to the local trust company instructing it to provide an accounting and to repatriate the assets to the United States. The corporate trustee responded by

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1. Federal Trade Comm'n v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999).
2. *Id.* at 1232.

informing the Andersons that the preliminary injunction constituted an "event of duress" under the terms of the trust agreement, and that the Andersons were removed as trustees. No accounting or repatriation of assets was made.

On learning of the failure of the Andersons to comply with the preliminary injunction, the FTC moved to find the Andersons in contempt, which the district court found. After several delayed hearings, the district court ordered the Andersons taken into custody.

The Ninth Circuit noted that the Cook Islands trust was "intentionally designed to frustrate United States courts' powers to grant effective relief to prevailing parties . . . ."[3] In reviewing the district court's finding of contempt, the Ninth Circuit held that the FTC had met its burden of showing by clear and convincing evidence that the Andersons violated specific orders of the court. The Andersons, however, did not overcome their burden of showing their inability to comply with the orders.

The Ninth Circuit observed that because it is the explicit intention of the grantors of APTs to frustrate the operation of U.S. courts, the burden of proving impossibility of performance as a defense to an order to repatriate assets will be "particularly high."[4] The Ninth Circuit specifically reserved whether an actual inability to comply with a court order would be a defense to a civil contempt charge. Instead, it agreed with the lower court that the Andersons had not, in fact, given up complete control of the trust. The primary factor relied upon was the Andersons' status as "protectors" of the trust, a position that gave them power to replace trustees and veto certain actions of the trustee. The Andersons did attempt to resign as protectors, but not until after they reported to the district court that they were unable to comply with its orders.[5] The Ninth Circuit explicitly did not decide the question of whether the lower court would have been affirmed on this point if the Andersons had not been protectors.[6]

2. *Bankruptcy Court Follows Affordable Media*

In re Lawrence,[7] decided September 8, 1999, was a proceeding to hold a Chapter 7 bankruptcy debtor in contempt of court for violating the court's order granting the bankruptcy trustee's motion to compel the debtor to turn over property in an offshore trust to the trustee. As in *Affordable Media*, which the bankruptcy court cited and with which it agreed, the debtor was found in contempt for his willful failure to repatriate assets from a foreign trust he had created. Though a "protector" was not mentioned, the debtor had authority under the trust instrument to replace the trustee. The bankruptcy court found that the debtor failed to meet his high burden of proving the impossibility defense.[8]

3. *Ramification of 1999 Cases*

The *Affordable Media* case is a landmark in offshore estate planning. It seriously undermines the working assumption of practitioners in this area that impossibility is a defense to an order to repatriate assets. Though the *Affordable Media* court relied chiefly on the status of the defendants as protectors in finding that they had effective control over the trust, the

3. *Id.* at 1236–37.
4. *Id.* at 1241.
5. *See id.* at 1243.
6. *See id.* at n.11.
7. *In re* Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999).
8. *See id.* at 501.

possibility that other factors not addressed there could result in a similar conclusion was left open.

II. Foreign Trust Rules

A. Background

The classification of a trust as either foreign or domestic has significant consequences for U.S. income tax purposes. If a trust that has previously been treated as a U.S. person becomes a foreign trust, as determined under the new Treasury Regulation § 301.7701-7, a taxable transfer will be deemed to have occurred. Section 684 of the Internal Revenue Code (I.R.C.) treats a transfer from a U.S. trust to a foreign trust as a sale or exchange for an amount equal to the fair market value of the trust assets, and any gain realized would be recognized by the transferring trust in the year of transfer.[9] Also, the status as "owner" of a grantor trust causes income of the trust to be taxed to that person.[10]

B. New Treasury Regulations Define "Foreign" Trusts

New regulations provide guidance in classifying a trust as domestic (United States) or foreign.[11] The regulations provide a two-part test that must be satisfied in order for a trust to be considered a U.S. person for income tax purposes, including the tax on the change from a domestic trust to a foreign trust. The two-part test to determine a trust's residence status is made up of (1) the control test and (2) the court test. The terms of the trust and the state law applicable to the trust are applied to determine whether these tests are met.[12] To satisfy the control test, one or more U.S. persons must "have the authority to control all substantial decisions of the trust."[13]

The court test requires that a "[1] court within the United States is [2] able to exercise [3] primary supervision over the [4] administration of the trust . . ."[14] For this purpose, the term "United States" retains its regular definition under I.R.C. § 7701(a)(9) and, therefore, does not include the territories of the United States.[15] The question of inclusion of courts of the territories was raised in comments to Proposed Regulation § 301.7701-7 and was rejected, as shown by the language in the final regulations.[16]

The term "primary supervision" means that a court "has or would have the authority to determine substantially *all* issues regarding the administration of the *entire* trust" (emphasis added).[17] Additionally, a court must be "able to exercise" this authority by issuing orders or

9. I.R.C. § 684(a) (1999).

10. *See* I.R.C. § 671 (1999).

