

Foreign Trusts: *Their Distinguishing Features and the Consequences of Their Use—An Update*

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I. WHAT MAKES A TRUST "FOREIGN"

A. Choice of Law; Points of Contact

1. Is the choice of the law of a jurisdiction which has no material connection with the trust effective?

The Uniform Trust Code ("UTC") which has already been enacted by 14 states and the District of Columbia empowers a settlor to select whatever law he wishes to govern the trust without requirement of any nexus with the jurisdiction whose law is chosen. See UTC § 107; compare with Restatement (Second) of Conflict of Laws § 270 which requires that the chosen law have a "substantial relation" to the trust. A settlor who chooses as the governing law of his trust a jurisdiction with which the trust has no nexus risks his home state or another jurisdiction where the trust is being administered asserting in personam jurisdiction over the trust and applying a law other than the chosen law. Cf. Nenko, *Relieving Your Situs Headache: Choosing and Rechoosing the Jurisdiction for a Trust* [40th Heckerling Institute on Estate Planning (2006)] at p. 3-18 ("A Home State court might be able to adjudicate a matter if it has personal jurisdiction over the trustee. One way that a client can avoid this pitfall is to use only trustees with little or no contact with the Home State.").

2. The difference between the law governing the essential validity of a trust and the law governing administration, interpretation and effect.

Issues of law which implicate the "essential validity" of a trust include by way of example compliance with the rule against perpetuities,

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compliance with the rule against unreasonable accumulations, compliance with rules designed to protect a spouse or dependents, compliance with rules pertinent to the reservation of excessive powers, and compliance with restraints placed upon the use of private purpose trusts. See Restatement (Second) of Conflict of Laws § 270, Comments on Clauses (a) and (b). Issues of trust administration include without limitation matters pertinent to the powers and duties of the trustee, the compensation of the trustee, the limitation of the trustee's liability, the removal of the trustee and the appointment of a successor and the terminability of a trust. See Restatement (Second) of Conflict of Laws § 271, Comment a. A settlor's failure to establish material nexus with the jurisdiction whose law is to govern an issue of "essential validity" risks having his trust held a nullity upon challenge.

B. Classification of a Trust as "Foreign" for U.S. Federal Income Tax Purposes.

1. The Rationale for the bias in favor of finding a "foreign" trust by application of *Treas. Reg. § 301.7701-7* rules.

The Small Business Job Protection Act of 1996 (the "1996 Act"), which brought clarity to the definitions of "domestic trust" and "foreign trust" for federal income tax purposes, had as its overarching goal the prevention of tax avoidance through the use of foreign trusts and the affirmative use of the "grantor trust" rules by the taxpayer. IRC §§ 7701(a)(30)(E) and (31)(B) as enacted created "...a strong statutory bias in favor of foreignness...Under this [new] test, a trust may be a foreign trust even if it was created by a U.S. person, all of its assets are located in the U.S. and all of its beneficiaries are U.S. persons. All it takes is one foreign person who has control over one "substantial" type of trust decision." McCaffrey, Harrison and Kirschner, *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their Beneficiaries* [Chapter 7 of A GUIDE TO INTERNATIONAL ESTATE PLANNING (ABA 2000)] at page 148. McCaffery, Harrison and Kirschner advise that ancillary but not merely incidental to improved enforcement, the Treasury Department hoped that, by tilting the definitions of foreign and domestic trusts so heavily in favor of a finding of "foreignness", it would improve the competitive position of U.S. financial institutions seeking trust business from NRAs who might hesitate to use a U.S. based trustee if they feared their trusts would have domestic status. *Id.*, fn. 8 at 149.

2. Just because a trust is "foreign" for federal income tax purposes does not mean that it is foreign for state income tax purposes nor does it mean that it is foreign for purposes of determining whether the US government may assert jurisdiction over the trustee in respect of the assets which it holds.

