

TAX HAVEN REPORTER TM

(P.O. Box CB 11552 • Nassau • Bahamas • tel/fax 242-327-7359)
<http://www.bahamasbahamas.com/> • email: taxman@batelnet.bs

Price \$200 Yr.

(Advice for Offshore/Tax Planning)

March 2003

In This Issue:

GW repeals the estate tax for decedents dying after 2009. See pages 1.

International Taxpayer - Classification for U.S. Tax Purposes. See page #2.

IRS regulations for Section §679 – 25 years in the waiting. See page #4.

Don't overlook new T.Reg. under §672 (foreign trusts, corporations, persons). See #5 and 18.

Working with the new T.Reg. – and a decipherment of some of it's impact. See page #3 to 18.

The estate tax is repealed for decedents dying after 2009.

(Special e-mail edition)

The federal estate tax (hereafter FET) is repealed for decedents dying after 2009. But note, that is almost 7 years from now.

With the repeal of the FET in 2010 (and beyond), a foreign estate based in any of the world's tax haven will have certain advantages over a domestic US estate.

1. A **foreign estate** (FE) would not be subject to US federal income taxes on most all its assets, whereas a **domestic estate** (DE) would need to pay **income** taxes annually if domiciled inside the US, subject to court ordered judgments and other attacks, and file tax returns, etc. too.

Take note, to accomplish this “end”, the **FE** would need to free itself of the CFC provisions (Code 951-thru 960), the PFIC provisions of §1297, and the FPHC (Foreign Personal Holding Company) provisions. Remember, an estate is nothing more than what an individual(s) owns or owned at death. An estate can include commercial property, stocks and bonds, trust assets (called revocable trusts), homes, land, money (cash), annuities, life insurance and general powers of appointments (over trust assets). Careful planning, and the use of foreign entities, like foreign trusts and foreign

partnerships and foreign corporations would have to be dissected by the planner – or much of the tax attributes of a **FE** would be lost.

2. If the FET is reintroduced to our tax system sometime in the future, a FE could still escape US taxation on most of its assets – especially intangible assets and tangible assets located outside the United States.
3. Distributions from foreign grantor trusts (FGT) are often not taxable to the US beneficiaries. See Rev-Rul 69-70 (see January 2003 THR and form **3520 Part IV**) Note, this IRS ruling was issued in 1970 and has not been repealed. Recently, the Treasury/IRS has tightened up on the use of Rev.Rul. 69-70, but “gifts” from a FT or non-resident estate or non-resident alien might still be received free of federal income taxes to US beneficiaries.¹
4. **Assets held in a FE (i.e., FT + offshore companies) are not able to be seized or frozen** – even under a US court order or via judgments – unless they are the proceeds of

¹. See the new T. Regs. 672(a)1 thru 672(f)(5) & new T.Reg. §679-1 thru §679-7 (2003 and beyond). Note that the regulations for Code-Section 679 were a long time coming – and not issued for some twenty-five years since the introduction of Section §679 in the Tax Reform Act of 1976. These new T.Reg. appear later in this issue of the THR.

crimes – in which case the tax havens have MLAT that allow investigations and seizures.

Interestingly, income tax evasion is not a crime in the tax havens, because taxes are not imposed in these nations. Drug money laundering and investor scams and rip-offs are crimes. All the havens have MLATs covering crimes .

Estate tax return. Generally, if the decedent died during 2002, an estate tax return (Form 706) must be filed if the gross estate is more than \$1,000,000.

"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or to altogether avoid them by means which the law permits, cannot be doubted." - **United States Supreme Court, Gregory v. Helvering, 293 U.S. 465 (1934)**

"Over and over again the courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everyone does so, rich or poor, and all do right, for nobody owes any public duty to pay more tax than the law demands; taxes are enforced extractions, not voluntary contributions." - **Judge Learned Hand**

"The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest amount of hissing." - **Jean Babtiste Colbert** (French Statesman: *Minister of Finance* - 1619 - 83)

"They have no right to put their hands in my pockets." - **General George Washington** (1732 - 99)

"The absence of income or significant corporate income taxes, along with political stability, is the bedrock on which foreign investment in The Bahamas has been built." - **Embassy of the United States (Nassau, Bahamas) (April, 1990)**

"One of the most effective applications of offshore trusts is in an ownership combination with a limited company."

- **Richard Graham-Taylor, partner Ernst & Young, Grand Cayman (January 1990)**

"There is one difference between a tax collector and a taxidermist - the taxidermist leaves the hide." - **Mortimer Caplin**

IRS Letter Ruling 9332006 & Rev-Rul 69-70 shows how America's wealthiest taxpayers might save millions (even billions) in taxes

In 1970 the IRS issued the following ruling to study...

Editor's note: This ruling is just one of the "puzzle pieces". This ruling does not eliminate the Federal Estate Tax – but tells you that trust distributions from a Foreign Grantor Trust can be received by a US beneficiary TAX FREE.

Revenue Ruling 69-70 states: "An individual beneficiary who is resident of the United States is not taxable on a distribution from a foreign trust considered to be owned by a nonresident alien grantor under subpart E of subchapter J of the Code" - these are the exact words of the Internal Revenue Service tax. (source: [University of Houston Law Library Revenue Ruling stacks](#))

FULL IRS TEXT of RULING FOLLOWS:

Rev-Rul 69-70: "Advice has been requested whether the income of a foreign trust, under the circumstances described below, is taxable to the beneficiary, an individual who is resident of the United States.

X, a nonresident alien individual, created a foreign trust for the benefit of a resident of the United States. Under the terms of the instrument, X reserves the absolute power to dispose of the beneficial enjoyment of both the income and the corpus of the trust. The trustees are nonresident aliens, and all the trust property had a situs outside the United States.

When income-producing property is placed in trust, the Federal income tax liability generally shifts from the grantor to the trust and beneficiaries in

accordance with subparts A through D of part I, subchapter J, Chapter 1, subtitle A of the Internal Revenue Code of 1954 (sections 641 through 669).

However, where the grantor retains dominion and control over the income and corpus of the trust, subpart E of subchapter J (sections 671 through 678) rather than subparts A through D of subchapter J, is applicable. Since X, a nonresident alien grantor retained the absolute power to dispose of the beneficial enjoyment of both the income and corpus of the trust, he is treated as the owner of the trust under IRC §674(a) of the Code. Accordingly, an individual beneficiary who is a resident of the U.S. is not taxable on that portion of the income distributed to him from the foreign trust which is considered to be owned by the nonresident alien grantor under subpart E of subchapter J of the Code.

It should be noted that United States source income of a foreign trust considered to be controlled by a nonresident alien grantor is taxed to the grantor. If the grantor is a resident of a non-treaty country, the provisions of section 871 of the Code apply concerning the tax. However, if the grantor is a resident of a treaty country, the provisions of the treaty may determine the tax." [Author of this ruling is our own IRS].

Applying Rev-Rul 69-70 to an example is one practical way to show off its significance.

EXAMPLE: Number 1 son Y of successful Bahamas businessman X marries American debutante Z in June of 1999. Both Y and Z plan to live in the United States permanently. Instead of giving them a lump sum of money as part of their wedding gift, Mr. X (a nonresident alien for purposes of U.S. tax law) asks his Bahamas lawyer to place \$1,000,000 in trust for Z and Y. The Bahamian trust is revocable by the nonresident alien grantor X - meaning he can call back the assets any time.

The trust designates Y and Z (both residents of the United States) as the sole beneficiaries, and stipulates that Y and Z have the power to add new names to the list of beneficiaries, should there be any little Zs or Ys in the future. The corpus of the trust consists of Dutch Antilles

issued Eurodollar bonds of Exxon Corporation paying 10% interest pa. Income of the trust is to be distributed to the beneficiaries, as it accrues.

Under the U.S. grantor trust rules neither Y nor Z is viewed as the owner of the trust corpus (\$1,000,000), because neither has the power to vest the trust assets in favor of his or herself. Having the power to name "new" income beneficiaries is not a grantor trust power under U.S. tax law, and will not shift the incidence of taxation away from the grantor to the U.S. beneficiaries. In addition, it is clear that income distributions paid by the foreign trust to Y and Z can be received free of all Federal Income taxes via Rev-Rul. 69-70, so long as there is a nonresident grantor for the trust (i.e., as long as Mr. X lives).

If the foreign trustee takes care not to purchase investments that incur a U.S. tax liability (such as dividends from U.S. stocks which incur a 30% withholding tax), the trust will have no tax liability to discuss with the IRS.

As for the U.S. beneficiaries, they should answer item 11(a) (YES) and item 12 (NO) on Schedule B, Part III which appears on the back of every U.S. taxpayer's IRS Form 1040. But this disclosure is frivolous.

IRS -LTR 9332006 Full Text

The use of an offshore testamentary trust to receive a U.S. persons assets only upon his death might afford some definite tax advantages, especially if the trusts assets are revocable by a nonresident alien individual or corporation. IRS LT. 9332006 confirms that upon his death, assets held in a foreign trust will no longer be subject to U.S. taxes, and not considered part of the U.S. person's U.S. estate, even if there are U.S. beneficiaries for the foreign trust.

