THE GREAT MYTH IN PRE-IMMIGRATION TAX PLANNING – WHY SECTION 679(A)(4) DOES NOT APPLY TO SUBTITLE B (U.S. ESTATE, GIFT AND GENERATION SKIPPING TRANSFER TAXES)

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In almost every article or discussion about pre-immigration tax planning, inevitably some statement similar to the following is said: ". . . for a nonresident alien contemplating immigration to the United States, careful trust planning is required at least five years prior to the time of the immigration."[1] Wow! Does this mean a non-resident alien who is contemplating moving to the U.S., on a temporary or permanent basis, that they must be aware of their future plans at least five years in advance! Must they make various transfers of assets, including completed gifts (if such are not costly in their home country) not knowing if they will indeed ever move or come to the U.S.?

Can it be true that anyone who might consider moving to the U.S. must be able to plan their financial affairs five years in advance to avoid harsh U.S. tax consequences and lose various levels of control over their assets? Is there a difference for income taxes versus transfer taxes (estate gift and GSTT)? Why is this "5 year" statement so frequently made by investment advisors and many tax practitioners?

To be sure, I.R.C. Section 679(a)(4) and the 2001 Treasury Regulation Section 1.679-5[2] (Pre-Immigration Trusts) have caused much confusion.

HYPOTHETICAL - NON-RESIDENT FUNDING OF FOREIGN TRUST

To illustrate how the law works, let us use an example as follows: Mr. Juan Perez ("**Mr. Perez**") is a Mexican citizen who is contemplating immigrating to and taking up residence in the United States ("**U.S.**") during 2005 or 2006. He does not know if he wants to stay and live in the U.S. temporarily or permanently as he has family in Mexico, Canada, Spain and the United States. He has homes in more than one country and often times rents an apartment temporarily in one of the countries outside of Mexico. Mr. Perez currently owns a majority interest in several Mexican corporations, as well as other assets, all being situated outside the U.S. Mr. Perez wants to know whether as part any pre-immigration tax planning considerations he might be able to reduce his exposure to U.S. estate or gift taxes that would otherwise apply upon his death if he becomes a U.S. domicile. This is particularly important since under Mexican law there is currently no type of estate, inheritance or other "death" tax.

Mr. Perez has received conflicting advice that any assets (the "**Assets**") transferred to a foreign trust (the "**Pre-Immigration Trust**") prior to becoming a U.S. resident should not be subject to estate tax because the Pre-Immigration Trust? This Pre-Immigration Trust will be be just such a trust referred to in the regulations -Section 1.679-5 (*Pre-Immigration Trusts*). Will Mr. Perez be treated as the owner of these Assets for U.S. transfer tax purposes (estate, gift and GSTT)?

APPLICATION OF U.S. RULES TO FOREIGN TRUST AND FOREIGN SETTLOR?

Before we discuss in any detail Section 679, we can ask the question whether the Internal Revenue Code and its provisions can even apply to a foreign trust, such as a Pre-Immigration Trust contemplated by the regulations. How can U.S. statutory law apply to a foreign trust with a foreign settlor even if there are no U.S. beneficiaries? What if the foreign trust is not subject to the jurisdiction of any United States court as contemplated by Treasury Regulation Section

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[1] *See William P. Streng, U.S. International Estate Planning, Part II. U.S. Income Tax Planning for Lifetime Wealth Accumulation and Investment Chapter 5. Foreign Estates, Trusts, and Beneficiaries, ¶ 5.06 FOREIGN TRUSTS AND U.S. GRANTOR TRUST RULES, ¶ 5.06[4][j] Strategies to Avoid Foreign Grantor Trust Treatment.*

[2] *Treas. Reg. Section 1.679-5(a) provide in its entirety as follows:*

> *If a nonresident alien individual becomes a U.S. person and the individual has a residency starting date (as determined under section 7701(b)(2)(A)) within 5 years after directly or indirectly transferring property to a foreign trust (the original transfer), the individual is treated as having transferred to the trust on the residency starting date an amount equal to the portion of the trust attributable to the property transferred by the individual in the original transfer.*

