Foreign Situs Trusts

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I. INTRODUCTION

With the passage of the Tax Reform Act of 1976,[1] Congress completed the most comprehensive and far reaching revision of the Tax Code since 1969. Taxation of certain international transactions received particular attention in the Act, especially those implicated in the Congressional attempt to regulate tax avoidance schemes. One of the most pervasive, or at least one of the most attractive, of such tax avoidance schemes had been the use of the foreign situs trust.

It is difficult to ascertain just how extensively foreign trusts have been employed in the past.[2] On one hand, it is easy to succumb to the suspicion that foreign trusts have been more

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1. The Tax Reform Act of 1976 [hereinafter cited as the Act or the 1976 Tax Reform Act] was passed by Congress and was signed by the President on October 4, 1976, as Pub. L. No. 94-455. Citations to the INTERNAL REVENUE CODE OF 1954 [hereinafter cited as INT. REV. CODE OF 1954 and referred to as the Code] are to the version in force immediately prior to the enactment of the 1976 Tax Reform Act, unless otherwise noted.

2. Prior to the 1976 Tax Reform Act, there had never been any periodic reporting requirements which would have enabled the Treasury Department to compile statistics regarding the year-to-year operation of foreign trusts after their establishment by U.S. citizens. The first of any foreign trust reporting provisions, in fact, was passed by Congress in the Revenue Act of 1962, which simply required that, upon the creation of, or the transfer of property to, a foreign trust, the grantor or transferor file such forms as the Secretary might prescribe. INT. REV. CODE OF 1954, § 6048. Apparently, from 1962 until December 31, 1973, a total of 1391 of the prescribed returns, Form 3520, were filed with the Service. *Shop Talk*, 42 J. TAX. 63 (1975). While these figures are perhaps the best indication of the numbers of foreign trusts which have been created, they are only approximate.

Comparable figures for the period prior to 1962 simply do not exist, and it is necessary to rely on the opinions of practitioners whose impressions have appeared in print. Several, in the early 1960s, referred to the increasing popularity of foreign situs trusts at that time. *E.g.*, Altman & Kanter, *Current Tax Planning Through Foreign Situs Trusts*, 47 A.B.A.J. 635 (1961); Hammerman, *Foreign Situs Trusts—Defining the Undefined*, 38 TAXES 529 (1960). Another wrote that, until 1960, not one trust had been created by a U.S. grantor for U.S. beneficiaries in either the Bahamas or Bermuda, two of the most obvious tax havens. Fine, *Amazing Tax Advantages of Foreign Trusts for United States Individuals*, TENTH ANNUAL TULANE TAX INSTITUTE 163 (1961). Perhaps the more realistic approach is to recognize that foreign trusts remained unfamiliar to all but a highly sophisticated circle of attorneys and that the frequency of their use was limited accordingly.

a subject of scholarly commentary than a widespread element of actual tax planning.[3] Certainly the costs of creating and administering such a device must render it inexpedient for all but the very wealthy.[4] Lending credence to this notion is the fact that the anticipated revenue effects of proposals designed to curtail the use of foreign trusts have always been insignificant.[5] On the other hand, the Treasury Department has consistently urged Congress to adopt measures discouraging the use of foreign trusts, arguing that they provided a vehicle which permitted a number of wealthy Americans to defer, or even avoid, their tax obligations.[6] A similar concern has been expressed from other quarters as well. Testifying before the 1974 House Ways and Means Committee on the Tax Reform Act,

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3. *See* Zimmerman, *Foreign Trusts: Their Present and Future Estate Planning Potential*, 31 J. TAX. 258, 260 (1969), which implies that it was this mushrooming publicity about foreign trusts, rather than the reality of their abuse, which in the past led the Treasury Department to seek reforms limiting their use.

4. It has also been suggested that even the very wealthy may shy away from foreign trusts, at least those established in Bermuda, the Bahamas, etc., either because of the stigma of "tax dodging" associated with these localities, Comment, *Foreign Situs Trusts: The Option of Utilizing a High Taxation Jurisdiction*, 52 TEX. L. REV. 949 (1974), or because of a "fear of persecution" by the Internal Revenue Service, Grundy, *The Off-shore Trust*, 1971 BRITISH TAX REV. 336, 338 n.8.

5. *E.g.*, Congress has estimated that the grantor trust rules of the 1976 Tax Reform Act, arguably the most stringent tax imposed on foreign trusts, will increase federal revenues only by 10 million dollars annually. H.R. REP. No. 94-658, 94th Cong., 1st Sess. 20 (1975) [hereinafter cited as H.R. REP. No. 94-658]; S. REP. No. 94-938, 94th Cong., 2d Sess. 25 (1976) [hereinafter cited as S. REP. No. 94-938].

6. William E. Simon, former Secretary of the Treasury, testified in a statement prepared for the Senate hearings on the 1976 Tax Reform Act that, "[t]he House Bill would end the tax loophole whereby many wealthy individuals avoid U.S. tax through the creation of foreign trusts." *Hearings on H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 97 (1976).

An even better indication of the attitude of the Treasury Department towards foreign trusts is provided by a letter from Mr. Fred Hickman, Assistant Secretary of the Treasury for Tax Policy, to Representative Vanik of the House Ways and Means Committee. Mr. Hickman stated: "You asked whether the use of foreign trusts by Americans constitutes a serious problem of tax avoidance. Although the seriousness of the problem is debatable, it seems likely that in most cases the primary reason why an American would choose to use a foreign trust rather than a domestic trust is to reduce or defer U.S. taxes." *Shop Talk*, 42 J. TAX. 63 (1975).

Finally, several courts have rather cryptically referred to Project Haven, a grand jury investigation into the use of foreign trusts, with respect to which the "morally dubious tactics" of the Internal Revenue Service have been challenged on Constitutional grounds. *See* United States v. Baskes, CCH 1977 STAND. FED. TAX REP., U.S. TAX CAS. (77-1, at 86,963) ¶ 9393 (N.D. Ill. March 23, 1977); United States v. Matthiessen, CCH 1977 STAND. FED. TAX REP., U.S. TAX CAS. (77-1, at 86, 792) ¶ 9351 (C.D. Cal. Feb. 11, 1977).

one practitioner characterized foreign trusts as "among the most flagrant types of tax abuse that the Committee should be concerned with in the foreign area."[7]

In several instances foreign trusts were designed strictly to allow beneficiaries or grantors to completely avoid taxation. For example, a foreign trust would be established in a country with little or no income tax. Money from the trust would then be deposited in a foreign bank with a branch office in the United States. The U.S. beneficiary of the trust would then apply to the American branch of the foreign bank for a loan in the same amount as that deposited in the main office. Collateral for the loan would be the money on deposit in the main office. The U.S. beneficiary would then have free use of what would ordinarily be taxable income, with the added benefit of a tax deduction for the interest on the loan. As can be seen, it was possible to establish a foreign trust the income of which could be accumulated and eventually distributed to U.S. beneficiaries without subjecting either the trust or its beneficiaries to an income tax at any time, anywhere in the world.[8] Although periodic Congressional efforts at reform succeeded in subduing some of the most flagrant abuses, those efforts failed to eliminate the lucrative opportunities for tax deferral provided by foreign trusts.

Congress may have accomplished its goal in the Tax Reform Act of 1976. The reforms in the Act directed towards foreign trusts approach the problem in three significant ways. First, the Act broadens the scope of the excise tax provisions to include appreciated property of whatever nature and increases the rate applicable to such transfers to equal the maximum capital gains rate. Second, and perhaps most importantly, a new section has been added that treats income earned by a foreign trust with one or more U.S. beneficiaries as if it were still owned by those persons who transferred property to the trust. Third, the Act modifies the so-called throwback rules, principally by adding an interest charge to the distributions of foreign trusts. This, then, gives domestic trusts more favorable treatment than foreign situs trusts.

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7. *Hearings on Tax Reform Before the House Comm. on Ways and Means*, 94th Cong., 1st Sess. 1934 (1975).

8. H.R. REP. No. 1447, 87th Cong., 2d Sess. 38 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 50-51 (1962).

This paper seeks to describe the provisions of the 1976 Tax Reform Act which alter the tax treatment of foreign trusts and to appraise their effectiveness in light of stated Congressional goals. To place these provisions in their proper context, the paper will first trace legislation designed to accomplish these ends.

