

Tax Planning for the United States Beneficiaries of Offshore Trusts

**STEP Bahamas
Presentation**

**January 8, 2004
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The **TAX MAN**
Cometh

Keep him away . . .

US Resident/Nonresident

- RESIDENT



Why is he frowning?

- NONRESIDENT



Why is he smiling?

Fiscal Residency - Three Tests

- Green Card
- Physical presence
- Substantial presence





* Reporting requirements apply

Income Tax Treaties

- Treaty may determine fiscal residence of alien
- Tie-breaker rules if resident of both treaty countries
- May eliminate double taxation
- May reduce tax rates or exempt certain items of income from tax
- Must disclose to IRS the treaty-based position

Domestic Trust vs. Foreign Trust

- Objective test for determining whether trust is domestic or foreign
 - Domestic Trust:
 - A court within the US is able to exercise primary supervision over the administration of the trust (Court Test); and
 - One or more US persons have the authority to control all substantial decisions of the trust (Control Test).
 - Foreign Trust: all other trusts

Grantor Trust

- Grantor treated as the owner of the assets of the trust
- Grantor subject to income tax

Nongrantor Trust

- Trust is treated as separate entity for income tax purposes
 - Simple Trust
 - Complex Trust
- Foreign nongrantor trust is taxed in a similar manner as a NRA

US Individual - Foreign or Domestic Trust

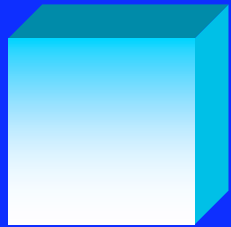
- If a US individual is the grantor of a trust, the trust will be a grantor trust if the grantor has retained any one of the following without the consent of an adverse party:
 - A power to revoke the trust
 - A right to control the beneficial enjoyment of the corpus or income
 - Certain administrative powers
 - A reversionary interest in either corpus or income (value must exceed 5% of the value of the relevant portion as of inception)
 - The right or power for the grantor or the grantor's spouse to receive income or have income applied to the payment of premiums of life insurance policies of which grantor or the grantor's spouse is the insured.

US Individual - Foreign Trust

- A foreign trust will be a grantor trust if a US individual transfers property to a foreign trust and the trust has US beneficiaries.
 - Exceptions:
 - Transfers by reason of death or for fair market value
 - Charitable trusts
 - Definition of US person
 - Determination as to whether there is a US beneficiary
 - NRA who becomes a US resident

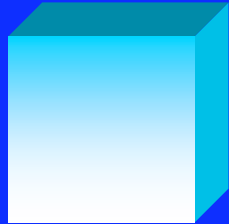
NRA - Foreign or Domestic Trust

- A trust will be a grantor trust if (1) a NRA is the grantor (2) grantor has “retained” a power and:
 - The trust is revocable by grantor without the consent of another person or with the consent of subordinate person who is subservient to the grantor;
 - 183 day rule
 - Incapacity of grantor
 - During lifetime of grantor, income or principal may be distributed only to the grantor or the spouse of the grantor; or
 - The trust is a compensatory trust



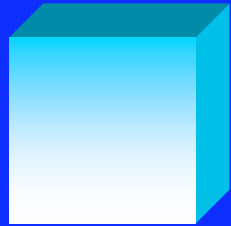
TAXATION OF UNITED STATES BENEFICIARIES OF FOREIGN TRUSTS

- ⊖ **Current Trust Income - Distributable Net Income (“DNI”)**
- ⊖ **Accumulation Distributions - Throwback Rule - Undistributed Net Income (“UNI”)**



EXAMPLE OF THROWBACK RULE

- ⊖ **Trust realizes US\$1.0 million capital gain in year 2004**
- ⊖ **Current DNI is only distributed to beneficiary each year until year 2024**
- ⊖ **In year 2024 Trust distributes US\$1 million more than DNI for that year**



COMPUTATION

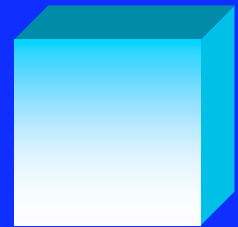
- Tax on US\$1,000,000 x 35% US\$350,000
- Interest at 8%* compounded over 20 years (395.22% x US\$386,000) US\$1,525,550
- Tax plus interest US\$1,875,550

* actual computation requires daily compounded interest with monthly fluctuations of interest rate



