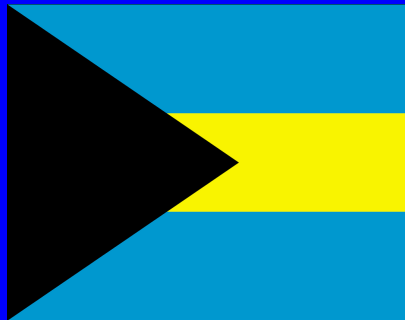


Tax Issues of Foreign Trusts With United States Beneficiaries



Presentation Before
STEP Bahamas
By: Steven L. Cantor
Cantor & Webb P.A.
March 30, 2006



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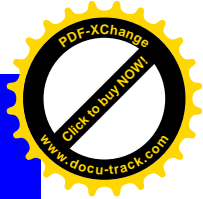
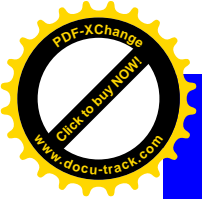
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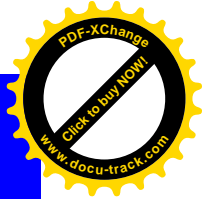
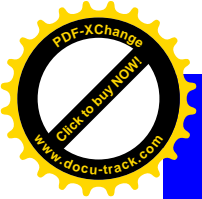
Discussion Points

United States Tax Issues

Planning Strategies

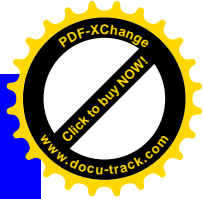
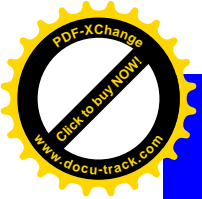
United States Reporting Requirements





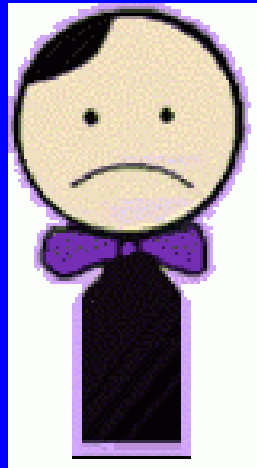
Who Is A United States Resident?





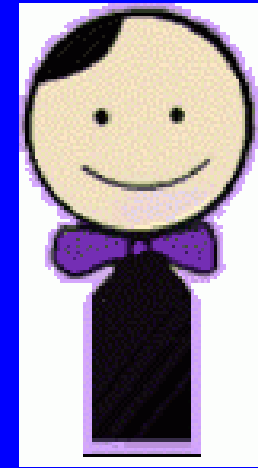
U.S. Resident/Nonresident

- RESIDENT

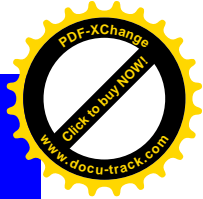
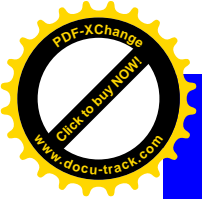


Why is he frowning?

- NONRESIDENT



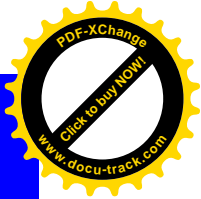
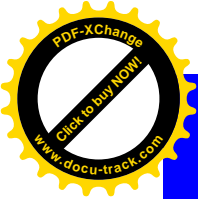
Why is he smiling?



Resident For United States Income Tax Purposes

- Green Card
- Physical presence
- Substantial presence
- Election





Were you a lawful permanent resident of the United States at any time during the current year?

Yes

No

Were you physically present in the United States for at least 31 days during the current year?

Yes

No

Were you physically present in the United States for at least 183 days during the current year?

Yes

No

You are a resident alien for income tax purposes during the current year.

You are not a resident alien for income tax purposes during the current year.

Substantial Presence Test: Were you physically present in the United States for at least 183 days during the current year and two preceding years, counting 100% of the days present in the current year, 1/3 of the days present in the immediately preceding year, and 1/6 of the days present in the second preceding year?