LTR 9332006 -- ISSUE (4). UPON A SETTLOR'S DEATH, WILL THE PORTION OF THE TRUST TREATED AS OWNED BY THAT SETTLOR CEASE TO BE SO TREATED EVEN IF THEN TRUST BENEFICIARIES INCLUDE UNITED STATES PERSONS? Section 679(a)(2)

(A) provides that the rules of section 679(a)(1) do not apply to "a transfer by reason of death of the transferor." While section 679(a)(2)(A) **does not expressly address the tax consequences of the termination of foreign grantor trust status by reason of the grantor's death**, the legislative history of the enactment of section 679 (H.R. Rep. No. 658, 94th Cong., 1st Sess. at 209 (1975); S. Rep. No. 938, 94th Cong., 2d Sess. at 218 (1976)) provides that "an inter vivos trust which is treated as owned by a U.S. person under [section 679] is not treated as owned by the estate of that person upon his death. **Accordingly, any portion of the Trust that is treated as owned by a Settlor under the rules of section 679 shall cease to be so treated upon that Settlor's death.**

DO YOU KNOW WHAT A REVENUE RULING IS?

A Revenue Ruling is not a law passed by Congress; it is a proclamation by the Internal Revenue Service explaining the facts as they relate to a particular set of laws. Revenue Rulings are the published conclusions of the IRS concerning the application of tax law to an entire set of facts.

Revenue procedures are official statements of procedures that either affect the rights or duties of taxpayers or other members of the public, or should be a matter of public knowledge. The purpose of these rulings is to promote a uniform application of the tax laws, and therefore IRS employees must follow the rulings. While taxpayers can rely on the rulings, they can also appeal adverse return examination decisions based on the rulings to the Tax court or other Federal courts.

The statement above was written by the IRS. It was taken (word for word) from one of their own publications.

**THIS DATA THAT FOLLOWS IS
CURRENT AS OF THE FEDERAL
REGISTER DATED FEBRUARY 13, 2003**

26 CFR - CHAPTER I - PART 1

§ 1.672(f)-1 Foreign persons not treated as owners.

(a) General rule -- (1) Application of the general rule. Section 672(f)(1) provides that subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code (the grantor trust rules) shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the United States or a domestic corporation. **Accordingly, the grantor trust rules apply to the extent that any portion of the trust, upon application of the grantor trust rules without regard to section 672(f), is treated as owned by a United States citizen or resident or domestic corporation.** The grantor trust rules **do not apply** to any portion of the trust to the extent that, upon application of the grantor trust rules without regard to section 672(f), that portion **is treated as owned by a person other than a United States citizen or resident or domestic corporation, unless** the person is described in § 1.672(f)-2(a) (relating to certain foreign corporations treated as domestic corporations), **or** one of the exceptions set forth in § 1.672(f)-3 is met, (relating to: trusts where the grantor can reconstitute trust assets; trusts where the only amounts distributable are to the grantor or the grantor's spouse; and compensatory trusts). Section 672(f) applies to domestic and foreign trusts. Any portion of the trust that is not treated as owned by a grantor or another person is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(2) Determination of portion based on application of the grantor trust rules. The determination of the portion of a trust treated as owned by the grantor or other person is to be made based on the terms of the trust and the application of the grantor trust rules and section 671 and the regulations thereunder.

(b) Example. The following example illustrates the rules of this section:

Example.

(i) A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his son, B, who is a United States citizen, with stock of Corporation X. A's brother, C, who also is a United States citizen, contributes stock of Corporation Y to the trust for the benefit of B. A has a reversionary interest within the meaning of section 673 in the X stock that would cause A to be treated as the owner of the X stock upon application of the grantor trust rules without regard to section 672(f). C has a reversionary interest within the meaning of section 673 in the Y stock that would cause C to be treated as the owner of the Y stock upon application of the grantor trust rules without regard to section 672(f). The trustee has discretion to accumulate or currently distribute income of DT to B.

(ii) Because A is a nonresident alien, application of the grantor trust rules without regard to section 672(f) would not result in the portion of the trust consisting of the X stock being treated as owned by a United States citizen or resident. None of the exceptions in § 1.672(f)-3 applies because A cannot revest the X stock in A, amounts may be distributed during A's lifetime to **B, who is neither a grantor nor a spouse of a grantor**, and the trust is not a compensatory trust. **Therefore**, pursuant to paragraph (a)(1) of this section, **A is not treated as an owner** under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code, of the portion of the trust consisting of the X stock. Any distributions from such portion of the trust are subject to the rules of subparts A through D (641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(iii) Because C is a United States citizen, paragraph (a)(1) of this section does not prevent C from being treated under section 673 as the

owner of the portion of the trust consisting of the Y stock. "

(c) Effective date. The rules of this section are applicable to taxable years of a trust beginning after August 10, 1999.

[T.D. 8831, 64 FR 43275, Aug. 10, 1999]

§ 1.679-2 Trusts treated as having a U.S. beneficiary.

(a) Existence of U.S. beneficiary -- (1) In general. The determination of whether a foreign trust has a U.S. beneficiary is made on an annual basis. A foreign trust is treated as having a U.S. beneficiary unless during the taxable year of the U.S. transferor --

(i) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and

(ii) If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.

(2) Benefit to a U.S. person -- (i) In general. For purposes of paragraph (a)(1) of this section, income or corpus may be paid or accumulated to or for the benefit of a U.S. person during a taxable year of the U.S. transferor if during that year, directly or indirectly, income may be distributed to, or accumulated for the benefit of, a U.S. person, or corpus may be distributed to, or held for the future benefit of, a U.S. person. This determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event.

(ii) Certain unexpected beneficiaries. Notwithstanding paragraph (a)(2)(i) of this section, for purposes of paragraph (a)(1) of this section, a person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest

in the trust is so remote as to be negligible. The preceding sentence does not apply with respect to persons to whom distributions could be made pursuant to a grant of discretion to the trustee or any other person. A class of beneficiaries generally does not include heirs who will benefit from the trust under the laws of intestate succession in the event that the named beneficiaries (or members of the named class) have all deceased (whether or not stated as a named class in the trust instrument).

(iii) Examples. The following examples illustrate the rules of paragraphs (a)(1) and (2) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's daughter, who is a nonresident alien, and FT is a foreign trust. The examples are as follows:

Example 1.

Distribution of income to U.S. person. A transfers property to FT. The trust instrument provides that all trust income is to be distributed currently to B. Under paragraph (a)(1) of this section, FT is treated as having a U.S. beneficiary.

Example 2.

Income accumulation for the benefit of a U.S. person. In 2001, A transfers property to FT. The trust instrument provides that from 2001 through 2010, the trustee of FT may distribute trust income to C or may accumulate the trust income. The trust instrument further provides that in 2011, the trust will terminate and the trustee may distribute the trust assets to either or both of B and C, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust assets must be distributed to C. Because it is possible that income may be accumulated in each year, and that the accumulated income ultimately may be distributed to B, a U.S. person, under paragraph (a)(1) of this section FT is treated as having a U.S. beneficiary during each of A's tax years from 2001 through 2011. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 3.

Corpus held for the benefit of a U.S. person. The facts are the same as in Example 2, except that from 2001

through 2011, all trust income must be distributed to C. In 2011, the trust will terminate and the trustee may distribute the trust corpus to either or both of B and C, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust corpus must be distributed to C. Because during each of A's tax years from 2001 through 2011 trust corpus is held for possible future distribution to B, a U.S. person, under paragraph (a)(1) of this section FT is treated as having a U.S. beneficiary during each of those years. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 4.

Distribution upon U.S. transferor's death. A transfers property to FT. The trust instrument provides that all trust income must be distributed currently to C and, upon A's death, the trust will terminate and the trustee may distribute the trust corpus to either or both of B and C. Because B may receive a distribution of corpus upon the termination of FT, and FT could terminate in any year, FT is treated as having a U.S. beneficiary in the year of the transfer and in subsequent years.

Example 5.

Distribution after U.S. transferor's death. The facts are the same as in Example 4, except the trust instrument provides that the trust will not terminate until the year following A's death. Upon termination, the trustee may distribute the trust assets to either or both of B and C, in the trustee's discretion. All trust assets are invested in the stock of X, a foreign corporation, and X makes no distributions to FT. Although no U.S. person may receive a distribution until the year after A's death, and FT has no realized income during any year of its existence, during each year in which A is living corpus may be held for future distribution to B, a U.S. person. Thus, under paragraph (a)(1) of this section FT is treated as having a U.S. beneficiary during each of A's tax years from 2001 through the year of A's death.

Example 6.

Constructive benefit to U.S. person. A transfers property to FT. The trust instrument provides that no income or corpus may be paid directly to a U.S. person. However, the trust instrument provides that trust corpus may be used to satisfy B's legal

obligations to a third party by making a payment directly to the third party. Under paragraphs (a)(1) and (2) of this section, FT is treated as having a U.S. beneficiary.

Example 7.

U.S. person with negligible contingent interest. A transfers property to FT. The trust instrument provides that all income is to be distributed currently to C, and upon C's death, all corpus is to be distributed to whomever of C's three children is then living. All of C's children are nonresident aliens. Under the laws of intestate succession that would apply to FT, if all of C's children are deceased at the time of C's death, the corpus would be distributed to A's heirs. A's living relatives at the time of the transfer consist solely of two brothers and two nieces, all of whom are nonresident aliens, and two first cousins, one of whom, E, is a U.S. citizen. Although it is possible under certain circumstances that E could receive a corpus distribution under the applicable laws of intestate succession, for each year the trust is in existence A is able to demonstrate to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that E's contingent interest in FT is so remote as to be negligible. Provided that paragraph (a)(4) of this section does not require a different result, FT is not treated as having a U.S. beneficiary.

