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Wealth Management

Using the Foreign Nongrantor Trust To Avoid Capital-Gain Income

A legal way to shelter assets, through fully disclosed transactions

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All we seem to hear about now in international tax law is the crackdown on U.S. persons and U.S. resident aliens being subject to substantial criminal and civil penalties for failing to report overseas assets. As such, this may seem like an odd time to publish an article on foreign trust planning. But this article addresses the legal way to avoid capital gains tax through fully disclosed transactions. Therefore, the scandals emanating from U.S. persons holding assets in foreign institutions such as UBS and Bank Leumi do not affect the planning techniques discussed in this article.

The plan involves the use of a specific type of foreign trust to shelter capital-gain income from U.S. taxing authorities. The trust to be used must be designed to avoid grantor-trust status because such status would negate the benefits of the trust. U.S. persons may set up a trust and obtain foreign-trust status even utilizing a U.S. trustee, and even where the only beneficiaries are U.S. persons.

First, the trust must be designed as a foreign trust. Foreign-trust status may be accomplished by either directing that a foreign court has primary supervision over the trust under I.R.C. §7701(a)(30)(E)(i) (the "court test"), or a non-U.S. person has control of at least one substantial decision of the trust under I.R.C. §7701(a)(30)(E)(ii) (the "control test"). (All section references herein are to the I.R.C. of 1986 unless specified otherwise.)

When a foreign trust is created, any transfers to the trust by a U.S. person cause sale treatment on the fair market value of the asset over its basis. §684(a). Thus, assets that have already appreciated may not be ideal assets to place into the trust.

Generally, a foreign trust will be treated as a grantor trust if the trust has a U.S. beneficiary in any year. §679(a)(1). However, grantor-trust status can be avoided, and the trust can become a foreign nongrantor trust (FNT), even where there is a U.S. beneficiary, as long as the transfer is "non-gratuitous," i.e., for fair market value. §679(a)(2). If a loan is used as consideration for the transfer, it must be a qualified obligation under §679(a)(3)(A)(i); Treas. Reg. §1.679-4(d). If these requirements are met, the trust is a FNT. FNT treatment is the treatment we are trying to achieve.

FNTs are ideal here because they are only taxed as non-U.S. persons and are therefore only taxed on their U.S. gross income. Gross income includes among other areas: interest (§861(a)(1)); dividends (§861(a)(2)); rents (§861(a)(4)); personal services (§861(a)(3)); and gains from U.S. real estate (§861(a)(5)). But gross income does not include income from sale of other capital assets (§641(b)). Section 641(b) inferentially provides that FNTs are not taxed on a sale of capital assets, as such gains are not enumerated in §861(a) and FNTs are otherwise taxed as nonresident aliens who are not taxed on such type of income. Income effectively connected with a U.S. trade or business is also subject to U.S. income tax. §871(b). A FNT must also obtain a U.S. taxpayer identification number if it has income effectively connected with a trade or business. Treas. Reg. §301.6109-1(b).

The properly drafted FNT does not pay tax on its capital-gain income, but how does the U.S. beneficiary obtain

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access to the funds without paying tax on such gain? If the sale proceeds are distributed to a U.S. beneficiary in the year of sale, it is treated as distributable net income (DNI) under §643(a)(6)(c), and taxed to the U.S. beneficiary pursuant to §652(a). In that case, the income is taxable to the U.S. beneficiary and carries its character as a sale of a capital asset under §652(b). Thus, a distribution in the year of sale does not work to avoid capital gains tax.

If the proceeds of the sale are distributed in a year after the sale occurred where the trust has no income, such distribution is considered an accumulation distribution (AD). The AD rule is codified in §661 and requires income tax to be paid on the distribution unless: (a) the transfer is a gift as provided in §663(a)(1); (b) there is current year's income (none in this example); or (c) there is no undistributed net income (UNI) in prior years. UNI is the amount DNI for the year exceeds trust accounting income for the year, plus the amount distributed and the taxes imposed on the trust. §665(a).

An AD carries out UNI from each prior year in which the income was earned. Thus the total UNI in the years in which there was capital gain income would cause the AD to be taxed in the year of distribution. In fact, not only is the UNI taxed in the year it is distributed, but there is a scheme causing interest charges to also be added to the tax on the distribution of UNI from prior years. This scheme is known as the "throwback rules." The throwback rules essentially look back at the untaxed income over the previous years and treats the distribution as income and adds interest on the tax, thereby roughly taxing the beneficiary as if the distribution had occurred in the years earned under §667. The interest charges are added by virtue of §668(a)(1).

Therefore, setting up a FNT designed to eventually return the funds to the U.S.-based grantor has no real tax benefit, as the untaxed income will eventually be taxed with interest when distributed back. So why would anyone do this? One reason is if the U.S. citizen was considering giving up citizenship in the future and moving to another country. But see §877 for rules designed to prevent expatriation to avoid U.S. tax. The second and more universal reason is if the transfers from the trust are structured properly as gifts.

If, instead of the FNT distributing the money to the grantor, the trust contains provisions to make transfers to the grantor's children (or other beneficiaries) through properly structured gifts, then these distributions go untaxed under §663(a)(1). Section 663(a)(1) provides as follows:

> §663. Special rules applicable to sections 661 and 662
>
> (a) Exclusions.—There shall not be included as amounts falling within section 661(a) or 662(a)—
>
> (1) Gifts, bequests, etc.—Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.

Thus, if the grantor is willing to place the assets in the FNT as a gift-giving tool (free of capital-gains tax), then the untaxed capital-gain income will be distributed to the U.S. beneficiaries income-tax free. The FNT trust terms would specify that the beneficiaries will receive specific dollar amounts which will not be restricted or in any way tied to income, and will be in a single lump sum or in no more than three separate lump sums.

With regard to compliance, Form 3520 must be filed for each year in which a foreign trust is created by a U.S. person. It is filed along with the income tax return of the U.S. person. Form 3520A is required to be filed each year on or before March 15 following the year for which reporting is required. Penalties result for failure to file Forms 3520 and 3520A.

If any accounts are in foreign institutions, Form TD F 90-221 must be filed if the account value is at least $10,000. The Form TD F 90-221 is due by June 30 of the year following the year in which the U.S. person held such account.

In conclusion, a properly structured trust can be used to forever avoid capital-gains taxes, if the proceeds of the capital-gain sale are distributed as lump sum gifts in a year after the year of sale as a gift. ■