Yes

No

Do you still meet the Substantial Presence Test if you do not count days you were in the United States as a qualifying student, teacher or trainee, professional athlete or foreign government-related individual? *

Yes

No

Do you still meet the Substantial Presence Test if you do not count the days that you were unable to leave the United States due to a medical condition that arose while you were in the United States? *

Yes

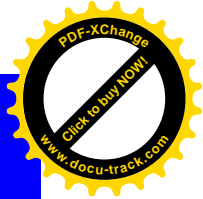
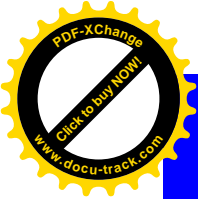
No

Do you (1) have a tax home in a foreign country and (2) have a closer connection to that country than you have to the United States? *

No

Yes

* Reporting requirements apply



Explanation of Tests

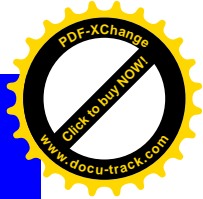
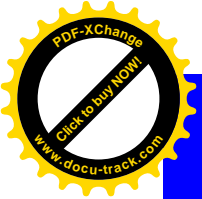
- Lawful permanent resident (“Green Card” holder) of the U.S. at any time during the calendar year;
- Present in the U.S. for 183 days or more during the current calendar year (“Physical Presence Test”); or
- Present in the U.S. for more than 31 days and less than 183 days during the current calendar year, but meet the Substantial Presence Test
 - One meets the Substantial Presence Test if the sum of 100% of the days present in the U.S. during the current taxable year, 1/3 of the days present in the U.S. in the immediately preceding taxable year and 1/6 of the days present in the U.S. in the second immediately preceding taxable year equals or exceeds 183 days.

Exceptions to Substantial Presence Test

- Tax home is a foreign country and have a closer connection to the same foreign country
- Days not counted:
 - Days present in the U.S. when unable to leave the U.S. due to a medical condition that arose while present in the U.S.
 - Days present in the U.S. as a student, teacher or trainee, professional athlete temporarily in the U.S. to compete in a charitable event or foreign government-related individual

Resident For United States Estate and Gift Tax Purposes

- Domicile means physical presence AND intent to remain indefinitely
- Facts and circumstances



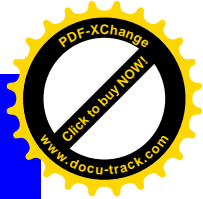
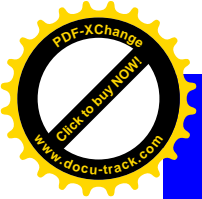
Tax Treaties

- May alter requirements for determining residence and domicile.
- Tie-breaker rules (facts and circumstances).
- Must disclose to IRS any treaty based position.

TREATY	
We, the nations of : _____	
Do enter into this agreement for the following purposes:	

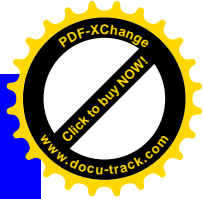
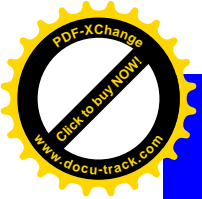
We agree and promise to:	

Signed this day,	19__
By:	_____



How Are They Taxed ?





United States Income Taxation of Citizens and Residents

- Income taxation on worldwide income.



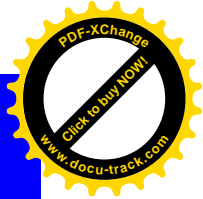
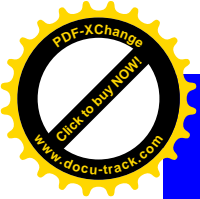
United States Ownership of Foreign Corporations

Flow-through of income of CFC or PFIC

- Controlled Foreign Corporation ("CFC")
 - More than 50% of vote or value owned by United States residents
 - Applies only to 10% shareholders - a U.S. person who owns 10% or more of the total combined voting power
- Passive Foreign Investment Company ("PFIC")
 - More than 75% of gross income is passive income or average percentage of assets which produce or are held for production of passive income is at least 50%
 - Applies regardless of percentage of ownership