Example 8.

U.S. person with **non-negligible contingent interest**. A transfers property to FT. The trust instrument provides that all income is to be distributed currently to D, A's uncle, who is a nonresident alien, and upon A's death, the corpus is to be distributed to D if he is then living. Under the laws of intestate succession that would apply to FT, B and C would share equally in the trust corpus if D is not living at the time of A's death. A is unable to demonstrate to the satisfaction of the Commissioner that B's contingent interest in the trust is so remote as to be negligible. Under paragraph (a)(2)(ii) of this section, FT is treated as having a U.S. beneficiary as of the year of the transfer.

Example 9.

U.S. person as member of class of beneficiaries. A transfers property to FT. The trust instrument

provides that all income is to be distributed currently to D, A's uncle, who is a nonresident alien, and upon A's death, the corpus is to be distributed to D if he is then living. If D is not then living, the corpus is to be distributed to D's descendants. D's grandson, E, is a resident alien. Under paragraph (a)(2)(ii) of this section, FT is treated as having a U.S. beneficiary as of the year of the transfer.

Example 10.

Trustee's discretion in choosing beneficiaries. A transfers property to FT. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of, any person who is pursuing the academic study of ancient Greek, in the trustee's discretion. Because it is possible that a U.S. person will receive distributions of income or corpus, or will have income accumulated for his benefit, FT is treated as having a U.S. beneficiary. This result applies even if, during a tax year, no distributions or accumulations are actually made to or for the benefit of a U.S. person. A may not invoke paragraph (a)(2)(ii) of this section because a U.S. person could benefit pursuant to a grant of discretion in the trust instrument.

Example 11.

Appointment of remainder beneficiary. A transfers property to FT. The trust instrument provides that the trustee may distribute current income to C, or may accumulate income, and, upon termination of the trust, trust assets are to be distributed to C. However, the trust instrument further provides that D, A's uncle, may appoint a different remainder beneficiary. **Because it is possible that a U.S. person could be named as the remainder beneficiary**, and because corpus could be held in each year for the future benefit of that U.S. person, FT is treated as having a U.S. beneficiary for each year.

Example 12.

Trust not treated as having a U.S. beneficiary. A transfers property to FT. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of C. Upon termination of the trust, all income and corpus must be distributed to C. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that A establishes to the satisfaction of the Commissioner under paragraph

(a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Because no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, either directly or indirectly, a U.S. person, and if the trust is terminated no part of the income or corpus of the trust could be paid to or for the benefit of, either directly or indirectly, a U.S. person, FT is not treated as having a U.S. beneficiary.

Example 13. U.S. beneficiary becomes non-U.S. person.

In 2001, A transfers property to FT. The trust instrument provides that, as long as B remains a U.S. resident, no distributions of income or corpus may be made from the trust to B. The trust instrument further provides that if B becomes a nonresident alien, distributions of income (including previously accumulated income) and corpus may be made to him. If B remains a U.S. resident at the time of FT's termination, all accumulated income and corpus is to be distributed to C. In 2007, B becomes a nonresident alien and remains so thereafter. **Because income may be accumulated during the years 2001 through 2007 for the benefit of a person who is a U.S. person during those years, FT is treated as having a U.S. beneficiary** under paragraph (a)(1) of this section during each of those years. This result applies even though B cannot receive distributions from FT during the years he is a resident alien and even though B might remain a resident alien who is not entitled to any distribution from FT. Provided that paragraph (a)(4) of this section does not require a different result and that A establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no other U.S. persons are reasonably expected to benefit from the trust, FT is not treated as having a U.S. beneficiary under paragraph (a)(1) of this section during tax years after 2007. "

(3) Changes in beneficiary's status -- (i) In general. For purposes of paragraph (a)(1) of this section, the possibility that a person that is not a U.S. person could become a U.S. person will not cause that person to be treated as a U.S. person for purposes of paragraph (a)(1) of this section until the tax year of the U.S. transferor in which that individual actually becomes a U.S. person. However, if a person who is not a U.S. person becomes a U.S. person for the first

time more than 5 years after the date of a transfer to the foreign trust by a U.S. transferor, that person is not treated as a U.S. person for purposes of applying paragraph (a)(1) of this section with respect to that transfer.

(ii) Examples. The following examples illustrate the rules of paragraph (a)(3) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's daughter, who is a nonresident alien, and FT is a foreign trust. The examples are as follows:

Example 1.

Non-U.S. beneficiary becomes U.S. person. In 2001, A transfers property to FT. The trust instrument provides that all income is to be distributed currently to C and that, upon the termination of FT, all corpus is to be distributed to C. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that A establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Under paragraph (a)(3)(i) of this section, FT is not treated as having a U.S. beneficiary during the tax years of A in which C remains a nonresident alien. If C first becomes a resident alien in 2004, FT is treated as having a U.S. beneficiary commencing in that year under paragraph (a)(3) of this section. See paragraph (c) of this section regarding the treatment of A upon FT's acquisition of a U.S. beneficiary.

Example 2.

Non-U.S. beneficiary becomes U.S. person more than 5 years after transfer. The facts are the same as in Example 1, except C first becomes a resident alien in 2007. FT is treated as not having a U.S. beneficiary under paragraph (a)(3)(i) of this section with respect to the property transfer by A. However, if C had previously been a U.S. person during any prior period, the 5-year exception in paragraph (a)(3)(i) of this section would not apply in 2007 because it would not have been the first time C became a U.S. person. "

(4) General rules -- (i) Records and documents. Even if, based on the terms of the trust instrument, a foreign trust is not treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of

this section, the trust may nevertheless be treated as having a U.S. beneficiary pursuant to paragraph (a)(1) of this section based on the following --

(A) All written and oral agreements and understandings relating to the trust;

(B) Memoranda or letters of wishes;

(C) All records that relate to the actual distribution of income and corpus; and

(D) All other documents that relate to the trust, whether or not of any purported legal effect.

(ii) Additional factors. For purposes of determining whether a foreign trust is treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of this section, the following additional factors are taken into account --

(A) If the terms of the trust instrument allow the trust to be amended to benefit a U.S. person, all potential benefits that could be provided to a U.S. person pursuant to an amendment must be taken into account;

(B) If the terms of the trust instrument do not allow the trust to be amended to benefit a U.S. person, but the law applicable to a foreign trust may require payments or accumulations of income or corpus to or for the benefit of a U.S. person (by judicial reformation or otherwise), all potential benefits that could be provided to a U.S. person pursuant to the law must be taken into account, unless the U.S. transferor demonstrates to the satisfaction of the Commissioner that the law is not reasonably expected to be applied or invoked under the facts and circumstances; and

(C) If the parties to the trust ignore the terms of the trust instrument, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a U.S. person must be taken into account.

(iii) Examples. The following examples illustrate the rules of paragraph (a)(4) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's daughter, who is a nonresident

alien, and FT is a foreign trust. The examples are as follows:

Example 1.

Amendment pursuant to local law. A creates and funds FT for the benefit of C. The terms of FT (which, according to the trust instrument, cannot be amended) provide that no part of the income or corpus of FT may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, either during the existence of FT or at the time of its termination. However, pursuant to the applicable foreign law, FT can be amended to provide for additional beneficiaries, and there is an oral understanding between A and the trustee that B can be added as a beneficiary. Under paragraphs (a)(1) and (a)(4)(ii)(B) of this section, FT is treated as having a U.S. beneficiary.

Example 2.

Actions in violation of the terms of the trust. A transfers property to FT. The trust instrument provides that no U.S. person can receive income or corpus from FT during the term of the trust or at the termination of FT. Notwithstanding the terms of the trust instrument, a letter of wishes directs the trustee of FT to provide for the educational needs of B, who is about to begin college. The letter of wishes contains a disclaimer to the effect that its contents are only suggestions and recommendations and that the trustee is at all times bound by the terms of the trust as set forth in the trust instrument. Under paragraphs (a)(1) and (a)(4)(ii)(C) of this section, FT is treated as having a U.S. beneficiary. "

(b) Indirect U.S. beneficiaries -- (1) Certain foreign entities. For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of --

(i) **A controlled foreign corporation**, as defined in section 957(a);

(ii) A foreign partnership, if a U.S. person is a partner of such partnership; or

(iii) A foreign trust or estate, if such trust or estate has a U.S. beneficiary (within the meaning of paragraph (a)(1) of this section).

(2) Other indirect beneficiaries. For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of a U.S. person through an intermediary, such as an agent or nominee, or by any other means where a U.S. person may obtain an actual or constructive benefit.

(3) Examples. The following examples illustrate the rules of this paragraph (b). Unless otherwise noted, A is a resident alien. B is A's son and is a resident alien. FT is a foreign trust. The examples are as follows: ""

Example 1.

Trust benefiting foreign corporation. A transfers property to FT. The beneficiary of FT is FC, a foreign corporation. FC has outstanding solely 100 shares of common stock. B owns 49 shares of the FC stock and FC2, also a foreign corporation, owns the remaining 51 shares. FC2 has outstanding solely 100 shares of common stock. B owns 49 shares of FC2 and nonresident alien individuals own the remaining 51 FC2 shares. FC is a controlled foreign corporation (as defined in section 957(a), after the application of section 958(a)(2)). Under paragraphs (a)(1) and (b)(1)(i) of this section, FT is treated as having a U.S. beneficiary.

Example 2.

