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## **WHAT EVERY TRUSTEE NEEDS TO KNOW ABOUT FOREIGN TRUSTS WITH U.S. BENEFICIARIES**

By Hal J. Webb and Steven L. Cantor

A variety of U.S. federal tax and reporting issues arise when a U.S. person is or becomes a beneficiary of a foreign trust. This article highlights what every trustee of a foreign trust with U.S. beneficiaries needs to know in order to understand the U.S. federal tax payment obligations and reporting requirements of the trust, the settlor(s) and the U.S. beneficiaries.

A trustee of a foreign trust with U.S. beneficiaries needs to know:

### **1. Whether the trust is considered to be a foreign trust or a domestic trust and under what circumstances that status may be changed.**

A domestic trust is any trust for which both (i) one or more U.S. persons has the power to make all substantial decisions concerning the trust (i.e. to whom to make distributions, to remove the trustee, to change the governing law, etc.) and (ii) the jurisdiction for court supervision of the primary administration of the trust is within the U.S. A foreign trust is any trust which is not a domestic trust.

### **2. Whether and to what extent the trust is, has been and will be a grantor trust or a nongrantor trust.**

A grantor trust is a trust for which a person (such as the settlor) is treated as the owner of the assets of the trust for U.S. federal income tax purposes. A trust which is not a grantor trust is a nongrantor trust. A nongrantor trust is a trust which is treated as owning its assets for U.S. federal income tax purposes rather than having ownership of its assets attributed to another person.

A person is the “grantor” of a trust to the extent that he or she either created the trust or made a gratuitous transfer to the trust. Thus, the settlor of a trust is a “grantor” of that trust. A foreign trust settled solely by a nonresident alien (who was the only transferor of property to the trust) is treated as a grantor trust while and to the extent that either (a) the settlor has the power to revert title in the assets of the trust in himself without the approval or consent of another person or with the consent of a related or subordinate party who is subservient to the grantor or (b) distributions may be made only to the settlor and/or the spouse of the settlor during the lifetime of the settlor. Certain compensatory trusts settled by a nonresident alien may also be grantor trusts, and a special grandfather rule applies to trusts created before September 20, 1995.

A person other than the grantor is treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself. This rule does not apply, however, to (i) a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence or (ii) a power that requires the consent of any other person, whether or not adverse to the power holder.

**3. The U.S. income, estate, gift and generation skipping transfer tax consequences to the settlor and each U.S. beneficiary, whether due to (a) powers or rights in connection with the trust or the entities owned directly or indirectly by the trust and/or (b) the direct or indirect receipt of distributions from the trust.**

Many foreign trusts contain provisions which provide an individual with various powers over the trust in the capacity as a protector or otherwise. If, for example, a U.S. person is a beneficiary of a trust and has the power to remove and replace the trustee of the trust without any restrictions as to the reason for the removal or as to who can serve as the new or additional trustee, such power may be treated as a general power of appointment over the assets of the trust with adverse tax consequences (particularly if the trustee can make discretionary distributions). Any power over a trust should be carefully considered before the trust instrument is executed in order to determine whether there would be any U.S. tax consequences in connection with such power if the power holder is or becomes a U.S. person.

**4. The U.S. federal reporting requirements, if any, of the trust, the settlor(s) and the beneficiaries of the trust (i.e., Internal Revenue Service Forms 3520, 3520-A, 8621, 5471, 1040, 1041, and U.S. Treasury Department Form TD F 90-22.1).**

Merely relying upon a representation by a settlor or beneficiary as to his or her compliance with tax and reporting requirements is not sufficient for the trustee. Each trustee should require proof of compliance.

**5. The manner in which the trustee maintains the trust and the entities owned by the trust could affect the tax payment obligations and reporting requirements for the U.S. beneficiaries.**

For various reasons, most trusts hold title to assets indirectly through a wholly-owned foreign corporation. Holding title to assets in this manner triggers various U.S. tax issues, particularly if the foreign corporation is ever treated as a passive foreign investment company or a controlled foreign corporation. Accordingly, tax planning should be done to minimize or eliminate the impact of the passive foreign investment company or controlled foreign corporation tax regimes.

**6. The type and situs of investments held directly or indirectly by the trust could affect the tax payment obligations and reporting requirements for the U.S. beneficiaries.**

The type and situs of investments held by a foreign trust (or a holding company owned by the trust) could trigger U.S. federal tax payment obligations and/or reporting requirements for the U.S. beneficiaries of the trust regardless of whether they receive a distribution or have a fixed interest in the trust. For example, if a foreign trust owns an offshore mutual fund which is treated as a passive foreign investment company, under certain circumstances the U.S. beneficiaries of the trust could be treated as indirectly owning such fund for U.S. federal tax purposes.