11. *See* Treas. Reg. § 301.7701-7 (as amended by T.D. 8813, 64 Fed. Reg. 4,970). Prior to amendment of I.R.C. §§ 7701(a)(30) and (31) by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1907(a)(1), (2), and (3), 110 Stat. 1903 (1996), and the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §§ 1601(i)(3)(A) and 1161, 111 Stat. 1099 (1997), the determination of the foreign or domestic status of a trust was determined on a case by case basis using judicially developed standards. *See* Rev. Rul. 60-181, 1960-1 C.B. 257 (relying on B.W. Jones Trust v. Commissioner, 46 B.T.A. 531 (1942), *aff'd* 132 F.2d 914 (4th Cir. 1943)).

12. *See* Treas. Reg. § 301.7701-7(b).

13. Treas. Reg. § 301.7701-7(a)(1)(ii).

14. Treas. Reg. § 301.7701-7(a)(1)(i).

15. *See* Treas. Reg. § 301.7701-7(d)(1)(ii).

16. *See id.*; T.D. 8813, 64 Fed. Reg. 4,970 (1999).

17. Treas. Reg. § 301.7701-7(c)(3)(iv).

rendering judgments concerning administration of the trust.[18] The "administration" of a trust means " ... the carrying out of the duties imposed [on a fiduciary] by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, ... defending the trust from suits by creditors, and determining the amount and timing of distributions."[19]

The language of the regulation requires that a court in the United States be able to exercise its authority over administration of the trust. "Administration" is defined as carrying out duties that are both ministerial (maintaining books and records) and discretionary (determining amount of distributions), and the applicable court must have authority over the trustee.[20]

A trust that was in existence as of August 20, 1996, and that was treated as a "domestic trust" as of August 19, 1996, may elect to continue treatment as a domestic trust.[21] To be treated as a "domestic trust," the trustee must have filed a U.S. Income Tax Return for Estates and Trusts (Form 1041) for the trust for the period including August 19, 1996.[22] This makes obsolete I.R.S. Notice 98–25.[23]

C. New Regulations Provide Rules for Trusts with Foreign Grantors

The IRS issued final, temporary, and proposed regulations regarding trusts with foreign grantors, covering distributions through intermediaries, the definition of the term "grantor," foreign persons not treated as owners, and recharacterization of purported gifts.[24]

Final regulations treat any property transferred to a U.S. person by an "intermediary" as property transferred directly by the foreign trust, if done pursuant to a plan in which one of the principal purposes was the avoidance of U.S. tax.[25] The definition of a grantor for purposes of I.R.C. §§ 641–85 is changed to include a person who directly or indirectly makes a gratuitous transfer to a trust.[26] The purpose of this rule is to ensure that someone will always be responsible for reporting a transfer even if made by a nominee. Transfers from one trust to another and from partnerships and corporations are also included.[27]

Final regulations provide that the grantor trust rules (the basic grantor trust rules) other than I.R.C. § 672(f) are first applied to determine whether any portion of a trust is treated as owned by someone other than a U.S. person.[28] If it is determined that any portion of the trust is treated as owned by a non-U.S. person, such person will be treated as an owner only if such person is a foreign corporation or meets an exception.

Gifts from foreign donors can be recharacterized under the new final regulations. Gratuitous transfers to U.S. donees from trusts created by foreign partnerships or foreign corporations that are treated as owners of the trusts are treated as a gift from the partnership or corporation.[29]

18. Treas. Reg. § 301.7701–7(c)(3)(iii).
19. Treas. Reg. § 301.7701–7(c)(1)(v).
20. *See id.*
21. Treas. Reg. § 301.7701–7(f)(1).
22. Treas. Reg. § 301.7701–7(f)(2).
23. I.R.S. Notice 98–25, 1998–1 C.B. 979.
24. *See* T.D. 8831, 64 Fed. Reg. 43,267 (1999).
25. *See* Treas. Reg. § 1.643(h)-1(a)(1).
26. *See* Prop. Treas. Reg. § 1.671–2(e), 64 Fed. Reg. 43,323 (1999).
27. *See* T.D. 8831, 64 Fed. Reg. 43,267.
28. Treas. Reg. § 1.672(f)-1(a)(1).
29. *See* Treas. Reg. § 1.672(f)-4.

