

**The
RISER
Report**

OFFSHORE TRUTH AND TAX CONSEQUENCES

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Welcome

Welcome to the November / December edition of **THE RISER REPORT**. **THE RISER REPORT** is a bimonthly publication covering issues and opinions related to asset protection and estate planning. **THE RISER REPORT** is written by Attorney Christopher M. Riser, of Mayer & Riser, PLLC (www.mayer-riser.com) in Highlands, North Carolina and published by Axius Publishing, LLC.

THE RISER REPORT will be sent by electronic mail to subscribers of our companion publication, **THE ADKISSON ANALYSIS**, and vice versa. If you aren't already a subscriber to **THE RISER REPORT**, you can subscribe at www.riserreport.com. Subscribe to **THE ADKISSON ANALYSIS** at www.falc.com. If you have yet to enter the age of e-mail and Web publications and are reading this issue from a friend's printed copy, you can subscribe by regular postal mail by writing to the address at the end of this issue.

In this issue, I give an overview of the U.S. taxation of offshore mutual funds. I also look at the new IRS rules regarding "qualified intermediaries" and the payment of U.S. withholding tax. Next, I examine the use of qualified personal residence trusts ("QPRTs") for U.S. estate and gift tax planning. I also review an important trust case from Jersey regarding the disclosure of letters of wishes. Briefly Noted contains tidbits of information on various topics. Finally, I review an important book about trusts, Peter Willoughby's *Misplaced Trust*.

Comments and suggestions are always welcome. Email them to comments@riserreport.com or use the feedback form on **THE RISER REPORT** Web site at www.riserreport.com.

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Offshore Mutual Fund Taxation

"Invest in our high-flying offshore mutual funds tax-free! Pay no tax until you repatriate your profits back to the U.S.!"

Such are the familiar cries of many offshore investment advisers. Each year, many U.S. investors fall for these pitches and invest in foreign mutual funds, usually filtering the invested funds through an offshore company, typically an IBC or LLC, specifically established for the purpose of investing in foreign mutual funds. Other U.S. investors who may own foreign mutual fund shares for non-tax reasons are U.S. expatriates who simply bought fund shares from a local foreign broker and U.S. resident aliens who have moved to the U.S. and still own the portfolio of foreign mutual fund shares they owned at home.

While no tax may be payable in the fund's jurisdiction, U.S. taxes are payable if the owner of the fund is (among others):

- a U.S. citizen or resident;
- an IBC or LLC owned by a U.S. citizen or resident;
- a foreign trust settled established by a U.S. citizen or resident; or
- any other structure, the underlying owner of which is a U.S. citizen or resident, and

which is not otherwise partly or wholly exempt from taxation (e.g., a captive insurance company) or not otherwise able to defer taxation (e.g., by having the fund shares purchased inside a U.S. tax-compliant variable annuity or variable life insurance policy).

What the SEC Rules Really Say

Furthermore, the reason given for using the IBC or LLC as the owner is that the use of a foreign entity is necessary to avoid SEC rules and state securities laws regarding the sale of securities which are not registered in the U.S. It is generally true that a foreign entity is not a 'U.S. person' under SEC rules. However, if a foreign entity is owned by U.S. persons and if the foreign entity was formed principally for the purpose of investing in unregistered securities, SEC rules treat the foreign entity as a U.S. person, thus subjecting advisers who market and sell unregistered securities to SEC sanctions if any activity related to the marketing and sale of such securities takes place in the U.S. Failure to meet SEC muster in this regard will not cause problems for the investor, although the mutual fund will likely redeem any shares deemed to be held by U.S. persons.

Taxation of Foreign Mutual Fund Shares

Foreign mutual funds are treated under the Internal Revenue Code as "passive foreign investment companies" (PFICs). While foreign mutual funds used to offer tax deferral benefits to U.S. investors, that has not been the case since 1986. Foreign mutual funds offer no tax benefits to U.S. investors. Technically speaking, a PFIC is any foreign company that derives at least 75% of its gross income from passive activities or that derives passive income from at least 50% of its assets. Nearly all of the income of a mutual fund is generally passive income. So, nearly all foreign mutual funds are PFICs.