United States Income Taxation of Nonresident Aliens

- Passive Income
 - Fixed or determinable annual or periodic income (i.e. interest, dividends, rents, royalties, etc.)
 - Subject to 30% withholding tax on the gross amount at the time of payment
- Effectively Connected Income
 - Taxed on a net basis (after deductions) at graduated tax rates as they apply to United States residents.
- Capital Gains
 - United States Real Property Interests
 - Physically present in U.S. for 183 days and U.S. tax home



United States Estate & Gift Tax of Citizens and Residents

- Taxed on worldwide assets
- Resident aliens are subject to estate and gift tax at the same rates and in a similar manner as United States citizens

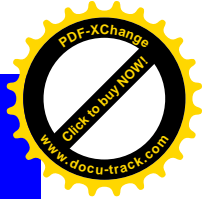
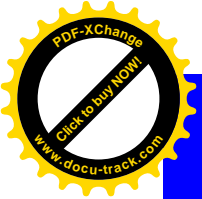


United States Estate Tax of Nonresident Aliens

- Nonresident aliens are subject to estate tax in a similar manner as U.S. citizens, except that the gross estate is limited to property situated within the U.S. and there are certain limitations on deductions and credits.

United States Gift Tax of Nonresident Aliens

- Nonresident aliens are subject to gift tax on gifts of real property and tangible personal property situated within the United States.
 - Gifts of intangible personal property are exempt
 - Cash is tangible personal property
 - Cash or property situated without the United States should not be intended to be used to purchase property situated within the United States
 - Jointly held real estate is a gift tax trap for the unwary



Situs of Assets

- Stock
- Bank Deposits
- Real Property
- Tangible
personal property
- Debt obligations
- Life Insurance



Applicable Credit Amount

- U.S. Estate and Gift Tax Applicable Credit Amounts (2006)
 - Nonresident Aliens
 - Estate: \$13,000, or transfer of \$60,000
 - Gift: \$0
 - Residents
 - Estate: \$780,800, or transfer of \$2,000,000
 - Gift: \$345,800, or transfer of \$1,000,000

Applicable Credit Amount for Residents

Year of Transfer	Value of Excluded Property* <u>(Estate Tax Only)</u>	Maximum Gift & <u>Estate Tax Rate</u>
• 2006	\$2,000,000	46%
• 2007	\$2,000,000	45%
• 2008	\$2,000,000	45%
• 2009	\$3,500,000	45%
• 2010	N/A	top individual income tax rate (only gifts)
• 2011	\$1,000,000	55%

*Value of excluded property for gifts is \$1,000,000 each year

Effective Tax Rates

- Effective U.S. Estate and Gift Tax Rates (2006)
 - Nonresident Aliens
 - Estate: 26% to 46%
 - Gift: 18% to 46%
 - Residents
 - Estate: 46%
 - Gift: 41% to 46%

Estate Tax Deductions

- Marital Deduction
 - Unlimited if surviving spouse is a U.S. citizen
 - Qualified Domestic Trust required if surviving spouse is not a United States citizen
- Mortgages
- Disclosure of entire gross estate

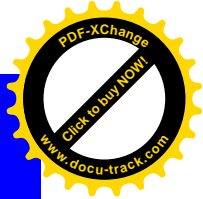
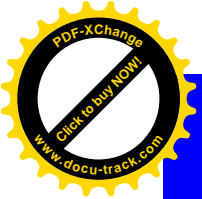
United States Gift Tax Annual Exclusion and Marital Deduction (2006)

- Gifts to:

- Non-Spouse: \$12,000
- Non-United States Citizen Spouse: \$120,000
- U.S. Citizen Spouse: \$12,000+
Unlimited Marital Deduction

United States Generation-Skipping Transfer Tax

- GST tax is in addition to estate and gift tax
- Applies only to transfers subject to U.S. estate and gift tax
- Tax = Rate * inclusion ratio; rate currently is 46%
- \$2,000,000 exemption in 2006 (adjusted to equal Applicable Credit Amount)



Reversion To Present Law

- THE 2001 ACT IS EFFECTIVE ONLY UNTIL DECEMBER 31, 2010.
- WITHOUT FURTHER LEGISLATIVE ACTION, ON JANUARY 1, 2011, PRE-ACT LAW WILL AGAIN APPLY (I.E., ESTATE TAX REPEAL ONLY IN 2010).