Trust benefiting another trust. A transfers property to FT. The terms of FT permit current distributions of income to B. A transfers property to another foreign trust, FT2. The terms of FT2 provide that no U.S. person can benefit either as to income or corpus, but permit current distributions of income to FT. Under paragraph (a)(1) of this section, FT is treated as having a U.S. beneficiary and, under paragraphs (a)(1) and (b)(1)(iii) of this section, FT2 is treated as having a U.S. beneficiary.

Example 3.

Trust benefiting another trust after transferor's death. A transfers property to FT. The terms of FT require

that all income from FT be accumulated during A's lifetime. In the year following A's death, a share of FT is to be distributed to FT2, another foreign trust, for the benefit of B. Under paragraphs (a)(1) and (b)(1)(iii) of this section, FT is treated as having a U.S. beneficiary beginning with the year of A's transfer of property to FT.

Example 4.

Indirect benefit through use of debit card. A transfers property to FT. The trust instrument provides that no U.S. person can benefit either as to income or corpus. However, FT maintains an account with FB, a foreign bank, and FB issues a debit card to B against the account maintained by FT and B is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, FT is treated as having a U.S. beneficiary.

Example 5.

Other indirect benefit. A transfers property to FT. FT is administered by FTC, a foreign trust company. FTC forms IBC, an international business corporation formed under the laws of a foreign jurisdiction. IBC is the beneficiary of FT. IBC maintains an account with FB, a foreign bank. FB issues a debit card to B against the account maintained by IBC and B is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, FT is treated as having a U.S. beneficiary. "

(c) Treatment of U.S. transferor upon foreign trust's acquisition or loss of U.S. beneficiary -- (1) Trusts acquiring a U.S. beneficiary. If a foreign trust to which a U.S. transferor has transferred property is not treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) for any taxable year of the U.S. transferor, but the trust is treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) in any subsequent taxable year, the U.S. transferor is treated as having additional income in the first such taxable year of the U.S. transferor in which the trust is treated as having a U.S. beneficiary. The amount of the additional income is equal to the trust's undistributed net income, as defined in section 665(a), at the end of the U.S. transferor's immediately preceding taxable year and is subject to the rules of section 668,

providing for an interest charge on accumulation distributions from foreign trusts.

(2) Trusts ceasing to have a U.S. beneficiary. If, for any taxable year of a U.S. transferor, a foreign trust that has received a transfer of property from the U.S. transferor ceases to be treated as having a U.S. beneficiary, the U.S. transferor ceases to be treated as the owner of the portion of the trust attributable to the transfer beginning in the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary (unless the U.S. transferor is treated as an owner thereof pursuant to sections 673 through 677). The U.S. transferor is treated as making a transfer of property to the foreign trust on the first day of the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary. The amount of the property deemed to be transferred to the trust is the portion of the trust attributable to the prior transfer to which paragraph (a)(1) of this section applied. For rules regarding the recognition of gain on transfers to foreign trusts, see section 684.

(3) Examples. The rules of this paragraph (c) are illustrated by the following examples. A is a resident alien, B is A's son, and FT is a foreign trust. The examples are as follows: ""

Example 1.

Trust acquiring U.S. beneficiary. (i) In 2001, A transfers stock with a fair market value of \$100,000 to FT. The stock has an adjusted basis of \$50,000 at the time of the transfer. The trust instrument provides that income may be paid currently to, or accumulated for the benefit of, B and that, upon the termination of the trust, all income and corpus is to be distributed to B. At the time of the transfer, B is a nonresident alien. A is not treated as the owner of any portion of FT under sections 673 through 677. FT accumulates a total of \$30,000 of income during the taxable years 2001 through 2003. In 2004, B moves to the United States and becomes a resident alien. Assume paragraph (a)(4) of this section is not applicable under the facts and circumstances.

(ii) Under paragraph (c)(1) of this section, A is treated as receiving an accumulation distribution in the amount of \$30,000 in 2004 and immediately

transferring that amount back to the trust. The accumulation distribution is subject to the rules of section 668, providing for an interest charge on accumulation distributions.

(iii) Under paragraphs (a)(1) and (3) of this section, beginning in 2005, A is treated as the owner of the portion of FT attributable to the stock transferred by A to FT in 2001 (which includes the portion attributable to the accumulated income deemed to be retransferred in 2004).

Example 2.

Trust ceasing to have U.S. beneficiary. (i) The facts are the same as in Example 1. In 2008, B becomes a nonresident alien. On the date B becomes a nonresident alien, the stock transferred by A to FT in 2001 has a fair market value of \$125,000 and an adjusted basis of \$50,000.

(ii) Under paragraph (c)(2) of this section, beginning in 2009, FT is not treated as having a U.S. beneficiary, and A is not treated as the owner of the portion of the trust attributable to the prior transfer of stock. For rules regarding the recognition of gain on the termination of ownership status, see section 684.

§1.672(d)-1 Power subject to condition precedent.

Section 672(d) provides that a person is considered to have a power described in subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. **However**, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise **can only** affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a **reversionary interest**, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment

of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

(Solution: Make FT revocable (by FC) over both corpus and income) – i.e., both corpus and beneficial enjoyment - with no reversionary interest permitted)

§1.672(f)-2 Certain foreign corporations.

(a) Application of general rule. Subject to the provisions of paragraph (b) of this section, if the owner of any portion of a trust upon application of the grantor trust rules without regard to section 672(f) is a controlled foreign corporation (as defined in section 957), a passive foreign investment company (as defined in section 1297), or a foreign personal holding company (as defined in section 552), **the corporation will be treated as a domestic corporation** for purposes of applying the rules of § 1.672(f)-1.

THR notes: The result of the above regulation (§1.672(f)-2)(a) “effectively” mean a foreign trust would not have a foreign “corporate” grantor if the foreign corporation is a CFC, PFIC or FPHC. But see (b) below. It would have a domestic grantor/settlor. Effectively, any tax advantages are lost if the FC is a CFC.

(b) Gratuitous transfers to United States persons -- (1) Transfer from trust to which corporation made a gratuitous transfer. **If a trust** (or portion of a trust) to which a controlled foreign corporation, passive foreign investment company, or foreign personal holding company has made a gratuitous transfer (within the meaning of § 1.671-2(e)(2)), makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation for purposes of § 1.672(f)-4(c), relating to gratuitous transfers from trusts (or portions of trusts) to which a partnership or foreign corporation has made a gratuitous transfer.

THR notes: The above rule indirectly tells us the CFC or PFIC need to be avoided by the foreign estate – because the US shareholders would then become taxable on the assets held by its revocable FT.

(2) Transfer from trust over which corporation has a section 678 power. If a trust (or portion of a trust) that a controlled foreign corporation, passive foreign investment company, or foreign personal holding company is treated as owning under section 678 makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation that had made a gratuitous transfer to the trust (or portion of a trust) and the rules of § 1.672(f)-4(c) apply.

THR notes: Again, a US tax liability can arise to the US shareholders (or US persons) under the CFC and PFIC or FPHC provisions. The non-CFC should have total power to revoke both corpus and income.

(c) Special rules for passive foreign investment companies -- (1) Application of section 1297. For purposes of determining whether a foreign corporation is a passive foreign investment company as defined in section 1297, the grantor trust rules apply as if section 672(f) had not come into effect.

(2) References to renumbered Internal Revenue Code section. For taxable years of shareholders beginning on or before December 31, 1997, and taxable years of passive foreign investment companies ending with or within such taxable years of the shareholders, all references in this § 1.672(f)-2 to section 1297 are deemed to be references to section 1296.

(d) Examples. The following examples illustrate the rules of this section. **In each example, FT is an irrevocable foreign trust, and CFC is a controlled foreign corporation.** The examples are as follows:

THR notes: Seemingly, none of the Treasury’s examples below apply if the FT is merely and solely “Revocable” under IRC §676 and the FC is not a CFC.

Example 1.

Application of general rule. CFC creates and funds FT. CFC is the grantor of FT within the meaning of § 1.671-2(e). CFC has a reversionary interest in FT within the meaning of section 673 that would cause CFC to be treated as the owner of FT upon application of the grantor trust rules without regard to section 672(f). Under paragraph (a) of this section, CFC is treated as a domestic corporation for purposes of applying the general rule of § 1.672(f)-1. Thus, § 1.672(f)-1 does not prevent CFC from being treated as the owner of FT under section 673.

Example 2.

Distribution from trust to which CFC made gratuitous transfer. A, a nonresident alien, owns 40 percent of the stock of CFC. A's brother B, a resident alien, owns the other 60 percent of the stock of CFC. CFC makes a gratuitous transfer to FT. FT makes a gratuitous transfer to A's daughter, C, who is a resident alien. Under paragraph (b)(1) of this section, CFC will be treated as a foreign corporation for purposes of § 1.672(f)-4(c). For further guidance, see § 1.672(f)-4(g) Example 2 through Example 4. "

(e) Effective date. The rules of this section are generally applicable to taxable years of shareholders of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies beginning after August 10, 1999, and taxable years of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies ending with or within such taxable years of the shareholders.

§1.672(f)-3 Exceptions to general rule.