So, how are PFICs taxed? There are three alternatives from which a taxpayer may choose.

Excess Distributions Method. First, the default method (i.e., the method used unless one of the alternatives is affirmatively elected) is the excess distributions method. At first glance it sounds good because the basic premise is that you pay no tax until you cash out. The devil is in the details. First, when tax is paid, all income and gains are taxed at the highest ordinary income rate (presently 39.6%). There is no long-term capital gains treatment. Second, you have to assume that all of the gains are earned ratably over the time the investment was held, even if the fund lost money the first few years and only made its gains in the last year when you cashed out. Why is that bad? Because of the third part of the triple whammy: interest charges, compounded annually. Annually compounded interest at a rate of 9% to 10% is charged on deferred tax. The results can be ugly. Consider this example:

\$100,000 is invested in foreign mutual fund (PFIC) shares on 1/1/1995. The fund performs poorly from 1995 to 2001, but does phenomenally well from 2002 to 2004, growing to \$500,000 by the time the shares are redeemed on 12/31/2004. The rule requiring the assumption of ratable returns will force you to assume that the \$400,000 gain was earned one-tenth in 1995, one-tenth in 1996, etc. For each year, tax is calculated at the highest tax rate with interest calculated on the deferred tax and compounded annually. The result would be an effective tax rate of about 69% on redemption after 10 years. 69% of the \$400,000 gain — about \$277,000 — would be lost to tax. The much-touted power of compounding obviously works in the government's favor here.

Mark-to-Market Method. This new method, added to the Internal Revenue Code in 1997, allows an owner of PFIC shares to mark gains to market at year end. In other words, you pay tax on the difference between the fair market value of the shares at the beginning of the year and the fair market value of the shares at the end of the year, and you start fresh each January 1st. Gains and losses are ordinary, not capital, so while this method is relatively simply to use and less punitive than the excess distributions method, it's no great deal. There are requirements that must be met by the fund in order for a shareholder to make a mark-to-market election, two of the most important of which are that fund prices must be readily available (e.g., from the Financial Times, etc.) and that the fund cannot require a minimum investment of more than \$10,000.

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Qualified Electing Fund Method. If the PFIC meets certain accounting and reporting requirements, a PFIC shareholder can elect to treat the PFIC as a qualified electing fund. The effect is that the PFIC shares are taxed like U.S. shares. So, a foreign mutual fund treated as a QEF is taxed just like a U.S. mutual fund. Sounds like a good deal. Why doesn't everyone make a QEF election for foreign mutual fund shares?

The reason that few investors make QEF elections for publicly traded foreign mutual fund shares is that it is essentially impossible to do so. Foreign mutual funds, even those that are essentially offshore clones of U.S. funds, simply do not keep U.S. books and tax records and provide U.S. tax information to their shareholders, which is a requirement for making the QEF election. Although I am aware of a couple of foreign funds traded in New York which allow shareholders to make a QEF election for U.S. tax purposes, I don't know of any foreign mutual funds traded publicly on a foreign stock exchange that keep records that allow shareholders to make a QEF election (if any reader knows of any such funds, please let me know at criser@mayer-riser.com).

Whichever of the foregoing three methods is chosen, an IRS Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, must be filed. If you are a do-it-yourself filer, be prepared to spend a good deal of time working through the Form 8621 instructions to learn how to complete it properly. If you use your CPA, you may have to be prepared to spend a good deal of money while your CPA learns how to complete it properly. Whatever you do, be sure it is filed. Failure to file the 8621 when required to do so can result in a \$10,000 fine.

One last tax possibility deserves brief mention. There may be some offshore funds sold to sophisticated U.S. investors on a private placement basis which funds are taxed as partnerships under U.S. tax law. Such funds generally don't have the unsavory tax consequences of PFIC shares (unless the fund itself invests in PFIC shares).

The bottom line? Don't believe any foreign investment adviser regarding the U.S. tax consequences of any investment. Know the consequences of investing in foreign mutual funds before you invest by getting tax advice from a qualified U.S. tax practitioner.

