Foreign Trusts, 1986

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U.S. "persons" transferred nearly $17 million in money and property to trusts located in 17 foreign countries in 1986 [1]. There were 255 transfers made during the year, which brings the average transfer value to $66,000.

A total of 411 foreign trusts had one or more U.S. beneficiaries during 1986 and had received transfers from U.S. persons during their existence. These foreign trusts had more than $94 million in total assets and received nearly $8 million in total income. Their $2.6 million of net income were included in the taxable income of their U.S. grantors or transferors.

BACKGROUND

Trusts are fiduciary arrangements created by persons (the "grantors") who transfer their ownership of property to other persons (the "trustees") subject to an obligation to protect and use that property for the benefit of other persons (the "beneficiaries"). The property (or "corpus") can be real or personal, tangible or intangible. The arrangement can be an "inter vivos trust" created by a living grantor, or a "testamentary trust" created as the result of the grantor's will.

The fiduciary relationship of a trust requires substantial management by the trustee, including a duty to act solely in the interest of the beneficiary. The powers, duties, restrictions, and obligations of the trustee, as well as the rights of the beneficiary, are based on the provisions of the trust agreement and the laws of the jurisdiction in which the trust was created. The beneficiary has the right to benefit from the trust's property, usually through receipt of the income produced from investments made by the trustee, or from the distribution of the trust's property itself. Factors a grantor might consider in selecting a jurisdiction in which to create a trust include the political and economic stability of a country, available banking and trust facilities, applicable trust laws, and tax laws.

For a trust to exist, there must be a separation of its ownership interests by the trustee from its beneficial interests. As a result, one person cannot be the grantor, trustee, and sole beneficiary of a trust all at the same time. However, if this person is not a beneficiary or is only one of two or more beneficiaries, then there is a separation of interests between two parties and a valid trust arrangement exists. (Trusts can have multiple grantors, trustees, and beneficiaries [2].) Similarly, a trust can exist if one of several joint trustees is also the sole beneficiary. Here again, there are at least two parties with separate interests.

The creation of a trust may result in U.S. income taxation of the grantor, the transferor, the trust, and the beneficiary. Domestic trusts are taxed as U.S. citizens or residents, whereas foreign trusts are taxed as nonresidents. The next section discusses foreign trusts in greater detail.

FOREIGN TRUSTS

Trusts are generally considered to be "foreign" if the fiduciary is a nonresident alien for U.S. tax purposes; if the property is transferred to the fiduciary, the property and records are maintained, and the trust instrument is executed outside the United States; and if the trust is created and governed under the laws of a foreign country. Foreign trusts that have U.S. persons as grantors, transferors, or beneficiaries are also subject to U.S. income taxation.

Section 1491 of the Internal Revenue Code imposes a 35 percent excise tax on certain transfers of property by a U.S. person to a foreign trust. The tax applies to transfers, including sales and exchanges, of appreciated property in which gain, under the tax code, is not realized by the transferor at the time of the transfer. To the extent that the U.S. person realizes a gain for income tax purposes at the time of the transfer (based on the excess of the "fair market value" of the property over its "adjusted basis"), the transfer is not subject to the excise tax.

When a U.S. person (grantor or transferor) directly or indirectly transfers property to a foreign trust with one or more U.S. beneficiaries, "grantor trust rules" apply. Under these rules, the person is treated for U.S. income tax purposes as the owner of the portion of the trust attributable to the transferred property. Furthermore, the person is currently taxed on all items of worldwide income (including capital gains) of the trust, whether distributed or accumulated, that are attributable to that property [3]. Section 679 of the Internal Revenue Code covers these grantor trust rules. That section, however, excludes: (1) testamentary trusts; (2) property transferred to a trust in a sale or exchange when the transferor realizes the gain for tax purposes; and (3) certain stock bonus, pension, or profit-sharing trusts.