II. ATTRIBUTES OF THE FOREIGN TRUST

For a considerable period of time, foreign trusts gained increasing popularity in spite of the dangers created by the failure of Congress, the Treasury Department, and the courts to identify precisely which criteria characterized a trust as a foreign entity.[9] It has always been unquestionably clear that a trust established by a foreign settlor and administered by a foreign trustee for the benefit of foreign beneficiaries qualifies as a foreign trust.[10] However, considerable difficulty arose once the trust began to acquire limited contacts with the United States.

In the face of this uncertainty, commentators reached a general consensus that a trust created in a foreign jurisdiction and administered there by a foreign trustee would be treated as a foreign trust for federal tax purposes.[11] Of critical importance was the fact that the fiduciary was a nonresident alien and that the trust was created under the law of a foreign jurisdiction. While some weight might be given to the place of administration and the location of the trust *res*, these factors were not

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9. *See generally* Altman & Kanter, *Current Tax Planning*, *supra* note 2, at 635; Hammerman, *Foreign Situs Trusts*, *supra* note 2, at 533-42; Hammerman, *IRS Clarifies Foreign Situs Trusts as Bill to End Some Tax Benefits Dies*, 13 J. TAX. 199 (1960); Tovey, *Structure and Tax Advantages of Foreign Situs Trusts*, 49 GEO. L.J. 697, 699-707 (1961).

10. *Cf.* Muir v. Commissioner, 182 F.2d 819 (4th Cir. 1950). In a suit by the trustee for a judicial determination on the apportionment of income between two beneficiaries, one an alien residing in the United States, the other an English citizen, the Commissioner did not contest the trustee's failure to file federal income tax returns, presumably on the basis that the trust was a foreign situs trust; here it had been created in England by an English grantor, administered by an English trustee, and funded by U.S. securities apparently held in England.

11. *See* sources cited in note 9 *supra*.

Congress has defined foreign trusts on the basis of these criteria in a committee report which accompanied an unsuccessful bill to discourage such trusts; that report indicated that the proposed amendments would apply to a "trust created by a U.S. citizen in a foreign country with a non-resident alien as trustee." S. REP. NO. 1616, 86th Cong., 2d Sess. 60 (1960).

controlling. Moreover, it remains well settled that a foreign trust may be created by a U.S. grantor for the benefit of U.S. beneficiaries; in fact, the provisions of the Tax Reform Act, applicable to "[a] United States person who . . . transfers property to a foreign trust . . . if there is a U.S. beneficiary,"[12] compel such a conclusion. Accordingly, the following discussion assumes the definition of a foreign trust to be a trust created by a U.S. person in a foreign jurisdiction with a nonresident alien as trustee.

III. TAXATION OF THE OPERATING FOREIGN TRUST, ITS GRANTOR, AND BENEFICIARIES

A. *Background and Historical Development*

The fundamental premise underlying the entire system of trust taxation is that the the trust and its beneficiaries are treated as separate taxable entities.[13] To avoid double taxation, the Code contains an elaborate set of rules designed to apportion tax liability between the two. In general, the trust is allowed a deduction for distributions made to beneficiaries, who in turn are required to include those distributions in their gross income. In simple trusts, where the income is distributed currently as earned, the trust simply serves as a conduit, channeling all the year's income, together with the entire tax liability, to the beneficiaries. In all other trusts—complex trusts—the trustee may retain annual income, pay any tax due, and distribute the amounts accumulated in later years. In theory, income is taxed to the trust when retained by it, and to the beneficiaries when distributed.

The measure of the respective tax obligations of the trust and its beneficiaries depends on distributable net income (DNI).[14] Defined as the taxable income of the trust, subject to various adjustments,[15] DNI establishes the maximum amount which the trust may take as an annual deduction.[16] When an annual distribution falls short of DNI, the trust pays the tax on the undistributed portion; the sum of that tax and the un-

12. 1976 Tax Reform Act, § 1013 (a), *adding* INT. REV. CODE OF 1954, § 679(a)(1).

13. Much of the following summary is based on H.R. REP. NO. 91-413, 91st Cong., 1st Sess., pt. 1, at 92 (1969).

14. INT. REV. CODE OF 1954, § 643(a).

15. *Id.*; the most significant of these adjustments is that taxable income is computed without regard to the deduction allowed for distributions to beneficiaries.

16. *Id.* §§ 651(b), 661(a).

distributed income are termed "undistributed net income."[17] Any distribution in excess of DNI is treated as an accumulation distribution and is taxed to the beneficiaries under the throwback rules.

Clearly, when current income accumulates in the trust, substantial benefits may be achieved under the progressive rate structure whenever the rate applicable to the trust is less than that of the beneficiaries. Accordingly, the Code has always contained provisions to vitiate these income-splitting possibilities by taxing beneficiaries on accumulated income distributed to them in substantially the same manner as though they had received it in the same year the income was earned by the trust. Every distribution in excess of DNI is treated as consisting of undistributed net income accumulated in prior years.[18] When "thrown back," the accumulation distribution is deemed to have been received by the taxpayer in those prior years in which the trust retained undistributed net income.[19]

The peculiar advantages which have in the past attached to foreign trusts resulted from the combined applications of the above described principles of trust taxation and the rules setting forth the tax treatment of foreign entities. For just as trusts generally are taxed as individuals,[20] foreign trusts are treated as nonresident aliens.[21] In addition to the income-splitting and tax deferral benefits available under all trusts, a foreign trust accumulating income could escape paying U.S. income tax or, for that matter, any income tax whatsoever.

A nonresident alien individual engaged in trade or business within the United States is taxed at section 1 rates only on that income which is effectively connected with the conduct of a trade or business within the United States.[22] Pursuant to the Foreign Investors Tax Act of 1966,[23] it is even possible for

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17. *Id.* § 665(a).
18. *Id.* § 666(a).
19. *Id.*
20. Id. § 641(b).
21. *See* Treas. Reg. § 1.871-2(a) (1977); *Hearings on the Tax Recommendations of the President Before the House Comm. on Ways and Means*, 87th Cong., 1st Sess. 271 (1961). *Compare* INT. REV. CODE OF 1954, § 7701(a)(31) *with* INT. REV. CODE OF 1954, § 872(a).
22. INT. REV. CODE OF 1954, § 871(b).
23. Pub. L. No. 89-809, tit. I, 80 Stat. 1539 (1966) (codified in scattered sections of INT. REV. CODE OF 1954).

a foreign trustee to trade in domestic stocks or securities through a resident broker, custodian, or agent, for such conduct is excluded from the definition of "trade or business within the United States."[24] The exclusion will still be available if the principal, *i.e.*, the trustee, maintains an office or fixed place of business within the United States,[25] but doing so will likely destroy the trust's status as a nonresident alien.[26]

Otherwise, the Code imposes a tax of 30 percent, or lower treaty rate if applicable, upon the fixed or determinable income, such as rents, interest, dividends, and the like, of a nonresident alien individual who is not engaged in a trade or business within the United States.[27] The tax is withheld at the source, and the responsibility for its payment lies with the person having the control, receipt, custody, disposal, or payment of the income.[28] No tax at all is placed upon the capital gains realized by the foreign trust within the United States, provided that the trust is not deemed to have been present in the country for 183 days or more during the taxable year.[29]

Finally, a foreign trust is not required to pay any U.S. taxes on income derived from sources outside the United States.[30] Thus the trust itself will incur U.S. taxes only to the extent that it earns ordinary income from sources within the United States, assuming it is not present in the country for more than 183 days.

In practice, the foreign trust, more likely than not, paid no income tax, either to the United States or to any other taxing jurisdiction. In other words, if the foreign trust were established in a country with little or no income tax, and if it limited its investments in such a manner that the income would not be taxable either by the United States or by the country of its source, then that trust would offer a lucrative method of accumulating and compounding tax-free income. Moreover, while the use of foreign trusts thus permitted the shifting of income

24. INT. REV. CODE OF 1954, § 864(b)(2).

25. INT. REV. CODE OF 1954, § 864(c) bars the exclusion where the taxpayer is trading in securities, but not where the taxpayer is trading for his own account.

26. *See* text accompanying note 11 *supra*.

27. INT. REV. CODE OF 1954, § 871(a)(1).

28. *Id.* § 1441(a).

29. *Id.* § 871(a)(2).

30. *See id.* § 871(a).

to a nontaxable entity, the structure of the throwback rules under the original version of the 1954 Code sanctioned not just the postponement of taxation, but rather its avoidance altogether, once the accumulated income was distributed to the beneficiaries.