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301.7701-7(a)(1) and (c)? What if the foreign trust does not have a single U.S. person (let alone a U.S. trustee) with any "substantial decision" powers as identified in Treasury Regulation Section 301.7701-7(d)(1)(ii)?[3]

Hence, an initial question is whether U.S. tax laws can even govern the potential U.S. taxation to the trust or possible future U.S. beneficiaries or the settlor who may become a U.S. person but not necessarily a beneficiary? According to the IRS and U.S. federal courts, "United States tax concepts apply to determine the tax consequences of events [for U.S. Tax purposes] even if those events occur outside of the United States and even if those events result from activities conducted by foreign persons."[4] Moreover, U.S. tax principles control over foreign tax principles or characterization absent express congressional intent to the contrary.[5] Indeed, the IRS has taken the position that U.S. tax principles govern notwithstanding the existence of a conflict with foreign tax treatment or policies.[6] Consequently, any future U.S. tax consequences associated with the Pre-Immigration Trust will be governed by U.S. tax laws (to the extent they are relevant in determining the U.S. tax consequences to its U.S. assets or any future U.S. beneficiaries), even though the trust will be formed outside the U.S. by a nonresident alien, under foreign law.

SECTION 679(A)(4) AND ITS APPLICATION TO PRE-IMMIGRATION TRUSTS

What about Section 679(a)(4)[7] which raises the concern that despite the transfer to the Pre-Immigration Trust, Mr. Perez will continue to be treated as the owner of the Assets for estate and transfer tax purposes?

Section 679(a)(4), in conjunction with Section 679(a)(1), provides that where a nonresident alien individual becomes a U.S. resident within five (5) years of transferring property to a foreign trust, the individual is treated at least for income tax purposes, as the owner of the property so transferred if the trust has one or more U.S. beneficiaries. This is consistent with the statute that provides that the portion transferred to the foreign trust by the non-resident alien, shall be treated "as if such individual transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer." See section 679(a)(4).

SUBTITLE A VERSUS SUBTITLE B

Does Section 679(a)(4) (an income tax provision) apply only for income tax purposes under Subtitle A, or can it also be construed as also applying to the estate, gift tax or generation skipping transfer provisions and calculations under Subtitle B (thus resulting in Mr. Perez's ownership of the Assets for estate tax purposes which would give rise to adverse and unexpected estate tax consequences upon Mr. Perez's death assuming he will eventually become a permanent domicile in the U.S.)?

The answer to this question is surprisingly straightforward. Based on the legislative history, with which the IRS is in accord, Section 679 only applies for purposes of income taxes. It has no relevance for purposes of the estate, gift tax or generation skipping transfer provisions and calculations under Subtitle B. Thus, it is indeed a myth that[8] transferring assets to a foreign trust prior to coming to the U.S. within five years, will necessarily cause the trust assets to be subject to U.S. estate taxes.

The key to any pre-immigration trust transfers is therefore not Section 679, but rather the various provisions set forth in Subtitle B, including the application of Sections 2031 through 2044.

Mr. Perez will indeed be able to make certain types of transfers of Assets without taxation (assuming they are not tangible assets situated in the United States) to the Pre-Immigration Trust, which would allow him the flexibility to move to the U.S. within five years of making such transfer. If he does move to the U.S. on some type of temporary or permanent basis

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[3] *A trust is a United States person and hence not a "foreign trust" pursuant to Section 7701(a)(30)(E) only if it satisfies both the "court test" and the ("control test") as follows:*

> *(i) A court within the United States is able to exercise primary supervision over the administration of the trust (court test);* ***and***
> *(ii) One or more United States persons have the authority to control all substantial decisions of the trust (control test). See Treas. Reg. Section 301.7701-7(cc) and (d).*

Hence it is quite easy to have a foreign trust under this statutory rule, if a single "substantial decision" is held by anyone other than a United States person (e.g., non-resident alien, foreign corporation, etc.).