A state's determination whether to tax a trust as "resident" is not

necessarily determined by reference to federal income tax law. See, e.g., McCaffrey et al., *supra*, fn. 6 at 149 [comparison of New York and federal law].

A trustee organized and operating in the United States is subject to the powers of the US Departments of Treasury, of Justice and of Homeland Security and of other government agencies tasked with enforcing the International Emergency Economic Powers Act and the USA Patriot Act regardless of whether the trust which it administers is foreign for federal income tax purposes. An effort to put a domestic trust beyond the reach of U.S. authorities in certain circumstances by use of a "flee clause" will cause a trust which is otherwise "domestic" for federal income tax purpose to be treated as foreign (subject to only limited exceptions). See Treas. Reg. §301.7701-7(c)(4)(D)(ii).

II. WHAT INCENTIVE TO CREATE A FOREIGN TRUST?

A. A Non-Resident Alien Without U.S. Issue or Other Significant Connections to the U.S.

1. Convenience and familiarity with the laws of a jurisdiction closer to home.

An individual resident in a jurisdiction whose law permits the creation of trusts would logically opt for a trust created under the laws of and administered in his own home jurisdiction or for a trust created under the laws of and administered in a jurisdiction whose trust laws in form and substance more closely resemble those of his own place of residence or nationality (e.g. the expatriate citizen of the U.K., Canada or Australia might better understand and prefer a Bermuda or Jersey trust).

2. Concern for U.S. taxation upon accumulations by a non grantor trust at a rate which in respect of ordinary income matches the highest rate imposed on a U.S. individual (viz. 35% at present).

Note, however, that a domestic non-grantor trust (a) may make distributions of current trust income (i.e., "distributable net income") having a foreign source to a non-resident alien ("NRA") beneficiary without obligation to withhold federal income tax on such distribution notwithstanding that such distribution is deductible by the trust for purposes of calculating its own taxable income and (b) may make distributions in kind of appreciated assets (including securities issued by U.S. persons) to NRA beneficiaries without adverse tax consequences (subject to an exception for "U.S. Real Property Interests").

3. The unanticipated incapacity of a foreign grantor and the consequence for trust classification.

The requirement that a NRA grantor (or his conservator) retain the power to revest trust property in the grantor even during a period when the NRA grantor is incapacitated if "grantor trust" status" is to be preserved can be a trap for the unwary (who are unfamiliar with the rule) and a "Hobson's choice" for those who are (which is worse: loss of "grantor trust" status or ceding of "unrestricted" control to a conservator who may alter the grantor's estate plan). See Treas. Reg. § 1.672(f)-3(a)(1).

4. A desire to avoid the submission of foreign operating company assets to the jurisdiction of the U.S. courts and to the enforcement powers of the executive branch of government in matters of economic and foreign policy.

See I.B.2, *supra*.

B. Non-Resident Alien Migrating to the United States on a Temporary Basis.

1. A fully revocable foreign grantor trust will not cease to be a grantor trust by reason of the grantor's acquisition of U.S. residence, but substantial disclosure will be required by *IRC § 6048* upon acquisition of U.S. residence by the grantor.

2. For long term planning purposes, the temporary migrant to the United States may prefer not to have a trust which will be a domestic trust at such time at his control terminates. *See II. A. 2 supra*.

3. Funding by a prospective migrant to the United States of an irrevocable foreign trust for the benefit of persons, some of whom have acquired or might be expected to acquire U.S. status, is highly inadvisable unless it is done 5 years in advance of immigration (*See IRC § 679*), and even with advance planning which avoids future tax on the grantor with respect to trust income, a foreign irrevocable trust may be problematic for U.S. beneficiaries.

C. U.S. Citizen or Long-Term Resident.

1. In select circumstances a very high net worth individual seeking a specialized offshore insurance policy (in order to avoid high state premiums, so called DAC taxes and restrictive insurance regulations governing the investment of the separate account for a variable universal life policy) may opt for a foreign trust in order avoid restrictions placed upon the sale of offshore insurance policies to U.S. residents.