III. Estate and Gift Tax Treaties

A. New U.S.-Germany Protocol

On November 5, 1999, the Senate approved a new Protocol for the 1980 U.S.-Germany Estate Tax Treaty. It is not yet in effect, as instruments of ratification have not been exchanged. The amendments made by the Protocol are effective for decedents dying and gifts made after the date ratifying instruments are exchanged.

Amending article 4, paragraph 3(c) of the Treaty, the Protocol extends from five to ten years the period during which an individual, who otherwise meets the domicile requirements, may be treated as not meeting the domicile requirement.[30]

In determining the taxability of transfers on certain types of assets situated in a state, only specified deductions and exemptions are allowed. The Protocol amends article 10, paragraph 4 to provide that these mandated deductions and exemptions are not applicable to a U.S. citizen or former long-term resident domiciled in Germany at the time of the transfer.[31] For instance, the United States is not required to provide the marital deduction with respect to transfers from a U.S. citizen residing in Germany for transfers to a spouse who is not a U.S. citizen.

The Protocol adds new paragraphs 5 and 6 to article 10 of the Treaty.[32] Paragraph 5 grants a pro rata unified credit to the estate of a decedent domiciled in Germany for purposes of computing the U.S. estate tax. Under I.R.C. § 2102(c)(1), a non-resident not a U.S. citizen is limited to a unified credit of $13,000. The new paragraph 5 invokes the mechanism of I.R.C. § 2102(c)(4), which allows a pro rata amount of the full unified credit, based on the proportion the gross estate situated in the United States bears to the worldwide gross estate.[33]

New paragraph 6 of article 10 allows a marital deduction for estates meeting certain conditions, with the intent to effectively limit the deduction to smaller estates.[34]

Finally, the "savings clause," by which each country reserves the right to tax certain estates or donors under the country's internal laws, without regard to the Treaty, was amended by the Protocol. The amendment expands the savings clause on behalf of the United States to cover two new classes of individuals: the first is the estate of a decedent or a donor who was domiciled in the United States; the second is the estate of a decedent or donor who was a former long-term resident within the meaning of I.R.C. §§ 877, 2107, and 2501(a)(3).

B. Other Estate Tax Treaty Developments

In a 1993 Field Service Advice released in 1999, the IRS held that the 1954 U.S.-Germany Income Tax Treaty did not exempt dividends and interest paid to the estate of a U.S. citizen who died as a resident of Germany.[35] The securities that paid the interest and dividends were of U.S. entities and were held by a revocable trust; upon the death of the settlor, the

30. Treasury Explanation of Proposed Protocol to U.S.-Germany Estate Tax Convention, 1999 Worldwide Tax Daily 210–22, para. 5 (1999).

31. *See id.* para. 7.

32. *See id.* paras. 14–16.

33. *See id.* para. 15.

34. *See id.* para. 16.

35. I.R.S. Field Service Advisory 1999-801 (Aug. 12, 1993), *available in* 1999 WL 1065250.

trust was distributed to her estate. Because the interest and dividends were paid to the estate, and not to the beneficiaries of the estate who were individuals residing in Germany, the estate was required to include such items in income. The IRS stated that the result would be the same under the 1980 U.S.-Germany Income Tax Treaty.

IV. Procedures

In *Estate of Michael v. Lullo*,[36] the U.S. Court of Appeals for the Fourth Circuit held that the lower court should have issued a writ of mandamus against the IRS because the taxpayer had no other method to vindicate its clear right to the full foreign tax credit in the closed estate.

Under the facts in *Estate of Michael v. Lullo*, after the estate tax return had been closed, the IRS reduced the amount of the previously allowed foreign tax credit by the amount of additional tax due on account of the IRS not including certain assets listed on schedules on the return in its closing agreement.[37] The IRS used this technique even though it admitted before the district court that it did not actually contest the validity or amount of the foreign tax credit claimed and proved during negotiations leading up to the closing letter.[38] Otherwise, any assessment was barred by the three-year statute of limitations under I.R.C. § 6501(a). In invoking an exception to the Anti-Injunction Act, the Fourth Circuit noted that the legal remedy of a refund suit is not relevant where "the IRS acts in complete disregard for the tax code . . . ."[39] The taxpayer could not resort to a petition in Tax Court because the IRS did not and could not issue a notice of deficiency.

