Advanced International Estate Planning

Law Firm of Mark Merric, LLC
4155 E. Jewell Ave., Suite 100; Denver, CO 80222
(303) 800-4369; (303) 261-8374
Mark@InternationalCounselor.com; www.InternationalCounselor.com

Mark Merric, JD, MT, CPA In addition to being an attorney, Mark Merric holds a Masters of Taxation and he is a Certified Public Accountant, as well as an Adjunct Professor at the University of Colorado–Denver Masters of Taxation, and a lecturer/ speaker at Fudan University China, ranked in the top three Chinese Universities. He has also been an adjunct professor at the University of Denver's, Law School Graduate Tax Program for 20 years. He has been quoted in Forbes, Investor's News, On the Street, the Denver Business Journal, Oil and Gas Investor, and the Sioux Falls Business Journal. Mr. Merric is an international speaker presenting at over 600 seminars, and he has published over 80 national articles. Mr. Merric is the manager of the Law Firm of Mark Merric, LLC and a manager for the Alliance of International Legal Counselor, LLC. Prior to practicing as an attorney, Mark Merric developed a strong business background working for a Final Four Accounting Firm and Fortune 500 Company. He is honored to have spoken multiple times at the following distinguished estate planning seminars:

- Regis Campfield's Notre Dame Tax and Estate Planning Institute;
- Lonnie McGee's Southern California Tax and Estate Planning Forum; and the
- Chicago Bar Association.

He is also a co-author of the following three treatises:

- The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, Commerce Clearing House (CCH) treatise, first edition;
- Asset Protection Strategies, American Bar Association (two chapters); and
- Asset Protection Strategies Volume II, American Bar Association published Apr. 2005 (MM responsible for 1/5 of the text).

Disclaimer

The law is constantly changing at an unprecedented pace. Also, each client's separate fact situation must be carefully examined before applying any principals of law. Furthermore, this outline is not intended to be a substitute for the practitioner's own research into this area of law and how the law applies to a client's specific situation. Therefore, the author takes no responsibility how the areas of law covered by this outline apply to the reader or the reader's clients. Finally, to ensure compliance with requirements imposed by the IRS Circular 230, we hereby inform you that any U. S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any matter addressed herein.

Procedures for Engagement

We would be more than happy to assist you with your request, however, let me first explain our procedures for engagement of our firm.

Our firm provides advice in estate planning, international taxation, business structures and transactions, and asset protection planning. Seldom, if ever, are there any "simple or quick questions in these fields. Almost all questions in these areas require a review of the relevant legal documents, organizational structure, past planning, as well as the client's objectives. Further, due to the liability issues involved combined with our time commitment, we do not answer technical questions, hypothetical questions, questions on outlines or articles unless we are engaged in writing. Our minimum engagement fee is $1,000.

Please note that we do not accept international taxation of foreign retirement plan type of work. Should you have individual foreign retirement plan type of work, the following person was recommended to us:

Mr. Amiram J. Givon
(650) 428-3900
agivon@gcalaw.com

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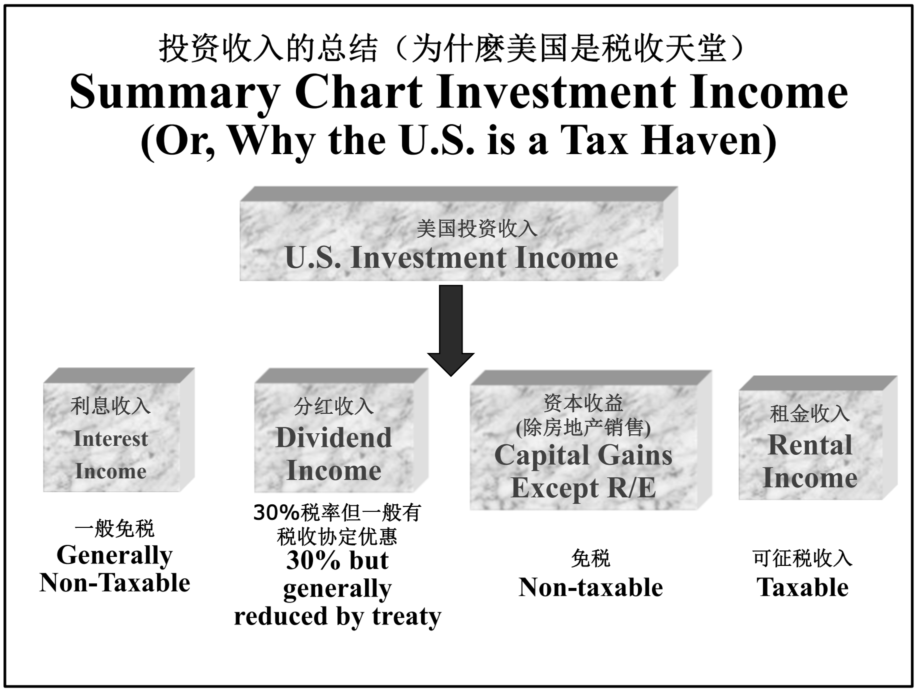
This outline first summarizes the noncitizen spouse scenarios to three tables with thre alternatives. For some reason, the estate planning of a nonresident alien "NRA" also breaks down into a 3 x 3 planning. However, this is not a matrix with nine possibilities. Rather, there are primarily three types of estate planning tools, three main possibilities with treaties, and usually three types of assets of primary concern. This outline ends with discussing one of the primary estate planning tools.



B. Summary Chart of Investment Income

Many times the U.S. complains of other nations being tax havens. Conversely, many foreign nations point to the U.S.'s favorable taxation for interest income, capital gains, and many times dividends under a treaty, and make similar statements regarding the U.S.

1. Interest Income

Usually, interest income will be excluded from U.S. taxation under either the portfolio interest or bank deposit interest exclusion. Further, even if interest income is not excluded, Almost always a treaty will provide a lower tax rate than the 30% FDAP rate.

2. Dividend Income

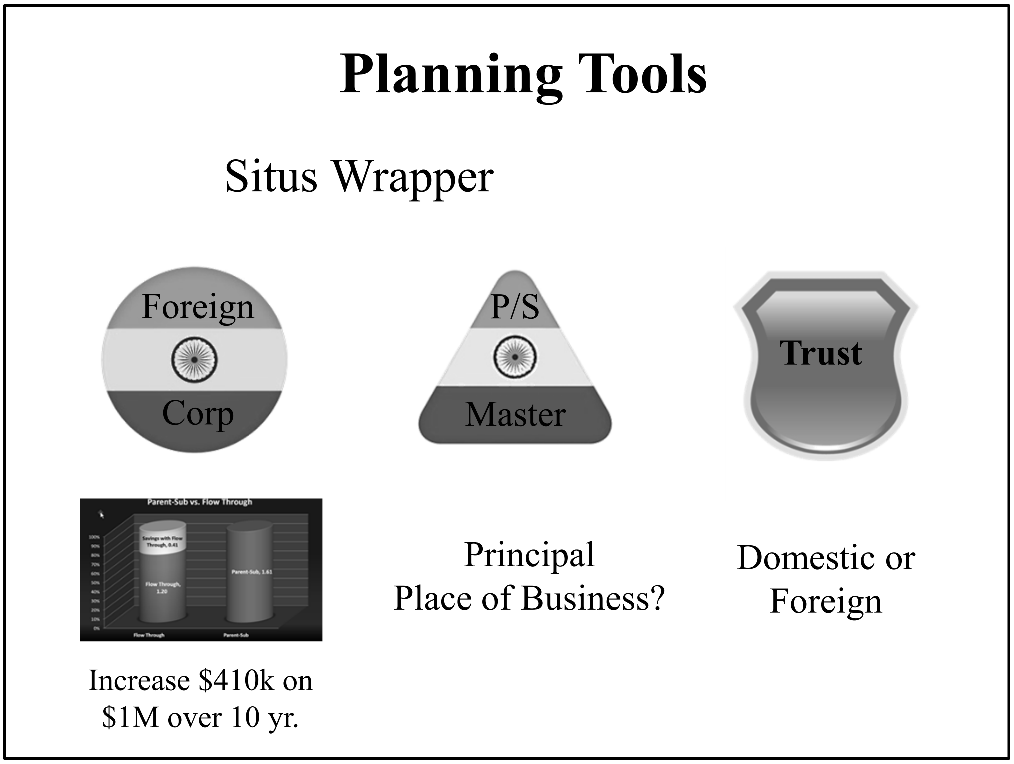
U.S. dividend income is subject to the normal 30% withholding tax, unless a lower rate of taxation is available pursuant to a tax treaty. IRC 1441(a). Tax treaties typically reduce dividends from 5% to 15%.

3. Capital Gains

Except for real estate and the sale of a U.S. partnership interest, a foreign person does not pay any tax on a capital gain transaction.

4. Rental Income

Gross rents received on real estate (unless it is a hotel or motel) does not qualify as a U.S. business. Therefore, unless an IRC 871(d) election is made, gross rents are subject to a 30% withholding tax.



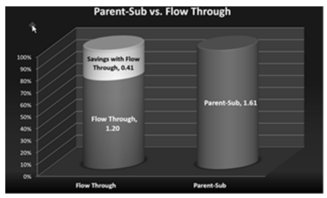
C. Three Primary Planning Tools For a NRA

The three primary planning tools for a NRA are the foreign corporation, a master foreign partnership, and domestic and foreign trusts. As discussed in the first outline, the foreign corporation is the most common estate planning tool due to its simplicity and generally it is the least expensive to create. Unfortunately, due to the double tax of a C corporation and the way that typically foreign tax credits work, it has a major downside from the income tax side. In one of the examples in the first outline, the foreign person invested $1 million in real estate over a 10 year period of time with a 5% increase in operating income per year. The increased income tax due to the double tax issue on sale was $410,000.

As an alternative, the concept of a foreign master partnership was proposed that held investments in both the NRA's home country as well as the U.S. The primary place of business of the foreign partnership would be the NRA's home country. This method of planning appears to have merit based on the assumption that the Service would follow Rev. Rul. 55-701 and the place of business is the situs of the partnership. As discussed in the first outline of this series, while many, if not most commentators, view this as the Service approach, it is not certain that the Service will follow this approach.

The last method is the method that we typically use for our domestic estate planning clients – planning with trusts. As to the NRA, the trust planning may be with domestic or offshore trusts.

Blocker Corporation



Increase $410k on
$1M over 10 yr.

Many times when at a seminar, the speaker will refer to something known as a “blocker corporation.” When used in the estate tax concept, all it means is that a foreign corporation is being used to block the estate tax by changing the situs. So one question I occasionally get which is more of a comment than a question, is so your not a fan of blocker planning. On smaller estates, it may be the only choice as the client assets don’t fit the model for a master limited partnership, or the cost/benefit ratio is not there for using a domestic or foreign trust. Otherwise, I prefer to be one of those people who want to have my cake, and eat it too. Hence, I prefer a flow through structure.

Three by Three Analysis of Planning Scenarios

Situs Rules

- **Domicile Treaty**
  - Primary taxation
  - Situs
- **Situs Treaty**
  - Situs of Certain Assets
  - General Foreign Tax Credit
  - No gift tax rule
- **Code Planning**

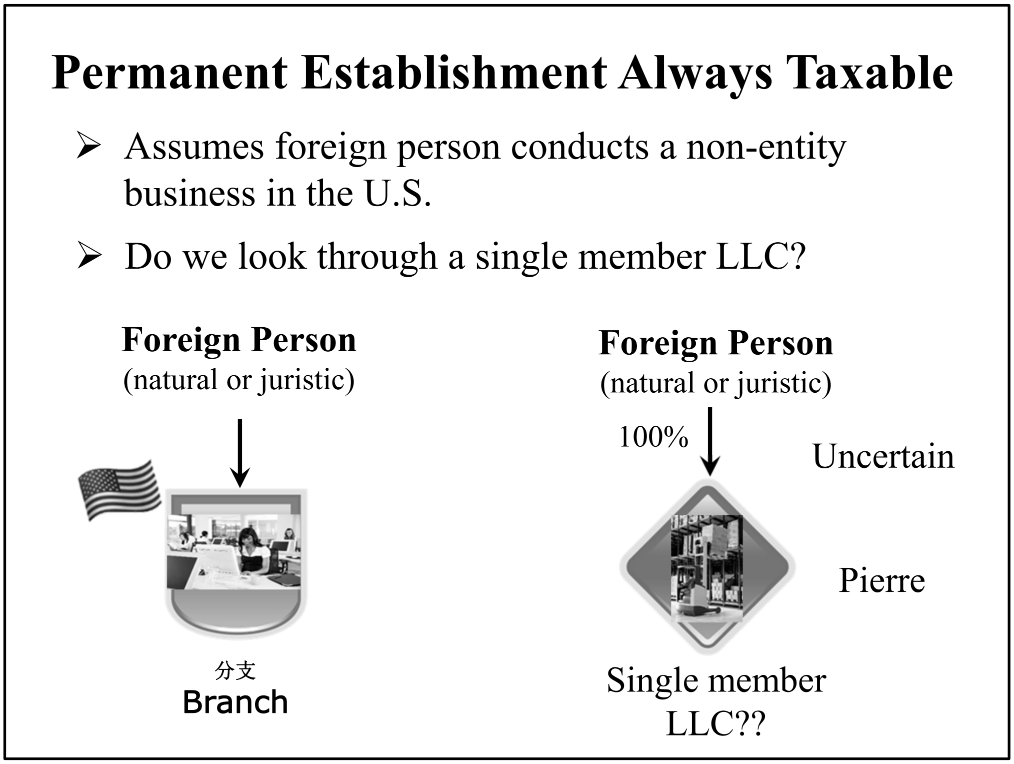
Type of Assets

- **Permanent Establish**
- **Intangible**
  - U.S. cash - no
  - P/S should be place of business
- **Real Estate**
  - Rental or Investment
  - Vacation Home

D. Three by Three Analysis of Planning Scenarios

The following pages summarizes some of the key planning differences between the various treaties and planning without a treaty. As noted in the previous outline, there are domicile treaties, situs treaties, and with most countries the U.S. has no estate or gift tax treaty. Almost all domicile treaties also incorporate a gift tax treaty, and many times include generation skipping transfer provisions. Conversely, situs treaties do not.

Related to the three planning scenarios, there are three major types of property that need to be analyzed: (1) permanent establishment; (2) intangible property; and (3) real estate. Personal property is not analyzed in this outline as usually it is immaterial in amount.



1. Types of Assets

   a. Permanent Establishment

A permanent establishment is always subject to U.S. estate and gift tax, regardless of whether or not there is a treaty. As previously, noted the term "permanent establishment" is an income tax treaty term that refers to when a foreign person (entity or individual) opens a branch operation in the U.S. In the above slide on the left, the foreign person opens a U.S. sales office. However, most foreign businesses do not operate in the U.S. as a branch. Rather, they form a U.S. entity. If is a single member U.S. LLC, which is disregarded for tax purposes, then for income tax purposes it is considered a branch. Does this mean that it is subject to U.S. estate tax if owned directly by the foreign individual? Title 26 of the United States Code, which is the Internal Revenue Code, states that unless expressly redefined elsewhere in the IRC, the following definitions apply. Treas. Reg. § 301.7701-2 & 3 treat a noncorporate 100% owned entity as a disregarded entity. Transfer taxes (estate, gift, and GSTT) are in subtitle B of title 26. Therefore, the general definition under title 26, would imply that the disregarded entity is a permanent establishment for estate an gift tax. This is the result for income taxation. However, analogous authority supporting the opposite position that the single member LLC should be treated as an entity, not a branch – permanent establishment is the gift tax case of *Pierre.* 133 T.C. 2 (2010). My recommendation would be to always use a dual member LLC or an FLP when planning for the foreign person.

硬币的正反两面
The Other Side of the Coin

Corporation

Company

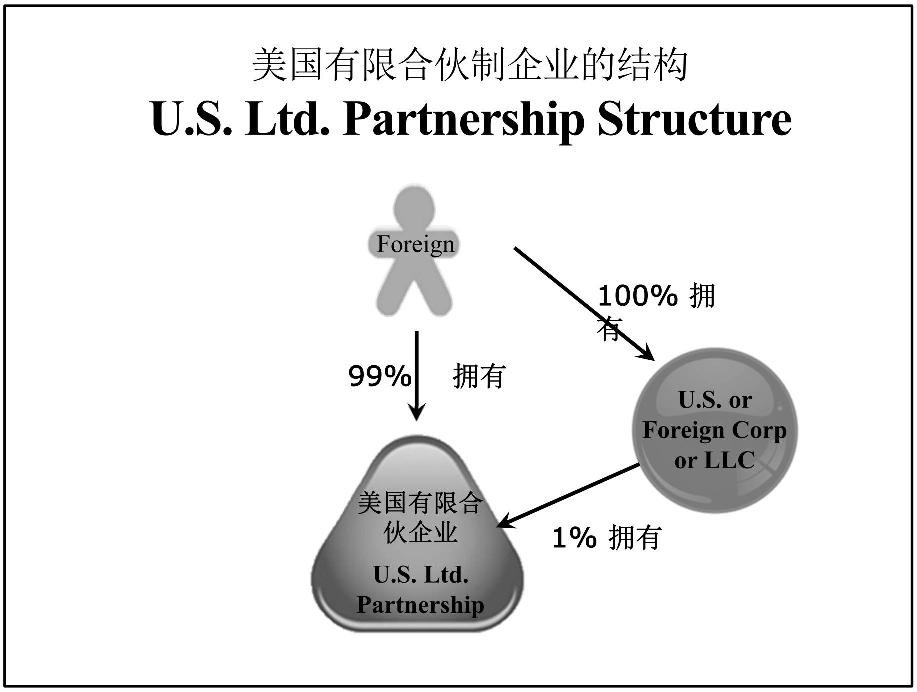
- How does the other country tax a U.S. LLC for income tax purposes?

Many, if not most, practitioners prefer using an LLC over the older FLP structure, where the general partner is a 1% corporation or a 1% limited liability company. While this works well for U.S. income tax planning, the planner also needs to look at how the other country taxes a U.S. LLC for income tax purposes – the other side of the coin.