2. A foreign trust will offer more certain "asset protection" than a domestic trust sited in a jurisdiction such as Alaska, Delaware, Nevada, Rhode Island or South Dakota, but significant caveats exist for those contemplating offshore asset protection trust planning

including violation of fraudulent transfer laws even in the selected offshore jurisdiction, severe penalties for noncompliance with tax reporting requirements, a refusal by the domestic judiciary to recognize the transfer where the "protected" asset remains within reach of a domestic court and the possibility of incarceration to encourage cooperation in the unwinding of the offshore trust arrangement.

III. BEWARE THE ASSUMPTION ALL TRUST LAW IS ESSENTIALLY THE SAME

A. English trust law and the trust laws of the fifty American states diverge materially.

The practitioner, who uses a California or New York form of trust agreement and simply fills in a choice of foreign law, acts at his or her peril.

B. Beneficiary Access to Trust Property.

1. English courts, by reason of the rule established by *Saunders v. Vautier*, have been much more willing than most American courts to entertain petitions for the variation or termination of a trust provided all beneficiaries are either capable adults or are adequately represented for the purpose of the variation. See generally HUDSON, UNDERSTANDING EQUITY & TRUSTS at pages 54-55 (2nd Edition 2004)

2. Courts in most American states, encumbered by the American *Clafin* Doctrine, continue to adhere to the proposition that the settlor's wishes should be given primacy; if one is preparing a foreign trust deed, careful drafting may curtail the scope for variation allowed by the law of jurisdictions influenced by England.

C. The Effect of Reserved Powers.

1. For sixty-five years American judicial doctrine and, with increasing clarity, the American Restatement of the Law of Trusts have adhered to the principle that substantial reservations of power by a trust grantor do not merit treating the trust as a mere agency which violates the Statute of Wills. See Restatement (Third) of Trusts §25, Reporter's Notes on §25, Comment b [highly critical of the distinction drawn by some English jurists between "trusts" and "mere agencies"].

2. Although opinion remains divided on the issue in England and in jurisdictions influenced by the law of England, there have been some recently decided cases which lend support to the proposition that an excessive reservation of power by the settlor may transmute a trust to a mere agency. See WADHAM, WILLOUGBY'S MISPLACED TRUST, Chap. 1 Trusts in Sham Transactions (2nd Edition 2002).

3. Enabling legislation has been adopted in several tax favored jurisdictions in order to circumvent a determination that a trust is a sham (or “mere agency”) by reason of an excessive reservation of powers by the settlor. See, e.g. Cayman Islands Trusts (Amendment) (Immediate Effect and Reserved Powers) Law 1998.

D. Accountings and Indemnification.

1. Judicial settlement of trust accounts is not widely available for trusts administered outside of the United States; and there is accordingly a materially greater reliance by trustees outside the United States upon indemnification provisions which, without benefit of this understanding, appear excessive by American standards.

2. A further reason for the lesser concern of American trustees for indemnification is found in § 7-306 Uniform Probate Code which has been adopted by at least 17 of the American states (and in respect of which comparable provision can be found in the laws of other states which have not adopted the UPC). § 7-306 of the UPC (a) relieves a trustee of liability in respect of contracts entered into by the trustee in its fiduciary capacity provided it has disclosed its status and (b) relieves the trustee of liability for torts committed in the course of trust administration unless the trustee is personally at fault.

3. Commentators have expressed the view (not uniformly complimentary) that this evolution in American trust law has had the general effect of rendering the trust estate a “quasi corporation” regarding liability to third party creditors. See, e.g., Curtis, *The Transmogrification of the American Trust*, 31 Real Prop. Prob. & Tr. J. 251, fn. 105 at 279 (1996). Curtis observes that the law in England is less solicitous of the interests of trustees and more concerned for the welfare of beneficiaries. *Id.*, 251 at 277. (“In England, trustees are personally liable for torts they or their agents commit while administering the trust, although, if the trustees have not exceeded their powers and have acted diligently and reasonably, they are often entitled to indemnification from the trust assets.”).