V. Charitable Contributions

In Technical Advice Memorandum 99-25-043,[40] the IRS construed a decedent's will to provide a charitable bequest to a U.S. affiliate of a foreign charity rather than to the foreign charity itself, thus allowing an estate tax deduction under I.R.C. § 2106.

The decedent, a citizen and resident of the country where the foreign charity was organized and operated, made a bequest of $1 million to be used to fund the expansion of a hospital operated by the foreign charity. The original of the will and the English translation of the will did not clarify whether the foreign charity or its U.S. affiliate was the intended beneficiary. A court in the foreign country held the bequest to be to the U.S. affiliate. The IRS said that it was reasonable to construe the bequest as being to the U.S. affiliate because the full bequest would be available to the hospital only if it passed free from U.S. estate taxes.

VI. Passive Foreign Investment Companies

Regulations were proposed to implement changes made by the Taxpayer Relief Act of 1997,[41] amending I.R.C. § 1296, by which a U.S. shareholder of a Passive Foreign Invest-

36. Estate of Michael v. Lullo, 173 F.3d 503 (4th Cir. 1999).
37. *See id.* at 505.
38. *See id.* at 507.
39. *Id.* at 523.
40. T.A.M. 99-25-043 (Mar. 8, 1999).
41. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1122(a), 111 Stat. 1099 (1997).

ment Company (PFIC) may make a mark-to-market election with respect to the stock of the PFIC if the stock is "marketable stock" within the meaning of I.R.C. § 1296(e).[42] These proposed regulations were made final shortly after year end.[43]

If stock in a PFIC is "marketable stock," the U.S. person who owns such stock may elect to include in gross income the excess of the fair market value of the stock over such person's adjusted basis.[44] The new regulations refine the concept of what is a marketable stock by explaining the meaning of "regularly traded," a term which is not as easily applied to foreign markets as in the United States. Generally, the new regulations apply concepts familiar to U.S. investors for regulated securities markets.

VII. Retirement Distributions

In IRS Private Letter Ruling 99–22–039, the IRS ruled that annuity payments from a U.S. employer to a nonresident alien were taxable only by the United Kingdom under the U.K.-U.S. Income Tax Treaty and, therefore, were not subject to U.S. withholding tax under I.R.C. § 1441(a).[45]

VIII. Qualified Domestic Trust

In IRS Private Letter Ruling 99–18–039,[46] the IRS ruled that the classification of the trust as a foreign trust under § 7701(a)(31)(B)[47] did not cause it to fail to qualify as a qualified domestic trust (QDOT) under § 2056A. Because the surviving spouse was not a U.S. citizen, in order to qualify for a marital deduction, the trustee had to elect to invoke the rules for a QDOT under I.R.C. § 2056A. In order to qualify under § 2056A, the ruling allowed the contribution to the QDOT by the surviving spouse of stock of a corporation created to own certain assets otherwise distributable to the surviving spouse under the decedent's will.

In IRS Private Letter Ruling 99–17–045,[48] the IRS ruled that the distribution of assets from a QDOT will not result in the imposition of additional estate tax under § 2056A. An individual, owning some U.S. assets, died testate as a citizen and domiciliary of a foreign country. The will left the residue of his estate to a trust for the benefit of his wife, who was not a U.S. citizen. The trust was intended to qualify as a QDOT under § 2056A.

The IRS examined the estate and determined that no assets were includable in the decedent's gross estate for U.S. estate tax purposes and, thus, the marital deduction was not claimed for property passing to the QDOT. The wife proposed to exercise her power under

42. *See* Passive Foreign Investment Companies; Definition of Marketable Stock, 64 Fed. Reg. 5,012 (1999); I.R.S. Announcement 99–35, 1999–14 I.R.B. 22 (1999) (correcting Passive Foreign Investment Companies; Definition of Marketable Stock).

43. T.D. 8867 (2000).

44. *See* I.R.C. § 1296(a).

45. P.L.R. 99–22–039 (Mar. 3, 1999).

46. P.L.R. 99–18–039 (Feb. 8, 1999).

47. Pub. L. No. 104–88, § 1907(a)(2), 110 Stat. 1903 (1996) (as amended by the Small Business Job Protection Act of 1996).

48. P.L.R. 99–17–045 (Jan. 29, 1999).

the will to request a complete distribution of all the assets currently held in the QDOT. Because the individual was a citizen and domiciliary of a foreign country and because of an estate and gift tax convention between that foreign country and the United States, the estate tax liability was zero. Accordingly, the IRS ruled that the proposed distribution from the QDOT to the surviving spouse would not result in the imposition of additional estate tax under § 2056A(b)(1).