AVOIDANCE OF THE THROWBACK RULE

- ⊖ **Domestic vs. Foreign Trust**
- ⊖ **Grantor vs. Non-Grantor Trust**



MINIMIZING THROWBACK RULE FOR EXISTING FOREIGN TRUSTS WITH UNITED STATES BENEFICIARIES

- θ Distributions of Appreciated Property “In Kind”**
- θ Distributions to Non-United States Beneficiaries**
- θ Life Insurance**
- θ Accounting Income Exception**
- θ Default Calculation Rules**
- θ Domesticating the Trust**
- θ Sale of shares of underlying company with built-in gain to Non United States Persons**

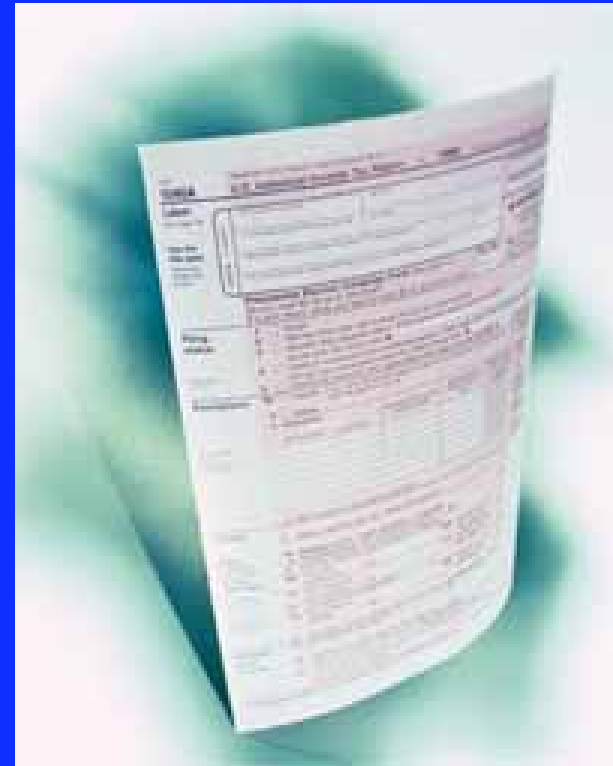


PLANNING FOR FOREIGN TRUSTS WITH ANTICIPATED UNITED STATES BENEFICIARIES

- θ Three Installment Rule
- θ All DNI always paid out
- θ United States Trustee and United States Governing Law – Convert Foreign Trust to Domestic Trust
- θ Pre-immigration considerations – Five Year Rule

Form TD F 90-22.1

- Report of Foreign Bank and Financial Accounts
- Must be filed by a US person who has a financial interest in or signature authority or other authority over any foreign financial accounts if the aggregate value of these accounts exceeds US\$10,000.00 at any time during the calendar year
- Due on or before June 30th of succeeding year
- Applies to certain trust beneficiaries



Form 3520

- Responsible party must file to report a “reportable event”
- US person must file if:
 - Treated as the owner of any assets of a foreign trust under the grantor trust rules
 - Received more than \$100,000 from a NRA or foreign estate (including foreign persons related to such NRA or foreign estate)
 - Received more than \$10,000 (adjusted for inflation - \$11,827 in 2003) from a foreign corporation or foreign partnership (including foreign persons related to such entity) that were treated as gifts
 - Received a distribution from a foreign trust
 - A party to certain loans
- Due the same day as the US person’s personal income tax return, including extensions

Form 3520-A

- Must be filed by a foreign trust which has at least one US owner.
- Sets forth a full and complete accounting of all trust activities, trust operations and other relevant information
 - Foreign Grantor Trust Owner Statement
 - Foreign Grantor Trust Beneficiary Statement
- Due the 15th day of the 3rd month after the end of the trust's tax year

Ownership of Foreign Corporations

- US beneficiaries of a trust may be deemed to own the shares of a foreign corporation which are owned by the trust
 - Controlled Foreign Corporation
 - Passive Foreign Investment Company
 - Foreign Personal Holding Company

Taxpayer Identification Numbers





REQUIREMENTS

A United States taxpayer identification number is now required on all returns, statements or other required documents, including FIRPTA forms (Internal Revenue Service forms 8288 {Withholding Tax Return}, 8288-A {Statement of Withholding} and 8288-B {Application for Withholding Certificate}), for all closings occurring after November 3, 2003.



Obtaining a taxpayer identification number *{requiring the submission of Internal Revenue Service form W-7 for an individual and form SS-4 for a foreign entity}* is not often as quick or simple a procedure one might expect, and waiting until immediately before the day of closing to apply for a taxpayer identification may result in the closing having to be delayed for quite some time.