For loads of non-tax information about offshore and onshore mutual funds, see Standard & Poors Micropal site at www.micropal.com.

Jersey Court Orders Letters of Wishes Disclosed

In a recent unreported decision in the case of *In re Rabaiotti Settlement* (No. 2000/090, 30 May 2000), the Royal Court of Jersey expressly assumed jurisdiction over two British Virgin Islands (BVI) trusts administered by a Jersey trustee from Jersey and ordered the Jersey trustees of two Jersey trusts as well as the two BVI trusts to disclose a trust settlor's letters of wishes to a trust beneficiary. The *Rabaiotti* case involved the attempt by John Rabaiotti to force the disclosure of copies of documents relating to four trust settlements (three created by his father and one by his sister) and of which he was a discretionary beneficiary along with other family members. Two of the trust settlements were governed by BVI law and two of the settlements were governed by Jersey law.

Mr. Rabaiotti was involved in a divorce case before the High Court of England and there was a dispute about how much Mr. Rabaiotti should be required to provide for his ex-wife. The English Court ordered Mr. Rabaiotti to make disclosure regarding the trusts of which he was a beneficiary. The documents for which Mr. Rabaiotti asked included trust deeds, trust accounts for the last three years, a current valuation of trust assets, schedules of distributions made in the last three years to Mr. Rabaiotti and his immediate family, and all current and past letters of wishes.

The trustees, Latour Trust Company Limited and Latour Trustees (Jersey) Limited, were not sure that it was in the best interests of the trust beneficiaries as a whole to make such disclosures to Mr. Rabaiotti. Therefore, the trustees applied to the Royal Court of Jersey under Section 47 of the Trusts (Jersey) Law 1984 for a determination of whether they should disclose the documents to Mr. Rabaiotti and whether they should intervene in the English divorce proceedings.

The first important step the Court took was expressly to assume jurisdiction over the BVI trusts, because (1) time was short; (2) the trusts were administered in Jersey; and (3) the Court had evidence that the right of a beneficiary to information about a BVI trust would be the same as under English law.

It is generally accepted that a beneficiary has a right to view trust documents relating to the financial position of the trust so that the trustee may be held accountable for his trusteeship. However, where a trustee deter-



In re Rabaiotti
appears to be the
first case from an
offshore
jurisdiction
dealing with the
disclosure of
letters of wishes

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mined in good faith that disclosure of certain documents would not be in the best interests of the beneficiaries as a whole, the trustee may refuse disclosure and seek the Court's help.

The Court determined that there should, in fact, be a strong presumption that trust beneficiaries are entitled to see trust documents like most of those sought in this case. However, the Court would always have discretion to refuse to order disclosure where this would be in the best interests of the trust beneficiaries as a whole.

The letters of wishes in particular caused the greatest concern in this case. The Court reviewed several decisions in which the disclosure of letters of wishes had been an issue, including the Australian case of *Hartigan Nominees Pty Ltd and Another v Rydge* (1992) 29 NSWLR 405 and *Re Londonderry's Settlement* (1965) Ch. 918. The Court determined that there was a strong presumption against disclosure letters of wishes so as to avoid eroding a trustee's immunity from having to provide reasons for acting in a particular way, so long as the act was bona fide and with no improper purpose, and also to respect the settlor's intentions that letters of wishes remain confidential. However, the Court determined further that disclosure of letters of wishes may be ordered where the beneficiary requesting disclosure can show that there is some countervailing circumstance which calls for disclosure, even where the letter of wishes was given to the trustee in confidence.

Mr. Rabaiotti and his sister (also a beneficiary) argued that their father had wanted the trust funds to be preserved for future generations, and as such, Mr. Rabaiotti would likely receive payments only from part of the income of the trust funds. They believed that the letters of wishes in the trustees' possession, like past letters of wishes that had been found among their father's papers after his death, would prove this intent. The letters of wishes found at the father's death had been disclosed to Mr. Rabaiotti's wife as required by the English Court, and Mr. Rabaiotti wanted to ensure that the English Court would have current information based on the most recent letters of wishes so that the English Court would not proceed misinformed.