As originally enacted, the Internal Revenue Code of 1954 limited the amount of the taxable accumulation distribution.[31] Thus, if a foreign trust minimized its undistributed net income in the five years preceeding a distribution of accumulated earnings, or at least if it made investments the income from which would not be included in DNI, the beneficiaries were not taxed on the distribution.[32] Apart from this exemption, the Code also contained numerous exceptions to the original throwback rules.[33] Perhaps the most expansive was an exclusion from the definition of a taxable accumulation distribution of all amounts paid to beneficiaries in a final distribution nine years after the date of the last transfer to the trust.[34] If properly created, trusts funded in successive years could, under this exception, assure the beneficiaries of an annual income which was not subject to taxation in their hands.

Not surprisingly, the preferential tax status of foreign trusts, arising by virtue of their existence outside the reach of the U.S. taxing authority and also by virtue of the inadequacy of the throwback rules, stirred concern both in Congress and in the Treasury Department. In the Trust and Partnership Income Tax Revision Bill of 1960,[35] the Senate Finance Committee proposed amendments to the Code which would have eliminated the application of the exceptions to the throwback rules with respect to foreign trusts, and which would have broadened the categories of foreign trust income subject to the new, ex-

31. Pub. L. No. 83-591, 68A Stat. 224 (1954) (current version at INT. REV. CODE OF 1954, § 666(a)).

32. Altman & Kanter, *Current Tax Planning*, *supra* note 2, at 639; Altman & Kanter, *Senate Finance Committee Looks at Foreign Situs Trusts*, 38 TAXES 585, 592 (1960).

33. Pub. L. No. 83-591, 68A Stat. 223 (1954) (current version at INT. REV. CODE OF 1954, § 665(b)).

34. *Id.* (formerly codified at Int. Rev. Code of 1954, § 665(b)).

35. H.R. 9662, 86th Cong., 2d Sess. (1960); *see* S. REP. No. 1616, 86th Cong., 2d Sess. 26, 60 (1960). Although the bill was reported out of the Senate Finance Committee, it failed to gain passage prior to adjournment.

panded throwback rules.[36] Significantly, the proposed measures would not have taxed income accumulated earlier than the five years preceeding distribution.[37]

The abortive Senate Finance Committee proposals clearly charted the direction for future reform. In the following year, the Kennedy Administration urged the revival of the Finance Committee measures with respect to foreign trusts then existing. As for trusts created in the future, the Administration advocated, rather presciently, that their income be taxed currently to the grantor.[38] Then, in the Revenue Act of 1962, the 87th Congress succeeded in enacting the first significant reforms applicable to foreign trusts.[39]

The 1962 amendments affected the taxation of foreign trusts in several important ways. First, the Act repealed the five year limitation to the throwback rules, as well as all other exceptions, with respect to foreign, but not domestic trusts.[40] Placed in a less advantageous position than the beneficiaries of domestic trusts, beneficiaries of foreign trusts could no longer escape taxation on accumulated earnings eventually distributed to them.[41]

Secondly, the 1962 reforms expanded the applicability of the throwback rules by broadening the definition of a foreign trust's distributable net income.[42] Formerly, the DNI of a foreign trust had included, in addition to those items of income computed in the DNI of a domestic trust, net foreign income.[43] Because neither capital gains nor income exempt from U.S. tax by treaty were required to be included in the distributable net income of a trust, they were not in the calculation of undis-

36. *See* Altman & Kanter, *Senate Finance Committee*, *supra* note 32, at 586, 651-54.

37. *Id.* at 654.

38. *Hearings on the Tax Recommendations of the President Before the House Comm. on Ways and Means*, 87th Cong., 1st Sess. 272 (1961).

39. Revenue Act of 1962, Pub. L. No. 87-834, § 7, 76 Stat. 985.

40. Revenue Act of 1962, Pub. L. No. 87-834, § 7(b), 76 Stat. 985 (formerly codified at Int. Rev. Code of 1954, §§ 666(a), 665(c), *repealed by* Tax Reform Act of 1969, Pub. L. No. 91-172, § 331(a), 83 Stat. 592).

41. *See* Zimmerman, *supra* note 3, at 258.

42. Revenue Act of 1962, Pub. L. No. 87-834, § 7(a)(1), 76 Stat. 985 (current version codified at INT. REV. CODE OF 1954, § 643(a)(6), *as amended by* 1976 Tax Reform Act, § 1013(c)).

43. Pub. L. No. 83-591, 68A Stat. 217 (1954) (current version codified at INT. REV. CODE OF 1954, § 643).

tributed net income, to which the throwback rules applied.[44] By redefining DNI to embrace those items of income,[45] the 1962 Act equalized the treatment of foreign and domestic trusts.

Finally, the Act for the first time required the grantor or transferor of a foreign trust to file an information return.[46] Failure to file the return entailed a substantial penalty.[47] It is difficult to ascertain whether the information submitted on these returns has proven valuable for the purposee of drafting remedial legislation; it has, however, been suggested that that information is not sufficient to enable the Internal Revenue Service to detect serious abuses of the foreign trust provisions.[48]

The Tax Reform Act of 1969 contained provisions which broadly restricted the usefulness of domestic trusts, at the same time indirectly enhancing the relative attractiveness of foreign trusts. Seeking to accord foreign and domestic trusts identical treatment,[49] Congress abolished all the throwback rule exceptions with respect to domestic trusts.[50] The effect of this amendment was to restrict the utility of all trusts, foreign and domestic, to tax deferral, rather than tax avoidance. Nonetheless, since the foreign trust usually paid no income taxes during the period of accumulation, the deferral benefits available to the foreign trust were relatively enhanced. While the domestic trustee paid tax annually on its undistributed income, such income accumulated tax-free in the foreign trust.

A second advantage accruing to the beneficiaries of foreign trusts arose as a result of a revision of the rules relating to capital gains. Pursuant to the Revenue Act of 1962, the capital gains of a foreign trust were included in its distributable net income, and each distribution to the beneficiaries was deemed to be proportionally composed of capital gains. Under the 1969

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44. *Id.*

45. Revenue Act of 1962, Pub. L. No. 87-834, § 7(a)(1), 76 Stat. 985.

46. INT. REV. CODE OF 1954, § 6048.

47. *Id.* § 6677(a).

48. New York State Bar Ass'n, *Report on Foreign Trusts*, 31 TAX L. REV. 265, 270 (1976).

49. *See* H.R. REP. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 94 (1969); S. REP. No. 91-552, 91st Cong., 1st Sess. 127 (1969).

50. Tax Reform Act of 1969, Pub. L. No. 91-172, § 331(a), 83 Stat. 592, *amending* Int. Rev. Code of 1954, Pub. L. No. 83-591, 68A Stat. 223 (current version codified at INT. REV. CODE OF 1954, §§ 665(b), 666(a)).

Act, however, the capital gains of domestic trusts were treated separately from ordinary income.[51] As a consequence, amounts distributed to the beneficiaries of a domestic trust were taxed as ordinary income until all the ordinary income accumulated throughout the existence of the trust had been exhausted.[52] In contrast, the beneficiary of a foreign trust could take advantage of the preferential capital gains rates in each distribution, without waiting first for all ordinary income to be exhausted.[53]

On the eve of the Tax Reform Act of 1976, foreign trusts appeared to provide a superior means of compounding income realized in tax-free investments. Also, taxpayers had achieved considerable savings by structuring complicated transactions, the linchpin of which was one or more foreign trusts. It is in light of these unintended statutory preferences granted to foreign trusts over domestic trusts, as well as the succession of unsuccessful legislative efforts to eliminate those preferences, that the provisions of the 1976 Tax Reform Act must be examined.

B. Changes under the Tax Reform Act of 1976

In many ways, the Tax Reform Act of 1976 represents a departure from past Congressional attempts to regulate foreign trusts. In prior years, Congress sought to vitiate the effects of tax deferral through a fine tuning of the throwback rules. Now, the principal approach of the Act is to attribute all ownership of the trust to those persons who fund it, requiring them to pay a current, rather than a postponed, tax on the trust's annual income. As a "safety net" provision, the Act also imposes an interest charge upon accumulation distribution taxes, whenever the grantor trust rules are inapplicable.

1. Grantor Trust Rules

By 1974, when the proposed amendments relating to foreign trusts were first considered by Congress,[54] the House Ways

51. Tax Reform Act of 1969, Pub. L. No. 91-172, § 331(a), 83 Stat. 596 (formerly codified at Int. Rev. Code of 1954, § 669), *repealed by* Tax Reform Act of 1976, § 701(d).

52. *Id.*

53. *See generally* Dale, *Foreign Trust Now Offer Particular Estate Planning Advantages*, 36 J. TAX. 20, 21 (1972).