The Foreign Investment in Real Property Tax Act of 1980 and the Tax Reform Act of 1984 combined to make foreign

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persons (including foreign trusts) who sell or exchange U.S. real property liable for a U.S. income tax on the gain realized from the disposition. In general, after December 31, 1984, a transferee of such property is required to deduct from the seller's proceeds, and to withhold for tax purposes, 10 percent of the amount realized on the sale or exchange. This withholding tax may not necessarily equal the actual tax liability of the foreign person on the disposition of the property.

A U.S. beneficiary of a foreign trust is liable for U.S. tax on his or her share of the trust's distributions, subject to a ceiling called "distributable net income" (DNI). The beneficiary includes the distributions received in his or her gross income for the current taxable year. The DNI of a foreign trust is an amount calculated similarly to the way taxable (net) income is calculated, but with certain adjustments. Among these adjustments is the provision to include foreign source income [4].

A foreign trust that does not actually distribute to its beneficiaries all its DNI in a taxable year has "undistributed net income." If, in a subsequent year, a non-grantor foreign trust distributes to its U.S. beneficiaries amounts in excess of the DNI for that year, then the excess amount is treated as an "accumulation distribution" and is taxed to those beneficiaries under "throwback" rules, described in the next paragraph. In addition, interest is charged on the tax deferral resulting from the accumulation of income.

The throwback rules are designed to tax beneficiaries on accumulation distributions at a rate equal to the rate that would have been paid had the income been distributed in the year it was earned by the trust. Beneficiaries are taxed on accumulation distributions in the year they are received. The beneficiaries' tax liability for the prior taxable year(s) in which the trust had undistributed net income is not changed.

A 6-percent simple interest charge per year is imposed on the beneficiary's tax on accumulated distributions from foreign trusts computed under the throwback rules. (This interest charge is not tax deductible.) For purposes of this interest charge, the accumulated distributions do not include foreign trust income for which a grantor had paid U.S. tax on that income. The interest charge is based on the length of time the tax has been deferred because of the trust's accumulation of income. In effect, the interest charge increases the effective income tax rate placed on accumulated distributions of foreign trusts. The total tax and interest charge is limited by the amount of the actual accumulation distribution [5].

FILING CHARACTERISTICS OF FORMS 3520

Form 3520, Creation of or Transfers to Certain Foreign Trusts, is required to be filed by any U.S. grantor, transferor, or fiduciary who created a foreign trust or transferred money or property into an existing foreign trust [6]. This form requires information about the trust and its beneficiaries. It is due within 90 days after the creation of, or transfer of any money or property to, the foreign trust.

During 1986, as already mentioned, U.S. persons transferred $16.9 million in money and property to 255 foreign trusts, for an average transfer value per trust of $66,000. By comparison, in 1982 (the most recent prior year for which data are available), the value of transfers was $11.3 million, and the number of trusts receiving transfers was 342 [7]. As a result, the average transfer value doubled from $33,000 during the 4-year period.

Most U.S. persons filing Forms 3520 have been grantors. In both 1982 and 1986, grantors accounted for about three-fourths of all filers. Transferors made up most of the remaining filers, with fiduciaries accounting for a very small percentage. Figure A shows the types of filers by percentage.

Figure A.—Forms 3520: Types of Filers, by Percentage, 1982 and 1986

Types of filers	1982	1986
All filers	100%	100%
Grantors	78	72
Transferors	19	27
Fiduciaries	2	1

NOTE: Detail may not add to totals because of rounding.

Figure B shows the six countries where nearly 90 percent of the foreign trusts were located for 1986. These trusts, in turn, accounted for 60 percent of the total amount of transfers. A small number of trusts created in the Bahamas (not shown separately) accounted for most of the transfers for the "other countries."

Figure B.—Forms 3520: Number of Trusts, Total and Average Transfer Values, by Country Where the Trust was Created, 1986

[Money amounts are in thousands of U.S. dollars]

Country	Number of trusts	Total transfer value	Average transfer value per trust
	(1)	(2)	(3)
All countries	255	$16,892	$ 66
Canada	127	1,396	11
Cayman Islands	43	2,885	67
Channel Islands	23	3,195	139
Switzerland	13	445	34
Bermuda	12	1,733	144
Liechtenstein	9	506	56
Other countries	28	6,732	240

With the exception of Canada, all the countries listed in Figure B, plus the Bahamas, British Virgin Islands, Gibraltar, and Hong Kong which are included in "other countries," are considered to be "tax haven countries" (described in the next paragraph) [8]. Together these tax havens accounted for nearly $15 million, or 89 percent, of the total transfers to foreign trusts by U.S. persons.

