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Whose Trust Is It Anyway? How Deference to Form over Substance Can Produce Unhappy Results for Those Who Settle Trusts

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"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." — *Attributed to Mark Twain*

One of the challenges of cross-border planning is occasionally confronting practices long perceived as effective that don't work once a U.S. person is added to the mix. Often this is due to the deference a foreign jurisdiction may give to the form of a transaction whose substance U.S. law refuses to ignore. Common practices by which trusts are settled provide an example. In many jurisdictions, trusts are commonly settled by an individual or entity that the United States will regard as an intermediary or agent of the U.S. person for whose benefit the foreign trust was established.

> *Example:* Jack is a U.S. citizen residing in Canada. Jack is the beneficiary of an irrevocable trust nominally settled by Jack's father. The trust will invest in commercial real estate, through a wholly owned corporation. Jack's father resides in Canada, is not a U.S. citizen, and does not have a green card. The trust settlement identifies Jack's father as the settlor and recounts delivery of $100 to the trustee in settlement of the trust. The trustee resides in Canada. The trust is a Canadian resident trust for Canadian income tax purposes and a foreign trust for U.S. income tax purposes.[1] Assume that Jack's father did, in fact, deliver the $100 to the trustee (who is not Jack) when the trust settlement was signed. The trustee uses the cash to subscribe for shares of a newly formed corporate entity organized to acquire the real estate. Shortly after formation, Jack makes an interest-free loan to the corporation of $100,000, which is used to make a down payment to acquire the property.

Jack's Canadian professional advisers accept the transaction exactly as described: a trust settled for Jack's benefit by his father. Income earned by the corporation will not be taxable to the trust unless distributed as a dividend. Dividend income paid to the trust will be taxable either to the beneficiaries if distributed to them or taxable to the trust if accumulated for distribution in subsequent years. Jack's U.S. advisers tell Jack a very different story.

- First, §679 and Treasury regulations interpreting and applying it regard Jack as the settlor because he is an indirect or constructive transferor of assets to the trust.
- Second, if Jack is regarded as the settlor of the trust, §674(a) and §677(a) treat the trust as a grantor trust and Jack as the owner of the income and principal of the trust for U.S. income tax purposes.

[1] *See generally* §7701(a)(31)(B).

- Third, ownership of the stock held by the trust will be attributed to Jack as the grantor of the trust, thereby invoking CFC and PFIC anti-deferral regimes.

Reg. §1.671-2(e)(1) provides that "a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust." Reg. §1.671-2(e)(2) defines a gratuitous transfer as any transfer for less than fair market value. Regulations under §671 treat a person who transfers property to a trust and the person who reimburses the transferor for the property transferred to the trust as both grantors, but only the latter person is treated as the owner of the trust.[2]

While it is clear from the example that Jack did not directly settle the trust, he arguably made an indirect or constructive transfer to the trust which will cause him to be treated as the owner of the trust under §671. This conclusion is supported by two interpretations of the facts:

- Jack's father acted as Jack's intermediary to effect an indirect transfer described in Reg. §1.679-3(c); or
- Jack's loan was not made for "fair market value" within the meaning of Reg. §1.679-4(b).

Treasury regulations provide a "transfer means a direct, indirect, or constructive transfer."[3] The regulations go on to describe an indirect transfer as a transfer "made pursuant to a plan, one of the principal purposes of which is the avoidance of U.S. tax."[4] A principal purpose of tax avoidance is deemed to exist if two conditions are satisfied. First, the settlor of the trust is related[5] to the beneficiary "or has another relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the U.S. transferor would make a transfer to the foreign trust."[6] Second, the U.S. person cannot demonstrate to the satisfaction of the Commissioner that:

(1) the relationship between the nominal settlor and the beneficiary establishes a "reasonable basis" for concluding that the intermediary would make a transfer to the foreign trust;

(2) the actions of the nominal settlor were independent of the U.S. person;

(3) the nominal settlor is not an agent of the U.S. person; and

(4) if required, a Form 3520 and any other reporting requirements under §6048 were satisfied.[7]

In response to the concerns created by the regulations, two arguments may be advanced as to why the analysis of Reg. §1.679-3(c) does not apply to Jack's situation as framed in the example. First, Reg. §1.679-3(c)(1) requires a transfer from the U.S. person (Jack) to the intermediary (Jack's father). However, that transfer may occur at any time, either before or after Jack's father settles the trust.[8] Second, the actual transferor (Jack) and the beneficiary of the foreign trust must be different individuals. Such a literal and circumscribed reading of the regulations may be misplaced. The phrase "has another relationship" is arguably broad enough to include the same person.