54. Originally, these amendments were introduced as sections 312-14 of the Energy Tax and Individual Relief Act of 1974, H.R. 17488, 93d Cong., 2d Sess. (1974), which failed to gain passage prior to the adjournment of the 93d Congress. For a summary of the provisons of this bill, see H.R. REP. No. 93-1502, 93d Cong., 2d Sess. 120 (1974).

and Means Committee had already identified what it felt to be the single greatest deficiency of the foreign trust provisions of the Code. The Committee clearly recognized that the likelihood that a foreign trust might accumulate income free from any tax whatsoever represented "an unwarranted advantage to the use of a foreign trust over the use of a domestic trust."[55]

To remedy this defect, the 1976 Tax Reform Act adds a new section especially tailored to foreign trusts, section 679.[56] Section 679 provides that any U.S. person who directly or indirectly transfers property to a foreign trust shall be treated as the owner of that portion of the trust which is attributable to such transferred property, if there is a U.S. beneficiary of any portion of the trust. While the scope of this general rule is extended by various accompanying attribution rules, the legislative history reveals an intent that its applicability be even broader than may be apparent from the face of the statute. Several specific exceptions, however, may enable tax and estate planners to employ foreign trusts under limited circumstances in the future.

Of the two prerequisites to the applicability of the rule, only the question of the existence of a U.S. beneficiary is treated by the Act in any detail; the other requirement, that there be a U.S. transferor, is clarified only in the Committee reports and will be discussed below. In general, a trust is treated as having a U.S. beneficiary unless the terms of the trust agreement satisfy both of two conditions. First, during the taxable year, no part of the income or corpus may be paid to or accumulated for the benefit of a U.S. person;[57] and second, if the trust were to terminate at any time during the taxable year, no part of the income or corpus may be paid to or for the benefit of a United States person.[58]

A new set of attribution rules establishes when the income or corpus of a foreign trust is paid to or accumulated for the

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55. H.R. REP. No. 93-1502, 93d Cong., 2d Sess. 121, 122 (1975); H.R. REP. No. 94-658, at 207.

56. 1976 Tax Reform act, § 1013(a), *adding* INT. REV. CODE OF 1954, § 679(a)(1).

57. "U.S. person" is defined by INT. REV. CODE OF 1954, § 7701(a)(30) to include any citizen or resident of the United States, domestic partnership, domestic corporation, or estate or trust other than a foreign estate or trust within the meaning of INT. REV. CODE OF 1954, § 7701(a)(31).

58. 1976 Tax Reform Act, § 1013(a), *adding* INT. REV. CODE OF 1954, § 679(c)(1).

benefit of a U.S. person. A foreign entity will be deemed to be a U.S. beneficiary if: (1) it is a foreign corporation, of which more than 50 percent of the total combined voting power of all classes of stock is owned by United States shareholders; (2) it is a foreign partnership, of which a U.S. person is a partner; or (3) it is a foreign trust or estate which has a U.S. beneficiary.[59]

In any taxable year in which a trust, which would have otherwise been subject to section 679 in the immediately preceeding taxable year but for the lack of a U.S. beneficiary, actually acquires a U.S. beneficiary, the United States transferor is then treated as the owner of the trust. The transferor will thus be required to include in his gross income for the year in which the trust acquires a U.S. beneficary all the undistributed net income retained by the trust as of the close of the immediately preceeding taxable year, to the extent that such undistributed net income is attributable to property transferred to the trust by the transferor.[60]

The Committee reports indicate that these requirements can be met only if the trust instrument (which is to be read to include any related written or oral agreements between the trustee and the transferor) specifically names all permissible beneficiaries, no one of whom is a U.S. person, or if it describes all beneficiaries as a class of unnamed persons which specifically excludes all U.S. persons.[61] In other words, the trust may be treated as a grantor trust if any person, whether or not adverse to the grantor, possesses the power to appoint U.S. beneficiaries or even to so amend the trust agreement in such a way that the trustee might be authorized to distribute corpus or income to a class which could conceivably include a U.S. person.[62] If a foreign trust does not have a U.S. beneficiary, it will, nonetheless, fall under the reach of section 679 should any of its beneficiaries become a U.S. person.[63]

The liability created by section 679 is imposed on any U.S. person who transfers property to a foreign trust which has or acquires a U.S. beneficiary, regardless of whether such a trans-

59. 1976 Tax Reform Act, § 1013(a), *adding* INT. REV. CODE OF 1954, § 679(c)(2).
60. 1976 Tax Reform Act, § 1013(a), *adding* INT. REV. CODE OF 1954, § 679(b).
61. H.R. REP. No. 94-658, at 210; S. REP. No. 94-938, at 219.
62. *Id.*
63. H.R. REP. No. 94-658, at 210 n.12.

fer is made directly or indirectly. If a U.S. person possesses sufficient control over a domestic or foreign entity to cause that entity to make a transfer to a foreign trust or if the entity merely serves as a conduit for such a transfer by a U.S. person, then the U.S. person will be considered to have made an indirect transfer.[64] For example, a foreign trust funded by a domestic corporation in which a U.S. person has a controlling interest may be regarded as owned by the shareholder. Also, Congress apparently expects the term "indirect transfer" to encompass loans to the trust, whether made by any U.S. person or merely guaranteed by him, regardless of the formality or informality of the guarantee.[65]

The general rule of section 679(a) applies equally to transfers that are donative as well as to sales or exchanges.[66] The Act, however, does except sales or exchanges that are made of property transferred at its fair market value in a transaction in which the transferor realizes all gain at that time and recognizes it either at the time or under an installment method of reporting.[67] This exception was designed to protect parties in ordinary business transactions, who transfer property to the trust in return for full and adequate cash consideration or installment payments, and who otherwise risk being treated as a partial owner of the trust assets.[68] However, the exception is not broad enough to cover transfers in return for a private annuity or other "open transactions."[69]

A U.S. person is regarded as the owner of a foreign trust only during his lifetime. Section 679 is not applicable to transfers to foreign trusts which take effect by reason of the death of the transferor.[70] Thus, the estate of a U.S. individual would not be taxed on the income of a foreign testamentary trust.[71]

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64. *Id.* at 209.

65. *Id.* at 209 n.9.

66. *Id.* at 210.

67. 1976 Tax Reform Act, § 1013(a), *adding* INT. REV. CODE OF 1954, § 679(a)(2). A transaction reported on an installment basis, however, will be subject to the section 1491 excise tax. *See* text accompanying notes 107-51 *infra*.

68. *See* Lerner, *U.S.A.: Legislative Proposals Affecting the Taxation of Foreign Trusts*, 75-3 TAX MANAGEMENT—INT'L J. 10, 13 (1975).

69. H.R. REP. No. 94-658, at 210.

70. 1976 Tax Reform Act, § 1013(a), *adding* INT. REV. CODE OF 1954, § 679 (a)(2)(A).

71. H.R. REP. No. 94-658, at 209.

Whether or not the foreign trust would be included in the gross estate of the settlor of an inter vivos trust would depend on the applicability of the estate tax provisions.[72] Therefore, all the advantages that were available by using a foreign trust prior to the 1976 Tax Reform Act are still within reach of the testamentary trust.

To facilitate the implementation of section 679, changes have been made in two other sections. Section 6048 has been amended to make it the responsibility of the grantor to file a trust information return. The information to be required has not yet been prescribed but will be provided at a later date by regulations. Failure to file such a return is covered by amendments to section 6677(a). In addition to any criminal penalty, a person failing to file such information is subject to a penalty equal to 5 percent of the entire trust corpus (not just the value of property transferred to the trust by the grantor) or $1,000, whichever is less.

It must be noted that the Tax Reform Act of 1976 makes many of these changes retroactive. Section 679 and the amendments to sections 6048 and 6677 apply to taxable years ending after December 31, 1975 (which encompasses taxable years beginning as early as February 1, 1975). This is, however, only in respect to trusts created or transfers made after May 21, 1974.

Any appraisal of the new grantor trust rules must begin by recognizing that, while they may be consistent analytically with the principles of federal income taxation, they seem to exceed what has customarily been the jurisdictional limit of the taxing power of the United States.