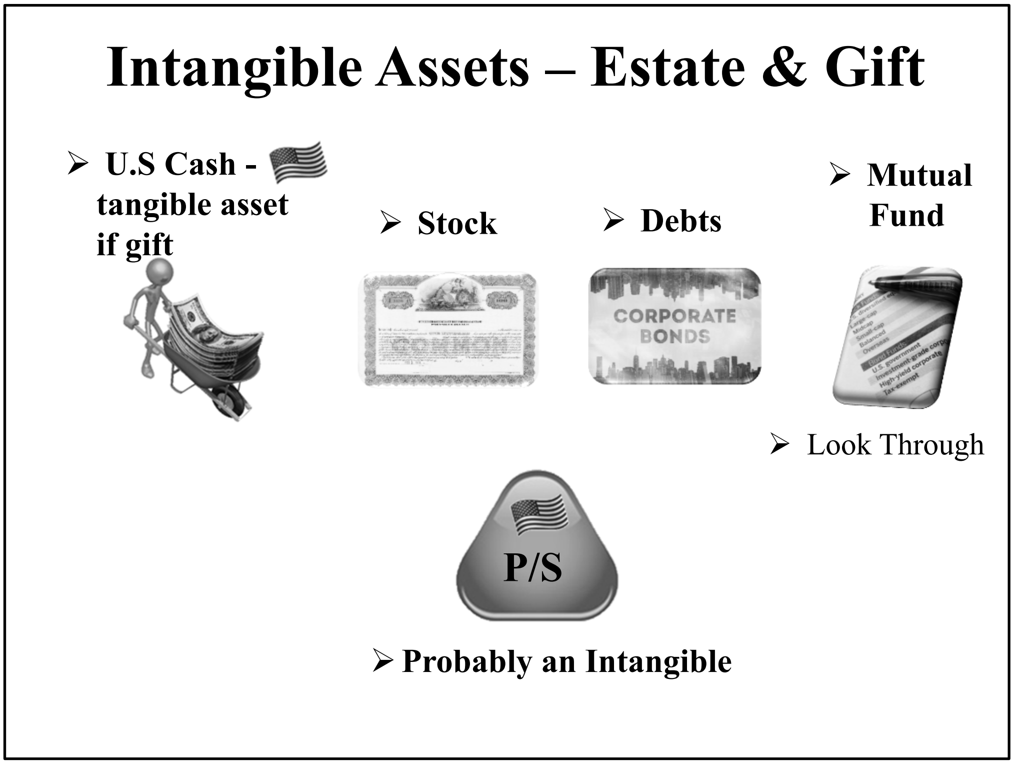
Where the U.S. style limited liability company was first created in Wyoming in the late 1970's, it did not gain state wide recognition in the U.S. until the mid 1990's. Conversely, its adoption by foreign nations has been not nearly as well received with only the following companies having U.S. style LLC legislation:

1. Isle of Man
2. Cook Islands
3. Seychelles
4. Turks & Caicos
5. Nevis
6. Belize
7. Cayman Islands

Further complications arise in terminology the U.S. uses to describe a corporation when compared with the rest of the world. The U.S. uses the word "corporation." The rest of the world uses the word "company." Therefore, most commentators think that a foreign country will tax a U.S. LLC as if it was a corporation. In most cases, this would result in a double tax on the other side of the coin – One at the corporate level, and one at the individual level.



Due to the double income tax issue associated with using a U.S. LLC if is taxed as a foreign corporation, generally, the old U.S. limited partnership structure will be a much more tax efficient vehicle.



b. Intangible Assets

From a code perspective, intangible assets many times have different results from an IRC perspective. As noted in the first outline of this trilogy, U.S. cash is generally considered a tangible asset. Therefore, it is not gifted. However, for estate purposes, there is a bank deposit (which includes C.D.s) exception where situs is outside the U.S. for estate tax purposes. Corporate stock is an intangible and bonds should be an intangible asset. However, mutual funds generally use a look through rule to the underlying assets.

As noted by Annette Glod, who most likely has the most detailed analysis on the issue, "most courts and commentators" have take the position that a partnership interest is intangible personal property. See then cites: Robert C. Lawrence III, International Tax and Estate Planning § 3.02(f) (3d ed. 1996) at 3-13. Stafford Smiley, *Dispositions of U.S. Partnership Interests by Nonresident Aliens*, 8 J. Partnership Tax'n 133, 142 (1991). She also mentions PLR 7737063 that as dictum mentions that a partnership interest is intangible property. Glod; U*nited States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues*, 51 Tax Law 109 (Fall, 1997), p. 6.

IRC - Intellectual Property

➢ **Either filed or used in the U.S.**

Treas. Reg. § 20.2105-1(e) . . . "intangible personal property the written evidence of which is not treated as personal property itself, if it is not issued by or enforceable against a resident of the U.S. or a domestic corporation or a governmental unit.

i. IRC – Intellectual Property

When a nonresident alien directly owns and/or is paid a royalty for intellectual property, Treas. Reg. § 20.2105-1(c) addresses the taxation.

Deciphering the above sentence has two key components. First, what does "the written evidence of which is not treated as the personal property itself" mean? The meaning may be derived from the example two subsections above under Treas. Reg. § 20.2105-1(c). Here, the regulation states, "written evidence of intangible personal property which is treated as being the property itself, such as a bond for the payment of money. In other words, the IRC is treating the bond and stock as if it is personal property.

The second part of the sentence states "if it is not issued by **or** enforceable against a resident of the U.S. or a domestic corporation or a governmental unit" is not situated in the U.S. This sentences construction appears to address two different issues. First, if the place of filing ("issued by) was the U.S., it is U.S. situs. Second, if it is used by a U.S. person, it is U.S. situs property. This appears to be the implied meaning due to the double "or" without the any serial comma's mean issued by the U.S. government which is a place of filing rule.

Please note, whereas the IRC appears to address all intellectual property, treaties only discuss patents, trademarks, and copyrights.

Planning Point - Partnership

Partnership Certificate

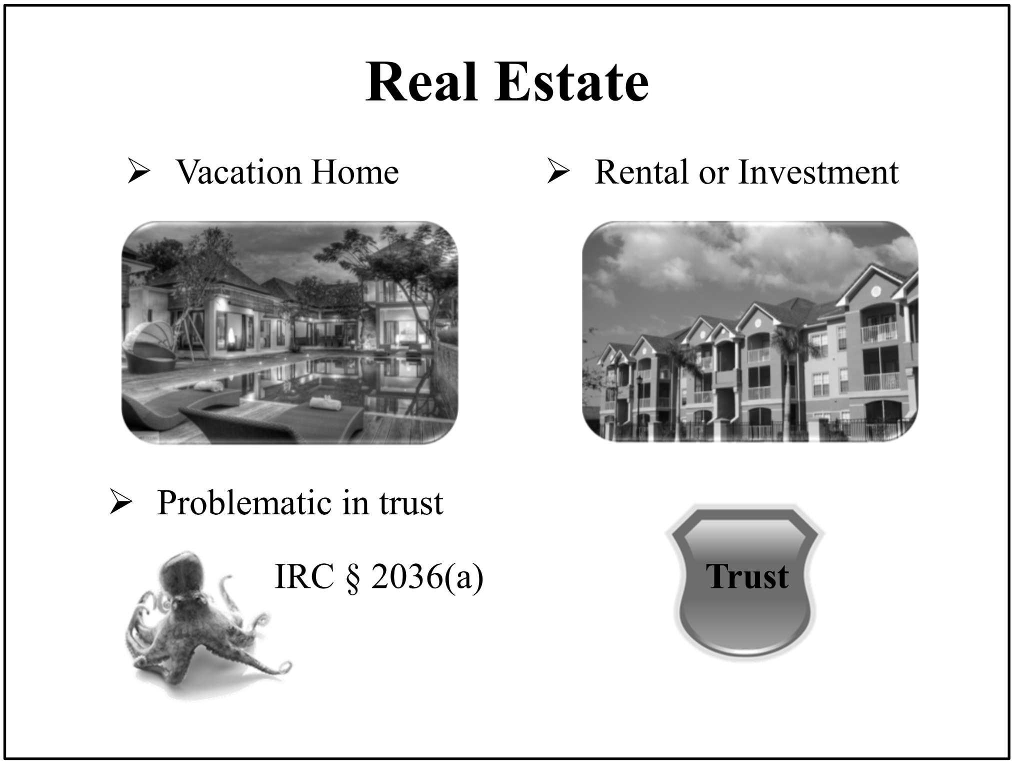
This partnership certificate certifies that Ching Shih owns a ninety-nine percent **profits and loss interest** in the Daoguang Can't Catch Me, limited partnership.

Her rights including **voting rights, if any,** are detailed in the partnership agreement dated February 30, 1880.

Also, her obligations as well as **any conditions on transfer** of this certificate are also detailed in said operating agreement.

ii. Partnership Planning Point

Generally, partnerships or limited liability companies do not issue partnership or membership certificates. In fact, for asset protection planning purposes with our domestic clients, we specifically advise against issuing partnership or membership certificates. However, when it comes to the nonresident alien owning a U.S. partnership, we want the certificate to be issued. This would help identify the partnership interest as an asset that may be treated as personal property and is not governed by Treas. Reg. § 20.2015-1(e). Further, a backup planning argument is that the partnership interest is personal property and is kept outside of the U.S. so it is non-U.S. source - the under the bed rule referred to in the tax treaty outline previously discussed.



c. Real Estate

Regardless whether there is a domicile treaty, a situs treaty, or no treaty at all, real estate is always sited where it is located of U.S. estate and gift tax. When planning for the nonresident alien, real estate may be broken into two categories: (1) vacation homes; and (2) rental or investment real estate. Vacation rental homes are a problematic asset as they do not work well with trust planning. This is because even if the vacation real estate is placed in an irrevocable trust, IRC § 2036(a) the income or <u>use</u> for life estate planning octopus rule would bring the property back into the estate. Conversely, from a U.S. perspective, using an domestic or foreign trust may be a good alternative for rental real estate or investment land.

Domicile Treaty

2. Summary of Domicile Treaties

There are six domicile type of estate planning treaties: United Kingdom, Netherlands (i.e. Holland), Denmark, France, Germany, and Australia.

Domicile Treaties

Domicile Treaties	Real Estate	Perma-nent Establish-ment	Inded pendent Services Fixed Place	Ships & Planes	Tangible Moveable Property	Commun ity Property	Partner ship Interest
Netherlands	X	X					
U.K.	X	X					
Austria	X	X					
Denmark	X	X	X	X			
Germany	X	X		X			**X**
France	X	X	X		X	X	

a. Summary Domicile Chart

As can be seen from the chart all domicile treaties provide that real estate is taxed where it is cities. Further, all domicile treaties provide that a permanent establishment in any nation is sited in that nation. Denmark and France treaties add that a person performing personal services in a country from a fixed place of business is also sited in such country. For all practical purposes, I would conclude that a person performing personal services from a fixed place of business was a permanent establishment in the first place. Similar to many situs treaties, Denmark and Germany provide that ships and planes are sited where such ship or plane is registered. The French treaty also provides that tangible property is sited where the property is located, as well as a community property and marital deduction rules. Finally, Germany has a provision has a potentially negative provision regarding real estate in a partnership, discussed on the next page.

Please note that the above chart is general in nature and a practitioner must read the treaties in detail.

Germany – Article VIII

Interests in Partnerships

If an interest in a partnership forms part of the estate or gift of a person domiciled in one of the countries and the partnership owns

immovable property (Real Estate) described in Article 5

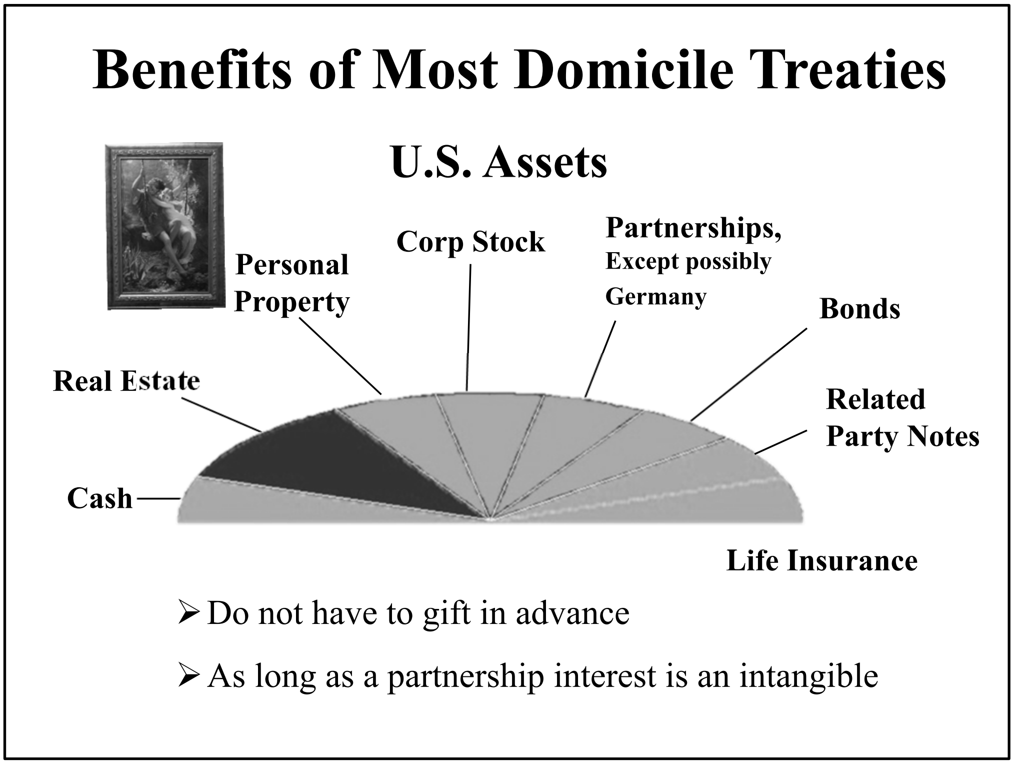
business assets (Permanent Establishment) described in Article 6

in the other country, the other country may tax the partnership interest but only to the extent the value of the interest is attributable to such property.

b. Germany - Article VIII – Interests in Partnership

The Germany treaty states that a nation <u>may</u> tax any real estate owned by a domestic or foreign partnership in the nation where such real estate is located. The same is true for an operating business (i.e. permanent establishment). The German treaty states the word "may," but it does not state that the U.S. or Germany has to apply its estate tax.

The IRC rule (without a treaty) is that if the real estate is owned by a U.S. partnership, it is U.S. situs property. If it was owned by a foreign partnership, it probably would be sited to its place of business. Rev. Rul. 55-701.



c. *Benefits of Most Domicile Type of Treaties*

Domicile treaties greatly simplify the estate planning for a foreign person, as almost all types of U.S. property are sited to the domicile of the NRA. This is the case, as long as a partnership interest is considered either intangible property (which most commentators agree upon) or tangible personal property. This mean that you do not have to gift these assets in advance. Rather, from a U.S. perspective, the foreign person may merely hold them to death for U.S. estate tax purposes.

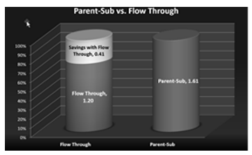
To further understand the benefits of a domicile treaty, I will discuss the business interests, related party notes, and real estate.

Planning Options Business Interests

No Situs Wrapper Needed

Corp.

U.S. Ltd. Partnership



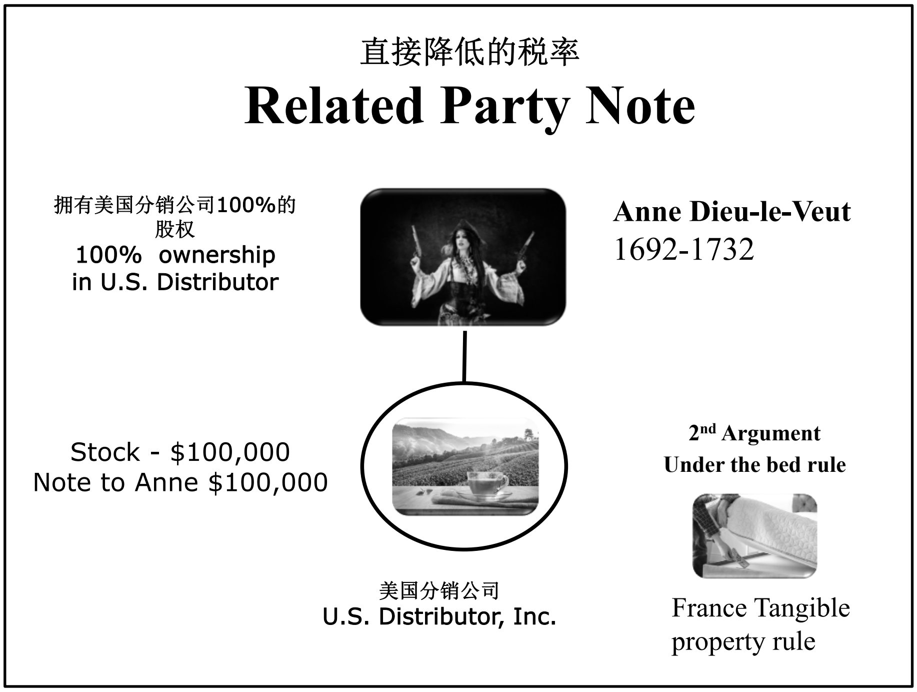
Increase $410k on
$1M over 10 yr.