(a) **Certain revocable trusts** -- (1) In general. Subject to the provisions of paragraph (a)(2) of this section, the general rule of § 1.672(f)-1 does not apply to any portion of a trust for a taxable year of the trust **if the power to revest absolutely in the grantor title to such portion is exercisable solely by the grantor** (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) without the approval or consent of any other person. If the grantor can exercise such power only with the approval of a related or subordinate party who is subservient to the grantor, such power is

treated as exercisable solely by the grantor. For the definition of grantor, see § 1.671-2(e). For the definition of related or subordinate party, see § 1.672(c)-1. For purposes of this paragraph (a), a related or subordinate party is subservient to the grantor unless the presumption in the last sentence of § 1.672(c)-1 is rebutted by a preponderance of the evidence. A trust (or portion of a trust) that fails to qualify for the exception provided by this paragraph (a) for a particular taxable year of the trust will be subject to the general rule of § 1.672(f)-1 for that **taxable year** and **all** subsequent taxable years of the trust.

Important exception 679(f)-3 is favorable to the taxpayer. Go back to page #1 of this issue of THR. See 672(f)-1.

(2) 183-day rule. For purposes of paragraph (a)(1) of this section, the grantor is treated as having a power to revest for a taxable year of the trust only if the grantor has such power for a total of 183 or more days during the taxable year of the trust. If the first or last taxable year of the trust (including the year of the grantor's death) is less than 183 days, the grantor is treated as having a power to revest for purposes of paragraph (a)(1) of this section if the grantor has such power for each day of the first or last taxable year, as the case may be.

(3) **Grandfather rule** for certain revocable trusts in existence on September 19, 1995. Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of § 1.672(f)-1 does not apply to any portion of a trust that was treated as owned by the grantor under section 676 on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) Examples. The following examples illustrate the rules of this paragraph (a):

Example 1.

Grantor is owner. FP1, a foreign person, creates and funds a **revocable trust, T**, for the benefit of FP1's children, who are resident aliens. The trustee is a

foreign bank, FB, that is owned and **controlled by FP1 and FP2**, who is FP1's brother. The power to revoke T and revest absolutely in FP1 title to the trust property is exercisable by FP1, **but only with the approval or consent of FB**. The trust instrument contains no standard that FB must apply in determining whether to approve or consent to the revocation of T. There are no facts that would suggest that FB is not subservient to FP1. Therefore, the exception in paragraph (a)(1) of this section is applicable.

Solution/Opinion: Favorable to the taxpayer. Only one foreign grantor (settlor) should have the power to revoke (but under §676) the FT, and that settlor should be a non CFC (i.e., with no US persons as shareholders – especially if your objective is to create a non taxable “foreign estate” and exploit foreign trusts with US beneficiaries somewhere along the line.

Example 2.

Death of grantor. Assume the same facts as in Example 1, except that FP1 dies. After FP1's death, FP2 has the power to withdraw the assets of T, but only with the approval of FB. There are no facts that would suggest that FB is not subservient to FP2. However, the exception in paragraph (a)(1) of this section is no longer applicable, because FP2 is not a grantor of T within the meaning of § 1.671-2(e).

See what happens when a single human grantor dies? FT should always have a grantor with the power to revoke both corpus and income of the trust. Use of a corporate settlor will solve this problem if it is not also a CFC.

Example 3.

Trustee is not related or subordinate party. Assume the same facts as in Example 1, except that neither FP1 nor any member of FP1's family has any substantial ownership interest or other connection with FB. FP1 can remove and replace FB at any time for any reason. Although FP1 can replace FB with a related or subordinate party **if FB refuses to approve or consent to FP1's decision to revest the trust property in himself**, FB is not a related or subordinate party. Therefore, the exception in paragraph (a)(1) of this section is not applicable.

THR Notes: FB (the trustee of FT) might not allow FP1 access to FT assets (his own fund!) Avoid this occurrence. A “protector clause” allowing the removal of the trustee might solve this problem.

Example 4.

Unrelated trustee will consent to revocation. FP, a foreign person, creates and funds an irrevocable trust, T. The trustee is a foreign bank, FB, that is not a related or subordinate party within the meaning of § 1.672(c)-1. FB has the discretion to distribute trust income or corpus to beneficiaries of T, including FP. Even if FB would in fact distribute all the trust property to FP if requested to do so by FP, **the exception in paragraph (a)(1) of this section is not applicable, because FP does not have the power to revoke T.** "

(b) Certain trusts that can distribute only to the grantor or the spouse of the grantor -- (1) In general. The general rule of § 1.672(f)-1 does not apply to any trust (or portion of a trust) if at all times during the lifetime of the grantor the only amounts distributable (whether income or corpus) from such trust (or portion thereof) are amounts distributable to the grantor or the spouse of the grantor. For purposes of this paragraph (b), payments of amounts that are not gratuitous transfers (within the meaning of § 1.671-2(e)(2)) are not amounts distributable. For the definition of grantor, see § 1.671-2(e).

THR Notes: The grantor or his/her spouse can direct FT distributions to anyone – as this is only a “special power of appointment – and special powers of appointment do not generally affect the status of a trust under the grantor trust rules.

(2) Amounts distributable in discharge of legal obligations -- (i) In general. A trust (or portion of a trust) does not fail to satisfy paragraph (b)(1) of this section solely because amounts are distributable from the trust (or portion thereof) in discharge of a legal obligation of the grantor or the spouse of the grantor. Subject to the provisions of paragraph (b)(2)(ii) of this section, an obligation is considered a legal obligation for purposes of this paragraph (b)(2)(i) if it is enforceable under the local law of the jurisdiction in which the grantor (or the spouse of the grantor) resides.

(ii) Related parties -- (A) In general. Except as provided in paragraph (b)(2)(ii)(B) of this section, an obligation to a person who is a related person for purposes of § 1.643(h)-1(e) (other than an individual who is legally separated from the grantor under a decree of divorce or of separate maintenance) is not a legal obligation for purposes of paragraph (b)(2)(i) of this section unless it was contracted bona fide and for adequate and full consideration in money or money's worth (see § 20.2043-1 of this chapter).

(B) Exceptions -- (1) Amounts distributable in support of certain individuals. Paragraph (b)(2)(ii)(A) of this section does not apply with respect to amounts that are distributable from the trust (or portion thereof) to support an individual who --

(i) Would be treated as a dependent of the grantor or the spouse of the grantor under section 152(a)(1) through (9), without regard to the requirement that over half of the individual's support be received from the grantor or the spouse of the grantor; and

(ii) Is either permanently and totally disabled (within the meaning of section 22(e)(3)), or less than 19 years old.

(2) Certain potential support obligations. The fact that amounts might become distributable from a trust (or portion of a trust) in discharge of a potential obligation under local law to support an individual other than an individual described in paragraph (b)(2)(ii)(B)(1) of this section is disregarded if such potential obligation is not reasonably expected to arise under the facts and circumstances.

(3) Reinsurance trusts. [Reserved]

(3) Grandfather rule for certain section 677 trusts in existence on September 19, 1995. Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of § 1.672(f)-1 does not apply to any portion of a trust that was treated as owned by the grantor under section 677 (other than section 677(a)(3)) on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to

gratuitous transfers to the trust after September 19, 1995.

(4) Examples. The following examples illustrate the rules of this paragraph (b): ""

Example 1.

Amounts distributable only to grantor or grantor's spouse. H and his wife, W, are both nonresident aliens. H is 70 years old, and W is 65. H and W have a 30-year-old child, C, a resident alien. There is no reasonable expectation that H or W will ever have an obligation under local law to support C or any other individual. H creates and funds an irrevocable trust, FT, using only his separate property. H is the grantor of FT within the meaning of § 1.671-2(e). Under the terms of FT, the only amounts distributable (whether income or corpus) from FT as long as either H or W is alive are amounts distributable to H or W. Upon the death of both H and W, C may receive distributions from FT. During H's lifetime, the exception in paragraph (b)(1) of this section is applicable.

Example 2.

Effect of grantor's death. Assume the same facts as in Example 1. H predeceases W. Assume that W would be treated as owning FT under section 678 if the grantor trust rules were applied without regard to section 672(f). The exception in paragraph (b)(1) of this section is no longer applicable, because W is not a grantor of FT within the meaning of § 1.671-2(e).

Example 3.

Amounts temporarily distributable to person other than grantor or grantor's spouse. Assume the same facts as in Example 1, except that C (age 30) is a law student at the time FT is created and the trust instrument provides that, as long as C is in law school, amounts may be distributed from FT to pay C's expenses. Thereafter, the only amounts distributable from FT as long as either H or W is alive will be amounts distributable to H or W. Even assuming there is an enforceable obligation under local law for H and W to support C while he is in school, distributions from FT in payment of C's expenses cannot qualify as distributions in discharge of a legal obligation under paragraph (b)(2) of this section, because C is neither permanently and totally

disabled nor less than 19 years old. The exception in paragraph (b)(1) of this section is not applicable. After C graduates from law school, the exception in paragraph (b)(1) still will not be applicable, because amounts were distributable to C during the lifetime of H.

Example 4.

Fixed investment trust. FC, a foreign corporation, invests in a domestic fixed investment trust, DT, that is classified as a trust under § 301.7701-4(c)(1) of this chapter. Under the terms of DT, the only amounts that are distributable from FC's portion of DT are amounts distributable to FC. The exception in paragraph (b)(1) of this section is applicable to FC's portion of DT.

Example 5.

Reinsurance trust. A domestic insurance company, DI, reinsures a portion of its business with an unrelated foreign insurance company, FI. To satisfy state regulatory requirements, FI places the premiums in an irrevocable domestic trust, DT. The trust funds are held by a United States bank and may be used only to pay claims arising out of the reinsurance policies, which are legally enforceable under the local law of the jurisdiction in which FI resides. On the termination of DT, any assets remaining will revert to FI. Because the only amounts that are distributable from DT are distributable either to FI or in discharge of FI's legal obligations within the meaning of paragraph (b)(2)(i) of this section, the exception in paragraph (b)(1) of this section is applicable.