**7. If the trust is not funded properly, the estate of the settlor of the trust could be subject to U.S. federal estate tax.**

When funding the trust, the settlor should not directly or indirectly transfer to the trust (or any entity owned by the trust) assets which are “situated within the U.S.” Only assets which are not “situated within the U.S.” should be transferred directly or indirectly to the trust or any entity owned by the trust. Otherwise, part or all of the assets of the trust could be subject to U.S. federal estate tax when the settlor dies.

Although it is unnecessary for a trustee to become an expert on U.S. international taxation and income taxation of trusts, it is important for a trustee of a foreign trust with U.S. beneficiaries to be aware of the issues raised in this article. Although these issues are complex and extensive, even a basic understanding of the U.S. federal tax and reporting concepts and obligations should enable a trustee of a foreign trust with U.S. beneficiaries to more easily perform their duties and understand planning opportunities.

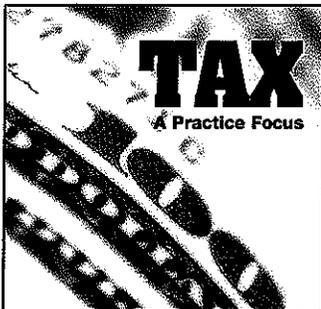
## U.S. Citizens Who Don't Know It

Some individuals may be surprised to learn that they're American citizens. And then they face the tax consequences.

BY STEVE TROW AND CHARLES BRUCE

Imagine that your foreign-born client has been an American citizen since birth—and doesn't know it.

This is a pleasant dream for an immigration lawyer, but it can be a nightmare for a tax adviser. The U.S. government taxes American citizens on their worldwide income and taxes their worldwide assets at death, even if they have no residence or domicile in the United States. This is a heavy price to pay if the client has never, or hardly ever, claimed the benefits of American citizenship.



These "unaware" Americans make interesting and challenging clients. For their lawyers, the trick is first to spot them, and then to guide them carefully through the citizenship, tax, and reporting maze.

How does this problem arise? Imagine, for example, that your client tells you that he used to be an American citizen,

but he lost that citizenship when he became a citizen of another country. Or that the client's parent or grandparent was an American citizen and lost that citizenship before the client was born.

Your client may be absolutely certain he is right, but he could be absolutely wrong. Unless the client has a Certificate of Loss of Nationality issued by the U.S. State Department, you should consider the possibility the client is still an American citizen, or that his parent or grandparent retained American citizenship and passed it along to the client.

Perhaps your client lived in the United States with his parents when he was a child and held lawful permanent resident (green card) status. He never applied for American citizenship, and he left the United States many years ago. Yet your client may be an American citizen if one or both parents obtained

American citizenship, even without any further action by the client or his parents. His children and grandchildren may also be American citizens.

A person can obtain American citizenship "accidentally" by birth in the United States, by birth abroad to an American citizen parent, or through the American naturalization of a noncitizen parent. If the legal requirements are met, the person becomes an American citizen automatically, by operation of law, regardless of his intention or his parents' intention.

American citizenship can pass through several generations of children and grandchildren born outside the United States, without any of them having any awareness of it.

Once obtained, American citizenship is difficult to terminate without a formal renunciation of citizenship before an American consul. Loss of American citizenship requires the voluntary performance of an expatriating act with the specific intention of relinquishing American citizenship. The person asserting loss of citizenship bears the burden of proof, and in most cases, there is a presumption of intent to retain citizenship rather than to relinquish it.

### ONE FAMILY, TWO COUNTRIES

Consider the following scenario:

Grandpa is born in the United States in the 1930s, moves to Canada in his early 20s, and is naturalized in Canada in his late 20s. He thinks he lost his American citizenship when he obtained Canadian citizenship, but he is wrong about that.

Dad is Grandpa's son, born in Canada in the 1960s. He has been an American citizen since birth but does not realize it. He is an American citizen because Grandpa was physically present in the United States for more than 10 years before his birth, including five years after Grandpa reached 14 years of age.

Junior is Dad's son, born in Canada in the 1990s. He too has been an American citizen since birth because Dad spent five years studying or working in the United States before his birth, including two years after Dad reached 14 years of age.

(This result could also occur if Dad never lived in the United States, but he served in the U.S. military or worked outside the United States for the U.S. government (such as for the U.S. Agency for International Development) or worked for an international organization (such as the United Nations, Organization of American States, or World Bank) for five years before Junior's birth. If so, Dad is deemed to have been present in the United States, and Junior is an American citizen.)

This "accidental" American citizenship can be good news if Grandpa wants to retire to someplace warm and sunny in the United States, if Dad gets a great job offer in the United States, or if Junior gets admitted to a U.S. university. It can be very good news when Grandpa and Grandma find that the United States has no immigration category to admit retirees with independent means, if Dad finds that his potential U.S. employer does not want to sponsor him for U.S. work authorization, or if Junior gets busted for using drugs and finds that the U.S. government wants to deport him.