Domicile

- Except Possibly Germany

d. Domicile Treaty Planning With Business Interests

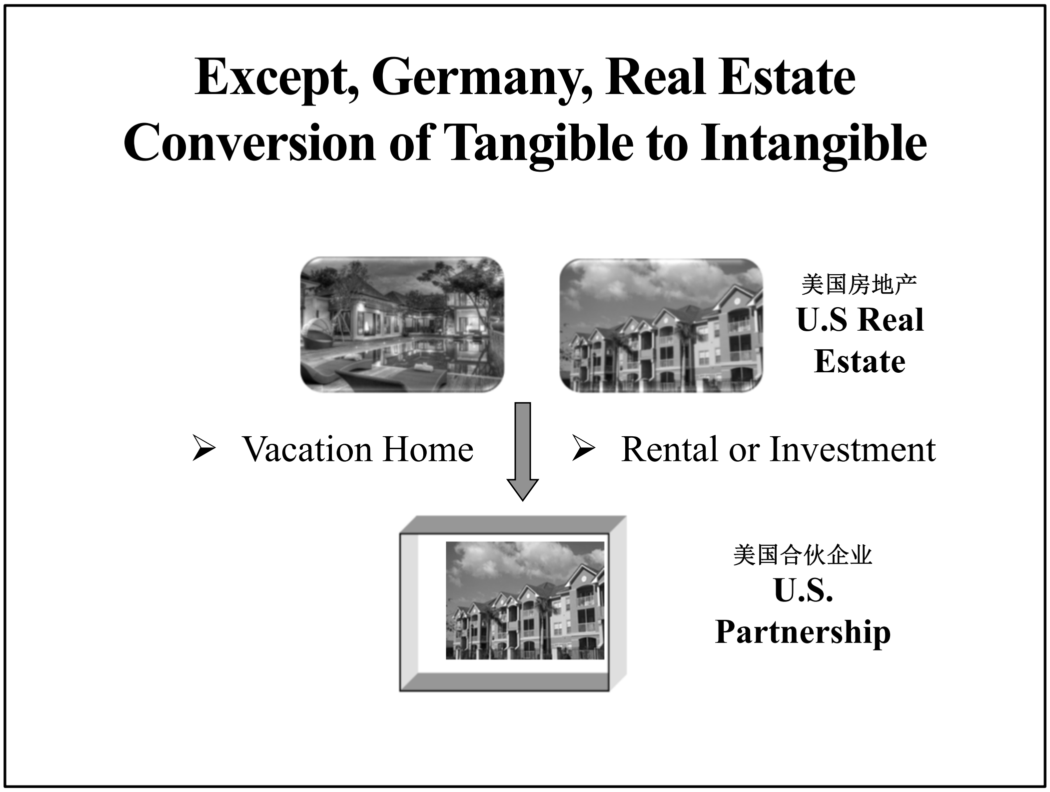
Domicile treaties make business operations planning fairly simple because intangibles are cited based on domicile. The foreign person may wish to operate the business as a U.S. corporation, regardless of the double income tax issue. Conversely, the foreign person may simply use a U.S. limited partnership structure and except for possibly Germany the situs of the intangible partnership asset would be Germany. This is under the assumption that a partnership interest is an intangible, which is the predominant view of most practitioners.



e. Related Party Notes

In the above example, Anne Dieu-le-Veut, a French pirate living from 1692-1732, was raiding English ships, and for our example assume she was selling the booty through her U.S. distributorship. Assume one of her primary exports was tea, which she could sell in the U.S. at greatly discounted prices, as he primary competitor would have been the British East Indies Company, who no one likes as well as whom she stole the tea from. When Anne formed her U.S. Distributorship, she capitalized it with $100,000 of stock as well as a note payable to Anne for $100,000. At the time of her death, the note receivable from her corporation was still outstanding in the amount of $100,000.

The note receivable would not qualify for the portfolio exemption, because Anne owned greater than or equal to a 10% interest in the foreign corporation. However, domicile treaties in essence site the note receivable as foreign source as they only site a permanent establishment or real estate to the U.S.



f. Conversion of a Tangible Asset to an Intangible

Real estate is a tangible asset. However, a partnership interest is most likely an intangible asset. Therefore, the real estate may be transferred into a partnership. Under the domicile treaties, the partnership interest should be sourced to the NRA's home country.

Situs Treaties

Australia	Greece
Ireland	Japan
Italy	South Africa
Finland	Switzerland

From an asset perspective, situs treaties provide little help

3. Summary of Situs Treaties

The above eight countries have situs treaties. As previously mentioned, situs treaties provide rules for siting various categories of assets. After reviewing the above eight treaties, My conclusion is that situs treaties provided little help when compared to the Internal Revenue Code's siting of assets.

The following analysis is general in nature, and the practitioner needs to make sure that he or she reads any treaty in detail to make sure how it applies to their clients fact pattern. Further, the analysis on discusses the siting of assets. It does not discuss any deductions or credits that may apply.

What's the Same as the Code

	Internal Revenue Code	Treaty
Bank Accounts	Not U.S.	Not Addressed Australia where located
Personal Property	Where Located	Same
Corporation	Where Formed	Same
Goodwill – Permanent Establ.	Where Operated	Where Operated
Partnership	Probably Same	Australia* Place of Business

* Also, 1955 U.K. treaty, before the Domicile treaty

a. *What's the Same as the Code*

Situs treaties are much more alike than they are different. Usually, there is simply one or two differences between the treaties, the exception being Australia. The above items detail certain types of property that are the same for both the code as well as most of the situs treaties, with exceptions noted below.

Personal bank accounts in the U.S. with a U.S. bank or their certificates of deposit are not U.S. situs under IRC § 2105(b). Since the code states that it is nontaxable to a nonresident alien, as to U.S. estate taxation, there should be no taxation. Therefore, only one of the estate planning treaties address this issue – Australia. Australia states the location of the bank account determines situs. Therefore, it may have an effect on Australia estate taxation.

All of the situs treaties say personal property is sited where it is located. Also, all of the situs treaties sites a corporation where it is formed. One active treaty, Australia, and the former 1946 U.S.-U.K. estate tax treaty designated address a partnership interest, holding the place of business is where the partnership interest is sited. Many authors think this is the most probably position the Internal Revenue Service would take on the subject.

What's Slightly Different

	Internal Revenue Code	Treaty
Patents; Trademarks	Registered or Used	Where Registered or Used
Copyright	Registered or Used	Where Used
Ships & Planes	Where Located?	Where Registered

- Two sentences in the treaty
- Second sentence deals with the use of the property

b. *What's Slightly Different*

Generally, a NRA will have first registered a patent, trademark, or copyright outside the U.S. Then such NRA may then license its use in the U.S. Under the code, the value of the royalty stream would be sourced to where it is used, the U.S. Situs treaties have almost the same rule. However, they do it with two separate sentences. The first sentence deals primarily with patents and trademarks. For example, the South Africa treaty states:

> "Patents, trade-marks, and designs shall be deemed to be situated at the place where they are registered."

So at first blush, it looks as if it is the place of the primary filing. However, the next sentence states:

> "Copyrights, franchises, and rights or licenses to use any copyrighted, patent, trade mark or design shall be deemed situated at the place where the rights arising therefrom are exercisable."

This sentence clarifies that if a U.S. person is paying the NRA a royalty (or any other fee for use), the value of this royalty contract is sited to the U.S. The result of second sentence when it is combined with the first sentence is that it is almost the rule as is under the IRC.

The IRC does not have a specific rule for ships and planes. Without a specific rule, it is possible that a NRA could possibly fly his or her luxury jet to the U.S. and die while in the U.S. with the result that the jet would be taxed to where it was located at time of death. This is the location of personal property at the time of death rule under the IRC.

Australia - Differences

	Internal Revenue Code	Treaty
U.S. Bank Accounts	Not U.S.	Where Located
Bond or Note Receivable	Portfolio Exempt or Taxable	Debtor-Payor Residence
Unless Note from Business - mention	Taxable	Taxable
Governmental Bond	Portfolio Exempt	Location of Government
Corporation	Where Formed	No Rule

- Treaty is not very helpful for siting assets

c. *Australia's Differences*

In genera, U.S. bank accounts are foreign sited under the IRC. However, the Australia treaty provides a worse rule. It states that bank accounts are sited where located. Under the IRC, bonds or notes receivable, assuming that such note has the correct language, are exempt from U.S. estate taxation. Again, Australia provides a worse rule. The bond or note is site to the debtor (i.e. payor's) residence. Conversely, if the note is from the taxpayers business, both nations provide that it is sited in the U.S. Under the IRC, a governmental bond would be tax exempt under the portfolio exemption. However, it is sited to the U.S. under the treaty. The Australia treaty is the only situs treaty that does not have a rule siting corporate stock. Therefore, the IRC rule of where formed would apply. In summary, the planner would probably not take a treaty position under the Australia treaty for siting assets.

Finland - Differences

	Internal Revenue Code	Treaty
Bond or Note Receivable	Portfolio Exempt or Taxable	Debtor-Payor Residence

Greece - Differences

	Internal Revenue Code	Treaty
Promissory Notes	Portfolio Exempt or Taxable	Debtor-Payor Residence
Debt Secured By Mortgage (Mortgage Receivable)	Portfolio Exempt if proper language	Situs of real estate

d. Finland Differences

Under the Finland treaty, Bonds or notes receivable are sited to the debtor-payor residence. This is worse than the IRC siting rule.

e. Greece Differences

The Greece treaty also sites bonds or notes receivable to the debtor-payor residence, which is worse than the IRC rule. Further, mortgages receivable are sited to the location of the real estate that is secured. Assuming the mortgage has the portfolio interest language, this is also worse than the IRC siting rule.

Ireland - Differences

	Internal Revenue Code	Treaty
Negotiable Note Receivable	Portfolio Exempt or Taxable	Where Located
Stock Shares	Place of Organization	Same; except UK & Northern Ireland Stock

Italy - Differences

	Internal Revenue Code	Treaty
Bond or Note Receivable	Portfolio Exempt or Taxable	Debtor-Payor Residence

f. Ireland – Differences

Ireland has a more favorable rule than the code for negotiable notes receivable. It uses a where located (i.e. under the bed) rule. It generally follows the place of formation rule for siting corporate stock, except that U.K and Northern Ireland stock are sited to Ireland under the treaty.

g. Italy – Differences

With bonds or notes receivable, Italy has a worse rule than the IRC, it uses the debtor-payor's residence.

Japan - Differences

	Internal Revenue Code	Treaty
Bond or Note Receivable	Portfolio Exempt or Taxable	Debtor-Payor Residence

South Africa - Differences

	Internal Revenue Code	Treaty
Note Receivable	Portfolio Exempt or Taxable	NRA Residence

h. Japan Differences

Japan's treaty also has a worse rule for siting bonds or notes receivable that the IRC. It sites the bond or notes receivable to the debtor payor residence.

i. South Africa - Differences

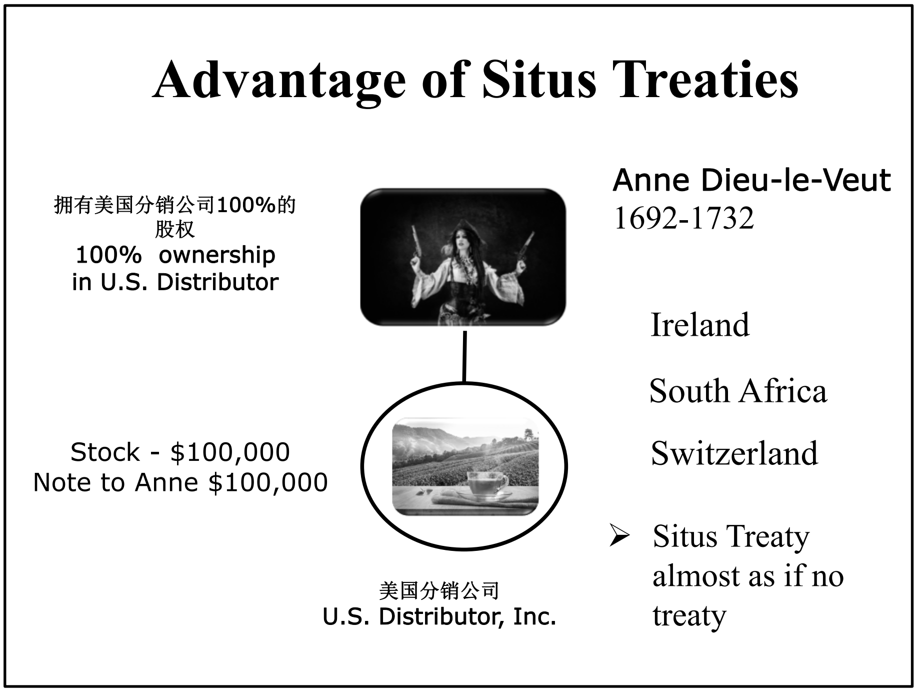
For related business notes, South Africa has a better rule than the IRC. It sites the related busines note to the NRA's residence.

Switzerland - Differences

	Internal Revenue Code	Treaty
Bond or Note Receivable	Portfolio Exempt or Taxable	NRA Residence

j. Switzerland Differences

Switzerland also has a better rule for related business notes, siting them to the NRA's residence.



k. Advantage of Situs Treaty Benefits

Based on the above analysis, it appears that the only asset situs benefit of much significance was a related business note being sited to the NRA's residence or place of location. Further, this only occurred in three situs treaties: Ireland, South Africa; and Switzerland. For this reason, I would strongly suggest that much of the planning for situs treaty countries is the same as if there was not treaty at all.

Treaties Optional?

- Particularly, Australia

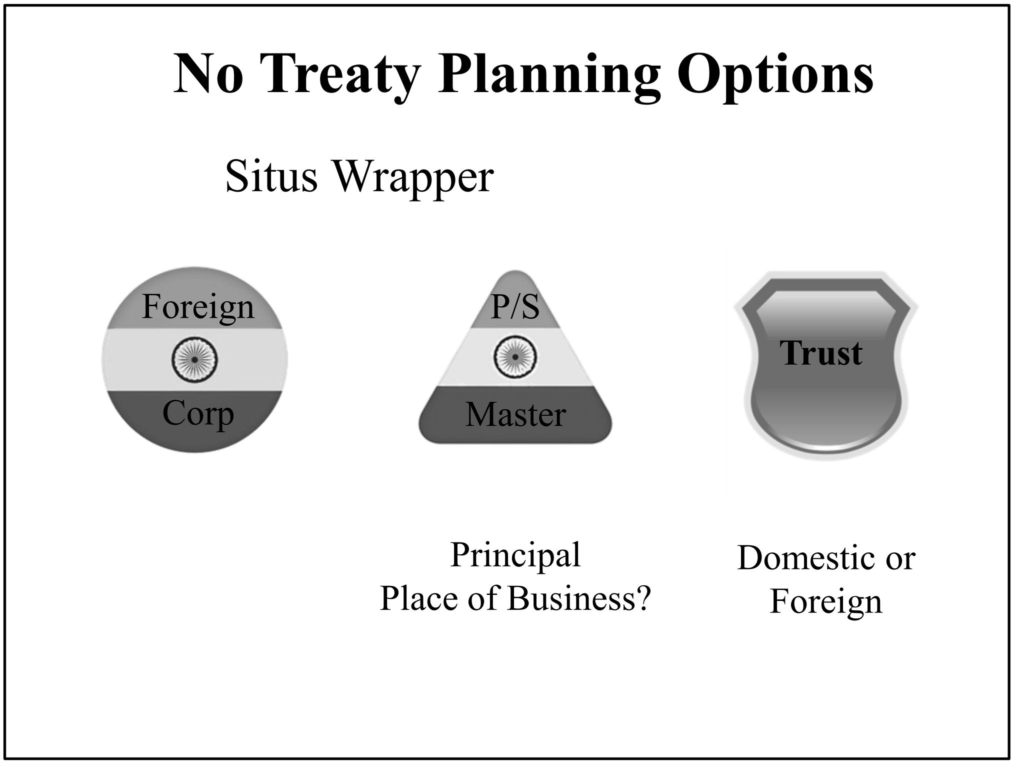
- Income tax treaty - optional
  - Rev. Ruling 84-17 – All or Nothing
- Treas. Reg. § 301.6114-1
  - Generally, report only if treaty position lowers the tax
- Situs treaty – probably optional
  - But see - Article III(2); GCM 33827
- Domicile treaty – inbound advantageous

l. Treaties Optional?

With an income tax treaty, there is little doubt that the taxpayer may decide whether or not he, she, or it wishes to take a treaty position. In fact, Rev. Rul. 84-17 states if a taxpayer takes advantage of a treaty benefit, it is an all or nothing proposition, meaning the taxpayer must adopt all of the tax position in the treaty or not use the treaty at all.

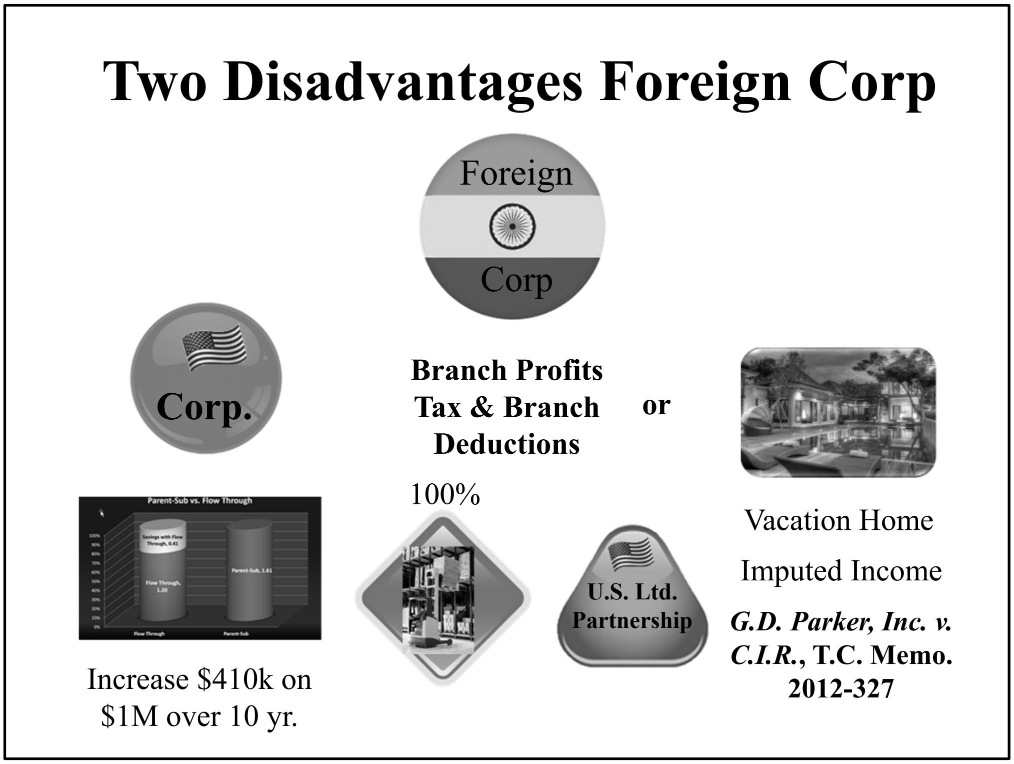
Using a situs estate tax treaty also appears to be optional. Treas. Reg. § 301.6114-1 provides that generally a treaty position is only reported if it lowers the tax. In that case, a computation is needed of the amount of tax before and after adoption of the treaty. Conversely, most situs treaties have language substantially similar to the Ireland treaty Article III (2) that states "Where a person dies domiciled in any part of the territory of one Contracting Party, the situs of any rights, interests, legal or equitable, in or over the following classes of property . . . be determined exclusively in accordance with the following rules . . ." Also see GCM 33827 reversed on a different point by GCM 34442 that quotes such language.