E. Trustee Exculpation for Negligence.

1. There is a mix of views in England and in jurisdictions influenced by English law regarding the extent of which a trustee, particularly a professional trustee, may be effectively exculpated for its own negligence by the terms of a trust agreement. The case of *Armitage v. Nurse* [1998] Ch. 241 holds that a clause in a trust instrument governed by English law which excludes a trustee’s personal liability is valid even when it purports to excuse gross negligence.

2. A view preferred by reformers is that a trustee may attain exculpation in respect of ordinary negligence if the trust agreement so provides, but that it may not contract to be relieved from the

consequences of gross negligence. Cf., Trusts (Jersey) Law 1984, §26(9), as amended, which provides that an exoneration clause may not excuse a trustee who is guilty of "gross negligence".

F. Letters of Wishes.

1. English practice (unlike American practice) tends to favor trust deeds granting broad discretions to a trustee which are circumscribed by "letters of wishes" (which are only vaguely analogous to the personal property memorandum favored in some American jurisdictions for the purpose of giving guidance to an executor in respect of tangibles). See generally, Hayton, *Letters of Wishes and Protectors as Devices to Further the Settlor's Purposes*, [Chapter 14 of A GUIDE TO INTERNATIONAL ESTATE PLANNING (ABA 2000)] at pages 601 et seq.
2. The American practitioner will readily apprehend the difference between a legally binding letter of wishes (which is uncommon) and a "morally binding" letter of wishes (which is equally uncommon), but it is a considerable challenge for him or her to grasp the import of a "legally significant" letter of wishes which by its express terms typically states that it is not intended to be legally binding.
3. A leading American practitioner has recently had published an article which urges the use of letters of wishes by American estate planners in order to offer to the trustee a reasonable sense of the settlor's state of mind and his or her purposes when establishing a discretionary trust. See Bove, *Letters of Wishes*, 145 *Trusts & Estates* 46 (January 2006). One may agree entirely with Bove's contention that it is wrong for a drafting attorney to draft a discretionary trust which offers no real guidance to the trustees regarding the exercise of their discretion with respect to trust beneficiaries but at the same time question whether it is not better to include such guidance in the body of the trust instrument itself rather than in a side letter.

G. Spendthrift Provisions.

1. English and American trust law both permit a settlor to provide in a trust limitations intended to protect the beneficiary (other than the settlor) from the consequences of his own profligacy, but English trust law, unlike American trust law, does not permit a constraint upon a beneficiary's power to alienate his interest, and as noted *supra* at III.B.1 English trust law is much more accommodating than American trust law of beneficiary endeavors to alter terms prescribed by the settlor.
2. Spendthrift protection may be accomplished in English influenced jurisdictions through the medium of a lapse clause which converts a potentially saleable vested interest to an entirely discretionary interest upon the occurrence of certain events. See HAYTON, THE LAW OF

TRUSTS at pages 56-57 (4th Edition 2003).

H. Self Settled Trusts.

1. Numerous jurisdictions of convenience have adopted debtor friendly laws for the purpose of encouraging trust business. Substantial differences exist regarding the length of time within which an irrevocable gratuitous transfer must occur in order to avoid being unwound pursuant to restrictions on fraudulent transfer.

2. A key element of effective asset protection planning is the right of a settlor to include himself as a discretionary beneficiary of his own irrevocable trust without causing the trustee to be subject to court order to exercise maximum discretion in favor of the settlor for the purpose of permitting his creditors to satisfy their claims.

3. Several U.S. jurisdictions have endeavored, with varying degrees of aggressiveness, to enable the use of self-settled trusts which, after a waiting period (more lengthy than that found in most offshore jurisdictions), permit trust assets to fall beyond the reach of the settlor's creditors notwithstanding that the settlor is himself named as an eligible discretionary beneficiary. See, e.g., the laws of Alaska, Delaware, Nevada, South Dakota and Rhode Island.