Example 6.

Trust that provides security for loan. FC, a foreign corporation, borrows money from B, an unrelated bank, to finance the purchase of an airplane. FC creates a foreign trust, FT, to hold the airplane as security for the loan from B. The only amounts that are distributable from FT while the loan is outstanding are amounts distributable to B in the event that FC defaults on its loan from B. When FC repays the loan, the trust assets will revert to FC. The loan is a legal obligation of FC within the meaning of paragraph (b)(2)(i) of this section, because it is enforceable under the local law of the country in which FC is incorporated. Paragraph (b)(2)(ii) of this

section is not applicable, because B is not a related person for purposes of § 1.643(h)-1(e). The exception in paragraph (b)(1) of this section is applicable. "

(c) **Compensatory trusts --** (1) In general. The general rule of § 1.672(f)-1 does not apply to any portion of -

(i) A nonexempt employees' trust described in section 402(b), including a trust created on behalf of a self-employed individual;

(ii) A trust, including a trust created on behalf of a self-employed individual, that would be a nonexempt employees' trust described in section 402(b) but for the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of § 1.83-3(e); and

(iii) Any additional category of trust that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(2) **Exceptions.** The Commissioner may, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), designate categories of compensatory trusts to which the general rule of paragraph (c)(1) of this section does not apply.

(d) **Separate accounting for gratuitous transfers to grandfathered trusts after September 19, 1995.** If a trust that was treated as owned by the grantor under section 676 or 677 (other than section 677(a)(3)) on September 19, 1995, contains both amounts held in the trust on September 19, 1995, and amounts that were gratuitously transferred to the trust after September 19, 1995, paragraphs (a)(3) and (b)(3) of this section apply only if the amounts that were gratuitously transferred to the trust after September 19, 1995, are treated as a separate portion of the trust that is accounted for under the rules of § 1.671-3(a)(2). If the amounts that were gratuitously transferred to the trust after September 19, 1995 are not so accounted for, the general rule of § 1.672(f)-1 applies to the entire trust. If such amounts are so accounted for, and without regard to whether there is physical separation of the assets, the general rule of

§ 1.672(f)-1 does not apply to the portion of the trust that is attributable to amounts that were held in the trust on September 19, 1995.

(e) Effective date. The rules of this section are generally applicable to taxable years of a trust beginning after August 10, 1999. The initial separate accounting required by paragraph (d) of this section must be prepared by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999.

§ 1.679-4 Exceptions to general rule.

(a) In general. Section 1.679-1 does not apply to --

(1) Any transfer of property to a foreign trust by reason of the death of the transferor;

(2) Any transfer of property to a foreign trust described in sections 402(b), 404(a)(4), or 404A;

(3) Any transfer of property to a foreign trust described in section 501(c)(3) (without regard to the requirements of section 508(a)); and

(4) Any transfer of property to a foreign trust to the extent the transfer is for fair market value.

(b) Transfers for fair market value -- (1) In general. For purposes of this section, a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. For purposes of this section, a distribution to a trust with respect to an interest held by such trust in an entity other than a trust or an interest in certain investment trusts described in § 301.7701-4(c) of this chapter, liquidating trusts described in § 301.7701-4(d) of this chapter, or environmental remediation trusts described in § 301.7701-4(e) of this chapter is considered to be a transfer for fair market value.

(2) Special rule -- (i) Transfers for partial consideration. For purposes of this section, if a person transfers property to a foreign trust in exchange for property having a fair market value that is less than the fair market value of the property transferred, the exception in paragraph (a)(4) of this section applies only to the extent of the fair market value of the property received.

(ii) Example. This paragraph (b) is illustrated by the following example: ""

Example.

A, a U.S. citizen, transfers property that has a fair market value of 1000X to FT, a foreign trust, in exchange for 600X of cash. Under this paragraph (b), § 1.679-1 applies with respect to the transfer of 400X (1000X less 600X) to FT. "

(c) Certain obligations not taken into account. Solely for purposes of this section, in determining whether a transfer by a U.S. transferor that is a related person (as defined in § 1.679-1(c)(5)) with respect to the foreign trust is for fair market value, any obligation (as defined in § 1.679-1(c)(6)) of the trust or a related person (as defined in § 1.679-1(c)(5)) that is not a qualified obligation within the meaning of paragraph (d)(1) of this section shall not be taken into account.

(d) Qualified obligations -- (1) In general. For purposes of this section, an obligation is treated as a qualified obligation only if --

(i) The obligation is reduced to writing by an express written agreement;

(ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation);

(iii) All payments on the obligation are denominated in U.S. dollars;

(iv) The yield to maturity is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal

rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter));

(v) The U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. transferor's taxable year for the year of the transfer and is paid within such period); when properly executed and filed, such an agreement is deemed to be consented to for purposes of § 301.6501(c)-1(d) of this chapter; and

(vi) The U.S. transferor reports the status of the loan, including principal and interest payments, on Form 3520 for every year that the loan is outstanding.

(2) Additional loans. If, while the original obligation is outstanding, the U.S. transferor or a person related to the trust (within the meaning of § 1.679-1(c)(5)) directly or indirectly obtains another obligation issued by the trust, or if the U.S. transferor directly or indirectly obtains another obligation issued by a person related to the trust, the original obligation is deemed to have the maturity date of any such subsequent obligation in determining whether the term of the original obligation exceeds the specified 5-year term. In addition, a series of obligations issued and repaid by the trust (or a person related to the trust) is treated as a single obligation if the transactions giving rise to the obligations are structured with a principal purpose to avoid the application of this provision.

(3) Obligations that cease to be qualified. If an obligation treated as a qualified obligation subsequently fails to be a qualified obligation (e.g., renegotiation of the terms of the obligation causes the term of the obligation to exceed five years), the U.S. transferor is treated as making a transfer to the trust in an amount equal to the original obligation's adjusted issue price (within the meaning of § 1.1275-1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of § 1.1273-1(c)) as of the date of the subsequent event that causes the obligation to

no longer be a qualified obligation. If the maturity date is extended beyond five years by reason of the issuance of a subsequent obligation by the trust (or person related to the trust), the amount of the transfer will not exceed the issue price of the subsequent obligation. The subsequent obligation is separately tested to determine if it is a qualified obligation.

(4) Transfers resulting from failed qualified obligations. In general, a transfer resulting from a failed qualified obligation is deemed to occur on the date of the subsequent event that causes the obligation to no longer be a qualified obligation. However, based on all of the facts and circumstances, the Commissioner may deem a transfer to have occurred on any date on or after the issue date of the original obligation. For example, if at the time the original obligation was issued, the transferor knew or had reason to know that the obligation would not be repaid, the Commissioner could deem the transfer to have occurred on the issue date of the original obligation.

(5) Renegotiated loans. Any loan that is renegotiated, extended, or revised is treated as a new loan, and any transfer of funds to a foreign trust after such renegotiation, extension, or revision under a pre-existing loan agreement is treated as a transfer subject to this section.

(6) Principal repayments. The payment of principal with respect to any obligation that is not treated as a qualified obligation under this paragraph is taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(7) Examples. The rules of this paragraph (d) are illustrated by the following examples. In the examples, A and B are U.S. residents and FT is a foreign trust. The examples are as follows: ""

Example 1.

Demand loan. A transfers 500X to FT in exchange for a demand note that permits A to require repayment by FT at any time. A is a related person (as defined in § 1.679-1(c)(5)) with respect to FT. Because FT's obligation to A could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d) of this

section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, § 1.679-1 applies with respect to the full 500X transfer to FT.

Example 2.

Private annuity. A transfers 4000X to FT in exchange for an annuity from the foreign trust that will pay A 100X per year for the rest of A's life. A is a related person (as defined in § 1.679-1(c)(5)) with respect to FT. Because FT's obligation to A could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, § 1.679-1 applies with respect to the full 4000X transfer to FT.

Example 3.

Loan to unrelated foreign trust. B transfers 1000X to FT in exchange for an obligation of the trust. The term of the obligation is fifteen years. B is not a related person (as defined in § 1.679-1(c)(5)) with respect to FT. Because B is not a related person, the fair market value of the obligation received by B is taken into account for purposes of determining whether B's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section, even though the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section.

Example 4.

Transfer for an obligation with term in excess of 5 years. A transfers property that has a fair market value of 5000X to FT in exchange for an obligation of the trust. The term of the obligation is ten years. A is a related person (as defined in § 1.679-1(c)(5)) with respect to FT. Because the term of the obligation is greater than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes

of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, § 1.679-1 applies with respect to the full 5000X transfer to FT.

Example 5.

Transfer for a qualified obligation. The facts are the same as in Example 4, except that the term of the obligation is 3 years. Assuming the other requirements of paragraph (d)(1) of this section are satisfied, the obligation is a qualified obligation and its adjusted issue price is taken into account for purposes of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section.

Example 6.