While the contours of those rules of international law which limit the extent of a country's tax jurisdiction have never been defined with any clarity, it would seem that Congress does not have the power to tax a foreign trust directly. One authority states the relevant general principles of international law as follows:

> states have authority, as an incident of sovereignty, to tax aliens resident within their territory and their property there situated. In theory, states are presumed to limit the taxation of nonresident aliens to their property situated within the jurisdiction of the taxing states and to income derived from sources therein.[73]

Whether or not these principles are mandatory or merely per-

72. *Id.*

73. 3 G. HACKWORTH, DIGEST OF INTERNATIONAL LAW 575 (1942).

suasive, U.S. practice has demonstrated compliance in the past.[74] In fact, foreign trusts, according to the definition set forth in the Code, are entities "the income of which, from sources outside the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includable in gross income. . . ."[75] It should be clear that the United States is justified in taxing currently the income of a foreign trust only by virtue of the artificial attribution of its ownership to a U.S. grantor.

Even this justification fails in view of its departure from the premises underlying grantor trust taxation. Traditionally, the Code has denied a grantor the opportunity to shift tax liability to a trust where the grantor has retained certain incidents of ownership, such as a power to revoke or a right to receive income. Preserving the practical effect, but not the rationale of the grantor trust rules, section 679 adds an entirely new criterion, the residence of the trust and its beneficiaries, one which bears virtually no relation to the queston of actual ownership. It is, in other words, all too possible for the grantor to convey all rights and interest in the trust, both legal and equitable, present and future, and yet still be treated as the absolute owner pursuant to the highly contrived and anomalous fiction created by section 679. Such a result might be achieved simply because of the random migrations of a beneficiary, factors over which the grantor can have little or no control.[76] The artificial attribution of ownership of the foreign trust should not be used to disguise what is in fact an expansion of Congress's traditional and customary power to tax nonresident aliens.

Further criticism of section 679 might be directed at its unfairness and its inadequacy. First, as implied above, the grantor is taxed on all the trust's income, whether accumulated or distributed. This appears to be true even where the income is paid and taxed currently to the beneficiaries, since there are no provisions permitting the beneficiary to credit taxes paid by

74. *Cf.* text accompanying notes 23-30 *supra*.

75. INT. REV. CODE OF 1954, § 7701(a)(31).

76. Of course, the grantor may draft provisions terminating the trust or at least the migrant beneficiary's interest, taking care not to subject himself to any of the other grantor trust pitfalls. This remedy is not, it should be noted, available to the transferor who was not the settlor.

the grantor. This increase in the grantor's tax liability will carry through on a state and municipal level, since many jurisdictions calculate state and local income taxes on the basis of federal adjusted gross income.

Finally, as broadly as Congress intended section 679 to be interpreted, its potential application remains in question. The Act states that the transferor will be taxed on direct or indirect transfers to a foreign trust,[77] and the legislative history describes in remarkably sweeping terms what should be considered an indirect transfer.[78] It seems likely that the Service will construe this portion of the section in as broad a manner as possible. Nonetheless, the statutory language does not foreclose the possibility of circuitous transactions which might circumvent the purposes of the section. For example, it is now unclear whether a trust whose governing instrument specifically precludes distributions to U.S. beneficiaries might nonetheless make payments to a nonresident alien, perhaps to a foreign bank, thereby permitting a U.S. person to obtain a loan from the bank's domestic branch office secured by the deposit overseas. Section 665(c) of the Code initially seems to prohibit such a transaction, for that section states as follows:

> For purposes of this subpart, any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust.

However, the subpart in which section 665(c) is codified is subpart D. The new grantor trust rules, section 679, are in subpart E.

Congress has indicated that a deposit in a bank which loans or has loaned money to a foreign trust will be treated as a transfer to the foreign trust.[79] Litigation may be required to determine whether a similarly circuitous transaction in reverse might be deemed a direct distribution to a U.S. beneficiary.

2. Taxation of Beneficiaries

The Tax Reform Act of 1976 makes several changes with respect to the treatment of accumulation distributions to bene-

77. 1976 Tax Reform Act, § 1013(a), *adding* INT. REV. CODE OF 1954, § 679(a)(1).
78. *See* H.R. REP. No. 94-658, at 208-10.
79. H.R. REP. No. 94-658, at 209 n.9.

ficiaries of foreign trusts. Three of those changes could be highly significant. The changes involve a change in the characterization of all gross income items on their distribution by a foreign trust, a major revision of the throwback rules, and a nondeductible interest charge imposed on distributions where the grantor is not taxed.

Prior to the Act, foreign trusts created by United States persons were required to aggregate both capital gains and ordinary income in the calculation of DNI. The rule now extends to *all* foreign trusts, including those created by nonresident aliens.[80] The Tax Reform Act now converts the character of any undistributed capital gains included in the distributed net income into ordinary income.[81] The Committee reports indicate that the effect of this amendment will be to treat all distributions from a foreign trust as ordinary income and to deny the benefit of the 50 percent deduction of net long term capital gains to both the trust and the beneficiaries.[82] The trust may, however, take into account the section 1202 deduction when computing the undistributed net income of the trust accumulated during each taxable year beginning on or before December 31, 1975 and distributed after that date.[83] For all income earned after that date, the Act does not permit the capital gains deduction.[84]

The Act has made some major changes in Code sections 665 through 669, the so-called "throwback" rules. These changes are applicable to domestic and foreign trusts alike. Of particular significance is the change in the method of computing the tax payable on an accumulation distribution. Previously, the taxpayer could elect to use an "exact" method in such a computation. The Act eliminates the "exact" method and modifies its former alternative, the "shortcut" method.[85] Briefly, the total tax paid by a beneficiary consists of the sum of a partial tax computed on his total taxable income reduced

80. INT. REV. CODE OF 1954, § 668.

81. 1976 Tax Reform Act, § 1013(c), *amending* INT. REV. CODE OF 1954, § 643 (a)(6)(C); *see also* H.R. REP. No. 94-658, at 213.

82. H.R. REP. No. 94-658, at 213.

83. 1976 Tax Reform Act, § 1013(c)(2), *adding* INT. REV. CODE OF 1954, § 643 (a)(6)(D).

84. H.R. REP. No. 94-658, at 213.

85. 1976 Tax Reform Act, § 701(a)(1), *amending* INT. REV. CODE OF 1954, § 667(a).

by all those amounts to which the throwback rules apply plus the tax computed under the "shortcut" method.[86]

The shortcut computation is made as follows. First, the taxpayer examines his taxable income for the five years preceeding the accumulation distribution, discarding both the year when his taxable income was the highest and the year when it was lowest. Next, the taxpayer adds on to his taxable income for each of the three remaining years an amount equal to the average annual distribution, that is, the total amount of the accumulation distribution divided by the number of years on the last day of which the trust was deemed to have had undistributed net income of which the accumulation distribution is composed. Then the taxpayer recomputes his tax for those three years on the basis of this increased, recalculated taxable income. The increase of his taxes so calculated over the taxes actually paid is then averaged over the three years. Finally, the taxpayer multiplies that average increase in taxes times the number of years on the last day of which the trust was deemed to have had undistributed net income. This final product is compared with the amount of taxes paid by the trustee and deemed distributed to the beneficiary under section 666(b) and (c). The excess, if any, is the tax payable by the beneficiary.[87]

Under Code section 668, the beneficiary of a foreign trust must now pay a nondeductible simple interest charge on the tax computed from the year in which the income distributed was first accumulated. This charge is in addition to any taxes that would be due on the distribution but is assessed only in the event that the grantor trust rules are inapplicable.[88] The computation of interest charge is made by multiplying an amount equal to six percent of the partial tax computed under Code section 667(b) by a fraction (the number of taxable years between each taxable year to which distribution is allocated under Code section 666(a) and the taxable year of distribution over the number of taxable years to which the distribution is allocated under Code section 666(a)).[89]

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86. *Id.*

87. 1976 Tax Reform Act, § 701(a), *amending* INT. REV. CODE OF 1954, § 667(b).

88. An example would be if a trust were funded by a testamentary transfer or by a nonresident alien settlor.

89. *See* text accompanying note 87 *supra;* the House Committee Report sets out

The total amount to be charged under Code section 668 is limited to the amount of accumulation distribution.[90] This limit is computed by adding the interest charge to the partial tax derived by Code section 667(b).

The interest charge computed under this section will be applicable to any undistributed net income existing in a trust as of January 1, 1977. This will be treated as if it were allocated under Code section 666(a) to the first taxable year beginning after December 31, 1976.[91]

IV. TAXATION OF TRANSFERS TO THE TRUST

A. *Estate and Gift Taxes*

One must recognize that the transfer to the foreign trust itself may invoke tax consequences. Accordingly, it is imperative that the draftsman devote careful attention to estate and gift tax considerations.[92] For it is not inconceivable that a foreign trust created with a view towards minimizing the income tax on its earnings could expose the grantor to a gift tax as well as bring the transferred property into his gross estate for inheritance tax purposes, drastically reducing the benefits otherwise obtained from the trust.