As far as domicile treaties, I cannot see where an NRA would not want to use the treaty. So on an inbound transaction, I don't think that there is an issue here. On an outbound transaction, if a code position was used to get out of U.S. estate tax, then the Service may be more likely to challenge the transaction. For example, three months before death, the decedent had moved back to the U.K. after living and being a resident in the U.S. for the last 15 years.



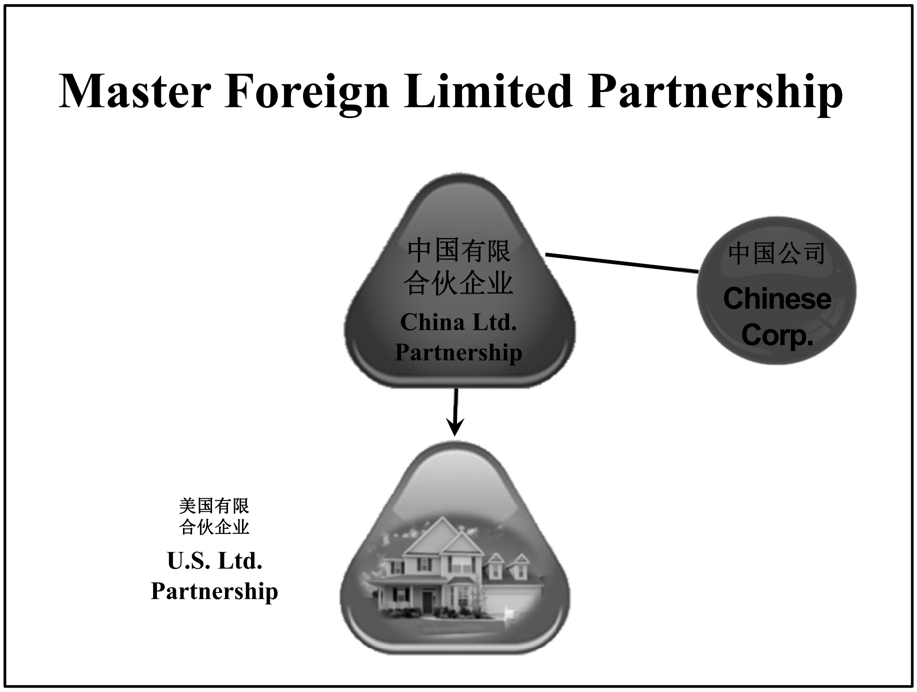
4. No Estate or Gift Tax Treaty Planning

This brings us back to the three primary planning tools for a NRA. Both the foreign corporation and the foreign master partnership change the situs from U.S. to foreign. The foreign corporation appears to have much more definite rules than the foreign partnership.



a. Two Disadvantages of the Foreign Corporation

There are two disadvantages to using a foreign corporation to switch situs. First, the primary disadvantage to the foreign corporation is the double corporate C tax. Also, should C corporate tax rates increase, the negative difference in tax would be greater. For an operating business or production of income property (e.g. rental property), the second disadvantage is the branch profits tax and the branch deduction computations. The branch profits tax is a another tax designed to apply another tax of at least 5% with favorable income tax treaties up to 30% for countries with no income tax treaty with the U.S. (India is 10%). The idea is that there is a dividend withholding tax imposed by the U.S. when it remits a dividend from the a subsidiary to a parent. Only for foreign corporations, the U.S. requires a similar type of computation referred to as the branch profits tax. It does not apply to foreign partnerships. In addition to the branch profits tax, the income tax computations are fairly complicated and arduous, significantly increasing the NRA's annual U.S. income tax compliance costs. Finally, as note in the first outline of this series, when a corporation owns a vacation home, rental income is imputed the shareholder for such personal use.



b. Master Foreign Partnership

If the underlying assets of the foreign partnership contain assets from different jurisdictions, the foreign partnership may be sometimes referred to as a "master foreign partnership." If more than one-half of the assets of the master foreign partnership represent assets that are outside the U.S., one may consider taking the position that the situs of the partnership is outside the U.S. If situs of the partnership is outside the U.S., the estate tax would be completely avoided. Furthermore, unlike the "foreign corporation wrapper" around U.S. real estate, the master foreign partnership would not result in a triple tax – just one flow through. Please note that this type of planning depends on a "primary business" situs interpretation by the courts. Presently, there is only Rev. Rul. 55-701 that state "place of business," not primary place of business.

Some Uncertainty With the Master Foreign Partnership

1. Primary Place of Business
   - Enough Foreign Assets
2. Tangible Property - Location
3. Place of Formation
   - Analogy to corporate rule
4. Possible Look Through Rule
   - Possibly Germany Treaty
5. Domicile – if domicile treaty

Some planners are hesitant to only use a master foreign partnership due to the uncertainty in this area. First, the concept of a master foreign partnership is built on the IRS following the primary place of business of the partnership theory for siting the partnership interest. As noted on the previous slide, the Revenue Ruling 55-701 which relies on the old U.K. estate and gift tax treaty and the Australia estate tax treaty use the terminology of "place of business." "Place of business" seems to imply that there is one primary place of business, however, there is no authority on this issue. Second, assuming the primary place of business is foreign, the NRA will need to have enough foreign assets in the foreign master partnership to justify the primary place of business being abroad.

If the Service takes the position that a partnership certificate is tangible property, then the location of the certificate would determine its situs. Hence, the back up planning position of keeping the certificate abroad so that it is cited by the under the bed rule.

Everyone would hope that the Service would follow the place of formation rule like it does for corporations. However, this is by analogy only, and there is no authority to support this other than analogy.

Finally, the last position that everyone hopes that the Service would not apply is a look through rule. While this position is contained in the Germany income tax treaty, it assumes that a partnership interest is not an intangible asset. As noted earlier in this outline by Annette Glod, "most courts and commentators" have take the position that a partnership interest is intangible personal property. See then cites: Robert C. Lawrence III, International Tax and Estate Planning § 3.02(f) (3d ed. 1996) at 3-13. Stafford Smiley, *Dispositions of U.S. Partnership Interests by Nonresident Aliens*, 8 J. Partnership Tax'n 133, 142 (1991).

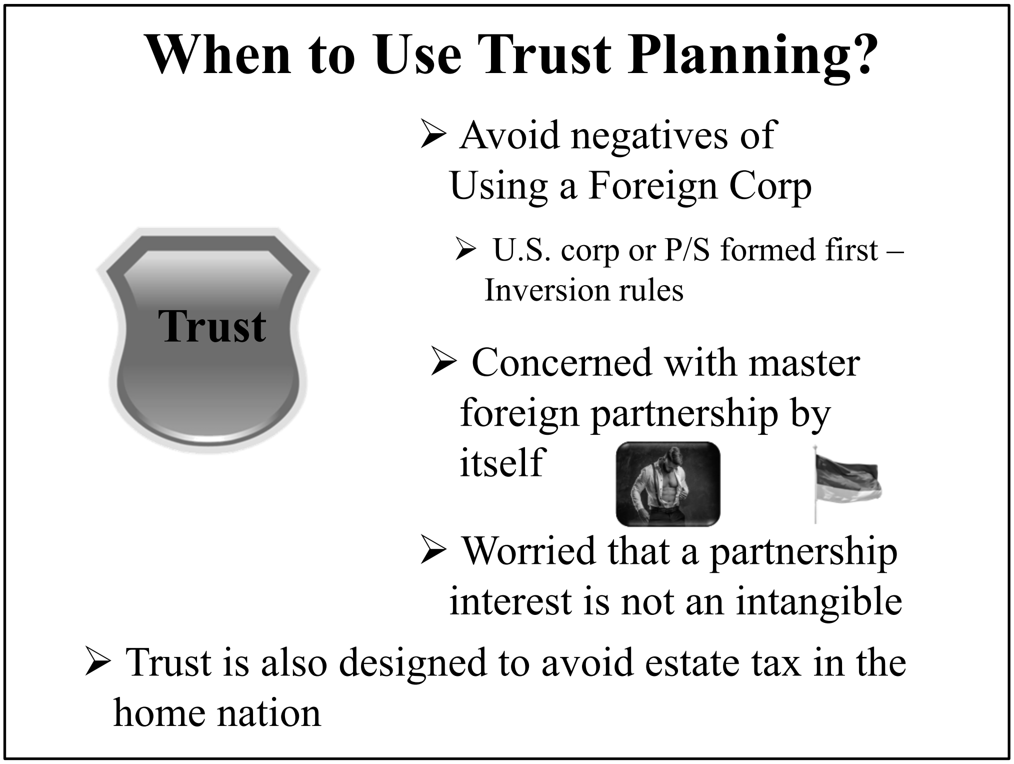
Trust Planning

1. When
2. When Not
3. Preferential Timing
4. Estate Taxation – NRA Trust
5. Grantor Trust
6. Estate Tax Octopus
7. Self – Settled Trust
8. Foreign v. U.S.
9. FACTA

F. Trust Planning

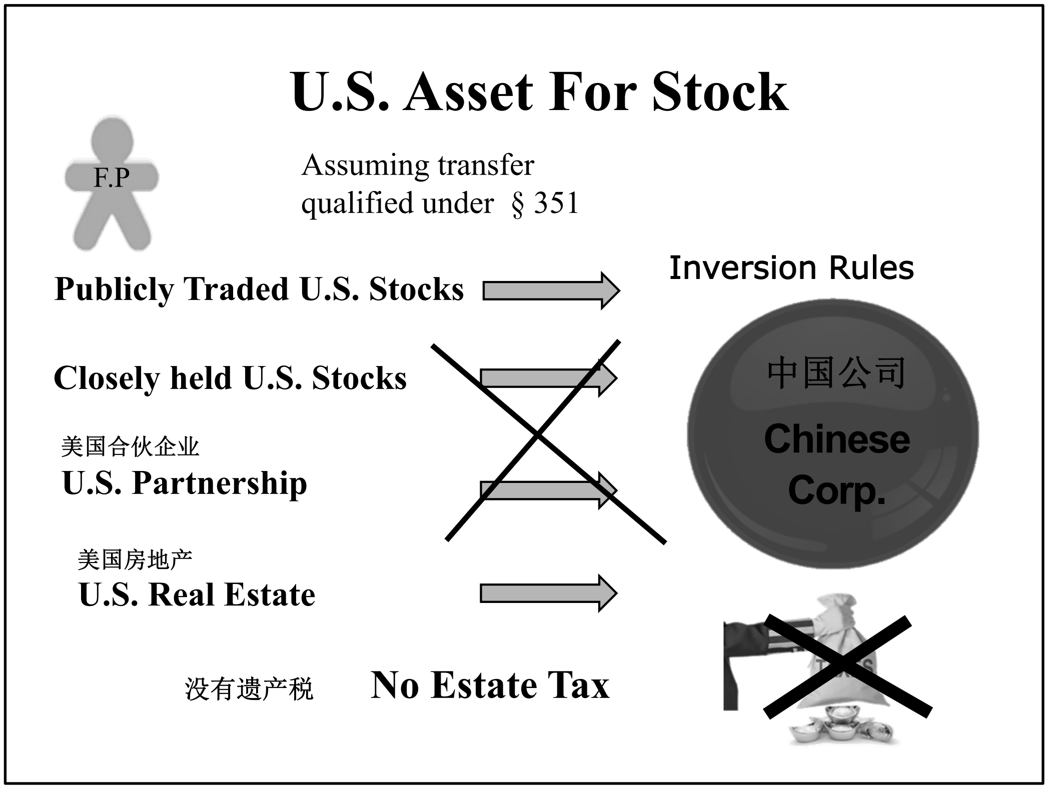
Before we discuss the situs of other assets, let's look at a layperson's definition of the types of property. This is going to be done at a 30,000 foot view in very general terms. In our analysis, there is primarily three types of property: real property; personal property; and intangible property. The earlier tax treaties use the terms immovable property and moveable property to refer to real and personal property respectively. In 1949 when the Ireland estate tax treaty was ratified, intangible property was not nearly as prevalent as it is today, but there were some commonly recognized types of intangibles such as patents, trademarks, copyrights, as well as goodwill.

For a very broad layperson's definition of real property, I would define it that you can touch it, but its hard to move. In the case of land, obviously, you cannot move it. However, if it is a smaller house, many times these can actually be moved although it is relatively expensive to move the house. Therefore, buildings stay in the real property category. Then you get the group of property that might be in the middle of being immovable or moveable, sometimes defined as "fixtures." For example, the plumbing you could remove from the building, but it would destroy parts of function of the building, so it retains its character as a "fixture" and is part of the building. But what about the water heater? In general if the personal property (which was the original classification of the water heater) becomes a component of the building it is classified as a fixture. Anyway, we will leave the fine details to the property attorneys as we just need some general guidelines for purposes of this outline.



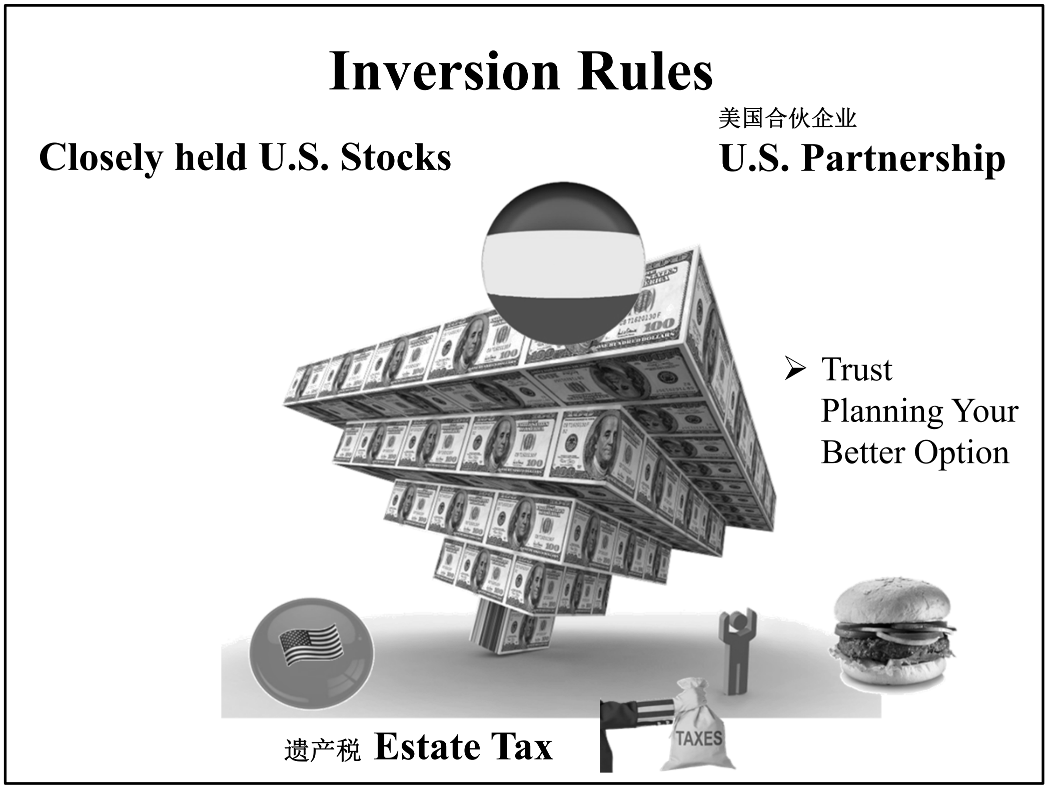
1. <u>When to Use Trust Planning</u>

If a NRA wishes to avoid the negative income tax issues of using a foreign corporation and has concerns with the master foreign partnership, a domestic or offshore trust may be the solution. Further, if the NRA has already created the U.S. corporation or U.S. partnership, then if it is transferred to a foreign corporation, the inversion rules will apply. Also, this outline discussed five possible theories of estate taxation of a partnership interest, concluding that the primary place of business should be the most likely theory used by the Service. With the possible uncertainty of how the U.S. will site a partnership interest, or if you are under the Germany estate tax treaty, trust planning may well provide a better solution.



A foreign person may transfer publicly traded stock and U.S. real estate to a foreign corporation in exchange for its stock. This should change the situs of the U.S. assets. However, if a foreign person transfers closely held U.S. stock or a U.S. partnership to a foreign corporation, this may well result in U.S. taxation. This is because in most cases, the inversion rules may well apply to the foreign corporation.

The above transfers of publicly traded stock and U.S. real estate assume that the transfer qualifies under IRC §351. Please note that transfers to foreign partnerships are much more complicated due the Treas. Regs. The under IRC §721(c).