Effect of subsequent obligation on original obligation. A transfers property that has a fair market value of 1000X to FT in exchange for an obligation that satisfies the requirements of paragraph (d)(1) of this section. A is a related person (as defined in § 1.679-1(c)(5)) with respect to FT. Two years later, A transfers an additional 2000X to FT and receives another obligation from FT that has a maturity date four years from the date that the second obligation was issued. Under paragraph (d)(2) of this section, the original obligation is deemed to have the maturity date of the second obligation. Under paragraph (a) of this section, A is treated as having made a transfer in an amount equal to the original obligation's adjusted issue price (within the meaning of § 1.1275-1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of § 1.1273-1(c)) as of the date of issuance of the second obligation. The second obligation is tested separately to determine whether it is a qualified obligation for purposes of applying paragraph (a) of this section to the second transfer.

§1.672(f)-4 Recharacterization of purported gifts.

(a) In general -- (1) Purported gifts from partnerships. Except as provided in paragraphs (b), (e), and (f) of this section, and **without regard to the existence of any trust**, if a United States person (United States donee) directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from a partnership, the purported gift or bequest must

be **included in the United States donee's gross income as ordinary income.**

(2) **Purported gifts from foreign corporations.** Except as provided in paragraphs (b), (e), and (f) of this section, **and without regard to the existence of any trust**, if a United States donee directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from any **foreign corporation**, the **purported** gift or bequest **must** be included in the United States donee's gross income as if it were a distribution from the foreign corporation. If the foreign corporation is a passive foreign investment company (within the meaning of section 1297), the rules of section 1291 apply. For purposes of section 1012, the United States donee is not treated as having basis in the stock of the foreign corporation. However, for purposes of section 1223, the United States donee is treated as having a holding period in the stock of the foreign corporation on the date of the deemed distribution equal to the weighted average of the holding periods of the actual interest holders (other than any interest holders who treat the portion of the purported gift attributable to their interest in the foreign corporation in the manner described in paragraph (b)(1) of this section). For purposes of section 902, a United States donee that is a domestic corporation is not treated as owning any voting stock of the foreign corporation.

THR Notes: Use a foreign revocable trust (see Rev-69-70) for distributions – not a foreign company – as the distributions from a foreign company will not be considered a non taxable gift - but taxable gross income.

(b) Exceptions -- (1) Partner or shareholder treats transfer as distribution and gift. Paragraph (a) of this section does not apply to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that either --

(i) A United States citizen or resident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest **for United States tax purposes as a distribution** to such individual and a subsequent gift or bequest to the United States donee; or

(ii) A nonresident alien **individual** who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for purposes of the tax laws of the nonresident alien individual's country of residence as a distribution to such individual and a subsequent gift or bequest to the United States donee, and the United States donee timely complied with the reporting requirements of section 6039F, if applicable.

(2) All beneficial owners of domestic partnership are United States citizens or residents or domestic corporations. Paragraph (a)(1) of this section does not apply to a purported gift or bequest from a domestic partnership if the United States donee can demonstrate to the satisfaction of the Commissioner that all beneficial owners (within the meaning of § 1.1441-1(c)(6)) of the partnership are United States citizens or residents or domestic corporations.

(3) Contribution to capital of corporate United States donee. Paragraph (a) of this section does not apply to the extent a United States donee that is a corporation can establish that the purported gift or bequest was treated for United States tax purposes as a contribution to the capital of the United States donee to which section 118 applies.

THR Notes: Interesting conclusion by US Treasury department. Capitalizations of a US corporation (i.e., a corporate donee) by FT are not taxable, if done in the normal course of business.

(4) Charitable transfers. Paragraph (a) of this section does not apply if either --

(i) The United States donee is described in section 170(c); or

(ii) The transferor has received a ruling or determination letter, which has been neither revoked nor modified, from the Internal Revenue Service recognizing its exempt status under section 501(c)(3), and the transferor made the transfer pursuant to an exempt purpose for which the transferor was created or organized. For purposes of the preceding sentence, a ruling or determination letter recognizing exemption may not be relied upon if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization.

(c) Certain transfers from trusts to which a partnership or foreign corporation has made a gratuitous transfer -- (1) Generally treated as distribution from partnership or foreign corporation. Except as provided in paragraphs (c)(2) and (3) of this section, if a United States donee receives a gratuitous transfer (within the meaning of § 1.671-2(e)(2)) from a trust (or portion of a trust) to which a partnership or foreign corporation has made a gratuitous transfer, the United States donee must treat the transfer as a purported gift or bequest from the partnership or foreign corporation that is subject to the rules of paragraph (a) of this section (including the exceptions in paragraphs (b) and (f) of this section). This paragraph (c) applies without regard to who is treated as the grantor of the trust (or portion thereof) under § 1.671-2(e)(4).

(2) Alternative rule. Except as provided in paragraph (c)(3) of this section, if the United States tax computed under the rules of paragraphs (a) and (c)(1) of this section does not exceed the United States tax that would be due if the United States donee treated the transfer as a distribution from the trust (or portion thereof), paragraph (c)(1) of this section does not apply and the United States donee must treat the transfer as a distribution from the trust (or portion thereof) that is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. For purposes of paragraph (f) of this section, the transfer is treated as a purported gift or bequest from the partnership or foreign corporation that made the gratuitous transfer to the trust (or portion thereof).

(3) Exception. Neither paragraph (c)(1) of this section nor paragraph (c)(2) of this section applies to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that the transfer represents an amount that is, or has been, taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation. A transfer will be deemed to be made first out of amounts that have not been taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation, unless the United States donee can demonstrate to the satisfaction of the Commissioner that another ordering rule is more appropriate.

(d) Definition of purported gift or bequest -- (1) In general. Subject to the provisions of paragraphs (d)(2) and (3) of this section, a purported gift or bequest for purposes of this section is any transfer of property by a partnership or foreign corporation other than a transfer for fair market value (within the meaning of § 1.671-2(e)(2)(ii)) to a person who is not a partner in the partnership or a shareholder of the foreign corporation (or to a person who is a partner in the partnership or a shareholder of a foreign corporation, if the amount transferred is inconsistent with the partner's interest in the partnership or the shareholder's interest in the corporation, as the case may be). For purposes of this section, the term property includes cash.

(2) Transfers for less than fair market value -- (i) Excess treated as purported gift or bequest. Except as provided in paragraph (d)(2)(ii) of this section, if a transfer described in paragraph (d)(1) of this section is for less than fair market value, the excess of the fair market value of the property transferred over the value of the property received, services rendered, or the right to use property is treated as a purported gift or bequest.

(ii) Exception for transfers to unrelated parties. No portion of a transfer described in paragraph (d)(1) of this section will be treated as a purported gift or bequest for purposes of this section if the United States donee can demonstrate to the satisfaction of the Commissioner that the United States donee is not related to a partner or shareholder of the transferor within the meaning of § 1.643(h)-1(e) or does not have another relationship with a partner or shareholder of the transferor that establishes a reasonable basis for concluding that the transferor would make a gratuitous transfer to the United States donee.

(e) Prohibition against affirmative use of recharacterization by taxpayers. A taxpayer may not use the rules of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance.

(f) Transfers not in excess of \$10,000. This section does not apply if, during the taxable year of the United States donee, the aggregate amount of purported gifts or bequests that is transferred to such United States donee directly or indirectly from all partnerships or foreign corporations that are related (within the meaning of section 643(i)) does not exceed \$10,000. The aggregate amount must include gifts or bequests from persons that the United States donee knows or has reason to know are related to the partnership or foreign corporation (within the meaning of section 643(i)).

(g) Examples. The following examples illustrate the rules of this section. In each example, the amount that is transferred exceeds \$10,000. The examples are as follows:

Example 1.

Distribution from foreign corporation. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer of property directly to A's daughter, B, who is a resident alien. Under paragraph (a)(2) of this section, B generally must treat the transfer as a dividend from FC to the extent of FC's earnings and profits and as an amount received in excess of basis thereafter. If FC is a passive foreign investment company, B must treat the amount received as a distribution under section 1291. B will be treated as having the same holding period as A. However, under paragraph (b)(1)(ii) of this section, if B can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B, **B may treat the transfer as a gift** (provided B timely complied with the reporting requirements of section 6039F, if applicable).

Example 2.

Distribution of corpus from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer to a foreign trust, FT, that has no other assets. FT immediately makes a gratuitous transfer in the same amount to **A's daughter, B, who is a resident alien**. Under paragraph (c)(1) of this

section, B must treat the transfer as a transfer from FC that is subject to the rules of paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, **B must treat the transfer as a dividend from FC unless** she can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer **as a distribution to himself and a subsequent gift to B and that B timely complied with the reporting requirements of section 6039F, if applicable**. The alternative rule in paragraph (c)(2) of this section would not apply as long as the United States tax computed under the rules of paragraph (a)(2) of this section is equal to or greater than the United States tax that would be due if the transfer were treated as a distribution from FT.

Editor's note: a resident alien is treated the same as a "US person" for US tax purposes. See person B in Example 2 above. It is not clear if the FT above is revocable by A, which should make the gratuitous transfer to B non-taxable. Irrevocable foreign trusts have always incurred taxes and surcharges, whereas revocable transfers are taxed differently. Review Rev-69-70. Not repealed at this writing. If FT is revocable by the foreign corporation owned by nonresident alien A, FT should be able to distribute to B without tax consequences.

Example 3.

Accumulation distribution from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien. FC is not a passive foreign investment company (as defined in section 1297). FC makes a gratuitous transfer of 100X to a foreign trust, FT, on January 1, 2001. FT has no other assets on January 1, 2001. Several years later, FT makes a gratuitous transfer of 1000X to A's daughter, B, who is a United States resident. Assume that the section 668 interest charge on accumulation distributions will apply if the transfer is treated as a distribution from FT. Under the alternative rule of paragraph (c)(2) of this section, B must treat the transfer as an accumulation distribution from FT, because the resulting United States tax liability is greater than the United States tax that would be due if the transfer were treated as a transfer from FC that is subject to the rules of paragraph (a) of this section.