I. The Rule Against Perpetuities.

1. American states, motivated to encourage trust business premised upon maximizing the benefit of the generation skipping transfer tax exemption, have been more aggressive than foreign jurisdictions of convenience influenced by English law in respect of the repeal of the rule against perpetuities.

2. As of the current date, at least eighteen American jurisdictions have abolished the perpetuities rule altogether while many English influenced jurisdictions of convenience such as the Bahamas, Bermuda and the British Virgin Islands have been satisfied simply to stretch out the permissible perpetuities period well beyond their traditional "lives in being plus 21 years". By contrast the Cayman Islands permits a circumvention of the rule against perpetuities if a settlor opts for a private "purpose trust" created pursuant to the Special Trusts (Alternative Regime) Law 1997; and respected commentators advise that because the English common law of trusts has never been adopted by Jersey, Channel Islands, it is possible for the assets of a trust which in that jurisdiction may not last longer than 100 years to be appointed to a new further trust in advance of the termination of the original trust without violating a rule against remoteness of vesting. See SNOWDEN & MATTHEWS, THE JERSEY LAW OF TRUSTS (3rd Edition 1993) ¶¶15.4 thru 15.9.

3. It is the abolition of the rule against perpetuities which has enabled

the much marketed dynasty trust. Substantial care needs to be taken in the drafting of such trusts to avoid creation of an endless trust regime over which successive generations of beneficiaries may exercise little or no control absent court intervention.

4. Care must also be taken in the granting of limited powers of appointment to intermediate generation beneficiaries not to trip over the prohibitions of IRC § 2514 in respect of the creation of further powers of appointment or to create a general power by enabling the discharge of support obligations in respect of minor children or children suffering from a disability.

J. No Contest Clauses.

1. "No contest" clauses are not commonly found in trust instruments prepared under the law of England or a jurisdiction influenced by the law of England. Until recently some practitioners skilled in English law would opine that on the basis of certain very aged judicial precedents, a forfeiture provision designed to discourage attacks by disappointed heirs should be enforceable, while other practitioners would argue that a settlor's effort to oust the jurisdiction of a court to determine issues such as duress and undue influence can not be given force and effect.

2. Note must now be taken of dicta in *Nathan v. Leonard & ors*, 2002 WL 820080, [2003] 1 W.L.R. 827, a Chancery Division case in which John Martin QC (sitting as Deputy Judge of the High Court) gives a vigorous defense of "no contest" clauses under English law and cites for support *Evanturel v. Evanturel* (1874) LR6PC1, a decision approved by the Privy Council. Deputy Judge Martin goes so far as to assert in his dicta that a "no contest" clause might be upheld as a matter of English law even if the contesting beneficiary prevails on the merits unless, as a result of the challenge, the whole of the trust or will is set aside. Compare Delaware law which provides that a forfeiture clause shall have no application to any action in which the beneficiary is determined by the court to have prevailed substantially. 12 Del. C. §3329(b)(2).

3. Widely varying views in respect of the enforceability of no contest clauses may be found among the 50 American states, California until recently being one of the strongest proponents of the upholding the clauses, and Florida taking the opposite position that such clauses are void and of no effect. California's legislature is now studying a proposal which, if adopted, would substantially repeal California's statute law upholding forfeiture provisions designed to discourage challenges to wills and trusts.

K. Power to Select Law Governing Essential Validity.

1. New York pioneered legislation which allows a testator or trust settlor to choose the law of New York for the determination of the

essential validity of a gratuitous transfer in lieu of the law of such person's own domicile. See Note, *Avoiding Civil Law Forced Heirship by Stipulating that New York Law Governs*, 20 Va. J. Int'l L. 887 (1980)

2. In the mid-1980's the Cayman Islands, borrowing from the philosophy of New York's law, enacted a provision permitting the ouster of the law of a settlor's domicile in favor of local Cayman law, principally for the purpose of enabling individuals domiciled in civil law jurisdictions having forced heirship rules to achieve full freedom of testamentary transfer.