According to the Instructions for Internal Revenue Service form W-7, one should “Allow 4 to 6 weeks for the IRS to notify you in writing your ITIN.” From our experience, one cannot guarantee how long the Internal Revenue Service may actually take to issue an individual taxpayer identification number (“ITIN”).



According to the Instructions of Internal Revenue Service form W-7, “Be sure to mail or bring with you:

- Your completed Form W-7, and
- The original documents, or certified or notarized copies of documents, that substantiate the information provided on the Form W-7.

The document(s) you present must be current and must verify: (a) your identity, that is, contain your name and a photograph, and (b) support your claim of foreign status. You may have to provide a combination of documents for this purpose. Examples of acceptable documents include, but are not limited to:

- A passport.
- A driver’s license.
- Documents issued by the U.S. Immigration and Naturalization Service (INS).
- An identity card issued by a state or national government authority.
- A foreign military or military dependent identification card.
- A foreign voter registration certificate.
- Birth, marriage, or baptism certificates.
- School records.

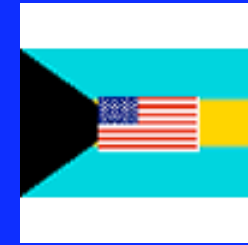
DOCUMENTS REQUIRED

Documents must be certified by the issuing agency or official custodian of the original record; or notarized by a U. S. notary public legally authorized within his or her local jurisdiction to certify that the document is a true copy of the original. To do this, the notary must see the valid, unaltered original and verify that the copy conforms to the original U.S. embassies and consulates worldwide. Non-U.S. notarizations will not be accepted.”



US/Bahamas Tax Agreement Comes Into Effect,

**by Mike Godfrey, Tax-News.com, Washington
02 January 2004**



Part of the tax and information exchange agreement (TIEA) between the United States and the Bahamas came into effect on Thursday, January 1 giving the latter the status of a permanent Qualified Jurisdiction.

The US gave The Bahamas provisional QJ status in 2000, but made an extension to the full six years conditional on the Bahamas signing a TIEA with the US before the provisional period expired. This led to extensive negotiations during 2001, which ended in the TIEA being signed in January 2002.

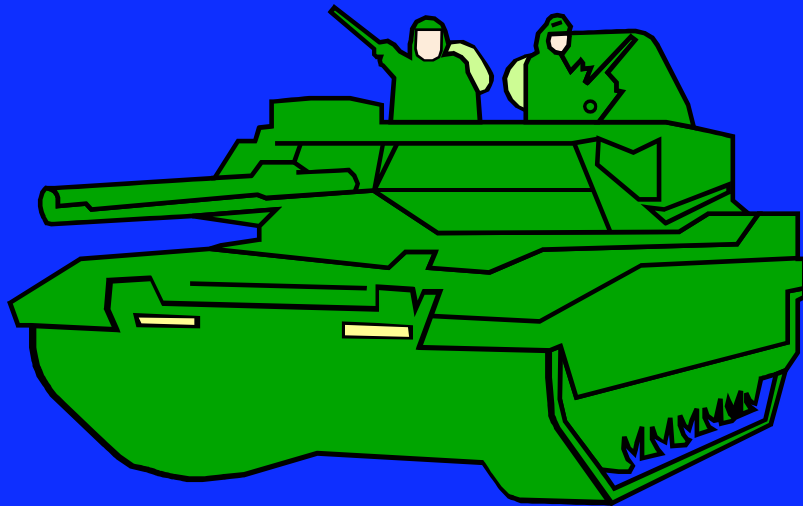
The TIEA will not, however, be retroactive and will only apply on criminal matters from January 1, 2004. Civil tax matters will be covered by the TIEA from January 1, 2006.

According to the US Treasury, once the Agreement is effective with respect to requests for information made in connection with civil tax matters, it will be consistent with the standards for an exchange of information agreement described in the Internal Revenue Code.

The Code generally allows US taxpayers to claim a tax deduction for expenses associated with a convention held in certain beneficiary countries with tax information exchange agreements with the United States to the same extent as a convention held in the United States.

Thus, beginning on January 1, 2006, The Bahamas will be considered part of the "North American area" for purposes of determining whether US taxpayers may deduct expenses incurred in attending conventions, business meetings and seminars in The Bahamas.

Steve's United States Tax War Stories



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