Effect Of Sunset Provision

- RECOMMENDED TAX PLANNING MAY INCLUDE KEEPING DYING PATIENTS ALIVE UNTIL 2010 OR "PULLING THE PLUG" ON THEM PRIOR TO JANUARY 1, 2011.



Foreign Trust

VS.

Domestic Trust

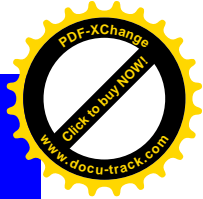
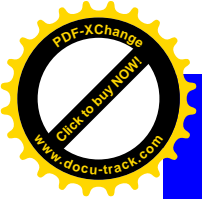


Domestic Trust vs. Foreign Trust

– Domestic Trust:

- Court Test: A court within the U.S. is able to exercise primary supervision over the administration of the trust; AND
- Control Test: One or more U.S. persons have the authority to control all substantial decisions of the trust.

– Foreign Trust: all other trusts



Court Test – Safe Harbor Rules

The court test is met under safe harbor rules if the following three conditions are met:

- The trust instrument does not direct that the trust be administered outside the U.S.
- The trust is in fact administered exclusively in the U.S.
- The trust is not subject to an automatic migration or "flee" clause that would cause the trust to migrate from the U.S. if a U.S. court attempts to assert jurisdiction over, or to otherwise supervise, the administration of the trust.
 - If the trust instrument contains an automatic migration clause that operates only in the case of foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S., this will not prevent the trust from meeting the court test.

Control Test – Substantial Decisions

U.S. persons must control all substantial decisions of the trust. These decisions include all non-ministerial decisions that persons are authorized or required to make under the terms of the trust instrument. They include, but are not limited to the following:

- Whether and when to distribute income or corpus.
- The amount of any distributions.
- The selection of a beneficiary.
- Whether a receipt is allocable to income or principal.
- Whether to terminate the trust.
- Whether to compromise, arbitrate, or abandon claims of the trust.
- Whether to sue on behalf of the trust or to defend suits against the trust.
- Whether to remove, add, or replace a trustee.
- Whether to appoint a successor trustee.
- Investment decisions.



Grantor Trust VS. Nongrantor Trust

Grantor Trust

- Difference between "Grantor" and "Owner"
- A trust is a grantor trust to the extent a person is treated as the owner of the assets of the trust for U.S. income tax purposes

Nongrantor Trust

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

United States Citizen or Resident - Foreign or Domestic Trust

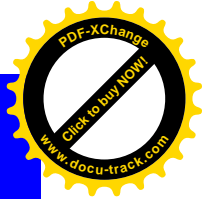
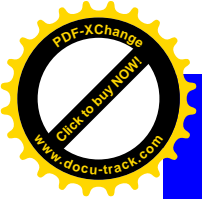
- If a U.S. person is the grantor of a trust, he will be treated as the owner of the assets of the trust to the extent he has retained any one of the following without the consent of an adverse party:
 - A power to revoke the trust
 - A right to control the beneficial enjoyment of the corpus or income
 - 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.
- A person other than a grantor can be treated as the owner of the assets of the trust

United States Citizen or Resident - Foreign Trust

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

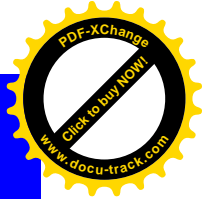
NRA – Foreign or Domestic Trust

- Must meet same tests as U.S. citizen or resident plus:
 - Revocable by grantor without consent of another person or with consent of subordinate person who is subservient to grantor (incapacity issue)
 - During lifetime of grantor, income or principal may only be distributed to grantor or spouse of grantor
 - Certain compensatory trusts



Income Taxation of The Trust and Its Beneficiaries





A Typical Trust Beneficiary



TAXATION OF UNITED STATES BENEFICIARIES OF FOREIGN TRUSTS

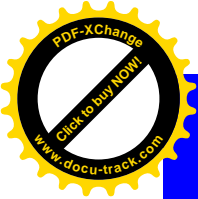
- Distributable Net Income ("DNI") =
current income
- Undistributed Net Income ("UNI") =
accumulated income