Mr. Rabaiotti and his sister wanted the Jersey trustees to provide the English Court with a maximum of information. However, the Jersey trustees did not want to submit to the direct jurisdiction of the English Court for fear that the English Court might attempt to vary the terms of the settlement. Although the Jersey Court believed that likely would not happen, neither did it see any good reason for the Jersey trustees to become directly involved in matrimonial litigation between a beneficiary and a third party. Thus the Jersey Court did not direct the trustees to intervene.

The Court finally determined that, there was no good reason for not disclosing all of the requested documents to Mr. Rabaiotti, including the letters of wishes. The Court determined that the general principles observed in relation to Jersey law regarding the disclosure of documents and the intervention in the matrimonial proceedings also reflected BVI law. Therefore, it made the same orders with respect to the BVI trusts as it did with respect to the Jersey trusts.

The decisions relating to the disclosure of letters of wishes on which the Jersey Court based its judgment were from courts in Australia (*Hartigan*) and England (*Londonderry*). The *Rabaiotti* case is the first case of which I am aware regarding the disclosure of letters of wishes from an "offshore" jurisdiction. There is some indication in the decision that if Mr. Rabaiotti's father had made it clear in the letters of wishes that they were to remain absolutely confidential, the Court may have reached a different conclusion in this case. I doubt it here, because it almost certainly was in the best interests of the beneficiaries as a whole to have the letters of wishes disclosed. However, in a closer case, a stronger indication of the intention that letters of wishes remain absolutely confidential may have swayed the Court in the other direction.

This case highlights two other important issues. First, with an increasing number of onshore matrimonial cases involving a spouse who is a beneficiary of an offshore trust, offshore trustees should be wary of submitting to the jurisdiction of a foreign court in matrimonial cases and should seek the direction of the court in the relevant jurisdiction before doing so as did the trustees in the *Rabaiotti* case. Finally, the *Rabaiotti* case serves as a reminder to settlors, trustees, and advisors that the courts of the place of administration may assume jurisdiction over a trust governed by foreign law simply by virtue of the fact that the trust is being administered on the court's home turf.

The full text of the *Rabaiotti* case is available to registered users (registration is free to qualified users) on the Jersey Legal Information Web site at www.jerseyinfo.co.uk.



Rabaiotti serves as a reminder that courts may assume jurisdiction over a trust simply because the trust is administered on the Court's home turf

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Qualified Intermediaries

“Qualified Intermediary” is a major buzzword in the offshore world as the year 2000 comes to a close. What exactly does it mean? Where does the term fit into the bigger U.S. tax picture?

On January 1, 2001, long-delayed U.S. Treasury Regulations [T.D. 8734, 62 Fed. Reg. 53387 (10/14/97), modified by T.D. 8804, 63 Fed. Reg. 72183 (12/30/98) and T.D. 8881, 65 Fed. Reg. 32152 (05/22/00)] will go into effect regarding U.S. tax withholding and reporting of cross-border payments of U.S. source income to foreign payees. These regulations will require foreign intermediaries to report tax obligations on U.S. source income in order to avoid 30% tax withholding on many payments of U.S. source income to foreign payees.

A “withholding agent” (basically any person or entity who makes a payment of U.S. source income to a person or entity whose address is outside the U.S.) must withhold 30% of any payment of U.S. source income that is subject to withholding (interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed and determinable annual or periodic income from U.S. sources) made to a foreign payee unless the foreign payee produces documentation showing that the payee is a U.S. person or is entitled to a reduced rate of withholding under an applicable treaty. However, a withholding agent is not required to withhold if the payee is, among other things, a “qualified intermediary.” The new Regulations set up a “qualified intermediary” system that will allow qualified financial institutions in qualified jurisdictions to certify the U.S. tax status of its customers. A qualified intermediary (QI) is a financial institution in a qualified jurisdiction that has entered into an agreement with the IRS that it will collect and keep certain information about its customers and will certify that information to withholding agents,

A QI can provide the withholding agent with the information necessary to allocate the portion of a payment related to each “withholding rate pool” under various treaties applicable to the QI’s customers. The identities of foreign customers do not need to be disclosed to the IRS or to withholding agents. Instead, the status of foreign payees and their entitlement to reduced withholding rates is confirmed by an independent auditor, and the IRS then audits the independent auditors. QI status also allows an intermediary to use collective refund procedures so that its customers do not have to file U.S. tax refund claims individually

Where there is a pool of U.S. underlying payees, however, the QI must provide a completed Form W-9 for each U.S. person or, alternatively, the name, address and taxpayer identification number (TIN) of each U.S. person. .