Although Jack made a loan to the corporation, the loan is treated as if it were made to the trust.[9] Unless Jack's loan to the trust satisfies the definition of a "qualified obligation" under Reg. §1.679-4(d), the loan will be treated as a gratuitous transfer to the trust such that Jack will be treated as the owner of the trust under §679(a)(1). The fair market value exception under §679(a)(2)(B) does not apply because §679(a)(3)(A)(i) makes the fair market value exception inapplicable in the case of an obligation given by a grantor of the trust.[10]

Even if Jack is not regarded as the grantor of the trust as the result of his relationship to his father, Jack will not be able to avoid being treated as the owner of the trust under §679(a)(3)(C)(iii) unless his loan is treated as a "qualified obligation" under the Treasury regulations. In order for Jack's $100,000 loan to be treated as a qualified obligation, it must satisfy six requirements:

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[2] *See* Reg. §1.671-2(e)(6) *Ex.* 3. Both the transferor and the person who reimbursed the transferor are responsible parties for purposes of the reporting requirements imposed by §6048. Section 6048 requires notification to the Secretary of the Treasury whenever a reportable event occurs. Reportable events for purposes of §6048 include creation of the foreign trust by a U.S. person or the transfer of any money or property to the foreign trust, unless the transfer was an exchange for consideration equal to the fair market value of the transferred property. The reporting requirements of §6048 are satisfied by filing Form 3520 for the year in which the trust was established or transfers occurred.

[3] *See* Reg. §1.679-3(a).

[4] *See* Reg. §1.679-3(c)(1).

[5] Relatedness is determined broadly by Reg. §1.679-3(c)(4) by reference to the scope of the term "related" in §643(i)(2)(B), which, in turn, references the loss disallowance rules of §267 (except for §267(f)) and §707(b) and using an "at least ten percent" in lieu of "more than fifty percent" threshold.

[6] *See* Reg. §1.679-3(c)(2)(i).

[7] *See* Reg. §1.679-3(c)(2)(ii).

[8] T.D. 8955 (July 19, 2001) Preamble, Comments Relating to §1.679-3: Transfers. A. Indirect Transfers — Principal Purpose of Tax Avoidance.

[9] *See* Reg. §1.679-3(f)(1).

[10] *See* §679(a)(3)(C)(ii).

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(1) the obligation is confirmed by a written agreement;

(2) the duration of the obligation does not exceed five years;

(3) the payments are denominated in U.S. dollars;

(4) the loan yields to maturity within a corridor of 100% to 130% of the applicable Federal rate under §1274(d) at the time of issuance;

(5) the statute of limitations for assessment is extended to a date at least three years after the maturity date of the obligation; and

(6) Jack reports the status of the loan including principal and interest payments on a Form 3520 for each year until the loan is repaid.[11]

The qualified obligation requirements apply to any deferred payment obligation the trust may provide to Jack regardless of whether the transaction between Jack and the trust is characterized by the parties as a loan, sale or exchange for an installment note, or sale or exchange for a private annuity. As observed above, even if Jack's transfer to the trust satisfies the qualified obligation requirements of the Treasury regulations, Jack will nonetheless be treated as the owner of the trust if he is determined to have indirectly or constructively transferred the $100 with which the trust was initially settled as a result of his relationship with his father. The §679 regulations are generally applicable to transfers occurring after August 7, 2000.[12] However, the qualified obligation rules of Reg. §1.679-4(c) and §1.679-4(d) apply to obligations issued or modified after February 6, 1995.[13]

Characterization of Jack as a settlor and owner of the trust has consequences beyond Jack's taxation on the income and gains of the trust. Jack's status as the grantor of the trust makes the corporation the trust owns a CFC.[14] With regard to the PFIC rules, stock owned by a trust is attributed to the grantor of the trust.[15] In contrast, determining the stock ownership of trust beneficiaries and the consequences of that ownership (especially in the case of PFICs) is less clear.[16]

[11] *See* Reg. §1.679-4(d).

[12] *See* Reg. §1.679-7(a).

[13] *See* Reg. §1.679-7(b)(1).

[14] *See* §958(b), §318(a)(2)(B)(ii).

[15] Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1032 (1987). *Accord* Reg. §1.1295-1(d)(2)(iii)(A)(*2*), §1.1295-1(d)(2)(iii)(B)(*2*).

[16] *See* M. Read Moore, *Indirect Ownership of CFC and PFIC Shares by U.S. Beneficiaries of Foreign Trusts*, 108 J. Tax'n. No. 2, 105 (Feb. 2008).

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