[4] *2002 IRS CCA LEXIS 134, citing, U.S. v. Goodyear Tire and Rubber Co. 493 U.S 132, 145 (1989), reh'g denied, 493 U.S. 1095 (1990); Biddle v: Comm'r, 302 U.S. 573, 578 (1938); Rev. Ruls. 73-254, 64-158. See generally, Mary F. Voce, Basis of Foreign Property Subject to U.S. Taxation, 49 Tax Law. 341 (Winter, 1996).*

[5] *Goodyear Tire and Rubber Co., at 145.*

[6] *1998 FSA LEXIS 630; 1997 FSA LEXIS 208; 1993 FSA LEXIS 44.*

[7] *All Section references are to the Internal Revenue Code of 1986 (the "**Code**"), as amended, and the Treasury Regulations promulgated thereunder unless otherwise provided.*

[8] *An NRA.*

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within five years from funding the Pre-Immigration Trust, then he will be treated as the grantor of the trust assets for U.S. **income** tax purposes under Section 679(a)(4). This may seem like a bad result for the taxpayer - "right"?

Actually, this is probably of no real consequence, unless (i) he has no right to the income from the assets held in the Pre-Immigration Trust from which to pay his U.S. income taxes, or (ii) he will be staying in the U.S. only on a temporary basis and eventually leaving to points beyond. If Mr. Perez moves to the U.S. on a permanent basis, he will probably have a better U.S. income tax result due to the application of Section 679(a)(4) as opposed to the possible application of the U.S. "throw back" tax on accumulated income in a foreign trust.

So at the end of the day, if Mr. Perez decides to immigrate to the U.S., he can actually pay less U.S. income tax by avoiding the application of the "throw back" tax by application of Section 679(a)(4). This is because accumulation distributions from foreign trusts are subject to a special tax, referred to as the "throwback" tax,[9] as well as an accompanying interest charge thereon,[10] which together are designed to approximate the U.S. tax burden a U.S. Person would have borne had the foreign trust distributed all its income in the year in which such income was earned, instead of accumulating it and distributing it in a later year.

The amount of the throwback tax is taxed as ordinary income at the U.S. person's marginal U.S. tax rates, and then the interest charge is calculated thereon. The application of the throwback tax and interest charge gives rise to potentially draconian U.S. tax consequences for any U.S. beneficiary.

For example, to give you an idea of the severity of the throwback tax interest charge, assume the following hypothetical facts, which all go into a series of complex calculations to determine the amount of the throwback tax and interest charge: (1) the Trust is formed in 2005 and funded with US$200,000 cash; (2) the Trust generated income of US$20,000 each year from 2005 through 2025 (20 years), meaning that, as of December 31, 2025, the trust will have US$600,000 in assets, and (3) the U.S. person's average U.S. taxable income for 2023 through 2025 was US$270,000, and he was subject to a marginal tax rate of 35 percent; and (4) the applicable interest rate on underpayment of tax was six percent.[11]

Based on these hypothetical facts, on the US$600,000 distribution to the U.S. beneficiary, he would be subject to a throwback tax of approximately US$140,000, together with an interest charge thereon of approximately US$284,000, for a total U.S. tax bill of approximately US$420,000. That means, without even considering California state taxes, the U.S. beneficiary would net approximately only US$176,000 on her total distribution of US$600,000 (of which US$200,000 was not even accumulated income but rather principle).

The application of Section 679(a)(4) will necessarily avoid this type of draconian result to Mr. Perez if the Pre-Immigration Trust accumulates income since he will be taxable annually on the income from it (once and if he becomes a U.S. Person) regardless of whether any distributions are actually made.

Returning to tax consequences of the Pre-Immigration Trust we should now look to whether Mr. Perez will (a) make the gratuitous transfer of some or all of the Assets to the Pre-Immigration Trust and whether that will be complete and effective for gift and estate tax purposes prior to Mr. Perez becoming a U.S. resident, and (b) have no interest in the Assets held by the Pre-Immigration Trust, or control over the Pre-Immigration Trust, which would require him to include the Assets, or a portion thereof, in his gross estate under the estate tax provisions of Subtitle B of the Code (i.e., the Pre-Immigration Trust must be treated as the owner with of the Assets for estate tax purposes).