Tax haven countries generally have tax and secrecy laws favorable to foreign persons. They attract foreign investment by having no income tax or by offering low income tax rates. Some collect certain fees instead of income taxes. Tax havens also offer bank or commercial secrecy laws that prevent foreign governments from obtaining financial information about persons transacting business in their country.

Cash ($12.9 million) and corporate stocks ($1.2 million) made up nearly 84 percent of the total transfers to foreign trusts. Other types of transferred property reported on Forms 3520 included municipal bonds and partnership interests.

"Registered Retirement Savings Plans" received $1.2 million of transfers by U.S. persons to foreign trusts. These 123 Canadian retirement plans were treated for Canadian income tax purposes in a manner similar to the "Individual Retirement Arrangements" used by U.S. taxpayers to defer taxation on current income set aside for retirement purposes. Although the Registered Retirement Savings Plans accounted for nearly half of the total foreign trusts, they had a low average transfer value ($9,600). There were two fundamental reasons for this low average. First, these savings plans were generally set up by individuals who transferred funds for the purpose of deferring relatively small amounts of Canadian taxes. Secondly, Canada limited the amount of income on which tax could be deferred.

Most of the foreign trusts that received transfers from U.S. persons in 1986 were created recently. In fact, 230 of them had been created since 1980. Fifty-five were created in 1986 and 103 others in 1985. However, a few foreign trusts were created as far back as the early 1960's.

More than half (145) of the 255 foreign trusts reported on Forms 3520 that they had only one beneficiary; 73 other trusts had between two and four beneficiaries each. The remaining trusts either had five or more beneficiaries (18) or failed to report any information on their beneficiaries (19).

A total of 488 beneficiaries (who were the ultimate recipients of the trust funds) was reported on the Forms 3520, of which 254 were U.S. residents. Persons who resided in Canada (122) and the United Kingdom (45) also were frequent beneficiaries of trusts. Also reported were beneficiaries who resided in France, Israel, New Zealand, West Germany, and the Philippines.

FILING CHARACTERISTICS OF FORMS 3520-A

Any U.S. person who directly or indirectly transferred property to a foreign trust (other than an employee's trust or an annuity plan) with one or more U.S. beneficiaries, was considered for U.S. tax purposes to be the owner of the part of the trust that was attributable to the transferred property. Once the transfer had been made, the person was thereafter required to file Form 3520-A, Annual Return of Foreign Trust with U.S. Beneficiaries, for as long as the trust had at least one U.S. beneficiary [9]. This return, which was required to be filed within 3 and one-half months after the end of the tax year of the grantor or transferor, contained balance sheet and profit-and-loss information for the trust.

Figure C shows income statement and end-of-year balance sheet data for the 411 foreign trusts reported on Forms 3520-A. (Tables 1 and 2, at the end of the article, show these data by selected countries in which the trusts were created.) Their total assets of $94.5 million were more than double the $45.2 million of assets reported for 393 foreign trusts for 1982. Average total assets per trust doubled, from $115,000 for 1982 to $230,000 for 1986.

Figure C.—Forms 3520-A: Income Statement and Balance Sheet Items, 1986

[Money amounts are in thousands of U.S. dollars]

Item	Number or amount
Number of returns	411
Total income	$7,872
Dividends	1,526
Interest	3,195
Net gain (less loss), sales of capital assets	2,491
Other income (less loss)	661
Total expenses	5,264
Net income (less deficit)	2,608
Net income	4,273
Total assets	94,456
Cash	13,273
Government obligations	5,502
Non-government obligations	15,366
Corporate stock	27,334
Other investments	12,543
Depreciable assets (net)	13,471
Other assets	6,967
Total liabilities	37,339
Net worth	57,117

