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Developments Regarding Taxation of Use of Trust Property

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- **Origins of Position that Use of Trust Property is Not a Distribution**
- **Legislative Proposals to Tax Use of Trust Property**
- **Interest in Use of Trust Property for Expatriation Exit Tax Purposes**
- **Comment**

Recent legislative proposals look to change the generally accepted position that a loan of tangible property from a trust, including the rent-free use of a residence or yacht owned by a trust, does not constitute a taxable distribution to a trust beneficiary. A recently amended Internal Revenue Service (IRS) form provides that an expatriate's property for the purposes of exit tax includes the right to use trust property. Advisers to multinational families should keep a close eye on such developments as they may have a significant impact on succession planning.

Origins of Position that Use of Trust Property is Not a Distribution

The Small Business Job Protection Act 1996 made significant changes to the tax laws applicable to foreign trusts and trusts established by non-US persons. The act added Section 643(i) to the Internal Revenue Code, which treats as a distribution for income tax purposes a foreign trust's loans of cash or marketable securities to any US settlor or beneficiary of the trust, or to any other US person who is related to such a settlor or beneficiary. An earlier version of the legislation would have treated the loan of tangible personal property, (eg, vacation homes, automobiles and boats) as a distribution. Since this language was not included in the final code section,

practitioners generally concluded that use of trust property by a beneficiary was not a distribution, so that such use did not give rise to US reporting obligations or tax consequences to a US beneficiary.

The 1996 act also amended Section 679 of the code, which treats the US settlor of a foreign trust that has one or more US beneficiaries as the owner of the trust's assets for US income tax purposes, under the so-called grantor trust rules (for further details regarding grantor trust classification please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates"). Whether a foreign trust has a US beneficiary is determined on an annual basis, with the foreign trust being treated as having a US beneficiary for a taxable year unless no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a US person. Neither the code nor the regulations address the use of trust property.

Even prior to the 1996 act, case law supported the position that use of trust property was not taxable to the beneficiary. In *Alfred I DuPont Testamentary Trust*[(1)] the US Tax Court held that amounts paid by trustees for the maintenance and improvement of a residence could not be deducted for income tax purposes as distributions to Mrs DuPont as the residuary beneficiary of the testamentary trust. The court discussed *Commissioner v Plant*,[(2)] in which the Second Circuit Court of Appeals noted that the *Plant* facts were:

> *"like one of a trust under which the trustee is directed to keep a house in repair and allow a beneficiary to live in it rent free. The advantage derived by a beneficiary under such a trust is not taxable as part of his income."*

Legislative Proposals to Tax Use of Trust Property

Stop Tax Haven Abuse Act

The proposed Stop Tax Haven Abuse Act recommends changes to Sections 643(i) and 679 of the code that would specifically address the use of trust property.

The proposed act would revise Section 643(i) so that it specifically applies to a foreign trust that makes a loan of cash "or other property, including real estate, marketable securities, artwork, jewelry, and other personal

property" so that such loan or use will be taxed as a distribution from the foreign trust.

In addition, the proposed act would add to Section 679 a new subsection which would provide that:

> "*Any United States person receiving from a foreign trust cash or other property, or receiving the use thereof, shall be treated as a beneficiary of such trust regardless of whether such person is a named beneficiary, except to the extent that such person paid fair market value for the benefit received.*"

Foreign Account Tax Compliance Act

Most recently, a House-Senate proposal announced on October 27 2009, entitled the Foreign Account Tax Compliance Act, proposes amending Section 643(i) to read:

> "*if a foreign trust makes a loan of cash or marketable securities (or permits the use of any other trust property) directly or indirectly to or by (A) any grantor or beneficiary of such trust who is a United States person, or (B) any United States person not described in subparagraph (A) who is related to such grantor or beneficiary, the amount of such loan (or the fair market value of the use of such property) shall be treated as a distribution by such trust to such grantor or beneficiary (as the case may be).*"

The proposed act provides an exception for the use of any trust property other than a loan of cash or marketable securities to the extent that the trust is paid the fair market value of such use within a reasonable period of time.

Although the proposed act does not amend Section 679 to specify that a US person receiving the use of trust property shall be treated as a US beneficiary for the purposes of that section, it otherwise attempts to enforce compliance in treating US persons as owners of property transferred to foreign trusts by integrating regulations previously clarifying that a foreign trust is treated as having a US beneficiary if any current,

future or contingent beneficiary of the trust is a US person.

This newly proposed legislation is even more aggressive in its attempts to address what is viewed as egregious non-compliance by US tax evaders. In addition to amending Sections 643(i) and 679, the proposed act would force foreign financial institutions, foreign trusts and foreign corporations to provide information about their US accountholders, grantors and owners. It would also require certain persons who provide any material aid, assistance or advice to US individuals acquiring certain direct or indirect interests in foreign entities to file an information return setting forth the identity of the foreign entity and the identity of the US individual.

Interest in Use of Trust Property for Expatriation Exit Tax Purposes

At the end of May 2009 the IRS released a substantially revised Form 8854 - Expatriation Information Statement. Form 8854 is used by US citizens who have relinquished their citizenship and long-term US residents who have ended their residency to provide information relevant to the mark-to-market (or exit) tax that is applied to persons expatriating after June 16 2008 (for further details please see "New Tax Law Applicable to Expatriates"). The mark-to-market tax applies to the net unrealized gain on the covered expatriate's worldwide assets as if such property were sold for its fair market value on the day before the expatriation date to the extent that the net gain exceeds $600,000.

The new instructions to Form 8854 confirm that the standard for determining whether a taxpayer owns an interest in property is whether that interest would be included in the taxpayer's gross estate for federal estate tax purposes. The instructions further state that:

> "*An interest in property includes money or other property, regardless of whether it produces any income or gain. In addition, an interest in the right to use property will be treated as an interest in such property.*"

Comment

The possibility that a beneficiary's use of trust property such as a home or yacht could result in US tax liability raises significant valuation issues. It is often difficult to place a value on outright ownership of items of real and

personal property, let alone the value of the use of property for varying lengths of time. For more than 10 years clients have been advised that the use of trust property is not considered a distribution from a foreign trust, and thus it is not necessary for a US beneficiary using trust property to file Form 3520 or include any amounts in taxable income. A change to this approach will have an impact on many an existing succession plan.

For further information on this topic please contact Jennie Cherry at Kozusko Harris Vetter Wareh LLP's New York office by telephone (+1 212 980 0010), fax (+1 212 202 4484) or email (jcherry@kozlaw.com).

Endnotes

(1) 66 TC 761 (1976), aff'd 574 F 2d 1332 (5th Cir 1978).

(2) 76 F 2d 8 (2d Cir 1935), affirming 30 BTA 133.

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