ESTATE TAX RULES

Generally. The U.S. estate tax is imposed on the taxable estates of all U.S. citizens and domiciled residents.[12] Sections 2031 through 2044 define the gross estate (the starting point in determining the taxable estate) and describe the property interests held by the decedent at death that are includible in the decedent's gross estate (also is a U.S. citizen or domicile) and thus subject to U.S. estate tax. In pertinent, the following property interests must be included in the U.S. decedent's gross estate:

[9] *§667*

[10] *§668. For years prior to 1996, the interest on the throwback tax is computed at a fixed annual rate of six percent, with no compounding. For years beginning on January 1, 1996, the interest rate applicable to the throwback tax is the floating rate imposed on underpayment of tax under §6621(a)(2), with compounding. The current interest rate is five percent. The compound interest based on the underpayment rate would be imposed not only on throwback tax, but also on the total simple interest for pre-1996 periods.*

[11] *For ease of illustration and calculation, a steady interest rate of six percent was used. However, the rate was as high as nine percent during periods in 1996, 1998, and 2001, which, of course, would mean the interest charge would be much higher.*

[12] *§2001. Generally speaking, a nonresident alien is subject to U.S. estate taxes on tangible and intangible assets situated in the U.S. at death, absent treaty provisions to the contrary. §2103. The U.S. gross estate of a nonresident alien would also include U.S. assets held in a foreign trust over which the nonresident alien retained an interest or power which, were the nonresident a U.S. citizen or resident, would result in the inclusion of the trust in the decedent's gross estate under Sections 2031 through 2044 (discussed next). Reg. §20.2103-1.*

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- Property, or an interest therein, transferred by the decedent within three (3) years of death;[13]
- Property, or an interest therein, transferred by the decedent with a retained life estate;[14]
- Property, or an interest therein, transferred by the decedent where the transfer does not take effect until the death of the decedent;[15]
- Property, or an interest therein, transferred by the decedent subject to a revocation power;[16] and
- Property, or an interest therein, subject to a general power of appointment held by the decedent.[17]

SECTION 679 AND INCOME TAX RULES

Generally. In general, under the grantor trust rules of Sections 671 through 677, the grantor of a domestic or foreign trust is treated as the owner of the assets held in the trust, and taxed on the income therefrom, if pursuant to the terms of the trust or otherwise:

- He retains a reversionary interest in either the corpus or the income that exceeds five percent of the value thereof;[18]
- He retains the power to control the beneficial enjoyment of the trust corpus or trust income without the consent of an adverse party;[19]
- He retains certain administrative powers over the trust;[20]
- He retains the power to revoke the trust;[21] or
- The income of the trust can be used for his benefit.[22]

Notably, the grantor's powers over, and interests held in, the trust assets that would cause the trust assets to be treated as owned by, and the trust income to be taxable to, the grantor (for income tax purposes) are quite similar and to some extent overlap with the powers and interests held by the grantor that would result in the trust assets being includible in the grantor's gross estate for estate tax purposes (i.e., reversion or revocation powers, control of income or corpus or beneficial enjoyment thereof, etc.). Thus, generally speaking in the context of U.S. trusts, if a grantor of a foreign trust retains powers and interests which cause the trust to be treated as a grantor trust under the foregoing grantor trust rules

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[13] *§2035(a) (including transfers to trust).*

[14] *§2036(a). "The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise . . . under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death . . . (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." Id. Note, §2036(b) contains special rules to determine whether stock of a controlled corporation must be included in the decedent's gross estate where the decedent transferred the stock but retained voting rights related thereto.*

[15] *§2037(a). The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has . . . made a transfer . . . by trust or otherwise, if . . . (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property . . . and the value of such reversionary interest immediately before the death of the decedent exceeds five percent of the value of such property." Id.*

[16] *§2038(a) and (a)(1) provide that, "[t]he value of the gross estate shall include the value of all property . . . [t]o the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death."*