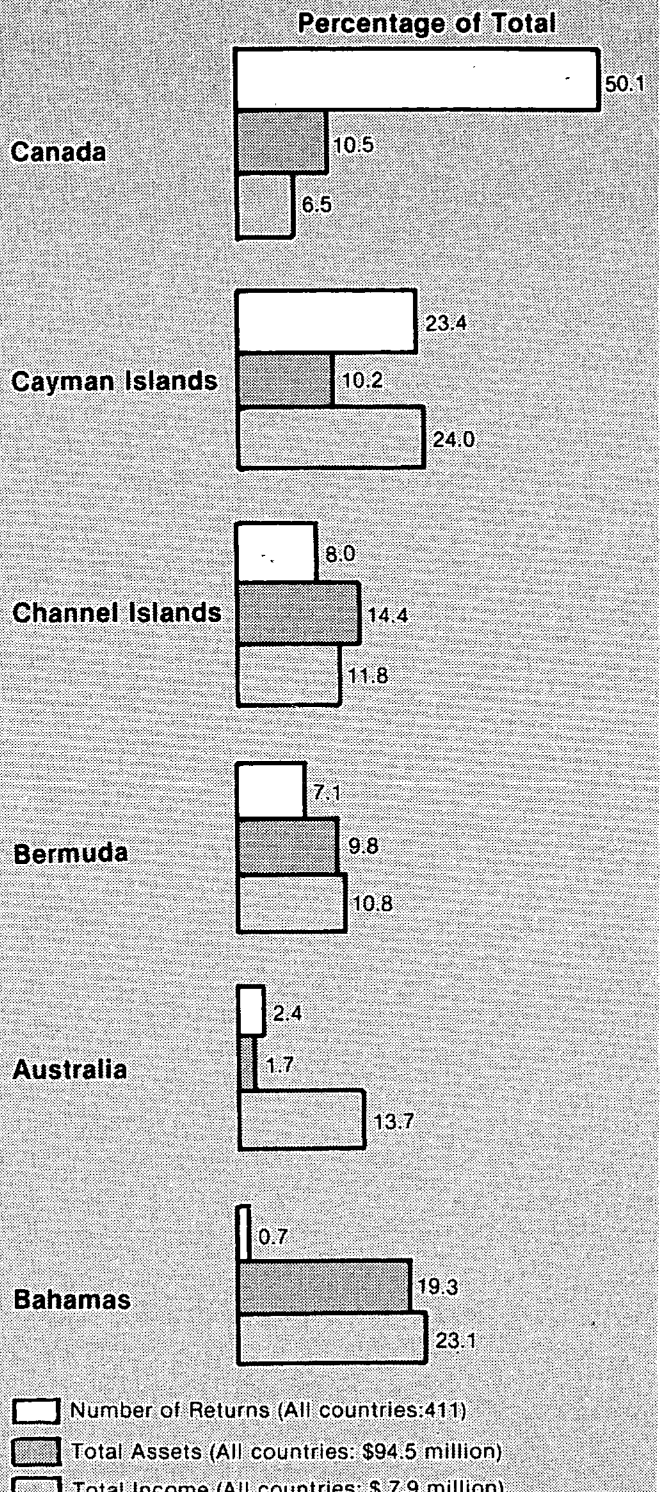
NOTE: Detail may not add to totals because of rounding.

The income statement data shown in Figure C generally represent the share attributable to the U.S. grantor or transferor of the foreign trust (see the Data Sources and Limitations section of this article). The allocable amount was based on the portion of the trust's assets attributable to property transferred by the U.S. person [10].

Most of the income allocable to U.S. grantors and transferors from foreign trusts was investment-related, including interest, dividends, and capital gains. After deducting expenses, net income (less deficit) of $2.6 million was reported for all the trusts — an average of $6,300 of net income per trust. These amounts of net income (and losses) were included in the taxable income of the U.S. grantors and transferors [11].

Figure D presents selected data items for trusts by selected foreign countries in which the trusts were created.