Income Taxation of Trusts

- Grantor Trust
 - Person treated as owner of assets is subject to U.S. income tax on current income (grantor trust does not have accumulated income)
- Non-Grantor Trust
 - Trust subject to U.S. income tax except that beneficiaries are taxed on receipt of distributions of current income and income required to be distributed whether or not actually distributed)
- Foreign vs. Domestic
 - Accumulation Distributions from foreign trust subject to throwback rules – U.S. income tax and interest charge
 - Accumulated income loses character
- CFC and PFIC

EXAMPLE OF THROWBACK RULE

- Trust realizes US\$1.0 million capital gain in year 2006
- Current DNI is only distributed to beneficiary each year until year 2026
- In year 2026 Trust distributes US\$1million more than DNI for that year

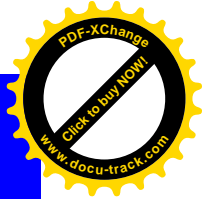
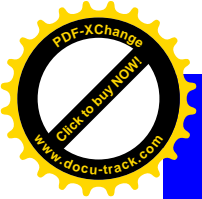


COMPUTATION

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

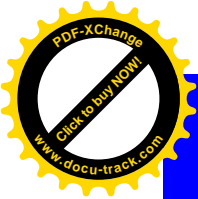
Actual amount due is US\$1,000,000
because tax and interest
cannot exceed distribution