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the following illustrative computation:

> [I]f amounts distributed in year 8 were earned in years 2, 3, and 4, the number of years for which interest is charged is determined first by calculating the number of years of accumulation for each year in which amounts distributed were originally earned (in this case 8-2 or 6 years for amounts earned in year 2, 8-3 or 5 years for amounts earned in year 3, and 8-4 or 4 years for amounts earned in year 4). The total of these number of years of accumulation (here 6+5+4, or 15 years) is then divided by the number of different years from which the amounts distributed were earned (3 different years). The result (5 years) is the average number of years of accumulation and is multiplied by the 6 percent interest rate to produce the total percentage of interest (30 percent) which is applied against the amount of the tax.

H.R. REP. No. 94-658, at 212 n.16.

90. 1976 Tax Reform Act, § 1014(b), *amending* INT. REV. CODE OF 1954, § 668 (c)(1).

91. 1976 Tax Reform Act, § 1014(b), *amending* INT. REV. CODE OF 1954, § 668.

92. To the extent that a U.S. citizen transfers property for less than full and adequate consideration, the Code imposes a gift tax on that part of the transfer which is gratuitous and not exempt. INT. REV. CODE OF 1954, § 2501. The gift tax rules apply whether the interests transfered are legal or equitable, present or future. *See* Treas. Reg. § 25.2511-1 (1977). Thus the settlor of a foreign trust will become subject to the gift tax whenever he creates a beneficial interest in someone other than himself. Similarly, an estate tax will be imposed upon a testamentary transfer to a foreign trust. INT. REV. CODE OF 1954, § 2033.

B. *Interest Equalization Tax*

Seeking to restrain the sale of foreign securitites to U.S. investors and thus to reduce what it then perceived as a ballooning balance of payments problem,[93] Congress passed the Interest Equalization Act of 1964.[94] That Act imposed a tax of 15 percent on the value of stock issued by a foreign issuer and acquired by a U.S. person and instituted a graduated tax on debt securities of foreign obligors.[95] Although foreign trusts did not fall within the meaning of a "United States person" as that term was defined by the Act,[96] the concept of "acquisition" was expanded by Congress to include transfers to such a trust for the purposes of purchasing securities for the benefit of a U.S. transferor.[97] In other words, any U.S. person who conveyed money or property to a foreign trust without receiving full and adequate consideration was treated as having made a taxable acquisition of foreign securities to the extent the trust did in fact acquire such securities.[98]

The lack of any reporting requirements in connection with the Act hampered the Internal Revenue Service in its enforcement of the foreign trust provisions.[99] To remedy this, Congress in 1969 created a presumption that the foreign trust acquired securities encompassed by the Act if a U.S. person simply

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93. H.R. REP. No. 88-1046, 88th Cong., 1st Sess. (1963); S. REP. No. 88-1267, 88th Cong., 2d Sess.(1964).

94. Act of Sept. 2, 1964, Pub. L. No. 88-563, 78 Stat. 809. The Act was repealed by the 1976 Tax Reform Act.

95. *Id.* § 2(a) (formerly codified at Int. Rev. Code of 1954, § 4911(a), (b)).

96. *Id.* (formerly codified at Int. Rev. Code of 1954, § 4920(a)(4)); *cf.* Rev. Rul. 66-281, 1966-2 CUM. BULL. 483 ("U.S. Person" does not include a trust where a nonresident alien is treated as the owner of the entire trust.).

97. *Id.* (formerly codified at Int. Rev. Code of 1954, § 4912(b)(1)). Within the context of § 4912(b)(1)(A), loans were not considered to be adequate consideration (*i.e.*, sales or exchanges), and thus the lender was deemed to have made a taxable acquisition. King v. United States, 545 F.2d 700 (10th Cir. 1976), *aff'g In re* King, 424 F. Supp. 117 (D. Colo. 1975); *see also* H.R. REP. No. 1046, 88th Cong., 1st Sess. 27 (1964).

98. *See generally* Dale, *supra* note 53, at 21. It bears noting that these provisions did not altogether encourage investment by the foreign trustee in domestic securities, inasmuch as the income from domestic sources was subject to a 30 percent (or lower treaty rate) tax that was withheld at the source. INT. REV. CODE OF 1954, § 871(a)(1). In contrast, the income derived from foreign securities was not taxed to the trust at all and was taxed to the beneficiaries only upon its eventual distribution. *Id.* §§ 872, 661(a), 662(a). *See* Kroll, *Foreign Trusts: Advantages and Problems*, 112 TRUSTS AND ESTATES 618, 620 (1973).

99. *See* S. REP. No. 91-928, 91st Cong., 1st Sess. 19 (1969).

transferred property to the trust.[100] Only by filing prescribed quarterly statements[101] evidencing that the trust had not in fact acquired any taxable securities could the transferor rebut the presumption.[102] Clearly, this burden was placed on the taxpayer in order to relieve administrative difficulties involved.[103]

These amendments further granted the President authority to raise or lower the tax rates in order to achieve an optimal balance of payments.[104] By Executive Order, the rates were lowered to zero for all acquisitions made after January 29, 1974.[105] The 1976 Tax Reform Act repealed the Interest Equalization Tax with respect to all acquisitions made after June 30, 1974.[106]

C. *Tax on Transfers to Avoid Income Tax*

In 1932 Congress recognized the possibility that a U.S. individual could transfer appreciated securities to a foreign corporation or trust and escape payment of a capital gains tax.[107] While the corporation or trust could sell the securities and realize the gain outside the tax jurisdiction of the United States, the original transferor, assuming him to be a controlling shareholder or a beneficial owner, would have lost neither control over nor benefits from the sale.[108] To discourage such avoidance of the capital gains tax, which was then imposed at a maximum rate of 25 percent, Congress included in the Revenue Bill of 1932 provisons for an excise tax of 27 1/2 percent on transfers of this nature.[109] The tax did not apply if the Commissioner were satisfied that the transfer was not carried out for the purpose of avoiding federal income taxes.[110]

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100. Interest Equalization Tax Extension Act of 1969, Pub. L. No. 91-128, § 4(a)(1), 83 Stat. 261, (formerly codified at Int. Rev. Code of 1954, § 4912(b)(1)(B)).

101. Act of Sept. 2, 1964, Pub. L. No. 88-563, § 3, 78 Stat. 809 (formerly codified at Int. Rev. Code of 1954, § 6011(d)(1)). The quarterly returns were filed on Form 3780. Treas. Reg. § 147.8-1(c)(1) (1965).

102. Interest Equalization Tax Extension Act of 1969, Pub. L. No. 91-128, § 4(a)(1), 83 Stat. 261.

103. *See* Dale, *supra* note 53, at 21.

104. Interest Equalization Tax Extension Act of 1969, Pub. L. No. 91-128, § 3(a), 83 Stat. 261.

105. Exec. Order No. 11,766, 3A C.F.R. § 127 (1974).

106. 1976 Tax Reform Act, § 1904(a)(21).

107. H.R. REP. No. 708, 72d Cong., 1st Sess. 51-52 (1932).

108. *Id.*

109. Revenue Act of 1932, ch. 209, § 901, 47 Stat. 284 (current version codified at INT. REV. CODE OF 1954, §§ 1491-94).

110. INT. REV. CODE OF 1954, § 1492(2).

This excise tax remained in the Code as sections 1491 *et seq.*, substantially unchanged until the Tax Reform Act of 1976. On the whole, the tax had not proven too burdensome, since it merely compelled the prospective settlor to fund a foreign trust with some asset other than appreciated securities. In certain situations, however, United States grantors have found it highly desirable to transfer securities rather than unappreciated assets of another character.[111]

Often, the owners of highly appreciated stock, desirous of preserving voting rights or simply maintaining a successful investment, were understandably reluctant to sell their shares, pay the lower capital gains tax, and fund a trust with the remaining proceeds. As a result, resourceful practitioners devised ingenious schemes to circumvent, or at least postpone the incidence of, both the excise and capital gains taxes. For example, the settlor might have secured a loan with his appreciated securities and contributed the borrowed money to the trust.[112] The interest was deductible to a limit,[113] and the taxpayer could conceivably repay the loan with the trust's accumulated earnings once distributed to him.[114]

A far more common method of escaping the excise tax was to sell appreciated securities to a foreign trust in exchange for a private annuity.[115] Prior to 1976, section 1491 expressly applied only to the excess of the fair market value of transferred stock over its adjusted basis in the hands of the transferor.[116] Arguably, the tax could have been imposed on this excess re-

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111. For example, commentators have suggested utilizing foreign trusts as a device for cleansing "tainted" items, such as section 1298 stock, the sale of which would otherwise produce ordinary income. By using the foreign trust, stock of such nature could have been converted into capital gains. *See* Kroll, *supra* note 98, at 621, 647.