[17] *§2041(a) and (a)(2) provide in pertinent that, [t]he value of the gross estate shall include the value of all property [t]o the extent of any property with respect to which the decedent has at the time of his death a general power of appointment . . . or with respect to which the decedent has at any time exercised or released such a power of (appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive."*

[18] *§67y(a).*

[19] *§674(a). There are many exceptions to this rule in §674(b)(1)-(8).*

[20] *§675. Enumerated powers include the power to purchase, exchange or otherwise deal with or dispose of the trust principle or income for less than adequate consideration, and the power to borrow trust assets for less than adequate interest or without adequate security.*

[21] *676(a).*

[22] *§677. Under Section 677(a), a grantor is treated as the owner of any portion of a trust whose income is or may be: (i) distributed to the grantor or the grantor's spouse; (ii) held or accumulated for future distribution to the grantor or the grantor's spouse; or (iii) applied to the payment of insurance premiums on the life of the grantor or the grantor's spouse.*

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(grantor has too much power over beneficial enjoyment of property), such powers and interests may also result in the assets of the trust, or portion thereof, being includible in the grantor's gross estate for estate tax purposes.[23]

In addition to the grantor trust rules described above, Section 679, which was added by the Tax Reform Act of 1976 (the "1976 Act")[24] and amended significantly by the Small Business Job Protection Act of 1996 (the "1996 Act"),[25] treats the U.S. grantor of a foreign trust that has one or more U.S. beneficiaries as the owner of the trust's assets under the grantor trust rules. Consequently, the U.S. grantor, who under Section 679 is deemed to be the owner of the foreign trust's assets, is taxed on the trust's worldwide income.[26] Section 679 applies in addition to the regular grantor trust rules of Sections 671 through 677.

Unlike the other grantor trust rules, however, Section 679 applies regardless of the terms of the foreign trust and regardless of any powers or interests the U.S. grantor or another person may have with respect to the foreign trust's income and corpus. Said differently, the U.S. grantor is deemed the owner of the foreign trust's assets even where the grantor has no powers or interests therein whatsoever, and even where the foreign trust is irrevocable and administered by an independent trustee. Of course, in our example, Mr. Perez is not a U.S. person (but may become one).

Section 679(a)(4), which was added by the 1996 Act, extends Section 679 to transfers in trust by certain foreign individuals who thereafter become U.S. citizens or residents.(such as might be the case with Mr. Perez).[27] As originally enacted, Section 679 did not apply to a transferor who was not a U.S. citizen or resident at the time of the transfer, because Section 679(a) referred to the making of a transfer by a U.S. person.[28]

Section 679(a)(4) provides that a nonresident individual, who becomes a resident of the U.S. within five (5) years after

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[23] *The assets would not, however, be includible in the grantor's gross estate solely as a result of the trust being a grantor trust, unless perhaps the deemed ownership rule of §679 (discussed below) applied for estate tax purposes. This is because neither the estate tax provisions of Subtitle B of the Code, nor the regulations thereunder, specifically cross-reference the grantor trust provisions of Subtitle A (the income tax provision). Thus, the assets would be includible in the grantor's gross estate, if at all, solely by operation of the applicable estate tax provisions. While the interests and powers that cause grantor trust status are similar to the interests and powers that cause inclusion in the gross estate, the income tax regime and estate tax regime have somewhat of an asymmetric relationship -- that is, a donor may make a transfer which is irrevocable and complete for gift and estate tax purposes but incomplete for income tax purposes (e.g., a "defective" grantor trust). In such case, the income of the trust is received by the beneficiaries tax-free, and the donor pays the income tax. There is no gift tax associated with payment of the tax because the donor is paying it not as a matter of volition, but as required by law.* ***[CITE]****. The trust assets also will not be includible in the donor's gross estate if the transfer to trust is complete for estate tax purposes. Often the means selected to cause grantor trust status for income tax purposes runs the risk of either being ignored by the IRS for income tax purposes (e.g., trust instrument merely empowers trustee to buy life insurance policies, but not necessarily on donor's life (see §677), or of potential attack by the IRS for estate tax purposes (e.g., where donor has too much power over beneficial enjoyment of property). Where a donor desires to establish a defective grantor trust, these risks may be avoided by creating a foreign trust. The advantage of creating a foreign trust is that the donor need retain no interest in or power over the trust at all (that could give rise to an IRS estate tax attack) and §679 will still apply to cause defective grantor trust status (i.e., donor taxed for income tax purposes but trust assets not included in gross estate). See Christensen, III, "Survivalist Planning: Trying to Preserve Wealth in the International Age," 24 U. Miami Est. Plan. Inst. ¶ 1101.3(C) (1990) (noting that the gift and estate tax conclusions follow because "[t]he legislative history of §679 makes clear that it has no impact for gift and estate tax purposes;" however, Mr. Christensen's article was written prior to the enactment of §679(a)(4)). At the time of the article, Mr. Christensen was a partner in the New York firm of Sullivan & Cromwell. He has chaired the Estate and Gift Tax and the Income Taxation of Trusts and Estates Committees of the New York State Bar, and is a professor in the tax program at New York University Law School.*

