

A REPRESENTATIVE CASE

Favorable Restructuring of Administration of Foreign Situs Trust Investments

By C. William Tanzi

In 2004, a non-U.S. citizen had created a discretionary foreign situs trust for the benefit of her two children, both of whom were living in the U.S. The trust was funded with a variety of liquid assets, totaling \$15 million. The trust was designed to be treated as a non-grantor trust for U.S. income tax purposes.

In view of the application of the “throwback rules” governing the taxation of the beneficiaries of foreign trusts*, in order to prevent the accumulation of undistributed net income (“UNI”) the trustee was faced with restricting the trust investments to tax-exempt bonds (with an unsatisfactory investment return) and/or adopting a buy-and-hold strategy in order to avoid the realization of capital gains (which are, nevertheless, treated as ordinary income if realized and distributed in later years).

In 2008, as part of a plan to re-structure the trust investments in order to mitigate the effect of the income tax “throwback rules”, the trustee invested \$10 million in asset value spread between two private placement life insurance policies, one structured as a modified endowment contract (“MEC”) and the other as a non-MEC.

With respect to the MEC policy, any withdrawals from the policy are considered distributable net income (i.e., ordinary income) in the year of withdrawal. The prior year accumulations within the policy are not taxable until withdrawn (or borrowed), and then only as current distributable net income not subject to the “throwback rules”. Thus, if the trust makes a distribution to U.S. beneficiaries

equal to the amount of the MEC withdrawal, no portion of the distribution will be subject to the “throwback rules” and a favorable tax benefit is obtained.

With respect to the non-MEC policy, any withdrawals from the policy up to premium basis will similarly be treated as current year distributable net income not subject to the “throwback rules”. If desired, amounts beyond the premium basis can be accessed by way of policy loans, the proceeds of which are in turn loaned to the trust beneficiaries (and, therefore, no distribution of UNI would occur).

Each beneficiary would give a promissory note (at the applicable federal rate) to the trust in exchange for the cash received. The relatively low AFR would thus provide the beneficiaries with an opportunity to achieve a greater return on the loan proceeds than the interest rate payable to the trust. However, such loans can only be structured with relatively short terms of 5 years or less.

This technique will achieve considerable tax savings and more flexible access to the assets of the foreign trust as compared to the trust’s previous investment allocation.

*The effect of the “throwback rules” is to make the accumulation of income in the foreign trust less attractive by capturing the incremental amount of tax that would have been paid if UNI had been distributed (and taxed) to the beneficiary in the years in which it was originally earned. Thus, the rules impose an interest charge upon the regular income tax that the beneficiary pays on the distribution. This interest charge is compounded over the length of time the income is accumulated in the trust. In addition, the rules strip capital gains of their favorable tax character if they are accumulated and distributed as UNI in later years.

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About C. William Tanzi —

C. William Tanzi has practiced for more than 25 years in the areas of estates and trusts law, wills and estate administration and estate and gift planning.

Bill Tanzi's practice emphasizes dynamic estate and gift planning, multi-generational wealth preservation and specialized tax and non-tax private client services for high and ultra-high net worth individuals.

Bill has extensive experience in the design, structure and administration of sophisticated estate and gift planning techniques for high net worth private clients, including family partnerships, LLCs, grantor trusts and personal residence trusts, various types of charitable trusts, private foundations and tax-exempt organizations, as well as the implementation of advanced estate liquidity and asset protection strategies, generation-skipping transfers and business succession plans.



His practice also encompasses international estate and gift tax issues, including "inbound" trust planning, and the structuring of foreign situs trusts and related entities. Bill's approach focuses on finding highly creative and practical solutions to the specific tax and non-tax issues inherent to planning for the preservation of personal wealth and closely-held business interests for clients and their families.

Bill Tanzi is admitted to practice in both New York and Connecticut, and is a member of the New York State (Section on Trusts and Estates Law), American and Connecticut Bar Associations.

Bill is also a member of the Lower Fairfield County Estate Planning Council and a member of the Attorney Advisory Committee of Lighthouse International, and has been a supervising partner of the estates and trusts practices at three recognized New York and Connecticut law firms.