Figure D
Forms 3520-A: Selected Foreign Trust Items, by Country Where Trust was Created, 1986



Only those countries that had trusts accounting for 10 percent or more of the total for all trusts for at least one of the three items shown are included in this figure.

As was the case with Forms 3520, Canadian trusts accounted for half of all Forms 3520-A filed annually. These trusts had relatively small amounts of assets and income, in addition to their low transfer values previously discussed. Of the 206 Canadian trusts, 175 were Registered Retirement Savings Plans.

Trusts in tax haven countries accounted for most of the assets and income reported for all the trusts. In fact, trusts in these countries had 82 percent of the total assets and 84 percent of the total income reported for all the foreign trusts in 1986, while accounting for only 45 percent of the Forms 3520-A filed that year. In addition to the four tax haven countries shown in Figure D, trusts created in the following tax havens are also included in the totals for 1986: British Virgin Islands, Gibraltar, Liechtenstein, Netherlands Antilles, and Switzerland.

There were 15 large trusts in 1986, each having a net worth of $1 million or more. (Net worth is the difference between total assets and total liabilities.) However, these few trusts accounted for 39 percent of the assets and 33 percent of the total income for all foreign trusts (see Figure E). All but one of these large trusts were created in the tax haven countries.

Figure E.—Forms 3520-A: Income Statement and Balance Sheet Items, for All Foreign Trusts and Trusts with Net Worth of $1 Million or More, 1986

[Money amounts are in thousands of U.S. dollars]

Item	All trusts	Trusts with net worth of $1 million or more	Percentage of total
	(1)	(2)	(3)
Number of returns	411	15	3.6%
Total income	$ 7,872	$ 2,606	33.1
Dividends	1,526	304	19.9
Interest	3,195	608	19.0
Net gain (less loss), sales of capital assets	2,491	1,694	68.0
Other income (less loss)	661	-	-
Total expenses	5,264	1,338	25.4
Net income (less deficit)	2,608	1,268	48.6
Net income	4,273	2,247	52.6
Total assets	94,456	36,763	38.9
Cash	13,273	4,712	35.5
Government obligations	5,502	2,472	44.9
Non-government obligations	15,366	1,518	9.9
Corporate stock	27,334	17,848	65.3
Other investments	12,543	4,919	39.2
Depreciable assets (net)	13,471	4,770	35.4
Other assets	6,967	524	7.5
Total liabilities	37,339	2,160	5.8
Net worth	57,117	34,603	60.6

NOTE: Detail may not add to totals because of rounding.

Although 62 percent of the foreign trusts that filed annual returns for 1986 had been created since 1980, this was substantially less than the 90 percent (230 out of 255) figure for those filing Forms 3520. The different filing requirements for the forms account for this difference. Forms 3520 were required to be filed within 90 days after a transfer to a foreign trust. Forms 3520-A were required to be filed annually after a transfer to a foreign trust, as long as the trust continued to have at least one U.S. beneficiary. Thus, these forms were often filed for many years. In fact, the 1986 study contained several Forms 3520-A for trusts created in the mid-1950's.

For 1986, grantors filed more than 90 percent of all Forms 3520-A, compared with 72 percent for Forms 3520 (see Figure A, presented earlier). Transferors made up the rest of the filers of the annual returns.

Most (246) of the foreign trusts reported on the annual returns for 1986 as having only one U.S. beneficiary. Another 110 trusts had between two and four U.S. beneficiaries each. The remaining trusts either had five or more U.S. beneficiaries (30) or failed to report any information on their beneficiaries (25). For the 386 foreign trusts which reported beneficiary information, there was a total of 753 U.S. beneficiaries.

SUMMARY

Tax haven countries played a large role in foreign trust activity for 1986. Trusts in these countries accounted for nearly $15 million, or 89 percent, of the transfers by U.S. persons to all foreign trusts. Similarly, annual returns for trusts in these countries accounted for the majority of assets (82 percent) and total income (84 percent) reported for all the foreign trusts.

Canadian trusts, primarily Registered Retirement Savings Plans, made up approximately half of the total foreign trusts for which returns were filed for 1986. However, their aggregate financial values were comparatively small. They accounted for only 8 percent of the value of transfers, and on the annual returns, for only 10 and 7 percent of total assets and income, respectively, for all the foreign trusts.