[24] *P.L. 94-55, §1013(a) (1976).*

[25] *P.L. 104-188, §1903 (1996).*

[26] *Prior to enactment of §679, if a foreign trust was not subject to the grantor trust rules (§§67l-677) and was thus a non-grantor trust, the trust was treated as the owner of the assets and taxable on the income therefrom to the extent the income was not currently distributed or required to be distributed to the beneficiaries of the trust. The, income of a foreign non-grantor trust was taxed basically in the same manner as the income of a nonresident alien individual -- foreign trusts were subject to U.S. tax only on their U.S.-source income (other than capital gains) and on any income effectively connected to a U.S. trade or business. Thus, a foreign trust holding offshore investments could accumulate income free from U.S. income tax. "Congress believed that allowing tax-free accumulation of income was inappropriate and provided an unwarranted advantage to foreign trusts over domestic trusts," and thus enacted §679 to prevent this perceived abuse. Preamble to Prop. Reg. §1.679-5, 65 F.R. 48185-02 (Aug. 7, 2000) (corresponding regulation -to §679(a)(4) governing income taxation of pre-immigration trusts); P.L. 94-455, Tax Reform Act of 1976, H.R. Conf. Rpt. No. 1515, 94th Cong. 2nd Sess. (Sept. 13, 1976).*

[27] *§679(a)(4) was added "to prevent taxpayers from improperly avoiding application of Section 679. Section 679(a)(4) ensures that certain foreign persons who transfer property to a foreign trust in anticipation of becoming U.S. persons (pre-immigration trusts) cannot avoid the rules of Section 679 by transferring property, directly or indirectly, to a foreign trust and then becoming a resident of the United States within 5 years after the transfer." Preamble to Prop. Reg. §1.679-5, 65 FR. 48185-02 (Aug. 7, 2000) (governing income taxation of pre-immigration trusts). Prop. Reg. §l.679-5 was issued in final form on July 20, 2001. Reg. §1.679-5, T.D. 8955, 66 F.R. 37886 (2001). The preamble-to the final regulation does not elaborate on the application of §679(a)(4).*

[28] See Chopin, "*Use of Foreign Trusts in Income and Estate Planning*," 21 U. Miami Est. Plan. Inst. ¶ 1205 (1987); Christensen, III, "*Survivalist Planning: Trying to Preserve Wealth in the International Age*," 24 U. Miami Est. Plan. Inst. ¶ 1101.3(B) (1990).

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directly or indirectly transferring property to a foreign trust, will be treated under Section 679 (and the reporting requirements of Section 6048) as if he made the transfer on the residency starting date.[29] Therefore, a foreign person who adopts U.S. residency within five (5) years after having created a foreign trust with a U.S. beneficiary will be treated as the owner of the assets originally transferred to the trust plus any undistributed income and appreciation in assets held by the trust and attributable to the original transfer. Accordingly the grantor, upon becoming a U.S. resident, is taxed on the worldwide income of the trust.[30] Again, this income tax treatment follows irrespective of whether the foreign trust is irrevocable or whether the grantor has any powers or interests with respect to the assets held in trust.