As noted, in the committee reports, the inversion rules were first passed in 1996 to prevent U.S. companies parent corporation from inverting and become nothing more than a subsidiary of a tax efficient parent company formed in a nation like the Netherlands. In other words an "inversion" is a corporate expatriation. The intent of IRC §7874 was to prevent U.S. multi-national companies from creating such a structure and escaping U.S. world-wide taxation. In essence what this statute says is that if a U.S. entity transfers its assets to a foreign parent, but retains the U.S. subsidiary, the foreign parent will be deemed to be a U.S. company still subject to world-wide taxation. The exception through 2004 to this rule was if a large foreign company acquired a small U.S. foreign, then the inversion rules would not apply. This was the case when Burger King expatriated from the U.S. Unfortunately, while the intent was to stop large multi-nationals, it traps many company nonresident alien transfers of a U.S. corporation or U.S. partnership interests to a foreign corporation.

For a detailed discussion of this issue *see When Intended Estate Planning Results in an Accidental Inversion.* Robert H. Moore and Michael J. Burno, Journal of International Taxation, June 2016.

When Not to Use a Trust?

- Trust income is double taxed abroad
- Vacation home
  - Unless rented

2. <u>When Not to Use Trust Planning</u>

While there are many situations where trust planning is appropriate for an NRA, there are many where it is not. In particular, if the trust income is double taxed abroad, the trust holds a vacation home, or the planner believes that the Service would apply a conduit or look through rule.

How is a Trust Taxed Abroad?

- Civil Foundations

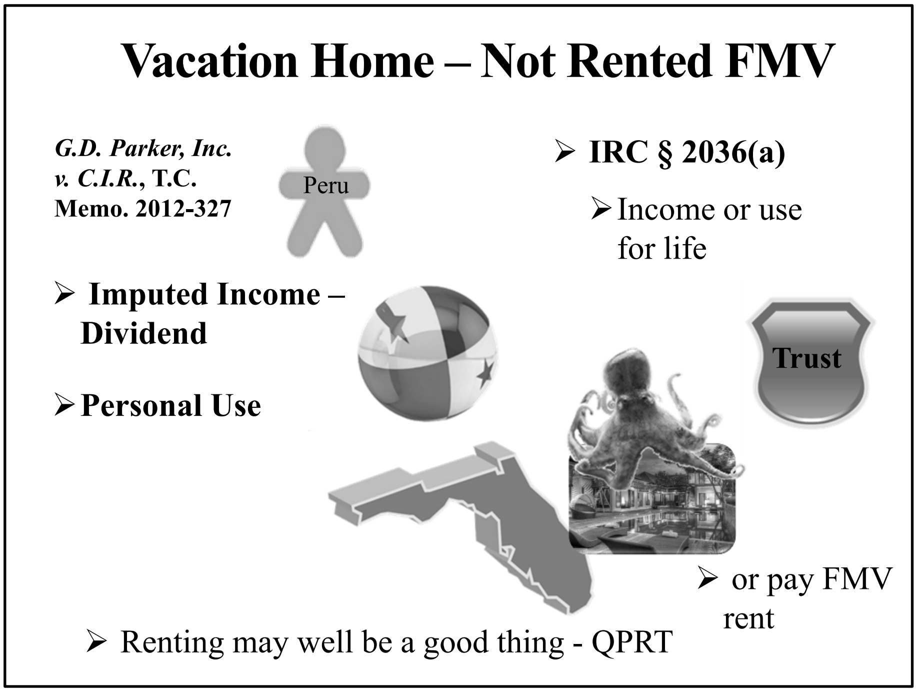
- Common Law
- Civil Law
  - Corporation
  - Distribution a dividend?

a. *Trust Income is Taxed Abroad*

Part of this problem is generated from the difference between common law countries and civil law countries. The modern concept of a trust is primarily derived from English common law (although Rome had testamentary trusts in Italy's history). Under English common law, a trust is not a legal entity formed by the Secretary of State. Rather, it is an arrangement where the trustee holds and manages property for the benefit of the beneficiaries. However, the trustee does not personally own the property, the trust is not an entity so how can it own the property, and the beneficiaries do not own the property.

Civil law countries find this a bit illogical. How can something that is not a legal entity hold property. Therefore, unless specifically adopted by a statute, most civil law countries do not recognize the concept of a trust. Rather, many of these nations allow a civil foundation to be formed for the benefit of one's family. For example, Lichtenstein has the Stiftung; Germany the Stiftugen; Dutch the Stifting and in the Arabic world a Wacq. With a civil foundation, these are formed under something similar to a non-profit corporate statute, and they are ran by a board of directors. Therefore, many civil law countries analogize a trust to a corporation and seek to tax any distributions as a dividend. This would result in a double tax, and it is highly probably that the home country would not grant a foreign tax credit for the tax paid in the U.S. (Please note, even if a foreign tax credit was granted, there would be timing issue with the taxation of the distribution as the trust may accumulate in one year and distribute the income in another year).

Therefore, the home nation's income tax law need to be consulted to make sure that trust distributions are not double taxed.

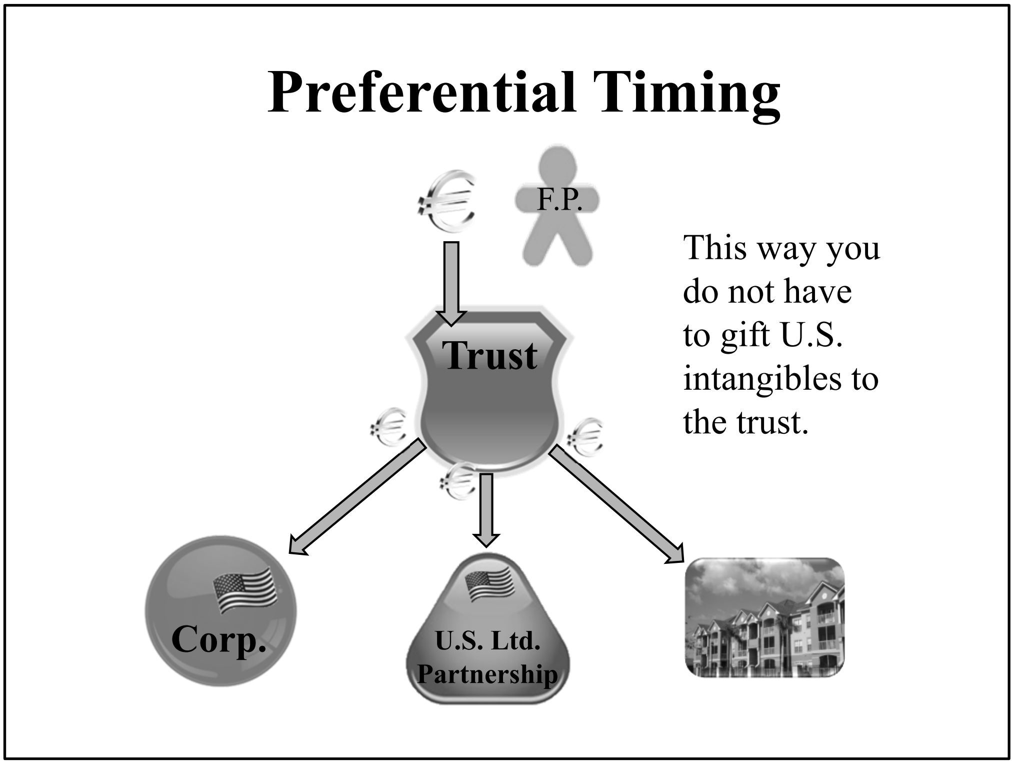


b. Vacation Home – Unless Rented FMV

Remember *G.D. Parker, Inc. v. C.I.R.,* T.C. memo 2012-327 was the well expected holding that when a corporation owns personal property (i.e. a 23 bedroom vacation home), the fair market value of renting rental is imputed to the owner. Therefore, ownership by a foreign corporation to change its situs was really not a viable option, unless the NRA wished to rent the property for FMV.

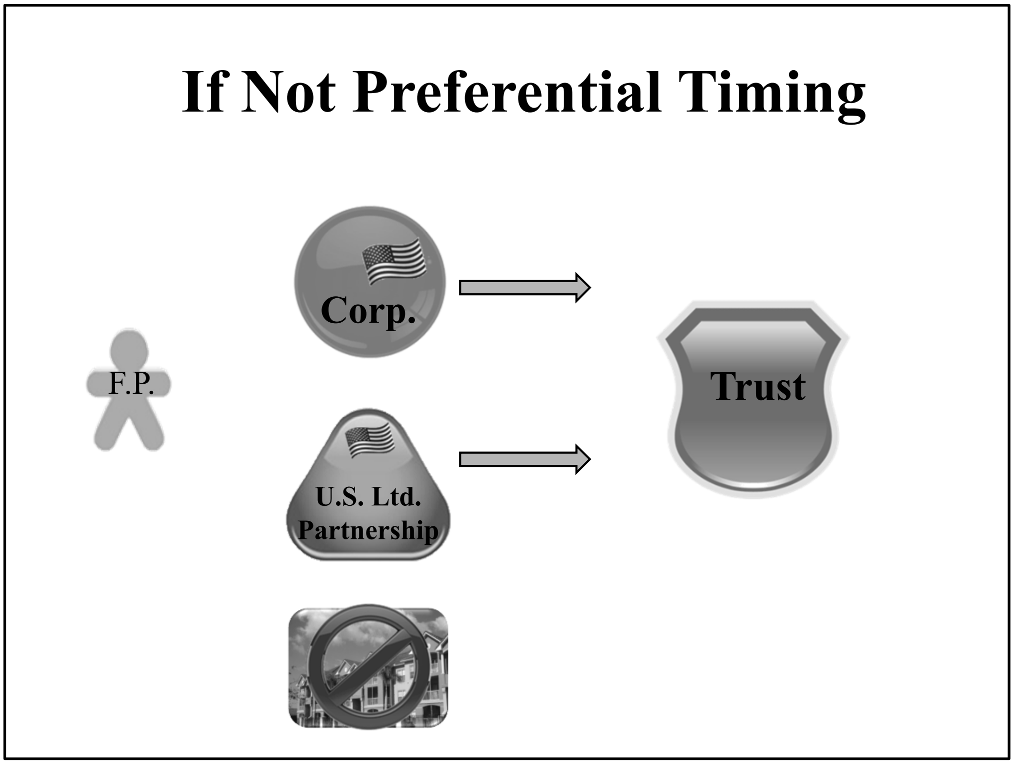
The estate tax also has an inclusion rule when someone uses property for life for less than FMV. IRC § 2036(a). . *Estate of Linderme v. Com'r*, 52 T.C. 305 (1969); Rapelje's Estate v. Com'r 73 T.C. 82 (1979) . Also see, *Estate of Trotter v. C.I.R.,* TC Memo 2001-250, where a transfer of a residence to an irrevocable trust that did not qualify as a QPRT and no rent was paid resulted in estate inclusion. This estate tax rule may also be avoided by the NRA renting the property for FMV. *Estate of Barlow v. Com'r*, 55 T.C. 666 (1971).

Please note that renting the property may well be a good thing depending on the taxation in the NRA's home nation (i.e. domicile nation). This assumes that the trust is not part of NRA's estate under the home nations laws. If the trust is not part of the NRA's home estate, then it works like a QPRT. The rent paid by the NRA reduces the NRA's assets without the imposition of a gift tax.



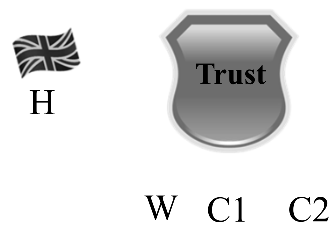
3. Preferential Planning

If we had our preferences, we would want the client to create the trust first, then the trust could form a corporation, family limited partnership, or invest in real estate. Otherwise, we will need the client to gift a U.S. intangible to the trust. For a U.S. corporation this is not an issue. Conversely, while most professionals think a partnership interest is an intangible, it is not absolutely certain. If real estate is gifted directly to the trust, it will trigger a gift tax, regardless of whether or not there is an estate tax treaty. Remember, a NRA does not have any gift tax exclusion (only an estate tax exclusion). Real estate would need to be wrapped in an FLP, held for some time, and then it may gifted – again assuming a partnership interest is an intangible.



If we don't have the optimal timing, U.S. corporate stock may be gifted to a trust. As long as a partnership interest is considered an intangible, it may be gifted to a trust. The exception here to worry about would be Germany. An NRA may not gift U.S. real estate directly to a trust without incurring a gift tax.

U.S. Estate Taxation of a “NRA Trust”



- § 2001 only deals with Citizen or Resident
- § 2101(a) tax imposed on every NRA
- § 2103 gross estate U.S. situs property
- § 2104(b) any transfer, by trust or otherwise, within the meaning of IRC § 2035 - § 2038

4. U.S. Estate Taxation of an NRA Trust

For purposes of this outline, the term “NRA Trust” means a U.S. or foreign trust where the settlor is a NRA. When determining the taxation, start with the U.S. domestic estate planning code rules and then add the international rules, and from there look at the treaty rules.

U.S. estate inclusion issues begin with IRC § 2001. However, this code section deals only with citizens and residents. The international estate parts are found in IRC § 2100’s. IRC § 2101(a) state that tax is imposed on every NRA. IRC § 2103 limits the tax to U.S. situs property. IRC § notes that a IRC § 2035 through § 2038 applies to a NRA.

Revocable Trust

- § 2001 only deals with Citizen or Resident
- § 2101(a) tax imposed on every NRA
- § 2103 gross estate U.S. situs property
- § 2104(b) any transfer, by trust or otherwise, within the meaning of IRC § 2035 - § 2038
- § 2038 Includes power alter, amend, or revoke
  - *City Bank Farmers Trust v Pedrick* (2nd 1948- L)
    - $ 79,000 on deposit NY Bank
    - Stocks and Bonds
    - Revocable with consent of trustee
    - Not allowed bank deposit exception

Now see GCM 38916

a. Revocable Trust

A revocable trust is included in the settlor's estate under IRC § 2038. All of the revocable trust authority holds that there is a look through rule to the underlying trust assets to determine situs. Some of the earlier cases hold that the underlying assets, in particular bank deposits, did not qualify for the bank deposit exemption. However, the Service changed its position on this issue in GCM 38916 (1982) for revocable trusts and simple trusts.

i. City Bank Farmers Trust v Pederick, 168 F.2d 618 (1948)

In *City Bank,* the U.K. resident created a revocable trust that required the consent of the trustee to revoke. The trustee had very little authority not to consent to revocation should the settlor wish for the trust to be revoked. The trust contained $79,000 deposits in a NY bank and stocks and bonds. The case has no discussion regarding whether the trust was included in the settlor's estate. I would suggest that this was because this was a forgone conclusion as the trust was revocable and the settlor retained a life interest to the income – two separate issues resulting in estate inclusion. The case has no discussion regarding the stocks or bonds, whether U.S. or foreign. I am guessing that the stock was U.S. as the trust was created in 1939 during World War II. If so, these assets would be included in the U.K. NRA's U.S. estate. Since U.S. situs assets would result in U.S. taxation, the only issue was whether the N.Y. bank deposits would qualify for the bank deposit exclusion. Judge Learned Hand held that they did not because of minimal consent required by the trustee to revoke the trust. Please note that the Service changed its position on this issue in GCM 38916 (1982).

Authority

- *Estate of Swan* (2nd Cir. 1957)

- Netherlands Settlor had power to revoke
- Held stock & Bank deposits
- Stiftungs like revocable trusts subject to § 811(d)
- §811(d) predecessor to IRC § 2038 – inc. revocable
- Securities in the estate; Bank deposits excluded

ii. Estate of Swan, 247 F.2d 144 (2nd Cir. 1957)

A Netherlands settlor created two Stiftungs prior to World War II. It held stock an bank deposits. The bylaws of the Stiftung held that the Settlor could revoke the private foundation at anytime. Therefore, the Second Circuit concluded that the trust was analogous to a revocable trust. Under IRC § 811(d) of the 1939 IRC (the predecessor of IRC § 2038) a revocable trust is included in the settlor's estate. The Stiftung held U.S. securities and U.S. bank deposits. Using a look through approach the Second Circuit determined that the U.S. securities were in the settlor's estate, but the U.S. bank accounts were excluded.

Authority

- GCM 38916 and Rev. Rul. 82-193
  - Holding is greater than the fact pattern
  - The fact pattern deals with a revocable trust
  - The GCM proposes a revenue ruling that apparently was not issued
  - Beginning Analysis is correct
    - IRC § 2038 – revocable trust included in estate
    - IRC § 2103 – Nonresident alien includes U.S. situs assets
    - IRC § 2104(b) – Nonresident alien subject to IRC §2035-§2038
    - IRC § 2105(b) – Bank deposit Exclusion

iii. GCM 38916

An NRA revocable trust with a N.Y was created by a NRA, who was from a nation that had not entered into an estate tax treaty. The analysis begins that the revocable trust is included in the decedent's estate under IRC § 2038. Note the analysis begins with whether the normal estate planning rules include the trust in the decedent's estate. Next, it notes the nonresident alien only includes U.S. situs assets. This is followed by a reference to IRC § 2104(b) that states an NRA is also subject to IRC § 2035 through § 2038. The GCM then notes that a NRA notes there is a bank deposit exception under IRC § 2105(b).

GCM 38916

- Beg. Analysis Continued
  - Case law had inconsistent holdings that a trust changed the nature of the bank deposit exclusion for **both:**
    - income tax purposes
    - estate tax purposes
  - Service was conceding the issue as applied to both income and estate issues for both revocable trusts and simple trusts
  - Limited conclusions to simple trusts – not complex trusts
    - A simple trust is an income tax term where the trust is required to pay all income and no principal payments are made

The drafter of GCM noted that there had been inconsistent rulings regarding whether a trust (including a revocable trust) was entitled to the bank deposit interest exclusion. For example, Judge Learned Hand held that a revocable trust that required a weak consent of the trustee to revoke was not entitled to the bank deposit exclusion. *City Bank Farmers Trust v Pederick,* 168 F.2d 618 (1948). The drafter also noted that there had also been inconsistent results with the <u>income</u> tax exclusion under IRC § 861. *Martin-Montis Trust v. Commr.,* 75 TC 381 (1980). In *Martin,* an income tax exclusion case, the Court held a simple trust, not a grantor trust, was entitled to the income tax exclusion under IRC § 861.