DATA SOURCES AND LIMITATIONS

The statistics for 1986 presented in this article were based on all Forms 3520 and 3520-A filed at the Internal Revenue Service's Philadelphia Service Center between January 1 and December 31, 1986. Because all these returns were used for the statistics, the data are not subject to sampling error.

In the case of multiple transfers by the same U.S. person to the same foreign trust, a single Form 3520 could have been used to combine all the transfers made during a 90-day period. The form would have to include separate information on each of the transfers. Subsequent transfers were reported on separate Forms 3520, subject to the same 90-day rule.

Because Forms 3520 and 3520-A are information returns, taxpayer reporting is occasionally incomplete. This problem occurred most frequently with Part I, Foreign Trust Income Statement, of Form 3520-A, which shows the income and expense items of the trust and the amount of each apportioned to the U.S. grantor or transferor. In most cases the grantor or transferor portion was used for these statistics. When only the income and expense information for the entire trust was reported, however, the full amounts were used for the statistics.

Because the filing requirements of Forms 3520 and 3520-A were somewhat different, an exact match of forms in the 1986 studies could not be expected. For instance, the filing requirements for Forms 3520-A included the condition of one or more U.S. beneficiaries, while Forms 3520 had no such requirement. On the other hand, Forms 3520 were required to be filed only when a transfer had been recently made, while part of the filing requirements for Forms 3520-A specified the occurrence of a transfer at any time since the trust had been created [12]. As a result of these filing requirement differences, only 76 of the 411 Forms 3520-A indicated that Forms 3520 were also filed for the given trust in 1986.

EXPLANATION OF SELECTED TERMS

Beneficiary. — For purposes of this article, a person who receives, will receive, or may receive money or property at any time from a foreign trust. This is the person for whose benefit a trust was created.

Fiduciary. — Any person who is a trustee, or a character similar to a trustee, and has the duty to act in good faith for the benefit of another person.

Grantor. — Any U.S. person who created, or was treated for tax purposes as the owner of, any portion of a foreign trust.

Transferor. — Any U.S. person other than the grantor or fiduciary who directly or indirectly transfers money or property to, or for the benefit of, a foreign trust. The term does not refer to a person who transfers money or property in accordance with a sale or exchange that was made for full compensation.

NOTES AND REFERENCES

[1] The term "U.S. person" includes individuals, corporations, partnerships, trusts, and estates. Individuals include U.S. citizens and residents.

[2] Except where otherwise specifically noted, this article uses the singular form of grantor, trustee, or beneficiary. However, for any given trust, any of these may actually be multiple entities.

[3] A nonresident alien, i.e., a non-U.S. person, who establishes a foreign trust with a U.S. beneficiary and retains grantor trust powers, is subject to U.S. income tax only on U.S. source, fixed or determinable income (e.g., interest, dividends, rents, and royalties) and income "effectively connected" with the conduct of a U.S. trade or business.

[4] Section 643 of the Internal Revenue Code specifies the computation of distributable net income.

[5] The Tax Reform Act of 1986 contained several provisions specifically affecting U.S. income taxation of trusts and their related parties. First, in general, tax rates on U.S. taxable income of trusts, grantors and beneficiaries were reduced. Second, trusts were required to make estimated tax payments much as individuals were. The last major provision of the Act related to trusts was that they adopt the calendar year as their taxable year. In general, these provisions were effective for taxable years beginning in 1987.

[6] Section 16.3-1(d)(4) of the Internal Revenue Regulations exempts from these filing requirements payments to foreign trusts for employees.

[7] Foreign trust studies are currently conducted once every 4 years, i.e., 1982, 1986, 1990, etc.

[8] For a complete list of tax haven countries, see Senate Report 99-130, *Crime and Secrecy: The Use of Offshore Banks and Companies*, Report by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, U.S. Senate, August 28, 1985.