If an intermediary is not a QI, in order to obtain the most favorable allowable withholding rates for its customers, it must collect information on all of its customer payees in order to provide to the U.S. withholding agent a withholding statement containing the information necessary to determine the amount of U.S. tax to be withheld and reported to the IRS with respect to every underlying payee along with a valid withholding certificate (if required for a particular type of payment) for each underlying payee.

A non-QI is not required to provide information and documentation for any underlying payees except for any person it knows is a U.S. person that is not an exempt recipient. However, if the non-QI doesn’t provide information and documentation the withholding agent generally will be required to treat the payment as made to a foreign payee subject to the maximum 30% withholding tax. In addition, either the non-QI or, if applicable, the U.S. custodian (e.g., of U.S. securities in which the non-QI’s customers have invested), must report payments to each of the non-QI’s customers, a burden few financial institutions or U.S. custodians will want to bear.



The Regs set up a qualified intermediary system that will allow qualified financial institutions to certify the U.S. tax status of its customers

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The IRS has thus far approved the know-your-customer rules of 25 jurisdictions. However, the KYC rules of several important jurisdictions, including The Bahamas and Liechtenstein, still await approval

Obviously, QI status is much better than non-QI status for the protection of customer privacy and the avoidance of burdensome and intrusive reporting to withholding agents. How does a financial institution obtain QI status? A financial institution can become a QI only by agreement with the IRS and only if the institution is located in a jurisdiction where the IRS has approved the “know your client” (KYC) rules. Once the jurisdiction’s KYC rules have been approved, a standard attachment is created and integrated into every QI agreement spelling out the types of documentary evidence required to verify payee information for that jurisdiction. The IRS will permit a branch of a financial institution (but not a separate juridical entity affiliated with the financial institution) located in a non-qualified jurisdiction to act as a qualified intermediary if the branch is part of an entity organized in a jurisdiction that has acceptable KYC rules and the entity agrees to apply its home jurisdiction KYC rules to the branch.

The IRS has so far approved the KYC rules of the following jurisdictions: Barbados, Belgium, Bermuda, Canada, Cayman Islands, Denmark, Finland, France, Germany, Gibraltar, Guernsey, Hong Kong, Ireland, Isle of Man, Italy, Japan, Jersey, Luxembourg, Netherlands, Norway, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The QI attachments for each approved jurisdiction may be viewed online at www.irs.gov/bus_info/qi/cntry-list.html. The IRS began entering into hundreds of QI agreements in mid-September.

As an example of what documentation is required to verify customer identity in person, the Isle of Man QI attachment requires for natural persons, a current photo ID (passport, national ID card, military ID or driving license); for partnerships, a copy of the partnership agreement and any other subsidiary agreements evidencing the appointment and powers of the current partners, or certified copies of extracts evidencing the same; for corporations, a copy of the certificate of incorporation or memorandum and articles of association; and for trusts, a copy of the trust deed and any subsidiary deed evidencing the appointment and powers of the current trustees, or certified copies of extracts evidencing the same. For accounts not opened in person, the QI may rely on copies of such documentary evidence provided by another person who is subject to IRS-approved KYC rules or from an affiliate or correspondent bank of the QI, or on certified copies of such documentary evidence provided by the accountholder or person acting on behalf of the accountholder.