112. *See* Tovey, *supra* note 9, at 709-10.

113. INT. REV. CODE OF 1954, § 163(d), *as amended by* 1976 Tax Reform Act, § 209(a)(1). The deduction for an individual is limited to $10,000 plus the amount of net investment income.

114. *See* Tovey, *supra* note 9, at 710 & n.50.

115. *See generally* Kanter, *The Foreign Trust—A "One World" Concept of Tax Planning*, U. SO. CAL. 1970 TAX INST. 467, 502; Kanter, *Recent Tax Court Decisions Shed Further Light on Private Annuity Transactions*, 42 J. TAX. 66 (1975); Kanter, *New Decisions Delineate Tests for Foreign Situs Trusts—Private Annuity Transactions*, 38 J. TAX. 82 (1973); Kassoy, *The Private Annuity and the Foreign Situs Trust*, 16 U.C.L.A.L. REV. 86 (1968).

116. INT. REV. CODE OF 1954, § 1491, *as amended by* 1976 Tax Reform Act, § 1015(a).

gardless of whether the transferor received the full fair market value of his securities in the transaction—thus realizing all gains at that time—or whether the transfer might have been merely donative. However, it was fairly well settled that the section 1491 tax applied only to gratuitous transfers.[117] The Internal Revenue Service apparently accepted the argument that section 1491 was not intended to penalize transferors by imposing an excise tax in addition to capital gains taxes. These taxes were to be imposed in the alternative, and section 1491 applied only to that portion of a transfer which was not made for full and adequate consideration.[118]

Normally the fair market value of the transferred securities was used to establish the present value of the annuity purchased by the transferor in the exchange.[119] The excess of present value, equal to the fair market value of the securities, over their adjusted basis in the hands of the transferor became gain realized by the transferor/annuitant.[120] But, while the transfer was considered to be a completed transaction for the purposes of avoiding the application of section 1491, it was not a taxable event in the sense that the taxpayer had to report all his gain at the time of the sale. Rather, he was deemed to receive in each payment a pro rata mixture of part nontaxable return of capital, part interest, and part capital gains.[121] The

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117. This is at least the assumption on which Congress proceeded when considering the provisons in the 1976 Tax Reform Act which would have eliminated this possibility. *See* H.R. REP. No. 94-658, at 213; S. REP. No. 94-938, at 223.

118. *See* Kanter & Horwood, *Section 1491 Tax and Private Annuity/Foreign Situs Trust Transaction*, 52 TAXES 388 (1974).

It should be noted, however, that where the transfer to the foreign trust is made without adequate consideration, a gift tax and the section 1491 tax may be imposed, and the trustee's basis will be the same as the basis in the hands of the transferor. Thus, while the sale by the trustee of the appreciated securities will not subject the trustee to payment of any capital gains tax, INT. REV. CODE OF 1954, §§ 862(6), 871(a)(2), such a tax will be paid upon distribution to the beneficiaries under the throwback rules, INT. REV. CODE OF 1954, §§ 643, 661-68. *See* Dale, *supra* note 53, at 22 n.16. *But see Shop Talk*, 34 J. TAX. 191 (1971).

119. Any excess in the fair market value over the present value of the annuity would be treated as a gift to the transferee, Rev. Rul. 69-74, 1969-1 CUM. BULL. 43, and vice-versa. For a sample annuity agreement which would avoid the situation in which a transfer would be treated as part gift, part sale, see Kanter & Horwood, *supra* note 118, at 406.

The present value of the annuity is calculated pursuant to Treas. Reg. § 20.2031-10 (1977).

120. Rev. Rul. 69-74, 1969-1 CUM. BULL. 43.

121. Rev. Rul. 69-74, 1969-1 CUM. BULL. 43; Kanter, *The Foreign Trust—A "One*

trustee could then sell the property with a stepped-up basis[122] and reinvest the proceeds free from United States tax.[123]

Although not unique to foreign trusts, there were several dangers inherent in the sales of annuities to trusts, the greatest perhaps being that the sale would be disregarded and treated as a transfer to the trust with a retained right to income for life, thus subjecting the grantor to tax as the owner of the trust.[124]

In *Simon M. Lazarus,*[125] for example, the Tax Court identified a number of factors which caused it to characterize such a transaction as a transfer in trust with a reserved right to income.[126] Most compelling in this decision were the facts that the annual payments appeared intimately geared to the amounts received as income by the trust; that no payments could be made from the corpus, which would pass intact to the remaindermen; and that the sale to the trust bore none of the incidents of an arm's-length transaction.[127]

Nevertheless, the foreign trust/private annuity transaction remained a viable vehicle for minimizing the tax burden on the holder of appreciated securities. Amendments to section 1491 contained in the 1976 Tax Reform Act have severely limited the usefulness of the device, however.

Whereas section 1491 formerly applied only to transfers of stock and securities, the Act now extends the incidence of the tax to the transfer of *any* property.[128] By doing this the Act has in one broad stroke eliminated many schemes formulated to circumvent the excise tax.[129] Another noteworthy change in this

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World" Concept, supra note 115, at 503-504, 508-510.

122. Kanter, *The Foreign Trust—A "One World" Concept, supra* note 115, at 504.

123. *See* text accompanying notes 22-30 *supra.*

124. In such a case, the grantor who transfers the property to the trust will pay a gift tax on the remainder, INT. REV. CODE OF 1954, § 2501(a); *see* Treas. Reg. § 25.2503-3 (1977), from which no annual exclusion may be taken, INT. REV. CODE OF 1954, § 2503(b); the value of the assets of the trust will nevertheless be included in his gross estate, INT. REV. CODE OF 1954, § 2036(a)(1); and since the grantor will be treated as the owner of the trust, he, and not the trust, will be liable for the tax on the trust income. INT. REV. CODE OF 1954, §§ 671, 677(a).

125. 58 T.C. 854 (1972), *aff'd,* 513 F.2d 824 (9th Cir. 1975).

126. 58 T.C. at 867.

127. *Cf.* Mark Bixby, 58 T.C. 757 (1972) (transfer held to result in a grantor trust, taxable under INT. REV. CODE OF 1954, § 671).

128. 1976 Tax Reform Act, § 1491(1).

129. For example, the transfer of interests in a partnership, the principal assets of which consisted of securities, might arguably have escaped the reach of section 1491,

section is the increase in the excise tax rate from the previous rate of 27 1/2 percent of the excess of the value of the securities transferred over their adjusted basis. The Act has raised the tax to 35 percent of the excess of the fair market value of the property transferred over the adjusted basis of such property plus the amount of gain recognized to the transferor at the time of the transfer.

Although section 1491 was orginally intended to create a substitute for the capital gains tax, the combined effect of these two revisions in the 1976 Act will be to establish an anomalous tax structure which bears little relationship to the realities of the transactions involved. On one hand, the section operates as a penalty provision, imposing a higher tax than would otherwise be appropriate upon transferred property which has not so greatly appreciated as to bring into effect the maximum capital gains rate. On the other hand, a taxpayer might seize the opportunity to transfer assets which would normally generate ordinary gain upon sale yet pay tax at only the 35 percent rate.

Congress was primarily motivated to amend the section in response to abuses arising out of private annuity transactions with foreign trusts. No longer will a taxpayer be permitted to avoid the excise tax by selling appreciated assets to a foreign trust and recognizing gain on a deferred basis.[130] The intent of Congress is that the tax apply to all transfers, whether donative or for full consideration,[131] and that the transferor be taxed on the excess of the fair market value of the property over its adjusted basis (*i.e.*, inherent gain), reduced only by any gain recognized at the time of the transfer.[132] In other words, as the House Committee report states,

> all sales and exchanges (including installment sales and private annuity transactions), regardless of how any gain on these transactions is reported, are within the scope of the excise tax provision. But to the extent the transferor immediately recognizes gain

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although the taxpayer ran a considerable risk of having such interests themselves classified as securities; now, however, such a transfer is clearly subject to the excise tax. *See* Lerner, *supra* note 68, at 11.

130. *See* text accompanying note 121 *supra*.