The GCM held that it was conceding the issue for both income tax and estate tax purposes that the estate and income exclusion applies to both revocable trusts as well as simple trusts. The GCM limited its coverage to simple trust, and specifically stated it was not commenting on complex trusts. Please note a simple trust is an income tax term where the trust is required to pay all income at least annually, no principal payments are made, and there is no charitable deduction.

GCM 38916

➢ Following Proposed a Revenue Ruling – **Never adopted**

For purposes of 2105(b) of the Code, when funds are deposited by a United States bank-trustee of a simple, revocable trust in a savings account of a bank, for a nonresident alien income beneficiary, these funds are treated as property without the U.S., and are excludible from the nonresident alien's gross estate.

Funds invested in securities of the United States corporations are property located within the U.S. and are includable under Section 2038(a).

The same conclusion would apply if the trust were irrevocable

The GCM also proposed a revenue ruling that was never adopted. It is the language in the proposed revenue ruling that is troubling as well as the reference to a simple trust for the estate exclusion that creates the confusion.

The first sentence states IRC § 2015(b) applies to a "simple, revocable" trust. First, a revocable trust is a grantor trust, it is not a simple trust. Perhaps the drafter meant the word "or" instead of the comma. However, a much clearer drafting would be "if a trust interest (which is either a revocable trust or simple trust) is included in a NRA settlor's or beneficiary's estate under IRC § 2035 through § 2038, then the NRA may still exclude bank accounts under the bank deposit exclusion.

The second sentence makes sense as applied to a revocable trust. However, the third sentence makes no sense when combined with the second sentence unless either a the author is advocating for a "look through rule," or the sentence also needs to be qualified to state the taxation only occurs if the trust interest is taxed in the first place under IRC § 2035 through § 2038.

The good news is the proposed Revenue Ruling was not adopted, as it needed quite a bit of refinement. Rather a different one was adopted under Rev. Rul. 82-193 that will be discussed next.

Please note, PLR 200243031 dealing with a foreign revocable trust that owned Amerian Depository Receipts (ADR's) followed the same logic detailed in the previous pages. A revocable trust is in included in the Settlor's estate. However, ADR's while bought in the U.S., an ADR represents that the owner holds a certain number of shares of a foreign stock. The PLR then stated that foreign stock is sited outside the U.S. under IRC § 2104(a).

Irrevocable Trust

- The trust interest was first included in Settlor's estate under IRC § 2035 - § 2038
- Rev. Rul. 82-193
  - Old Clifford Trust - meaning
    - Income taxed to beneficiary for 10 years
    - Principal reverts to the settlor
  - Reversion is included in NRA's estate under IRC § 2033
  - Held a U.S. bank account
    - Income to beneficiary exempt under IRC § 861
    - Reversion of bank account exempt estate under § 2105(b)

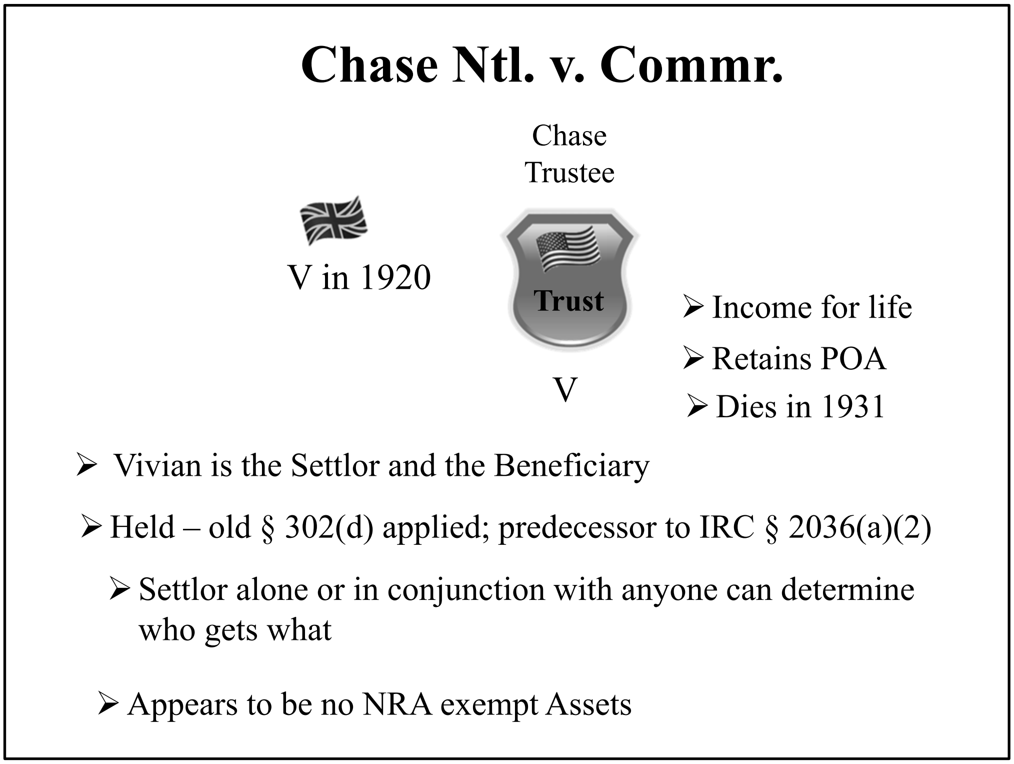
b. Irrevocable Trusts – Included Under IRC § 2035 - § 2038

With these cases, the trust interest was first included in the Settlor's estate under IRC § 2035 - § 2038.

i. Rev. Rul. 82-193

This is the revenue ruling that actually was issued, rather than the proposed one discussed on the previous page. Many years ago, there was an income tax play with something referred to as a Clifford Trust. With this trust, the Settlor would place property in trust for 10 years for the benefit of his child. The child would receive the income and be taxed at the Child's tax rate on such income. At the end of 10 years, the principal would revert to the settlor. In this revenue ruling, both the Settlor and the child are NRAs. The only asset is a U.S. bank account.

Revenue Ruling 82-193 also has a logical sequence of discussion. First it notes that the Settlor's reversion would be included in the Settlor's estate under IRC § 2033. *Adriance v. Higgins,* 113 F.2d 1013 (2nd Cir. 1940). Next the Revenue Ruling notes that the income tax exclusion applies the NRA income beneficiary. Then it holds that the NRA settlors interest is excludable under IRC § 2105(b).



ii. Commr. v. Chase National Bank of NY, 82 F.2d 157 (2^{nd} Cir. 1936)

In 1920, Vivivian created an irrevocable trust in N.Y. where she received a life interest and retained a testamentary power of appointment to appoint the property to anyone. At the time of her death, she did not exercise the power of appointment.

Old § 302 stated that a decedent's estate included:

> "(d) To the extent of any interest therein of which the decedent has at anytime made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke . . ."

Old § 302(d) is the predecessor of IRC § 2036(a)(2), and both state in layperson terms that if a settlor has a power to determine who gets what, either alone or in conjunction with any person, the trust property is included in the Settlor's estate.

This case does not appear to have any NRA exempt assets, as there is no discussion of this issue in the case.

Commr. v Nevius

U.K.
Trustees

W

H in 1917

- This is a beneficiary case
- H & S both domicile U.K.

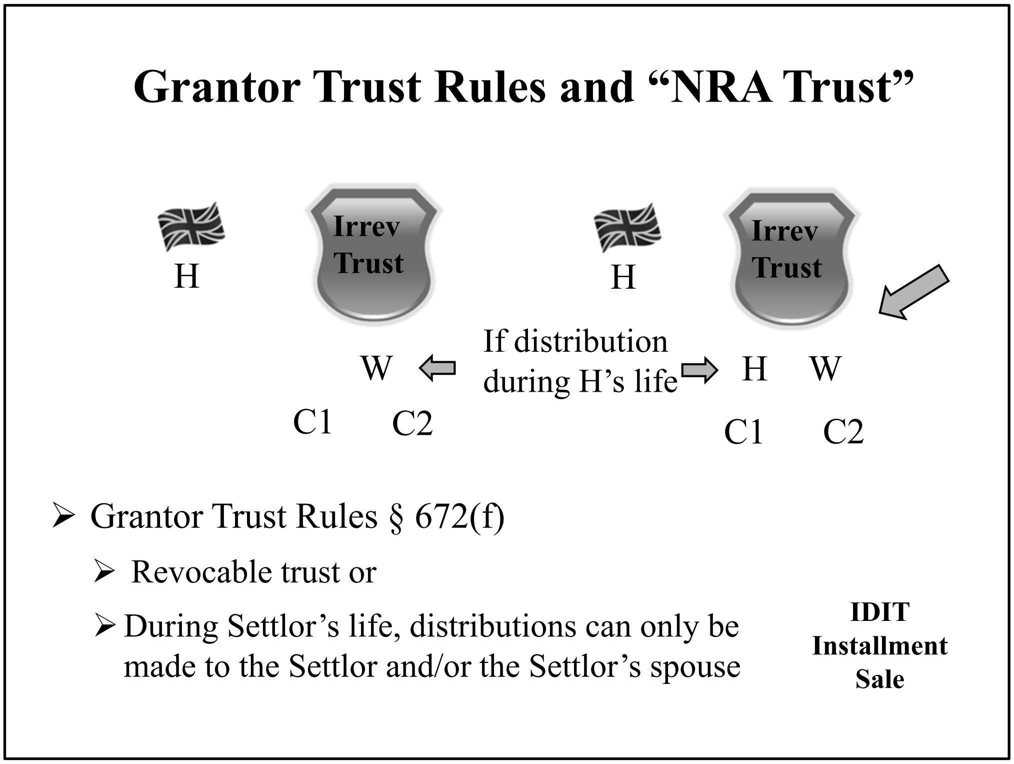
- 1/8 th
- Income for life
- Testamentary GPA
- Dies in 1930

- Old IRC § 302(f) – GPA included in estate
- Trust argued U.S. estate tax applied to decedents, not to trusts that held legal title
- Held § 302(f) applied, equitable interests may be taxed
- Learned Hand Concurring – notes § 302 read in conjunction with the deductions [exclusions] of a NRA

iii. Commr. v. Nevius, 76 F.2d 109 (2nd Cir. 1935)

In 1927, H created an irrevocable trust in England where his spouse received a 1/8th income interest for life and a general power of appointment at time of death (1930), which she exercised. The Second Circuit Court held that the English trust was in the NRA spouse's estate, because she could appoint the trust to anyone [including her estate or creditors] at the time of her death. Therefore, to the extent of any U.S. situs assets, which was the U.S. corporate stock, such assets were included in the spouses U.S. estate.

The English trustees argued that the U.S. estate tax applied to decedents not to trusts. This argument was based on the trustees held legal title. The Second circuit held the U.S. estate tax went farther than mere legal title, rather it taxed equitable interests. Hence, the estate planning octopus, which we will discuss in the following pages. Also, Judge Learned Hand in a concurring option notes that IRC § 302, which contains the general power of appointment rule, must be read in conjunction with the deduction [exclusions] afforded a NRA.

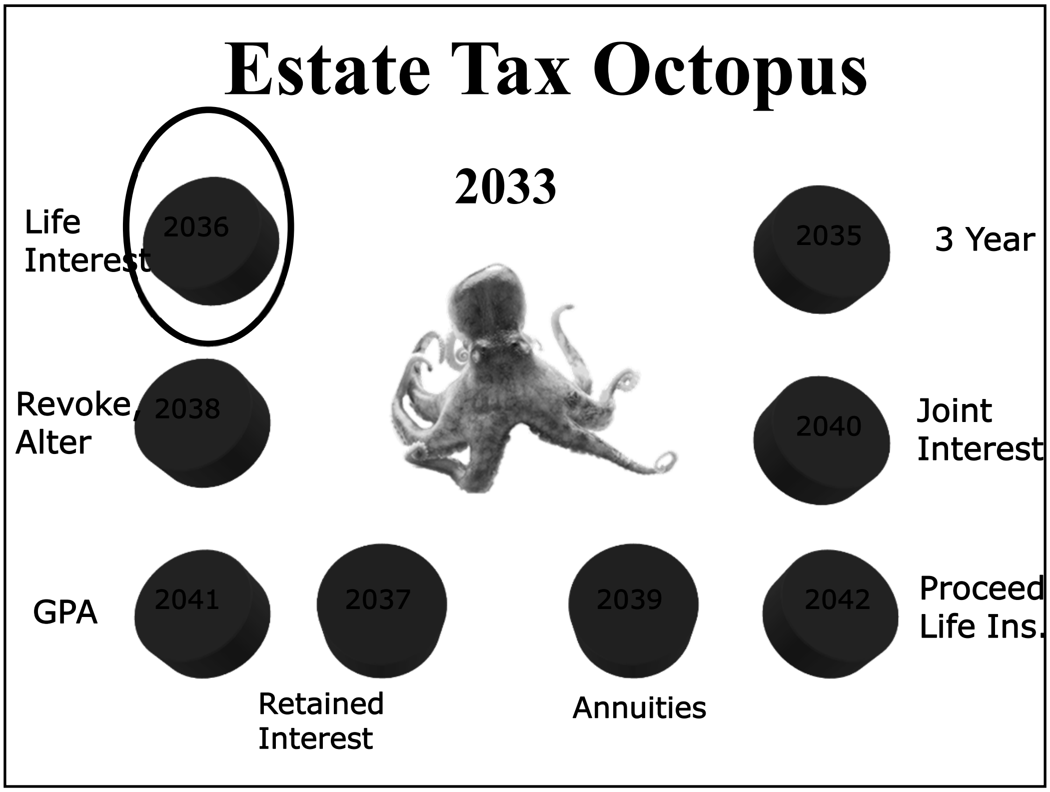


5. Grantor Trust Rules

Since 1996, the rules regarding the taxation of grantor trusts severely limit the application of the grantor trust rules to NRAs. Under IRC § 672(f), grantor trust taxation is limited to two situations:

(1) The NRA settles a revocable trust; or
(2) During the grantors life, income and principal may only be distributed to the grantor and/or the grantor's spouse.

The two diagrams above depict NRA grantor trusts. Note that the diagram to the right is a self-settled estate planning trust that we will discuss later in this outline.



6. Overview of Estate Planning Octopus

a. Head of the Octopus

IRC § 2033 - Under IRC § 2033, a decedent's estate includes all property that the decedent had an interest in at the time of death. IRC § 2033 may be viewed as the head of the estate planning octopus. In addition to all the property that the decedent owned at the time of his death, there are eight other major rules for property that is included in the decedent's estate. These are referred to as the eight arms of the estate planning octopus, which are listed as follows:

b. Arms of the Octopus

(1) IRC § 2037 - Transfers taking effect at death
(2) IRC § 2039 – Annuities –
(3) IRC § 2035 - Gifts w/in 3 years of death
(4) IRC § 2040 - Joint Interests
(5) IRC § 2042 - Proceeds of life insurance
(6) IRC § 2036 - Transfers with a retained life estate
(7) IRC § 2038 - Power to revoke, alter, amend
(8) IRC § 2041 - Powers of Appointment

IRC § 2036
One of the Deadliest Arms

- Titled "Retained Life Interest"
  - Misnomer – estate planning arm much more expansive
- Affects completed gifts
  - Outside of trust
  - In trust
- Affects family limited partnerships
- Spousal lifetime access trusts
- Self settled estate planning trusts

b. IRC § 2036

i. Much More Expansive Than the Life Interest Rule

As previously stated, one common mistake that many practitioners make is that they assume that if someone has gifted property away it is excluded from the estate. However, if any one of the estate planning octopus arms applies, the property subject to the arm is brought back into the decedent's estate. This is true even if part of the decedent's applicable exclusion was used completing the gift, and even if the decedent paid gift tax.

IRC § 2036 is one of the deadliest of the estate planning arms. Part of this is caused by the misleading title to the section – retained life interests. While IRC § 2036 deals with retained life interests, it is much more expansive than this. It has been applied to completed gifts in trust and outside of trust. It has also been applied to family limited partnerships when partnership interests have been gifted to family members. Finally, if voting rights are retained when the stock of a closely held corporation is gifted, the inclusion arm of IRC § 2036 also applies.

IRC § 2036
One of the Deadliest Arms

- Life Interest Rule
  - Income or Use for Life

Vacation Home

- Hidden Rules
  - Implied promise theory
  - Creditor can reach the assets

- Self-Settled Estate Planning Trust

ii. Three Tentacles to the IRC § 2036(a)(1) Octopus Arm

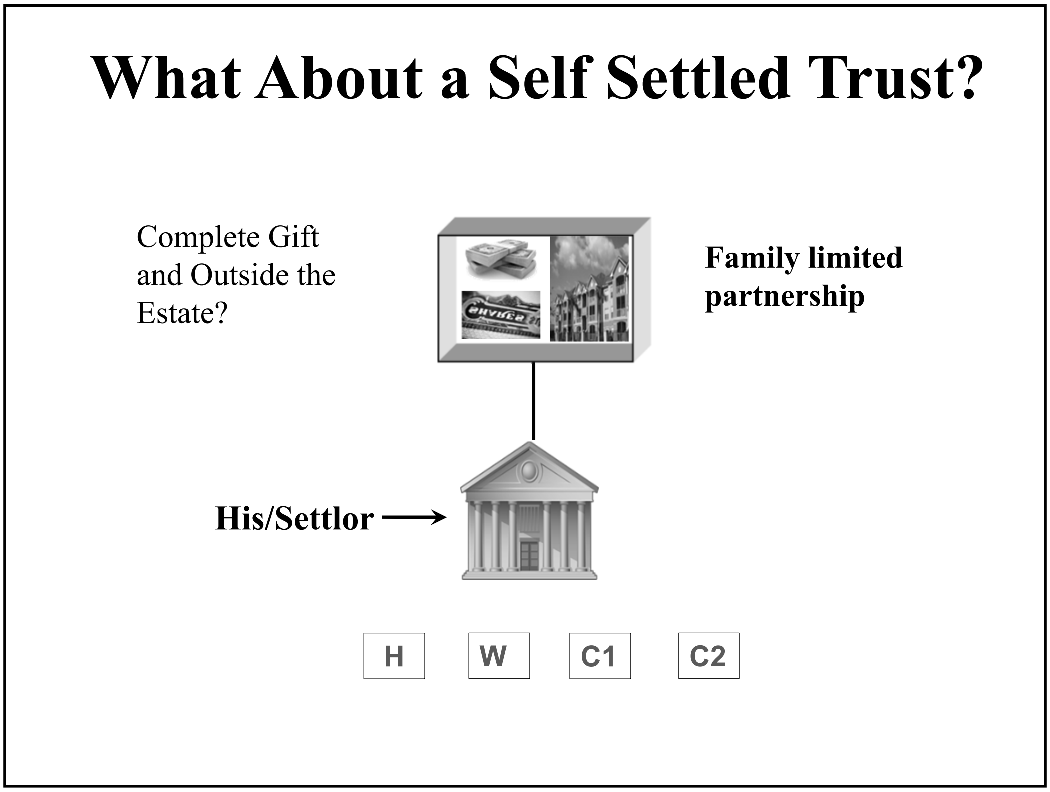
In addition to the three parts of IRC § 2036, there are an additional three parts under IRC § 2036(a)(1): (1) the life interest rule; (2) implied promise theory; and (3) whether the creditor can reach the assets of the trust.