Jurisdictions still awaiting approval as of the time of publication are Andorra, Austria, The Bahamas, Israel, Liechtenstein, Monaco, and the Netherlands Antilles. The IRS intends to apply more rigorous oversight to financial institutions or their branches in jurisdictions that the IRS considers to be tax havens or bank secrecy jurisdictions and show an unwillingness to cooperate with the U.S. with regard to transparency and the provision of tax information. The IRS will do so, for example, by imposing increased or more rigorous audit requirements and/or stricter enforcement standards (including a more rigorous approach to defaults) on businesses operating in such jurisdictions. The IRS has informed QIs that they should not assume that, because they have an agreement covering a business in a particular jurisdiction, such jurisdiction will not later be identified as a specified tax haven or secrecy jurisdiction. Any enhanced audit requirements or stricter enforcement standards will, however, be imposed only on agreements entered into or renewed after identification of the jurisdiction as a specified tax haven or secrecy jurisdiction.

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Asset Protection

Qualified Personal Residence Trusts

Making gifts is a simple and common method of reducing the size of your taxable estate for U.S. estate tax purposes. However, if a simple outright gift of an asset is made, the value of the asset transferred will reduce your federal estate and gift tax exclusion amount (\$675,000 in 2000) dollar-for-dollar and could cause federal gift tax to be paid if the exclusion amount has been used completely. Furthermore, in a few states, including North Carolina, state gift tax may be payable, and at a much lower threshold.

Many techniques are available to leverage the exclusion amount by reducing the value of a gift. One such technique is the use of a Qualified Personal Residence Trust ("QPRT," pronounced "kyéw-pert" by acronym-obsessed estate planners). A gift of a personal residence is made to a special type of trust set up to allow the transfer of the residence to be made at a discounted value with the blessing of Congress and the IRS.

To create a QPRT, you transfer a primary residence or a secondary residence, such as a vacation home, to a special irrevocable trust. The Internal Revenue Code allows you to set up two QPRTs. If you have two QPRTs, one of them must hold your primary residence. The QPRT document provides that you have the right to live in the residence rent-free for the term of the trust. After a specified period of time (e.g., 10 years), which period of time you set in the trust document, the trust ends, and ownership of the residence is transferred to the "remainder beneficiaries" — usually your children or a trust for your children.

Because the trust document contains the special QPRT language and because the remainder beneficiaries have to wait to receive the property, for gift tax purposes, you've made a gift of only a portion of the value of the residence, specifically, the value of the remainder interest. The value of the remainder interest is, theoretically, what someone would pay you today for the right to own your residence at the expiration of the trust term, based on a present value calculation using interest rates set by the U.S. Treasury. The longer the term, the greater the discount.

If the residence (which includes the land included in the trust as part of the residence) appreciates in value, all of the appreciation inures to the benefit of the remainder beneficiaries and escapes estate and gift tax upon transfer to them. The effect is that the value of the residence will have been "frozen" as of the date of the creation of the trust, with the only gift and estate tax event occurring at the original transfer into the trust.

"What's the catch?," you ask. The catch is that to obtain the benefit of the discounted gift tax value, you must survive the term of the trust. If you do, the residence will not be included in your estate for estate tax purposes. You will have transferred the residence to the remainder beneficiaries at a deeply discounted gift tax value. By doing so, you will have used up less of your federal estate and gift tax exclusion amount, leaving more available to use to avoid taxation on other assets.

When you create a QPRT, you decide how long you want the trust to last. The longer the term, the greater the potential tax savings. Ideally, you should choose the longest term that you feel confident that you will survive. However, even conservatively short terms can produce significant tax savings. The following example will illustrate the tax savings a QPRT can produce.

Example

Jane, a healthy 65-year old widow, owns a home on ten acres in Highlands, for which she and her husband paid \$100,000 in 1980. When Jane's husband died in 1995, the home was worth \$400,000 and Jane's income tax basis was stepped up to \$250,000. In October 2000, when the home had an appraised value of \$550,000, Jane transferred her home to a QPRT that will last for a term of 10 years. During those 10 years, Jane will continue to live in the house and pay the property taxes and other expenses of upkeep. Over the 10 years, the value of the home appreciates at a rate of 7% per year (this appreciation rate is perhaps a *conservative* estimate based on the way things have been going in Highlands over the past several years!). When the trust ends, the property will pass to Jane's children, who will take the trust's income tax basis of \$250,000.