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

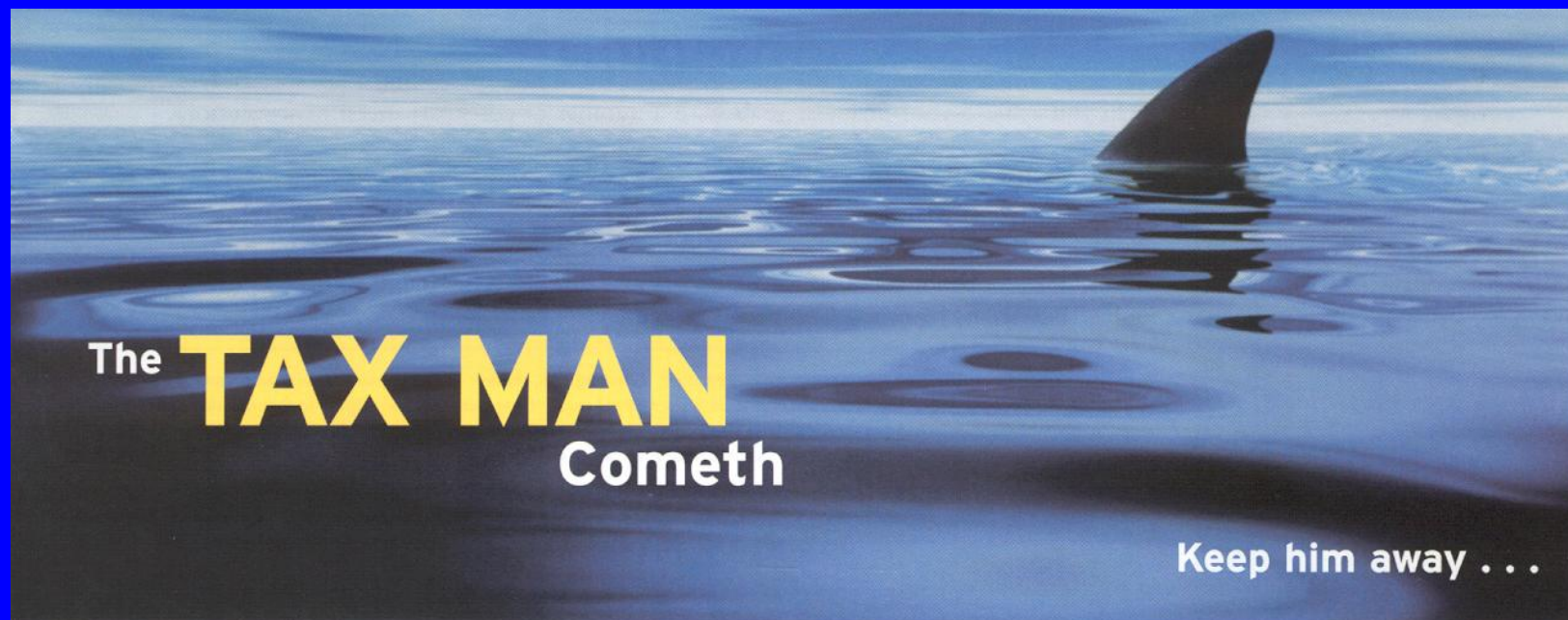


An Unhappy Trust Beneficiary

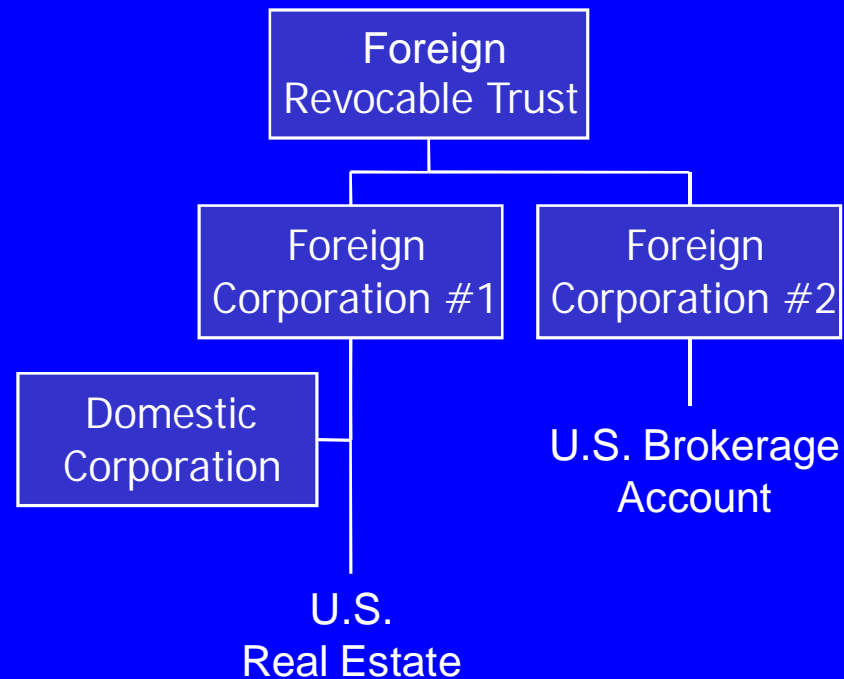




Planning Strategies



Common Structure For United States Assets



General Considerations for Foreign Trusts

- Consider United States tax issues in funding trust
- Address conversion to domestic trust (i.e., domestication, creation of new trust, distribution to stand-by trust, etc.)
- Beware of powers held by U.S. persons
- Provide calendar year-end accountings which conform to United States tax accounting standards
- Certain loans or guarantees treated as distributions

Planning For Foreign Grantor Trusts

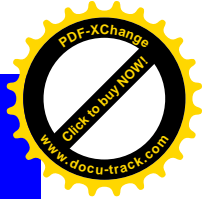
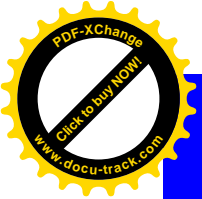
- Consider disregarded entity or partnership
- Consider “stepping-up” basis and paying dividends if trust owns a corporation
- Address incapacity of grantor
- Consider using grantor as intermediary

Planning for Foreign Nongrantor Trusts

- Distributions of specific property or pecuniary amount in three installments or less
- “In Kind” distributions of appreciated property
- Distributions to NRA Beneficiaries
- Utilization of life insurance products
- Distribution of all DNI each year

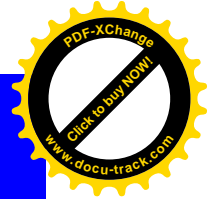
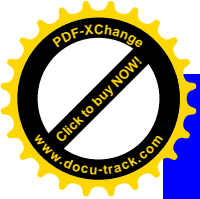
Planning for Nongrantor Trusts (Cont'd)