3. Most tax favored jurisdictions and some American states have followed the leads of New York and of the Cayman Islands, but care should be taken to distinguish between such jurisdictions and jurisdictions which allow the selection of law which will govern only the interpretation and effect (as opposed to the essential validity) of a trust instrument.

L. Private Family Trust Companies.

1. Numerous tax favored jurisdictions permit limited purpose licensing of private trust companies in order to enable families of great wealth to create and control their own corporate fiduciaries.

2. The states of Delaware, South Dakota and Wyoming are among those cited as having laws favorable to the creation of private family trust companies within the United States.

3. Private family trust companies may be particularly suitable where it is intended that a family trust concentrate investment substantially or even exclusively in a closely held family business which pays limited or no dividends and which will typically represent an excessive focus of investment in a single enterprise operating within a single segment of the economy. See Armstrong, *The Private Trust Company: Can It Reconcile the Competing Imperatives of the Prudent Investor Rule and the Settlor's Direction To Retain* [STEP, San Francisco Branch, 1.17.2006].

4. A special challenge associated with private family trust companies is the determination of who should hold the shares of the private family trust company; some jurisdictions of convenience have created the concept of the "purpose trust" to address the share ownership problem; other jurisdictions are enabling private purpose companies which have no authority to issue shares.

IV. COMMON TRUST DRAFTING CONCERNS IN AN UNCERTAIN WORLD.

A. What if the grantor or a person in possession of a power of appointment becomes subject to duress.

1. Unfortunately, in some parts of the world, kidnapping has become a cottage industry and in the same or other parts of the world incarceration by government may occur suddenly and without due process - - what is a trustee to do if it receives instructions from a power holder who it knows or suspects is under duress?

2. *FTC v. Affordable Media, LLC, et al*, 179 F 3d 1228 (9th Cir 1999) has frequently been cited in conjunction with discussions of offshore asset protection trusts, but the *Affordable Media* case history, which recites the fact that two rather unsympathetic individuals were held in federal prison in Nevada for several months by reason of having caused their Cook Islands Trust to be rendered irrevocable and beyond the reach of the Federal Trade Commission, suggests a caveat for drafters who include duress clauses in trust agreements: consider carefully the consequences of achieving what you wish for.

B. Political Turmoil in the Jurisdiction of Trust Administration.

1. An early and famous example of the use of a flee clause to preserve assets in the event of war or insurrection was the so-called "U.S. Philips Trust", a brilliant scheme devised immediately in advance of the German occupation of the Netherlands during the Second World War, the purpose of which was to sever Western Hemisphere assets of N.V. Philip's Gloelampen-Fabrieken from the parent company in the Netherlands and to cause them to be held on a temporary basis by the Hartford National Bank and Trust Company (Connecticut U.S.A.).

2. In the early 1970's, at a time when the cold war was still at its height, the fear that certain jurisdictions of convenience deemed suitable for offshore trust administration might turn upon and confiscate locally administered trusts in the event of Cuban style revolution caused it to become common place to include in offshore trust agreements a provision that a corporate fiduciary would be automatically replaced by another corporate fiduciary (typically affiliated) in a different, more secure jurisdiction upon the declaration of an "emergency event".

3. Rarely would it be explained to American drafters of offshore trusts that traditional English style trust provisions for indemnification of a former trustee could subvert the intended effect of a flee clause absent negotiated limitations upon trustee indemnification in the event of the termination of a trusteeship by reason of an emergency event.

4. The U.S. Congress and the Treasury Department, anticipating that flee clauses aimed at dealing with revolution in a jurisdiction of convenience might as easily be used to slip assets beyond the jurisdiction of the United States in the face of government claims, have provided in final regulations defining domestic and foreign trusts that the inclusion of certain species of flee clauses in a trust instrument will cause a trust, otherwise qualified as a domestic trust, to be treated as a foreign trust (with all of the attendant problems of IRC § 6048 reporting and of the punitive provisions applicable to distributions to US beneficiaries of trust income which has acquired the status of “undistributed net income”).