[9] The following types of transfers do not require the filing of a Form 3520-A: (1) transfers made as the result of the death of the transferor; (2) transfers made on or before May 21, 1974; and (3) any sale or exchange of property at fair market value in which the entire gain to the transferor is realized at the time of the sale, or is returned under the Internal Revenue Code section 453 installment method.

[10] The balance sheet information shown in Table 2 represents the total amounts for foreign trusts. Unlike the income statement data, the amounts do not represent only the share attributable to U.S. grantors and transferors.

[11] See the income reported from "estates and trusts" in *Statistics of Income — Individual Income Tax Returns*, Internal Revenue Service, U.S. Department of the Treasury.

[12] Forms 3520-A were filed by U.S. persons who directly or indirectly transferred property to foreign trusts with one or more U.S. beneficiaries. In the case of two transferors or grantors who did not file joint U.S. income tax returns but did transfer property to the same trust, two Forms 3520-A would have been filed for that trust. To this extent, the 411 Forms 3520-A shown in the data would not actually represent 411 different foreign trusts.

Table 1.—Forms 3520-A: Income Statement Items, by Selected Country Where the Trust was Created

[Money amounts are in thousands of U.S. dollars]

Country where trust was created	Number of returns	Income: Total	Income: Dividends	Income: Interest	Income: Net gain (less loss), sales of capital assets	Income: Other income (less loss)	Total expenses	Net income (less deficit)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
All countries	411	7,872	1,526	3,195	2,491	661	5,264	2,608
Canada	206	515	8	95	3	408	496	18
Cayman Islands	96	1,888	(1)	222	1,689	-22	380	1,509
Channel Islands	33	930	6	909	17	-3	638	292
Bermuda	29	846	117	169	520	41	42	805
Australia	10	1,078	1,027	46	7	-2	959	119
British Virgin Islands	8	(1)	-	(1)	-	-	407	-407
Liechtenstein	7	216	-	208	8	-	29	187
Gibraltar	5	517	330	187	-	-	67	450
Bahamas	3	1,821	-	1,335	247	240	1,245	576
Switzerland	3	16	3	13	-	(1)	13	3
United Kingdom	3	35	35	1	-	-	982	-946

[1] Less than $500.

NOTE: Detail may not add to totals because of rounding. Data for certain countries are not shown to avoid disclosure of information about specific trusts. The data shown in this table generally represent the share attributable to the U.S. grantors or transferors of the foreign trusts. (See the Data Sources and Limitations section of this article.)

Table 2.—Forms 3520-A: Balance Sheet Items, by Selected Country Where the Trust was Created

[Money amounts are in thousands of U.S. dollars]

Country where trust was created	Number of returns	Assets: Total	Assets: Cash	Assets: Government obligations	Assets: Non-government obligations	Assets: Corporate stock	Assets: Other investments	Assets: Depreciable assets (net)	Assets: Other assets	Total liabilities	Net worth
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
All countries	411	94,456	13,273	5,502	15,366	27,334	12,543	13,471	6,967	37,339	57,117
Canada	206	9,900	1,191	-	109	51	136	8,006	407	8,439	1,461
Cayman Islands	96	9,675	1,490	4	-	5,451	1,711	223	797	3,358	6,317
Channel Islands	33	13,580	3,718	1,343	-	1,373	2,885	453	3,808	4,265	9,315
Bermuda	29	9,239	1,134	1,862	-	1,864	4,269	-	110	403	8,837
Australia	10	1,585	254	-	-	271	275	19	766	766	819
British Virgin Islands	8	5,846	83	-	-	5,430	125	-	208	5,046	799
Liechtenstein	7	3,630	1,257	-	1,518	-	200	-	655	327	3,303
Gibraltar	5	3,687	2,425	1,261	-	1	-	-	-	-	3,687
Bahamas	3	18,239	1,642	1,000	13,682	-	1,705	-	209	14,584	3,655
Switzerland	3	926	2	-	56	-	866	-	2	52	874
United Kingdom	3	5,124	20	33	-	-	299	4,770	2	2	5,122

NOTE: Detail may not add to totals because of rounding. Data for certain countries are not shown to avoid disclosure of information about specific trusts.