Jane has made a gift for gift tax purposes in the amount of \$204,753 (the present value of the remainder interest). This amount is well within the \$675,000 federal estate and gift tax exemption amount. Although Jane is required to file a federal gift tax return, she is not required to pay any federal gift tax



A QPRT allows the transfer of a residence at a discounted gift tax value with the blessing of Congress and the IRS

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(although I note that there would be a few thousand dollars of North Carolina gift tax to pay). If Jane survives the 10-year period of the QPRT, the value of the house will not be included in her estate. The balance of Jane's federal estate and gift tax exemption amount will be available to offset estate tax on other property that she owns at the time of her death. Assuming that the residence appreciates at the 7% rate, and that the rest of Jane's estate is worth \$800,000 at the time of her death, instead of her estate owing \$345,000 in estate tax, she will have passed on a residence worth over \$1 million and her estate will owe no estate tax, allowing that \$345,000 value to pass to her family rather than to tax collectors.

If Jane's children decided to sell the property after Jane's death for \$1 million, they would incur capital gains tax of about 27% (combined state and federal) tax (\$202,500) on the capital gain of \$750,000. Even so, the children will be almost \$150,000 better off than if Jane had simply left the home to them outright at her death and about \$90,000 better off than if Jane had made an outright gift of the home to them in 2000. If Jane had made an outright gift, rather than using the QPRT, the outright gift would have reduced her exclusion amount by \$550,000 rather than by only \$204,753, and there would have been estate tax payable at her death of \$145,500. Adding this \$145,500 estate tax to a potential capital gains tax of \$202,500 if the children were to sell the home makes for total potential tax consequences of \$348,000 on an outright gift.

Tax Consequences if Jane Dies Early

Jane's life expectancy at age 65 is significantly greater than 10 years. However, if Jane does unexpectedly die within the 10-year term of the QPRT, the estate tax effect will be the same as if she had never created the QPRT. The home will be included in her estate at its value at the time of her death, and the gift she made when she transferred the home to the trust will not be taxed. The only costs risked are the legal and appraisal costs involved in establishing the QPRT and transferring the home to the trust.

Selling the Home During Jane's Lifetime

As trustee of the QPRT, Jane can sell the home during the term of the trust. Jane is treated as the owner of the home for income tax purposes and gets the same income tax benefits that would apply if she sold the home outside the trust, including the \$250,000 capital gains exclusion on the sale of a primary residence. The only restriction on selling the home is that the trust must explicitly prohibit the sale of the home back to Jane personally or a related party. Jane can decide whether to use the proceeds of a sale to buy another home or to leave the proceeds in the trust and convert the QPRT to a grantor retained unitrust ("GRUT") or a grantor retained annuity trust ("GRAT"). A GRUT would pay Jane a fixed percentage of the value of the trust as determined each year. A GRAT would pay Jane a fixed annuity amount. The principal of a GRAT or GRUT converted from a QPRT would not be included in Jane's estate if she outlived the original 10-year term of the trust.

Jane's Right to Live in the Home after the Trust Ends

After the QPRT term ends, the home is owned by Jane's children or by a trust for their benefit (probably a better choice from an asset protection perspective). She cannot then require that the children allow her to live in the home rent-free. This would cause the value of the home to be included in her estate. The most common solution would be for Jane to lease the home from the children. The rental payments will further reduce the size of her taxable estate (without counting as gifts), and the amounts received by the children as rent will be diminished only by income tax and not by a larger estate tax.

QPRTs may be combined with "fractional interest discounting" (i.e., the concept that the sum of the parts are less than the whole) to produce even more dramatic estate and gift tax savings. For example, a husband and wife might each contribute a 50% tenancy in common interest in a residence to a QPRT, each gift being discounted anywhere from 15% to 40%, depending on the results of a qualified appraisal, which discounts will leverage the QPRT's effectiveness even more than usual.

The QPRT is not the result of a complicated loophole in the tax laws. Congress intentionally provided this beneficial technique by writing specific provisions into the Internal Revenue Code in 1990. There is nothing wrong with legally minimizing your estate and gift tax exposure in planning to pass your property on to your intended beneficiaries. A QPRT can give you the opportunity to pass to your family hundreds of thousands of dollars that otherwise would go to pay death taxes.