C. Confidentiality.

1. A settlor will frequently express the desire to screen beneficiaries, particularly young and financially immature beneficiaries, from information regarding trust accounts both to prevent unwanted dissemination of family financial information to third parties and to obviate the disincentive to work which might be created by acquainting a young family member with the dimensions of his parents’ or grandparents’ wealth.

2. English commentators have properly noted that non-disclosure of trust accounting information to beneficiaries precludes them from enforcing their rights as beneficiaries and that limitations upon disclosure are inconsistent with the core notion of a trust in consequence of which such limitations should not be enforced by a court. See, e.g., WADHAM, *supra*, Chap. 12 Attempts by Beneficiaries to Obtain Documents or Information.

3. Modern American trust law is similarly hostile to unreasonable limitations upon the dissemination of accounting information to trust beneficiaries. Of particular note is the controversy which has attended §§ 105(b)(8) and (b)(9) of the UTC which mandate that it is a trustee’s duty to notify qualified beneficiaries of an irrevocable trust who have attained the age of twenty-five years of the existence of the trust, of the identity of the trustee, and of their right to request trustee’s reports. According to commentary, “[t]hese subsections have generated more discussion in jurisdictions considering enactment of the UTC than have any other provisions of the Code. A majority of the enacting jurisdictions have modified these provisions, but not in a consistent way.” O’Brien, *The Trustee’s Duty To Provide Information To Beneficiaries: When Can the Settlor Say “Don’t Ask, Won’t Tell”?* [40th Heckerling Institute on Estate Planning (2006)] fn. 9 at p. 4-2.

4. Trust settlors, who might heretofore have regarded a foreign trust as an optimum means for shielding assets from the eyes of his own government, need to carefully consider that under three pronged pressure from the OECD, the European Union and the U.S. Treasury

Department, reputable jurisdictions of convenience throughout the world are being forced to fall in line with mandates which require financial institutions and professional advisors to "know their clients" and, in appropriate circumstances, to disclose to government authorities "suspicious transactions".

5. "Money laundering", which is the focus of government insistence on "transparency" in jurisdictions of convenience, has been redefined and depending upon the specific circumstances may be determined to include fiscal evasion. Cf., Christensen and Pieroni, *Initiatives Against Money Laundering of Importance to Estate Planners*, Estate Planning Journal (2006).

V. THE U.S. TAX CONSEQUENCES OF A FOREIGN TRUST.

A. Transfers by a U.S. Grantor to a Foreign Trust.

1. Substantial and timely disclosure of contributions by a U.S. grantor to a foreign trust is now required to be made on IRS Form 3520 pursuant to the provisions of *IRC § 6048 and IRS Notice 97-34*.
2. The penalties for non-compliance with information reporting are positively draconian - - pursuant to the provisions of *IRC § 6677* a penalty is levied upon an unreported contribution to a foreign trust in an amount equal to 35% of the gross value of the amount transferred.
3. Anti-abuse provisions added to *IRC § 679* target attempts to avoid through the use of putative loans, the consequences of grantor trust treatment for a foreign trust funded by a U.S. person for the benefit of U.S. persons.

B. Foreign Trust Distributions to U.S. Persons Who Are Not the Grantor.

1. The burden is on the U.S. beneficiary to report and to prove to the satisfaction of the Internal Revenue Service a claim that either the distribution he or she has received from a foreign trust is a non-taxable distribution from a qualifying grantor trust or that the distribution from a non-grantor foreign trust consists exclusively of the current year's DNI which is not subject to the interest surcharge of *IRC § 668*.
2. The DNI of a foreign trust, unlike the DNI of a domestic trust, includes capital profit.
3. The *IRC § 668* surcharge levied in respect of a distribution from a foreign trust to a U.S. beneficiary which is deemed derived from undistributed net income ("UNI") is now an adjustable rate interest charge on deferred tax, the calculation of which is exceedingly complex on account of the fact that distributions of UNI are no longer

deemed to occur on a "first in first out" basis for purposes of *IRC § 668*.