- Accounting Income Exception
- Default Calculation Rules
- Conversion to domestic trust
- Liquidation or checking-the-box on corporations immediately after death of grantor
- Sale of shares of underlying company with built-in gain to non-U.S. persons



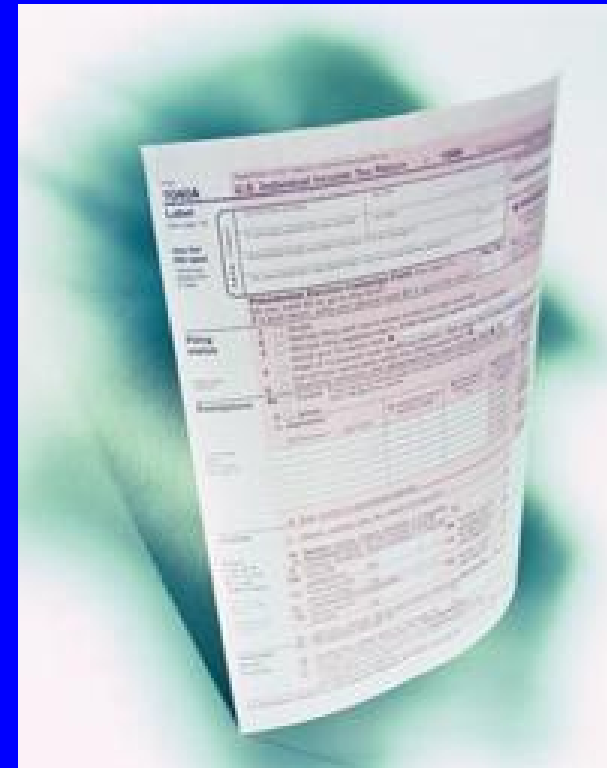
United States Reporting Requirements

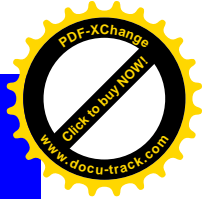
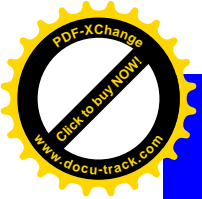




U.S. Treasury Department Form TD F 90-22.1

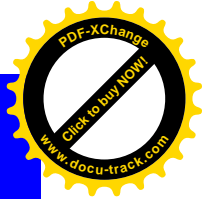
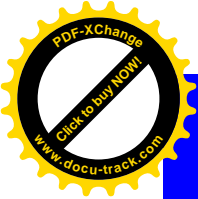
- Report of Foreign Bank and Financial Accounts
- Must be filed by a US person who has a financial interest in or signature authority or other authority over any foreign financial accounts if the aggregate value of these accounts exceeds US\$10,000.00 at any time during the calendar year
- Due on or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





IRS 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
 - Transferred property to foreign trust
 - 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) 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
- Signification penalties apply

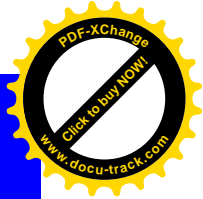
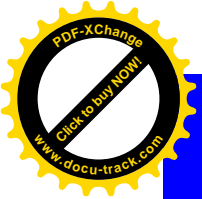


IRS Form 3520-A

- Must be filed by a foreign trust if a U.S. person is treated as the owner of the assets of the trust
- 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
- Significant penalties apply

Ownership of Foreign Corporations

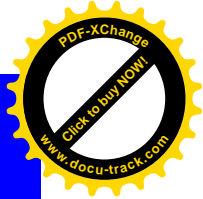
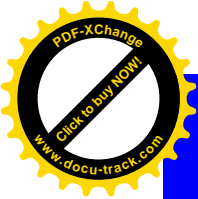
- US beneficiaries of a trust may be deemed to own the shares of a foreign corporation which are owned by the trust
 - CFC
 - PFIC



Pitfalls to Avoid

- General Power of Appointment in favor of U.S. person
- Failure to timely file reporting requirements
- Gift paid from account owned by by foreign corporation or foreign partnership
- Taking on structure or making distributions without U.S. tax advice





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