(1) Life Interest

The rule that most practitioners are familiar with is the life interest rule. Under the life interest rule, if the decedent received the income or use of the property at the time of the decedent's death, the property would be included in the decedent's estate.

(2) Hidden Rules

However, in addition to the life interest rule specifically mentioned in the code, there are two hidden rules that are found in the treasury regulations – not the code: (1) the implied promise theory (Treas. Reg. § 20.2036-1(b)(2); and (2) a creditor of the decedent can reach the assets that were gifted Treas. Reg. § 20.2036-1(c)(1)(i).



7. <u>Self Settled Estate Planning Trust</u>

If one is able to draft around the doctrine of reciprocal trusts, husband and wife have access to the property gifted to both trusts. The amount that might be accessed depends upon the distribution standards as well as any savings clauses. Planning with trusts that have reciprocal beneficiaries generally requires both a husband and wife. Furthermore, to access trust assets, one must do so through the other spouse. Is there a possibility that a trust could be designed where a settlor could also be a beneficiary of a trust and the trust property might be excluded from the estate? This type of trust has been referred to as a self settled estate planning trust (i.e. "rainy day trust™"). A typical design for this type of trust has the following components.

(1) The settlor as well as his spouse and descendants are named as beneficiaries.

(2) An independent trustee is appointed within the meaning of IRC § 672(c).

(3) The settlor may remove the independent trustee without cause and appoint another independent trustee within the meaning of IRC § 672(c).

(4) The Trustee may make discretionary distributions (i.e., a common law discretionary trust) of any amount of income or corpus to any beneficiary – including the settlor.

a. Three Tentacles to IRC § 2036

The biggest and most deadly arm of this estate planning octopus is IRC § 2036. It is the biggest arm of the octopus for estate tax inclusion, because the arm breaks down into three tentacles, and one of the three tentacles further breaks down into three more sub-tentacles. All of these tentacles and sub-tentacles bring trust property back into the estate using different rules. The three main tentacles are:

(1) IRC § 2036(a)(1) – dealing with retained life interests;

(2) IRC § 2036(a)(2) – which is generally concerned with the ability of a trustee to designate who receives what; and

(3) IRC § 2036(b) – concerned with voting rights in closely held corporations.

By case law, IRC § 2036(a)(2) and IRC § 2038 have an external standard (i.e. ascertainable standard) exception to their application.[1] The same is not true for IRC 2036(a)(1), there is no external or ascertainable standard exception. It is under IRC § 2036(a)(1) tentacle where three potential estate tax inclusion issues of a self-settled trust surface. IRC § 2036(a)(1)'s Three Sub-Tentacles are:

(1) retained life interest;

(2) implied promise; and

(3) whether a creditor may reach the assets of a trust in satisfaction of a legal obligation.

Personal property you can touch and move with reasonable effort. Conversely, intangible property is something you cannot touch. Since the late 1940's, there has been an evolution regarding situs on tangible property such as stock certificates and bond certificates where the certificates are tangible property, but they represent intangible rights.

[1] *Estate of McTighe,* TC Memo 1977-410; *Jennings v. Smith,* 161 F.2d 74 (2nd Cir. 1947); *Estate of Pardee,* 49 TC 140 (1967); PLR 9347014.

[2] Treas. Reg. § 20.2036-1(a)(1).

[3] Treas. Reg. § 20.2036-1(b)(2).

Classification of Distribution Interests

- Mandatory Interest
- Support Interest
  - many times an ascertainable standard
- Discretionary Interest

b. IRC § 2036(a)(1) – Life Interest Rule

In order to determine whether there is an estate inclusion issue under IRC § 2036(a)(1) for an APT, one must look to the common law classification of trusts to determine whether a beneficiary holds an enforceable right to a distribution. Generally, in determining whether a beneficiary had an enforceable right to a distribution, there are primarily three classifications of trusts: (1) mandatory interest ; (2) support interest; and (3) a discretionary interest.

i. Mandatory Distribution Interest

Usually, a mandatory distribution standard requires that a fixed amount, percentage, or definition of income be paid out annually. For tax purposes, a QTIP, which requires all income to be paid to the surviving spouse, is a mandatory distribution. The same for the annuity or uni-trust interest in a GRAT or CRUT. Similarly, a $100,000 distribution to a certain beneficiary that is required to be made each year is a mandatory distribution. If the settlor holds a mandatory distribution interest, there is an estate inclusion issue

under IRC § 2036(a)(1).[1]

[1] *Estate of Uhl,* 241 F.2d 867 (7th Cir. 1957) as to the $100 mandatory income distribution that resulted in estate inclusion of the corpus necessary to produce the $100 payment.

ii. Support Distribution Interest

Under common law, the term support trust means that the distribution creates an enforceable right in a beneficiary based on a standard. Generally, a support trust is created with mandatory words such as "shall" or "must" combined with a standard that is capable of judicial interpretation. For example, Courts have determined the following language to create a support trust:

- "[T]he trustee shall pay…[to the settlor's] daughters such reasonable sums as shall be needed for their care, support, maintenance, and education" [emphasis added] was determined to be a support trust.[1]
- "[T]he Trustee shall use a sufficient amount of the income to provide for the grandchild's support, maintenance and education" [emphasis added] was held to be a support trust.[2]

If the settlor/beneficiary has an enforceable right to a distribution, again there is an estate inclusion issue.[3]

iii. Discretionary Interest

It is only if a settlor hold a discretionary interest where he or she holds neither an enforceable right to a distribution nor a property interest that there is not an estate inclusion issue under the IRC § 2036(a)(2) tentacle.[4] For purposes of this article, the term common law discretionary trust refers to a trust where a beneficiary has neither an enforceable right to compel a distribution nor a property interest, and no creditor may attach such interest. At this point the author needs to clarify an area of confusion among some practitioners. Under common law, the term "purely discretionary trust" or "wholly discretionary trust" under common law did not require that the distribution interest not have any standards. Rather, in the hundreds of cases on point, almost all common law discretionary trusts contained a standard for making distributions. However, as discussed in detail in may upcoming LISI Series on Spousal Access Trusts, the Restatement Third rewrites the definition of a common law discretionary trust creating an enforceable right in almost all discretionary trusts. The good news, it does not appear that the courts are adopting the Restatement Third in this area of law.

1 *In re Carlson's Trust*, 152 N.W.2d 434 (SD 1967).

2 McElrath v. Citizens and Southern Nat. Bank, 189 S.E.2d 49 (GA. 1972).

3 *Estate of Boardman v. Comm'r,* 20 T.C. 871 (1953); *Estate of John J. Toeller,* 165 F.2d 665 (7th Cir. 1946); and *Blunt v. Kelly,* 131 F.2d 632 (3rd Cir. 1941). For creditor purposes when a beneficiary has an enforceable right to a distribution, it is referred to as a "support trust."

4 *Estate of Uhl*, 241 F2d 867 (7th Cir. 1957), as to the principal that was wholly in the discretion of the trustee "the settlor reserved no right to compel the trustee to pay him any sums . . . ." Both the *Estate of German,* 7 Cl. Ct. 641 (1985) and *Estate of Wells,* 475 F2d 1142 (Ct. of Claims 1964) are self settled discretionary trust cases where the court held in favor of the taxpayer, and it appears the Service did not attempt to argue that there was an enforceable right in a discretionary trust.

The bad news is that there is nothing other than a state a statute codifying the Restatement Second that will prevent a judge from doing so. Therefore, unless the trust is to be sited in a jurisdiction that has addressed this enforceable right issue , I would suggest the following distribution language:

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determine to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. When making distributions, my Trustee may, in its sole, absolute, and unfettered discretion may, but need not, consider a beneficiary's income or other resources that are available to the beneficiary outside of the trust and are known to the Trustee. The power to make a distribution in my Trustee's sole, absolute, and unfettered discretion includes the power to withhold making a distribution to any beneficiary in my Trustee's sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary's favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted as to provide my Trustee with the greatest discretion allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall be accumulated and added to the principal of the trust."

The author is hopeful that the above language would create neither an enforceable right to a distribution nor a property right under even a Restatement Third analysis. This being the case, the first estate planning sub tentacle of IRC § 2036(a)(1) does not create an estate inclusion issue.

Analogy to a Constitutional Trust

- Continuous distribution for living expenses
- Substantial Distribution to settlor
  - Partnership assets needed to pay the estate tax
- Transferred almost all of net worth to the trust (P/S in FLP cases)

c. Analogy to the Constitutional Trust

Prior to the Service's first successes in attacking some FLPs under IRC § 2036, much of the case law for recovery dealt with a tax scam commonly known as the Constitutional, pure, equity, apocalypse, or contract trust ("Constitutional trust"). With these trusts, the settlor was also a beneficiary of the trust (i.e. self-settled trust). Under this type of trust, promoters claimed that neither the settler (nor the trust) paid any income tax, because the settler did not control anything. There was no gift tax, because the settler was transferring property in exchange for beneficial shares. Finally, there was no estate tax, because the settlor, who was also a beneficiary of the trust, held nothing more than a mere expectancy of a distribution. The income tax benefits of these trusts were false due to the grantor trust rules, as well as assignment of income cases. The gift tax benefits were also false. Conversely, under common law, a discretionary interest in trust is not a property interest and a beneficiary does not have an enforceable right to a distribution. Therefore, unless there is some other estate tax inclusion rule, the Constitutional trust would escape estate taxation. As one method to force inclusion of the Constitutional trust into the decedent's estate, the Service had three lines of cases based on an oral promise between the settlor and the trustee that the trustee would make a distribution to the settlor/beneficiary whenever he or she requested a distribution.

i. Continuous Distributions For Personal Expenses

The first line of cases attacking the Constitutional Trust was that after formation, continuous distributions were made only to the settlor as a beneficiary to meet their personal expenditures. When there are multiple beneficiaries of a trust, a trustee will normally not make distributions only to the settlor/beneficiary. Therefore, these cases held that there must have been an oral promise with the trustee to make continuous distributions whenever the settlor requested. Estate of Skinner, 197 F. Supp. 726 (3rd Cir. 1963); Estate of Marguerite Green, 64 TC 1049 (1971); but See Estate of Wells, TC Memo 1981-574 where all income was paid to the settlor, but she used such distributions only for travel – not ordinary and necessary expenses.

As a bad fact, supporting estate inclusion under IRC § 2036(a)(1), many of the FLP cases cite continuous distributions made from the partnership to pay the personal expenses of mom or dad. To make matters worse, generally, these distributions were also disproportionate distributions discussed in the failing to respect the separateness of the partnership.

ii. Substantial Distribution to the Settlor

Again, analogizing to the Constitutional trust, when there are multiple beneficiaries and the trustee makes a large distribution only to the settlor/beneficiary, there seems to be an implied promise to make a distribution whenever the settlor would make a request. Estate of McCabe, 475 F2d 1142 (Ct. of Claims 1964). This point is more subtle when looking at family limited partnerships. In most of the bad fact FLP cases, the client died within a couple of years after creating the FLP. Further, almost all of the client's assets were transferred to the FLP. Therefore, even with the minority discounts, the client would owe a substantial estate tax. However, at time of the death, the client's estate lacked the assets to pay the estate tax – unless there was a substantial distribution from the partnership. Again, the Constitutional analogy factor appears to be being applied to FLPs, because after the death of the client, the partnership must make a substantial distribution to pay the decedent/client's estate tax.

iii. Transfer Almost All the Client's Net Worth

In Strangi, a client transferred 98% of his net worth to the FLP. In Estate of Paxton, 86 TC 785 (1986) the Tax Court found an implied promise when a client transferred virtually all of his net worth to a Constitutional trust. The Tax Court held that no one would leave himself or herself penniless during the later years of his or her life and would need his or her assets the most. Therefore, when Paxton transferred most of his assets to a Constitutional Trust, there had to be an implied promise that the Trustee would return the assets to Paxton as a discretionary beneficiary of the trust if he ever needed the assets. This is the same bad fact that is frequently cited in the FLP cases.

Exception Creditor & IRC § 2041

- **Difference between**
  - A power of appointment IRC § 2041 and
  - Reserved right under IRC § 2036
- **Distribution Interest**
  - Cannot initiate the Action
  - Fiduciary duties of a trustee

d. Exception Creditors & IRC § 2041

Some commentators have expressed concern that the exception creditors provided in many DAPT statutes may result in an estate tax inclusion issue, because these exception creditors may reach the assets of a DAPT. Comparing third party trusts to a self-settled trust, over about ½ of the states provide for a child support exception creditor. To a lesser extent, alimony is an exception creditor. Finally, to a much lesser extent, governmental claims, necessary expenses of a beneficiary, and attorney fees are exception creditors in some states.

i. Is There a Difference Between IRC § 2041 and § 2036

One might note that there appears to be no case, revenue ruling, or PLR on point where the presence of a state exception creditor created an estate inclusion issue for a beneficiary of a third party trust under IRC § 2041. Therefore, one might conclude that there may not be an issue under IRC § 2036. The following analysis will support the author's disagreement with such a statement.

First, § 2041 does not apply to a power reserved by the settlor of a trust, rather it applies to a donee who receives a power. Treas. Reg. § 20.2041-1(b)(2). IRC § § 2036-2038 apply to reserved powers of a settlor. While IRC § § 2036-2038 have many substantially similar estate inclusion principals with IRC § 2041, the code sections are not identical. In order to point out a most likely determinative issue between these code sections, the analysis will begin with IRC § 2041 and exception creditors.

ii. Is a Distribution Interest, By Itself, a Power of Appointment

Treas. Reg. § 20.2041-1(c)(1) states, "A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors." A power exercisable in favor of one's creditors is a general power of appointment, and an ascertainable standard will not cure the estate inclusion issue of a legal obligation.

If a beneficiary's distribution interest is classified as a power of appointment and there is no other theory, such as an "act of independent significance," then all third party trusts in states that provide for exception creditors would have estate inclusion issues. Since there appears to be no case, revenue ruling, or PLR with this holding, it appears that either a distribution interest, by itself, is not a power of appointment or an exception creditor is an act of independent significance.

Treas. Reg. § 20.2041-1(b) does not provide a precise definition of a power of appointment. Rather, it holds:

> "(1) In general. --The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment."

In order to discuss what constitutes a power of appointment, the author will provide a brief discussion of the following various beneficial interests in trust. For these examples assume that the trustee is an independent trustee within the meaning of IRC § 672(c).

(1) Crummey withdrawal power – With this power, the holder alone, almost always without any restrictions such as a limitation for HEMS, may withdraw from $5,000 to the annual exclusion amount annually during a specified period of time. Since the holder may unilaterally withdraw the amount, it is a power, it is also a general power of appointment.

(2) Withdrawal right of the corpus. Some trusts are drafted so that a beneficiary as an unconditional withdrawal right of 1/3 of the principal at a specified age, let's say age 25, ½ of the principal at age 30, and the balance of the principal at age 35. This is also a power that may be unilaterally executed by the beneficiary and is a power of appointment.

(3) Instead of giving the beneficiary a withdrawal right, the trustee is required to distribute 1/3 of the assets at age 25; ½ of the assets at age 30; and the balance at age 35. Here, the beneficiary does not have a unilateral power to withdraw the assets. Rather, the beneficiary must sue the trustee should the trustee not distribution the trust assets pursuant to the terms of the trust.

One might wonder whether (3) is a power of appointment. In (1) and (2), the beneficiary unilaterally had the power to demand the distribution, not subject to any fiduciary powers. In (3), the beneficiary may also make a demand that the distribution is due, however should the trustee not follow the terms of the trust, the beneficiary may also have to sue the trustee to force a distribution. Conversely, the same is true for (1) and (2), a beneficiary may have to sue a trustee to follow the terms of a trust regarding a power of appointment. Based on the above, some planners might classify (3) as a power of appointment, and others might conclude it is a distribution interest.

The analysis becomes more convoluted when one attempts to distinguish between current distribution interests.

(4) If a beneficiary has a mandatory right to a quarterly distribution of income, is this a power of appointment? Similar to the discussion in (3) above, once the quarter has passed and there is no distribution, the beneficiary may sue the trustee for a distribution. In the event that (3) is classified as a power of appointment, the same result seems to apply with a mandatory interest.

(5) With a support interest, upon the beneficiary making a request for a distribution, the beneficiary has an enforceable right to a distribution pursuant to the standard. Is this interest classified as a power of appointment?

(6) With a common law discretionary interest, a beneficiary has neither an enforceable right to a distribution, nor a property interest. Therefore, these interests are not classified as either a "power" or a "right."

Regarding (6), there appears to be considerable authority that a common law discretionary interest is not a power of appointment. Rev. Rul. 76-378 states:

"While the decedent had the power to invoke a process of judicial review had the trustee, in the judgment of the decedent, failed to liberally exercise its discretionary power of invasion on the decedent's behalf, this kind of power does not transfer a power of invasion granted an independent trustee to the beneficiary o the trust."