In this scenario, Mr. Perez intends to transfer some or all of the Assets to the Pre-Immigration Trust while he is a nonresident. The Pre-Immigration Trust would necessarily be an irrevocable trust (for transfer tax purposes), and Mr. Perez should not have any powers or interests in the Pre-Immigration Trust that would not initially treat it as a grantor trust for income tax purposes (assuming it will eventually have a U.S. beneficiary and it is not revocable pursuant to Sections 672(f)). Accordingly, the Pre-Immigration Trust would not initially be a grantor trust under Section 672(f) (assuming Mr. Perez has a family member who is beneficiary of the trust who is a U.S. person). However, if he immigrates to the U.S. and becomes a U.S. person within five (5) years of the transfer, Section 679(a)(4) would cause it to then become a grantor trust, for U.S. income tax purposes, by operation of this section.

Under Section 679(a)(4), Mr. Perez would be deemed to have transferred the Assets (and any undistributed income) to the Pre-Immigration Trust on the date he became a U.S. resident for purposes of **Subtitle A**. Thus, under Section 679(a)(1), Mr. Perez would be treated as the owner of the Assets held in the Pre-Immigration Trust and, consequently, he would be taxed on the worldwide income of the Pre-Immigration Trust whether distributed or not.

While it is clear that Mr. Perez would be treated as the owner of the Assets for income tax purposes by operation of Sections 679(a)(4) and 679(a)(1) if the Trust remained a foreign trust, there seems to be some uncertainty among certain commentators regarding whether Mr. Perez would also be treated as the owner of the Assets for estate tax purposes by operation of the same sections. If Section 679 does in fact apply to treat Mr. Perez as the owner of the Assets for estate tax purposes, there is a risk that such deemed ownership would trigger otherwise inapplicable estate tax provisions of Subtitle B of the Code thus requiring Mr. Perez to include the Assets in his gross estate.[31]

On the other hand, if the deemed ownership rule of Section 679 only applies for income tax purposes under Subtitle A, the Assets would be includible in Mr. Perez's estate only if they were otherwise includible under Sections 2031 through 2044 of Subtitle B (discussed at II above). In this hypothetical, it is crucial that the Pre-Immigration Trust be irrevocable and Mr. Perez should not have any powers or interests causing inclusion of the Assets held in trust to be included under the provisions of Subtitle B (without consideration to the deemed ownership rule of Section 679 of Subtitle A), the Assets should not be includible in Mr. Perez's gross estate and, therefore, would not be subject to estate tax.

SECTION 679 DOES NOT APPLY FOR ESTATE TAX PURPOSES

Legislative History - 1976 Act. As noted above, Section 679 was added to the Code in 1976 in an attempt by Congress to eliminate the advantage, in terms of income tax-free accumulation, that foreign trusts had over domestic trusts. The concern was that if foreign trusts or their grantors are not subject to U.S. income taxes, the trust could invest indefinitely in offshore investments (in tax haven jurisdictions and U.S. investments of foreign persons not subject to U.S. income tax, e.g., "portfolio interest" debt, non-real estate capital gains, etc.) and defer paying income tax until distributions are made to U.S. beneficiaries. The conference reports of the House and Senate both discussed at length present law with regard to income taxation of foreign trusts, and the reasons why Section 679 should be enacted. The entire discussion addresses income tax issues only.

Regarding the application of then new Section 679 (and its deemed ownership rule) to the estate tax provisions of

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[29] The "residency starting date" is the date that the grantor becomes a U.S. resident as determined under §770l(b)(2)(A). §679(a)(4)(C). Since the transfer to the foreign trust is deemed made on the residency starting date, the transfer is therefore treated as made-by a "U.S. person" and the rules of § 679 come into play.