4. An attempt by a U.S. beneficiary to circumvent the consequences of the *IRC § 668* surcharge in respect of UNI, by taking a putative loan from a foreign trust or receiving a distribution through a foreign intermediary beneficiary of convenience, is now rendered at best problematic and in all likelihood impossible by amendments to *IRC § 643*. See Treas. Reg. § 1.643(h)-1 [Distributions by certain foreign trusts through intermediaries].

5. Although Congress has, for the time being, determined not to provide by statute for imputation of income to the beneficiary of a foreign trust who makes use of trust property (other than cash) without paying fair rent for such usage, the matter remains under study.

VI. IS OFFSHORE LIFE INSURANCE A VIABLE ALTERNATIVE TO A FOREIGN TRUST.

A. Although there are some arguable overlaps between a trust and a variable universal life insurance policy, a trust and life insurance are as different as "apples and oranges".

B. From a U.S. perspective, an offshore life insurance policy which is "U.S. compliant" for purposes of *IRC § 7702* does not enjoy federal tax benefits which are materially different from those associated with an onshore life insurance product.

1. The motivating factors for purchase of an offshore product include avoidance of state premiums, avoidance of the 1% to 1.5% so-called DAC tax levied by a domestic insurance carrier and the avoidance of state insurance regulations which bar access to certain aggressive investments sought for the separate accounts of variable universal life policies by certain high net worth individuals.

2. If an offshore carrier through mismanagement of a life insurance policy causes it to fall out of compliance with *IRC § 7702*, the consequences for a U.S. policyholder are extremely harsh - - *IRC § 7702*, borrowing from the philosophy of foreign personal holding company income imputation, forces ordinary income recognition on an annual basis of accretions in cash surrender value.

C. It is conceptually possible for a non-U.S. person to create a tax free source of income for a U.S. child or remoter issue through the use of a carefully constructed variable universal life policy, which mimics what might formally have been achieved through the use of a grantor trust pre-August 20, 1996 under the old Rev. Rul. 69-70 doctrine, but such a plan does require the purchase of a significant amount of insurance, the premiums paid in respect of the policy cannot be too heavily front loaded and excessive

withdrawal or borrowing may jeopardize the continued compliance of the policy with provisions of *IRC § 7702*.

D. Refinements by the Internal Revenue Service to the rule requiring diversification of investment in order for a policy to be *IRC § 7702* qualified and its confirmation that if a policy holder is capable of directly or indirectly controlling the investments around which insurance is wrapped, the policy holder rather than the issuer will be taxed on the proceeds have made variable universal life insurance a less flexible estate planning product. See Rev. Rul. 2003-91, 2003-2 CB 347 (Holder of variable contract won't be considered owner of assets that fund contract so that interest, dividends and other income derived from assets aren't included in the policy holder's gross income *so long as* such holder can not select or direct particular investment to be made by separate account or sub-account, can not sell, buy or exchange assets held in account or sub-account, and has no involvement in investment decisions) and Rev. Rul. 2003-92, 2003-2 CB 350 (Holder of variable life insurance contract will be considered owner of partnership interests that fund contract *if* partnership interests are available for purchase by the general public).

E. Some commentators have correctly observed that a U.S. person investing in an offshore insurance policy is not required to make reports comparable to those associated with the funding of a foreign trust or the maintenance of a foreign bank or brokerage account, but in reality, offshore insurance policies are of interest only to select group of very high net worth individuals and the attraction is not premised upon any material differences in federal income tax treatment between such policies and comparable domestic policies.

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This article should not be construed as legal advice, since legal opinions are only given to clients in response to inquiries involving specific facts.