Example 4.

Transfer from trust that is treated as owned by United States citizen. Assume the same facts as in Example 3, except that A is a United States citizen. Assume that A treats and reports the transfer to FT as a constructive distribution to himself, followed by a gratuitous transfer to FT, and that A is properly treated as the grantor of FT within the meaning of § 1.671-2(e). A is treated as the owner of FT under section 679 and, as required by section 671 and the regulations thereunder, A includes all of FT's items of income, deductions, and credit in computing his taxable income and credits. Neither paragraph (c)(1) nor paragraph (c)(2) of this section is applicable, because the exception in paragraph (c)(3) of this section applies.

Example 5.

Transfer for less than fair market value. FC is a foreign corporation that is wholly owned by A, a nonresident alien. On January 15, 2001, FC transfers property directly to A's daughter, B, a resident alien, in exchange for 90X. The Commissioner later determines that the fair market value of the property at the time of the transfer was 100X. Under paragraph (d)(2)(i) of this section, 10X will be treated as a purported gift to B on January 15, 2001. "

(h) Effective date. The rules of this section are generally applicable to any transfer after August 10, 1999, by a partnership or foreign corporation, or by a trust to which a partnership or foreign corporation makes a gratuitous transfer after August 10, 1999.

Annual Exclusion (annual gift giving)

A separate annual exclusion applies to each person to whom you make a gift. For 2002 and 2003, the annual exclusion is **\$11,000**. Therefore, you generally can give up to \$11,000 each to any number of people in 2002 and 2003 and none of the gifts will be taxable.

If you are married, both you and your spouse can separately give up to \$11,000 to the same person in 2002 or 2003 without making a taxable gift. If one of you gives more than \$11,000 to a person in 2002 or 2003, refer to gift splitting in Publication 950, Introduction to Estate and Gift Taxes.

§ 1.676(a)-1 Power to revest title to portion of trust property in grantor; general rule.

If a power to revest in the grantor title to any portion of a trust is exercisable by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party, the grantor is treated as the owner of that portion, except as provided in section 676(b) (relating to powers affecting beneficial enjoyment of income only after the expiration of certain periods of time). If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a nonadverse party, or both, the grantor is treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. See section 671 and §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.671-2 Applicable principles.

(4) If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust.

§ 1.672(b)-1 Nonadverse party.

International Taxpayer - Classification for U.S. Tax Purposes

The term "United States person" means:

- * A citizen or resident of the United States
- * A domestic partnership
- * A domestic corporation
- * **Any estate other than a foreign estate**
- * **Any trust if:**
 - * A court within the United States is able to exercise primary supervision over the administration of the trust, **and**
 - * One or more United States persons have the authority to control all substantial decisions of the trust

Foreign Persons

A foreign person includes:

- * Nonresident alien individual
- * **Foreign corporation**
- * Foreign partnership
- * Foreign trust
- * **A foreign estate**
- * Any other person that is not a U.S. person

Generally, the U.S. branch of a foreign corporation or partnership is treated as a foreign person.

Check-the-box Entities (See Form 8832 and Instructions)

For Federal tax purposes, certain business entities automatically are classified as corporations. Other business entities may choose how they are classified for Federal tax purposes. Except for a business entity automatically classified as a corporation, a business entity with at least two members can choose to be classified as either an association taxable as a corporation or a partnership, and a business entity with a single member can choose to be classified as either an association taxable as a corporation or disregarded as an entity separate from its owner.

Foreign Trusts, 1998

by Daniel S. Holik • IRS/US Treasury Department
writer (government stats.)

The Statistics of Income (SOI) study of 1998 foreign trust returns reflects both the substantial and increasing interest in foreign investment by U.S. taxpayers and the new information reporting requirements for foreign trust activity that were instituted by the Small Business Job Protection Act of 1996. For 1998, some 1,572 foreign “grantor” trusts reported \$339 million of net income, distributions of \$687 million, and **total assets of \$5,513 million.**

By comparison, for 1990, the last previous year for which extensive statistics were published, 291 foreign grantor trusts reported \$5 million of net income and total assets of \$154 million.

U.S. “persons” also transferred nearly \$852 million in assets to foreign trusts in 1998. Transfers to the British Virgin Islands, Bermuda, the Cook Islands, and the Isle of Man accounted for over 81 percent of the total transferred assets. **Finally, in transactions generally separate from foreign trust activity, U.S. persons received \$1,319 million of gifts or bequests from nonresident aliens, foreign estates, foreign corporations, and foreign partnerships during 1998.**

THR Editor’s note: The bolded statement above (in green) by IRS agent/writer Daniel S. Holik refers to a different type of “grantor trust” than the foreign grantor trusts with total assets of \$5,513 million (see red above). Note. Gifts or bequests from nonresident aliens are not taxable to the US beneficiaries.

The following statement was gleaned from the IRS's online website in December 2002. It was buried in a 14-page article....(Publication 1136) (Rev. 11-2001) Bulletin Fall, 2001.

"For 1998, some \$1,300 million were reported as gifts or bequests from nonresident alien individuals or foreign estates, while \$19 million were reported as gifts from foreign corporations or foreign partnerships." - IRS/Treasury Department (Foreign Trusts - by Daniel S. Holik).

Take note: US recipients of the above **Foreign Estates** investigated by IRS agent/writer Daniel S. Holik are required to report income distributions on distributions of **over \$100,000.**

Take note#2: Since only \$100,000 distributions were reported to the IRS, the “REAL” (i.e., actual) amount of trust distributions to US taxpayers is certainly 5 to 10 times greater than the \$1.3 billion reported (as much as **\$50 billion** or more is my estimate). **These are annual distributions, we are talking about.**

Take note#3: The corpus held in these foreign estates is more than likely 100 times (in size) the annual distribution numbers - or perhaps as much as **5 Trillion dollars**. (Our speculation - even the IRS does not know).

Are the kings of American industry avoiding the Federal Estate Tax? You can bet some of them are.

Want to know why and how the old monied Dupont Nemours and Roosevelt families were able to buy 4,000 acres of waterfront property on the island of Providencials in the tax free, crown colony (or "Overseas Territory") of the Turk and Caicos Islands for 1 cent an acre?

This 4,000 acre sale (now a marina and resort town - with an airport for jumbo jets (the \$50,000,000 airport was donated by the UK government) went down in the 1970's - not the 1870's!?!?)

Source: A Turks & Caicos Government 3 full-page advertisement in Investor's Daily (1985).

A New 8th edition of Tax Havens of the World (2003) (US\$90) is available now.

To order a copy, e-mail your name and address to us, and we will have our fulfillment people in New York send you this newer 2003 edition today – no waiting.

Send your check or MO afterwards.

The book is also available at Amazon.com and Barnes & Noble.

NEWSLETTER...Subscribers.

An e-version of our newsletter (*Tax Haven Reporter*) is available for \$200. Note: **The new book 8th edition/2003 is free with newsletter subscription. Just e-mail us your address.**

To subscribe to both the newsletter and the new 2003 *Tax Havens of the World*:

Send check or MO to *Tax Haven Reporter* • P.O. Box CB 11552 • Nassau, Bahamas • tele/fax 242-327-7359 • e-mail taxman@batelnet.bs. Subscription price is \$200 year (12 issues).

Foreign customers, please make payments with U.S. dollar drafts drawn against a U.S. bank, or International Postal Money orders, or currency. Copyright • 2003 *Tax Haven Reporter*. "All rights reserved."

Orders going outside the US, Canada or Mexico - add \$30 for global priority shipping of the book.

Thomas Azzara

New Providence Estate Planners, Ltd.

54 Sandypoint Drive

P.O. Box CB 11552

Nassau, Bahamas

Fax/phone: (242) 327-7359

e-mail: taxman@batelnet.bs

<http://www.bahamasbahamas.com/>

From: Top Offshore Banker (incorporated in 1984/brought public by Price Waterhouse)(domiciled in a no-tax haven 1,100 miles from Miami - an island Paradise)(the Government has accounts here too)(this bank is domiciled in a stable UK overseas tax haven - like Cayman and Bermuda and BVI).

Date: Monday, May 26, 2003 9:25:05 AM

To: Taxman in Nassau

Subject: Re: Fixed Deposits between 100,000 - 300,000 offer

Dear Sir,

TCD's 100,000-300,000 pay 4.25% for 1 year

5.00% for 2 years

We do not offer 4-month rollovers

3 months pay 4.25%

**VERY OLD UPDATE: Manhattan Prosecutor Criticizes Caymans Tax Pact
By DAVID CAY JOHNSTON - December 8, 2001 New York Times**

"Federal Reserve data show that \$800 billion is being held in Cayman Islands accounts for Americans, an amount equal to roughly one-third of all domestic bank deposits."

Robert M. Morgenthau, the Manhattan district attorney, is critical of the agreement that Treasury Secretary Paul H. O'Neill signed last week with the Cayman Islands to share information that would help the United States track down suspected income tax evaders, calling it "a sham."

Manhattan District Attorney Robert Morgenthau told senators recently that about \$800 billion in U.S. dollars is on deposit at some 600 banks licensed in the Cayman Islands -- more than twice the amount deposited in all New York City banks combined.