[30] As an aside, unless §679(a)(4) applies for gift tax purposes, the grantor should not be subject to gift tax on the transfer of property to an irrevocable (non-grantor) foreign trust so long as (i) the actual transfer is made while the grantor is a nonresident, and (ii) none of the property is tangible property situated (physically located) within the U.S. §§2501(a)(2), 2511(a); Reg. §25.251l-3(b)(1). On the other hand, if §679(a)(4) applies for gift tax purposes (§§2501-2524), and the gratuitous transfer to the foreign trust is deemed made on the residence starting date (i.e., gift made by a U.S. resident), the transfer may be subject to gift tax. §2501(a).

[31] For example, if Mr. Perez was treated as the owner of the Assets for estate tax purposes, he may be required to include the Assets in his gross estate under §2031(a), which provides that, "[t]he value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." Inclusion may also be required under §2033(a), which provides that, "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

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Subtitle B, the House Report provides, in pertinent, that:

> "an inter vivos trust which is treated as owned by a U.S. person under this provision [Section 679] is not treated as owned by the estate of that person upon his death. These rules only apply for income tax purposes. Whether the corpus of the inter vivos trust is included in the estate of the U.S. person depends on the estate tax provisions of the Code. Such provisions, as well as the gift tax provisions of the Code, are unaffected by this amendment."[32] *[Emphasis added.]*

Legislative History - 1996 Act. Section 679(a)(4) was added by the 1996 Act. No references were located in the 1996 Act legislative history (or Bluebook) regarding the application of Section 679 for estate tax purposes, though this probably was due to the fact that the legislative history to the 1976 Act clearly confined the scope of Section 679 to income tax provisions under Subtitle A. In other words, Section 679(a)(4) did not broaden the scope of Section 679 beyond the income tax provisioning Subtitle A, it just enlarged the class of grantors subject to Section 679. Apparently, Congress was aware of foreign grantors who were avoiding the application of Section 679 by transferring assets to a foreign trust just prior to immigrating to the U.S. Thus, Section 679(a)(4) was added to curb this perceived abuse.

During 2000 the Treasury issued proposed regulations under Section 679, including proposed Regulation Section 1.679-5 which is the regulation corresponding to Section 679(a)(4) (the proposed regulation, which has since been issued in final form, is titled, "Pre-Immigration Trusts"). The preamble to the proposed regulation is consistent with the legislative history of the 1976 Act and provides, in pertinent, that:

> "Section 679 applies only for income tax purposes. The estate and gift tax provisions of the Code determine whether a transfer to a foreign trust is subject to the federal gift tax, or whether the corpus of a foreign trust is included in the gross estate of the U.S. transferor."[33] *[Emphasis added.]*

CONCLUSION

After an extensive review of the legislative history, policy reasons behind enactment of Section 679 (as amended by the 1996 Act) and applicable IRS rulings, the law is clear under Section 679 (and its deemed ownership rule) does not apply for purposes of the estate and gift tax provisions of Subtitle B of the Code.[34] Therefore, provided Mr. Perez retains no rights or powers in the Assets held by the Pre-Immigration Trust that would require the Assets to be included in his gross estate under Sections 2031 through 2044 of Subtitle B, the Assets will not be so included, irrespective of the deemed ownership rule and income tax consequences under Section 679.

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[32] P.L. 94-455, Tax Reform Act of 1976, HR. Rpt. No. 658, 94th Cong., 1st Sess. at 209 (Nov. 12, 1975). The Senate Report contains the exact same language as quoted. P.L. 94-455, Tax Reform Act of 1976, S. Rpt. No. 938, 94th Cong., 2nd Sess. at 218 (June 10, 1976). In PLR 9332006 (1992), the IRS quoted this passage in holding that "any portion of the trust that is treated as owned by a settlor under the rules of Section 679 shall cease to be so treated upon that settlor's death." Essentially, the IRS held that the estate tax provisions of Subtitle B govern whether the trust assets are includible in the settlor's gross estate, without reference to §679.

[33] Preamble to Prop. Reg. §1.679-5, 65 F.R. 48185-02 (Aug. 7, 2000).

[34] For recent guidance on the IRS position to this effect, see PLR 200338015.

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