131. H.R. REP. No. 94-658, at 213.

132. 1976 Tax Reform Act, § 1015(a), *amending* INT. REV. CODE OF 1954, § 1491.

in the transfer, the amount against which the tax is applied is reduced.[133]

A principal drawback of the amended rule is its potential for taxing gain twice, once by virtue of the excise tax on the transfer and again by virtue of the capital gains tax upon distribution. This situation arises as a result of the fact that the transferee (*i.e.*, the trust or the transferor to whom its ownership is attributed) is permitted no step-up in the basis of the transferred property, nor is the transferor allowed a credit against income tax for the excise tax.[134] An even more harsh application would result in the event the transferor is deemed the owner of the trust pursuant to the newly enacted grantor trust rule.[135]

A less punitive, but equally anomalous, provision in the section is the requirement that gain be calculated on the basis of the fair market value of the transferred property.[136] While probably no different in application from "value," use of fair market value may result in a higher taxable gain than would be possible were appreciation measured on the basis of "amount realized."[137] Even though the "fair market value" terminology may be necessary to embrace donative transfers as well as arm's-length sales, in the latter circumstance the taxpayer may pay what is in effect a capital gains tax on more gain than was actually realized.

Although not entirely relevant to a discussion of foreign trusts, the excise tax is not applicable to transfers by or to nonresident alien individuals.[138] Thus, while such a transaction would probably not enable a taxpayer to elude the grantor trust rules,[139] a sale of appreciated property to a foreign individual,

133. H.R. REP. No. 94-658, at 213.

134. 1976 Tax Reform Act, § 1014(a), *adding* INT. REV. CODE OF 1954, § 679.

This conclusion seems to follow logically from Rev. Rul. 69-450, 1969-2 CUM. BULL. 168, which held that a transferor who was deemed to be the owner of a foreign trust and thus required to report all its income was nonetheless responsible for paying the section 1491 tax. *See* New York State Bar Ass'n, *supra* note 48, at 282 & nn.35, 36.

135. *Cf. id.*, at 284.

136. 1976 Tax Reform Act, § 1015(a), *amending* INT. REV. CODE OF 1954, § 1491.

137. *See* Alpert & Feingold, *Tax Reform Act Toughens Foreign Transfer Provisions of 1491 and Liberalizes 367*, 46 J. TAX. 2, 3 (1977).

138. INT. REV. CODE OF 1954, § 1491, *as amended by* 1976 Tax Reform Act, § 1015(a).

139. *See* H.R. REP. No. 94-658, at 209; *see generally* text accompanying notes 64-65 *supra*.

who could not be subject to the 35 percent tax, would not create problems of double taxation. In addition, section 1491 presumably does not apply to transfers by an estate. No excise tax would be imposed on the creation of a testamentary foreign trust.[140] Such an exception may prove significant in light of the enactment of provisons requiring a carryover of basis of property acquired from a decedent.[141]

Finally, the amendments to section 1491 promise to increase the difficulty of conducting ordinary commercial transactions with a foreign trust. Even though a party completing an arm's-length sale with a foreign trust may recognize all gain at the time of the transfer, it may nonetheless be necessary to file a return,[142] or at least obtain a determination by the Secretary that the transfer was not one in pursuance of a plan whose principal purpose is the avoidance of income tax.[143] Moreover, certain contributions to foreign corporations and transfers to foreign partnerships are also included in the breadth of the excise tax provisions. In view of the fact that the 1976 amendments were enacted specifically in response to perceived abuses out of transactions with foreign trusts,[144] it is certainly possible to question the propriety of extending the complexity of these amendments to circumstances where similar abuses have not been documented.[145]

Pursuant to section 1057, which was added to the 1976 Tax Reform Act by the Senate Finance Committee,[146] a taxpayer may elect to treat a transfer otherwise taxable under section 1491 as a sale or exchange of property for an amount equal to its fair market value.[147] The taxpayer must recognize as gain

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140. *See* INT. REV. CODE OF 1954, § 1491, *as amended by* 1976 Tax Reform Act, § 1015(a).

141. *See* Alpert & Feingold, *supra* note 137, at 2.

142. Treas. Reg. § 1.1494-1 (1977).

143. INT. REV. CODE OF 1954, §§ 1492(2), 1494(b).

144. This appears implicit in the fact that the only legislative history relating to the excise tax can be found in the sections of the committee reports dealing with foreign trusts. *See, e.g.*, H.R. REP. NO. 94-658, at 213-14.

145. Indeed, one might also doubt the need for such highly technical additions to the Code where the potential for tax avoidance inherent in foreign trusts is great, yet apparently only rarely ripens into actuality. *See* text accompanying notes 2-5 *supra; see also* New York State Bar Ass'n, *supra* note 48, at 281, which questions the very efficacy of section 1491.

146. *See* S. REP. NO. 94-1236, 94th Cong., 2d Sess. 456 (1976) (Conference Committee Report).

147. 1976 Tax Reform Act, § 1015(c), *adding* INT. REV. CODE OF 1954, § 1057.

the excess of the fair market value of the transferred property over its adjusted basis in his hands.[148] The problem of double taxation posed by section 1491 would be avoided under such an election, since the transferee in a section 1057 transaction is permitted to increase his basis in the property according to the amount of gain recognized by the transferor.[149]

There is scant legislative history on this provision, and the precise contours of its applicability remain uncertain. As an addition to subpart O, it is clearly designed to approximate more closely than section 1491 a tax on gains to property transferred to a foreign trust. As such, this new section presumably imposes a tax only on transfers made for full and adequate consideration. The computation of taxable gain, however, is made on the basis of fair market value rather than amount realized, again leaving open the possibility that the amount to which the tax applies will not be equivalent to the actual gain realized.[150]

Most curiously, the section 1057 computation is no different from that involved in section 1491 prior to amendment. While the statutory context would seem to imply that all gain be recognized at the time of the transfer,[151] failure of Congress

148. *Id.* The problem of double taxation posed by section 1491 would be avoided since the transferee in a section 1057 transaction is permitted to increase his basis in the property according to the amount of gain recognized by the transferor.

149. S. REP. No. 94-938, at 223.

Presumably, a taxpayer who elects to treat a transfer as a sale or exchange under section 1057 of the Code, in lieu of paying the section 1491 excise tax, should not fall within the scope of the grantor trust provisons. *See* Alpert & Feingold, *supra* note 137, at 4.

It should be noted that while section 1057 merely requires the transferor to recognize gain from the sale or exchange, section 679(a)(2)(B) requires that gain be recognized and realized at the time of the transfer. It should not, then, be possible to fund a foreign trust using a section 1057 election and take advantage of the section 679(a)(2)(B) exception, since the unfunded trust would not be capable of furnishing the full and adequate consideration apparently required in a section 679(a)(2)(B) sale or exchange. No conclusion is reached here whether it might be feasible to sell property to a foreign trust at its fair market value in exchange for payments made by the trust on an installment basis, where the payments might bear some relation to the expected earnings of the trust and where the transferor would defer recognition of the section 1057 gain until the payments were received. If the transferor made such an installment sale, but did not elect to pay the section 1057 tax, he would be subject to the section 1491 excise tax, since section 1491 taxes all appreciation that is not reduced by gain recognized at the time of the transfer.

150. *Cf.* text accompanying note 137 *supra*.

151. *See* Alpert & Feingold, *supra* note 137, at 4. Indeed, it is possible that Con-

to so state lends support to the argument that a taxpayer may utilize the section 1057 election in, for example, a private annuity or installment sale transaction, where recognition of taxable gain is deferred. Congress surely cannot have intended to modify section 1491 so as to foreclose such transactions then reenact it in substantially similar form, yet the ambiguity of section 1057 does nothing to prevent one's reaching such a conclusion.

V. CONCLUSION

It is easily discernable that the creature known as the foreign trust has been substantially altered by the Tax Reform Act of 1976. What was once a readily available form of tax avoidance has been transformed into a mere shell of itself. Unless used as an estate planning device a foreign situs trust now may be more liability than asset to its creator.

Some of the changes implemented by the Act may be thought of as harsh. Regardless of the seeming severity, Congress's goal of closing a tax avoidance loophole appears to have been met. Until the regulations concerning this portion of the Act are released it is mere speculation to comment on the effectiveness of the changes. However, it is to be expected that the regulations will be in agreement with the legislative intent. Therefore, based upon existing information, the foreign situs trust can no longer be thought of as a means of tax avoidance.

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gress simply assumed that the references to section 1491 in section 1057 were sufficient to incorporate the legislative history behind the excise tax provisions into section 1057.