Yet American citizenship can be bad news if Grandpa, Dad, or Junior has substantial income. Even though they have paid Canadian taxes all their lives, they may owe additional income and gift taxes (as well as interest and penalties) to the U.S. government. By failing to file U.S. tax returns, they may have lost the right to claim exemptions, exclusions, deductions, and credits available under U.S. law. If they have the misfortune to be subject to the U.S. Alternative Minimum Tax, only 90 percent of what they have paid to Revenue Canada in years before 2005 can be offset against their U.S. income taxes.

And American citizenship can be very bad news if Grandpa, Dad, or Junior dies with substantial assets. If the death occurs in 2007, the U.S. estate tax on a \$5 million estate would be approximately \$1.5 million. On a \$20 million estate the tax would be more than \$8 million. On a \$100 million estate, the tax would be more than \$44 million.

There is no credit against U.S. estate taxes for the Canadian taxes due at death. (The reason is that the Canadian tax is an income tax on unrealized gains on capital property that is deemed to be sold at death.) U.S. beneficiaries cannot avoid the U.S. tax because the liability shifts to them as transferees, or in some cases, as constructive executors.

### HOW TO TELL

How can you spot an "accidental" American citizen? The first step in the analysis is easy . . . ask your client:

- Was he was born in the United States?
- If not, does he have a parent, grandparent, or great-grandparent, living or dead, who was born in the United States, or who ever held American citizenship or American permanent resident (green card) status?

If the answer is no to both questions, it is unlikely that your client obtained American citizenship at birth. If yes to either question, your client may be an American citizen, even if he believes he is not.

The second step in the analysis is more difficult and requires tracing the family's citizenship, residence, and employment back through time.

U.S. citizenship law is complex and has changed many times

over the past three generations. The requirement for residence or physical presence in the United States by a U.S. citizen parent before the birth of a child abroad is different depending on the date and place of birth of the child, on whether one or both parents are U.S. citizens, and on whether the child is born in or out of wedlock.

From 1934 to 1952, a person who acquired American citizenship by birth abroad was required to reside in the United States for some number of years during a certain age range to retain citizenship. These retention requirements were later repealed, but not retroactively. The requirements for derivative American citizenship upon the naturalization of one or both parent have also changed over time.

If you find that your client or his recently deceased relative is or was an accidental American citizen, he may owe back taxes, interest, and penalties for failure to file U.S. income, gift, and estate tax returns. There may also be civil or criminal penalties for failing to file Foreign Bank Account Reports.

If the client comes forward voluntarily it may be possible to negotiate a compromise with the Internal Revenue Service. If the IRS spots the problem first, however, the opportunity for compromise is greatly reduced.

### GOODBYE, AMERICA?

Your client may wish to consider terminating his American citizenship to reduce his exposure to future U.S. taxes.

He will need to be current on U.S. taxes to achieve any benefit, because loss of citizenship is not recognized for tax purposes if taxes are due. A client who terminates American citizenship without catching up on back taxes has the worst of both worlds—no longer an American citizen, but still taxed as one.

If the client dies before you or the IRS spot his American citizenship, the opportunity for terminating citizenship is almost always lost. At the other extreme, terminating the American citizenship of a child is very difficult and usually best deferred until 18 years of age.

There are detailed anti-expatriation tax rules that apply to American citizens who terminate their citizenship. In general, expatriates continue to be subject to U.S. income tax for a 10-year period following expatriation, but only on U.S. source income (which is broadly defined). Full income taxation comes back into play if the expatriate spends significant time in the United States (more than 30 days per year in most cases). Estate- and gift-tax rules follow the same pattern, so if the expatriate dies during this 10-year period, his assets, wherever located, are subject to U.S. estate tax.

Congress is considering an "exit tax" that would supersede existing rules and treat an expatriating individual as though he sold everything he owns the day before expatriating. Everything is taxed except the first \$600,000 (\$1.2 million for a couple). Any gifts or bequests from an expatriate to a U.S. person (citizen or tax resident) would be taxed in the hands of the recipient.

Accidental Americans considering giving up their U.S. citizenship need to pay attention to this possibility of a new exit tax. A client with sizable assets and large built-in gains might want to expatriate under the existing rules, before the exit tax goes into effect. Unfortunately, if the exit tax is approved by

Congress, there may not be enough time to complete all the necessary steps, including getting current on tax filings, before its effective date, which would probably be the date that the president signs the bill. Clients facing this situation need to contact counsel immediately to figure out the alternatives.

But clients should not assume that they must do something right away. A client who does not have large built-in gains, for example, might prefer the exit-tax regime because the 30-day rule about spending time in the United States would no longer apply, and there is no requirement to file tax returns for the next 10 years. This choice might be especially attractive if the client did not care about the rule that taxes gifts and bequests in the hands of the U.S. recipients.

Clients who have just discovered that they are U.S. citizens

need to take a deep breath and not despair. It's usually not nearly as bad as they first think. They probably need to catch up with their tax filings and get used to the annual reporting routines that we all deal with.

Those who decide that they really don't need U.S. citizenship on top of their other nationality should carefully work through the procedures for terminating citizenship, recalling that—like many things in life—coming in is cheaper than going out.

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