Rev. Rul. 76-378 cites Estate of Mary Joyce Cox, 59 T.C. 825 (1973) and Security-Peoples Trust Co., 238 F.Supp 40 (W.D. Pa. 1965). In Estate of Cox, the Tax Court held that the trustee, not the beneficiary, had the power of invasion. In other words, the Tax Court did not even get to the analysis of whether there was a general power of appointment, because the beneficiary of a discretionary interest did not have a power. The power to make distributions was in the trustee. The court further held, "To decide that the beneficiary had an implied power of invasion would be inconsistent with such arrangement and with the provision expressly granting the trustee sole and exclusive management powers." When interpreting the "management powers," the Tax Court concluded that "it seems clear that the petitioner's power of management was intended to include the power of determining when Mrs. Cox's income was insufficient and when the corpus should be invaded." Conversely, the District Court in Security-Peoples Trust Co. held that the beneficial interest was not a general power of appointment. At the same time, it seemed to imply that the beneficial interest alone was not a power of appointment when the court held, the trustee had the discretion alone to invade income or principal for the beneficiaries, with regard to protection of interests of future and remainder beneficiaries. Some further analogous authority that a distribution interest is not a power of appointment is also provided by Rev. Rul. 82-63 that when reviewing whether a power of appointment exists, when the power is vested in a trustee, not the beneficiary, there is not a power of appointment.

Except for Rev. Rul. 82-63, all of the cites immediately above deal with a discretionary interest combined with an independent trustee. Therefore, one might narrowly conclude that that the above authority may not apply to a support interest. Rev. Rul. 82-63 makes another possible distinguishing point between a distribution interest and a power of invasion. The ruling states, "a power of invasion is different than a power of distribution." In this revenue ruling, the Service noted that in Dana v. Gring, 371 N.E.2d 755 (Mass. 1977), the decedent was to receive income for life and as much of the principal as the trustees deemed necessary for the reasonable welfare or happiness. Unlike the Revenue Ruling 76-368 and cases cited on the previous page, the decedent/beneficiary was one of three trustees. Generally, this would result in an automatic estate inclusion issue, because in her power as one of the three co-trustees, the beneficiary could make discretionary distributions to herself. Therefore, her powers as a co-trustee would create a power of invasion when coupled wither her beneficial interests. However, with quite a few contortions, the Massachusetts Supreme Court concluded that based on the circumstances "happiness" was an ascertainable standard. Part of this reason was that as a co-trustee with fiduciary duties could not have distributed trust principal to a life beneficiary solely on the basis of her subjective desires. "In the absence of instructions to the contrary (a trustee is bound) to administer his trust with an eye to the remainder interest as well as to the interest of a life beneficiary." The court also noted that as a general rule, a trustee beneficiary may not participate in decisions regarding distributions of principal to himself.

While many authorities will have different opinions regarding the Massachusetts holding that in certain circumstances "happiness" is an ascertainable standard, this is not the critical point of discussion under Rev. Rul. 82-63. The Service published the revenue ruling to advise all taxpayers that it would not be following a different factually distinguished case - *Brantingham v. U.S.*, 631 F.2d 542 (7th Cir. 1980). In Brantingham, the decedent had a power in a non-fiduciary capacity to invade the corpus for the beneficiary's maintenance, comfort, and happiness." The Revenue Ruling notes that, "The discretionary power in Gring was a fiduciary power of distribution and was, therefore, limited by the fiduciaries' obligation to preserve the corpus for all beneficiaries. The court noted that the trustees had to administer the trust with "an eye to the remainder interest. The power in Brantingham was a power of invasion, exercisable by the decedent in an individual capacity and, therefore, was not limited by any fiduciary considerations regarding preservation of the corpus for other beneficiaries. . ."

The analysis in Rev. Rul. 82-63 brings forward a very important distinction. A power held in an individual capacity, unless otherwise stated in the trust document, may be exercised in a non-fiduciary capacity. There is no requirement to look at any other interests that a different beneficiary may hold, before the beneficiary demands a distribution. Conversely, if a beneficiary is serving as a trustee, he or she has fiduciary obligations, before making any distribution to himself or herself. These fiduciary obligations still do not prevent an estate inclusion issue if the beneficiary's distribution interest is not limited to an ascertainable standard. However, Rev. Rul. 82-63 may be interpreted that a distribution interest alone is not a power of appointment. If a distribution interest is not a power of appointment, an exception creditor does not create an estate inclusion issue for a third party trust.

On the other hand, in the event a support distribution interest is a power of appointment, then another issue would need to examined, is an exception creditor an act of independent significance. Otherwise, consider the following situation. The trust instrument states, "the trustee shall make distributions for health, education, maintenance, and support." The trust is sited in Georgia. Spouse and children are named as beneficiaries. Spouse is not a trustee, and she passes away. She had an enforceable right to a distribution that was based on an ascertainable standard. So at first, it does not appear that she has a general power of appointment. Yet, under Georgia law, any tort creditor may reach the assets of a support trust. GA CODE Ann. § 53-12-28(c)(1). Therefore, if a support distribution interest is classified as a power of appointment, a tort creditor may reach the support distribution interest, which would result in estate inclusion issue under § 2041.

iii. Difference Between IRC § 2036 and IRC § 2041

IRC § 2041 regarding estate inclusion issues for donees requires that the decedent hold a power of appointment. Conversely, IRC § 2036 does not require the settlor/decedent to hold a power of appointment. Rather, IRC § 2036 requires that the settlor hold a mere enforceable right to income or principal. Estate of Boardman v. Comm'r, 20 T.C. 871 (1953); Estate of John J. Toeller, 165 F.2d 665 (7th Cir. 1946); and Blunt v. Kelly, 131 F.2d 632 (3rd Cir. 1941).

Exception Creditor & DAPTs

- **Reserved right under IRC § 2036**
  - Enforceable right = estate inclusion
  - Creditor can reach the beneficial interest = estate inclusion
- **Acts of Independent Significance**
  - Not directly on point
  - Except, possibly breaking a law

e. Exception Creditors & Domestic APTs

As previously noted, a settlor's interest in a self settled trust should be drafted so that the settlor/beneficiary does not have an enforceable right to a distribution. However, unlike offshore APTs that address the asset protection from the English discretionary nature of the beneficiary's interest, domestic APTs relied on American spendthrift protection. When doing so, almost all domestic APTs created exceptions to the spendthrift provision, allowing these exception creditors to reach a settlor/beneficiary's interest in these trusts. If an exception creditor can reach a beneficiary's interest, does this create an estate inclusion issue under IRC § 2036?

Treas. Reg. § 20.2036-1(b) states –

"(2) The "use, possession, right to the income, or other enjoyment of the transferred property" is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit. The term "legal obligation" includes a legal obligation to support a dependent during the decedent's lifetime." {emphasis added}."

At first glance, it appears that all domestic APTs that provide for any exception creditor would be included in the settlor's estate. However, some authors have taken the position that certain exception creditors are "acts of independent significance." In the event an action is classified as an "act of independent significance," then there is not an estate tax inclusion issue. For example, a trust provides that the beneficiaries are the settlor's children. After the creation of the trust, the settlor and his spouse give birth to another child. By the terms of the trust, the newborn child is automatically added as a beneficiary. Unless child birth (and adoption) are acts of independent significance, the act of giving child birth would change the beneficial interests of the trust under IRC § 2036(a)(2) and IRC § 2038(a)(1). Furthermore, even if the settlor did not have a child, immediately prior to death, there would be the astronomical chance that the settlor or the settlor's spouse could have or adopt a child. Therefore, Rev. Rul. 80-255 held that a trust beneficiary that is added by giving birth or adoption is an act of independent significance, and therefore there is no estate inclusion issue.

Related to a child support exception creditor, the author questions whether Rev. Rul. 80-255 is on point. Not paying child support is simply not paying a legal support obligation. It seems to be quite a bit of a stretch, to analogize the birth or adoption of a child to not paying child support years later, presumably after a divorce.

Another act of independent significance is a settlor changing a beneficial interest through the act of divorce. In Estate of Tully, 528 F.2d 401 (Ct. Cl. 1976), decedent had entered into an employment contract whereby the employer promised to pay death benefits to his widow. The Court of Claims held that the decedent did not have the power to revoke within the meaning of IRC § 2038, even though the decedent could have divorced the spouse, thereby eliminating the spouse's possible status as widow. The Court held, "In reality, a man might divorce his wife, but to assume that he would go through an entire divorce process merely to alter employee death benefits approaches the absurd." A similar result was reached in PLR 8819001, where the trust contained a provision that stated, "In the event decedent and his wife become divorced, his wife shall have no further rights therein, an no further payments shall be paid to her." The PLR went on to cite Estate of Tully, "the act of divorcing one's spouse is an act of independent significance, the incidental and collateral consequences of which is to terminate the spouse's interest in the trust.

The above acts of independent significance directly deal with a spouse's beneficial interest in an employment contract or a trust being terminated upon a divorce. The Court of Claims Court in Tully noted that the settlor would have the power to terminate the interest by filing a divorce, however, to do so solely for the purpose of altering beneficial interests would be absurd. The author would agree that divorcing one spouse to alter the beneficial interests in almost all cases would be absurd. However, this is not why people divorce. Generally, they no longer get along. The act of not paying child support or alimony may well be due to financial hardship after a divorce or possibly an anger issue. In this respect, the author questions whether there is a direct analogy regarding how the above authority supports an act of independent significance for child support.

Conversely there may be an indirect analogy. Behind the Court's statement that divorcing one's spouse to alter benefits (or beneficial interests) "approaches the absurd," deals with the probability that such action would ever occur. Personally, the author has been involved in the creation of offshore and domestic APTs for over 15 years, and has never seen or heard from any other planner that an APT was used to shirk a child support obligation. The author finds it almost astronomically remote that a person who can afford to settle an APT, would sit in jail, in order to shirk a child support order. Therefore, as to child support there may be an indirect analogy applicable to an act of independent significance based on the remoteness of the occurrence of the event.

The issue of remoteness was also discussed in Ellis v. Comm'r, 51 T.C. 182 (1968). In Ellis, as part of a prenuptial agreement, the taxpayer created a trust for his spouse. The trust provided that the trustee "shall pay to or apply for the benefit of the donor's wife, Viola ELLIs, such amounts as the trustee form time to time, in its discretion, deems advisable for her care, comfort, or support and shall add to principal any income not so distributed." Husband reduced the amount of the reported gift to the trust based on the income interest that his wife was to receive. Husband argued that with regard to the gift of the life estate, he retained sufficient control over the disposition of income, as to make the gift of the life estate incomplete. The trustee was a bank. Husband could not appoint himself as trustee. Rather, husband argued that under Arizona law, the trustee needed to look to the husband's obligation to support his wife before making a distribution. Therefore, the husband could refuse to provide any support for his wife (i.e. throw her out of the house and refuse to pay for any expenses while he was happily married), and this would force the trustee to make distributions for her support.

The Tax Court did not accept petitioner's reasoning. Rather, it noted that "in theory, this [argument] may appear to be control, but as a practical matter it would be extremely difficult for petitioner to exercise this power. For petitioner to cause a situation to occur which would compel the trustee to distribute the trust's income to Viola, petitioner would have to create a major domestic crisis. Thus, due to the undesirable consequences which would result, we believe it is extremely unlikely that the petitioner would or could cut Viola off at any time he so desired."

The above fact pattern does not seem to be on point with a divorced person not paying alimony. In Ellis, the taxpayer is not divorced or even contemplating divorce. If he arbitrarily ceases supporting his spouse, the court is implying that he most likely would end up in a divorce. Therefore, the court finds the likelihood of the taxpayer purposefully refusing to support the spouse he currently is married to as quite remote. In contrast the fact pattern regarding non-payment of alimony seems quite different. With alimony, a divorce has occurred. Sometimes, there is quite a bit of hostility between the parties, and one party simply stops paying. Unlike child support, someone who does not pay alimony usually does not end up being incarcerated. Furthermore, where the author has never met a potential client that sought to shirk a child support obligation by the creation of an APT, the same is not true with alimony. The author has had potential clients and has heard from other advisors of clients seeking to create a domestic APT to shirk an alimony claim. To date, the author has turned down these type of engagements. In this respect, if "remoteness" is the pivotal test to whether a certain act constitutes an act of independent significance, it appears an alimony exception creditor creates a greater estate inclusion issue than a child support exception creditor.

On the other hand, there was another holding in Ellis that may prove to be more fruitful. The court went on further to note that Arizona law required a husband to support his wife during coverture, by statute. The court then concluded, "Under these circumstances, petitioner should not be considered to have any control where to exercise the power it would be necessary to do any unlawful act." A narrow reading of the holding would be that it only applies to a spouse's duty to support the other spouse while he or she is married. A broad reading of the holding would support the conclusion that any act that would require the breaking of a law is an act of independent significance. At present, "breaking the law" is undefined. However, the author would guess that it means breaking a criminal statute. In this respect, a child support exception creditor, and in some states possibly an alimony exception creditor could be an act of independent significance.

Not paying child support might be classified as an act of independent significance under either a remoteness theory or a breaking the law theory. Alimony might possibly be classified as an act of independent significance in some states under a breaking the law theory. However, what about other possible state exception creditors?

In addition to child support and alimony, the Restatement (Second) and (Third) of trusts lists the following exception creditors.

1. governmental claims;
2. attorney fees;
3. necessary expenses of a beneficiary.

Depending on whether the governmental claim is based on a criminal claim, it may be considered breaking the law. Conversely, non-payment of attorneys who represent a beneficiary and non-payment of hospital or other necessary expenses of a beneficiary would not be breaking a law. Obviously, a tort creditor exception would not be an act of independent significance.

U.S. Trust or Foreign Trust

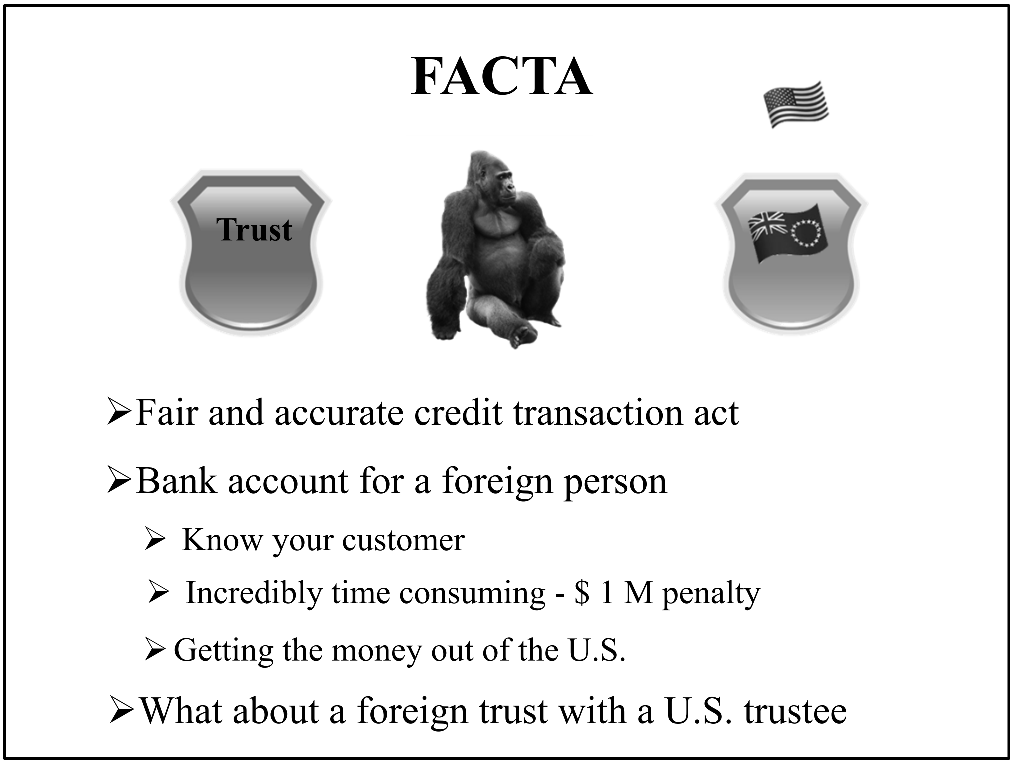
 

- Easily a seminar or two by itself
- Beneficiaries – U.S. or NRA or both
  - U.S. Beneficiaries throw back income rules if foreign trust
    - Unless a grantor trust
- U.S. trust accumulates income
  - Capital gains taxed
  - Most likely nontaxable to a foreign trust

8. U.S. Trust or Foreign Trust

The determination of whether a U.S. trust or a foreign trust should be most likely made based on the income tax issue involved. An in-depth discussion of this topic is a seminar or two by itself. Anyway, let's look at a couple of the high points. First, if a foreign trust has U.S. beneficiaries, the throw back rules will apply if the trust accumulates income. The effect of the throwback rules is to eliminate any capital gains benefits and apply a most likely non-deductible interest charge. Conversely, if the foreign trust is drafted to be a grantor trust, the throwback rules would not apply.

A nonresident alien is exempt from capital gains tax unless it involves real estate or the sale of a partnership interest. Most likely a foreign trust that accumulates income also is not subject to the same capital gains tax. A U.S. trust that accumulates income would be subject to tax on the capital gains.



9. Fair and Accurate Credit Transaction Act

While the objective of FACTA was to stop people laundering money around the world, it actually has also resulted incredible constraints on international business transactions, the formation of legitimate business structures as well as legitimate trust planning. The problem is that the bank needs to make sure that the customer is not involved in any illegal activities which gets into the know your customer rules, which are incredibly time consuming. This is because banks can be subject up to a $1 million penalty for failure to having proper review procedures of their clients. Further, when it is a U.S. trust, what are all the procedures for getting a wire transfer out of the U.S. Finally, add a neat twist to the entire structure. Can you draft a trust so that it is a foreign trust even though it has a U.S. trustee? Of course you can. Anyway, if you need a reference to a U.S. Trust company with quite a bit of experience in this area, I would consider contacting:

France Becker at
South Dakota Trust Company
Fbecker@sdtrustco.com
605 721-0630

For Foreign Trusts:

Asiacititrust.com
Southpac.co.ck