Setting up a QPRT requires sophisticated trust drafting by a qualified estate planning attorney. The residence involved must be appraised by a qualified appraiser and must be properly transferred to the trust by deed. Gift tax returns must be filed (and in North Carolina, and perhaps in Tennessee and Connecticut, state gift tax may be payable). However, compared to the overall potential tax savings, the cost of establishing a QPRT is relatively low.



A QPRT can give you the opportunity to pass to your family hundreds of thousands of dollars that otherwise would go to pay death taxes

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Briefly Noted

Website Insurance

“Cyberspace liability” insurance policies are becoming more popular to cover risks associated with online business that may not be covered under standard commercial general liability policies. Currently about a dozen such policies are available. Examples of risks covered by cyberspace liability policies include:

- Losses of the insured due to viruses, hackers, data loss and server overload
- Damage to third parties resulting from viruses spread from an insured’s computers
- Online invasion of privacy and defamation
- Infringement of intellectual property rights

One such online provider of such policies (not investigated or endorsed by me) is Media/Professional Insurance at www.mediaprof.com/cyberliability.htm.

Reparations Tax Credit and Refund Scam

The IRS is cautioning African-Americans not to be misled by anyone offering for a fee to help them file for non-existent tax credits or refunds related to reparations for slavery. IRS centers have received a growing number of such claims this year, repeating similar experiences in 1994 and 1996.

One promoter in Miami was charging victims \$100 to handle claims and warned victims not to contact the IRS because “the IRS didn’t want the general public to know about the tax credit.” Taxpayers who repeatedly file such claims after receiving a denial notice may be subject to a penalty for filing a frivolous tax return.

Islamic Finance

A Malaysian banker has launched an Islamic finance Web site at IslamiQ.com. The site is intended to help Muslims invest in world markets without violating religious rules — such prohibitions against insurance and the payment of interest — providing information on financial products and services that are compliant with Islamic principles. Islamic finance has been rapidly developing over the last several years, evidenced by the interest of western banks like ANZ, HSBC, and Deutsche Bank, all of which have established Islamic banking and finance divisions. Islamic equity indexes exist for the NYSE (the DJ Islamic Market Index) and the London Stock Exchange (the FTSE Global Islamic Index). Read more about the Islamic finance sector in the Oct. 26th issue of the Financial Times, available online at www.ft.com.

Tax Protestor Loses — Again

Every month, a new batch of opinions in losing tax protestor cases are issued around the country. In one recent case, a U.S. district court in New York dismissed a taxpayer’s suit for a refund. Joseph Letcher (a longtime admirer of another infamous losing tax protestor, Irwin Schiff), who had lost at least one prior tax case after failing to file returns for a number of years, added to the jurat on his 1995 1040 asserting that “any information, marks and signature that appear on the 1995 tax return are provided without prejudice and under duress” and referring to an attached sheet where he made the usual tax protestor case about evil social security numbers, wages not being income, and his being forced into a contract with the United States by means of the 1040. Because of the alterations to the jurat, the court found that the return was invalid.

And on a Culinary Note...

I was in London the last two weeks of October studying for and taking the exam to qualify as an English solicitor. Most of the time, I was holed up in my hotel memorizing the finer points of English conveyancing, etc. However, my wife and I, both food buffs, had a couple of days to enjoy ourselves after the test. We ate dinner at a fantastic Polish restaurant in Kensington called Wodka (12 St. Albans Grove, W8, London; Tel 0207 937 6513). I’ve been telling anyone who might care, so, for readers who find themselves in London, don’t miss this one! The atmosphere and service were excellent and the food was outstanding: herb dumplings, venison medallions with cherry sauce and roasted pears, pierogi, stuffed cabbage, and excellent desserts. The meal for two with wine and gratuity was about £60 — quite a deal for such an excellent meal in London! The restaurant is also famous for its vodka selections (of course...).



Cyberspace liability insurance policies are generating a great deal of interest in the insurance market for e-businesses

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Misplaced Trust
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trust industry is
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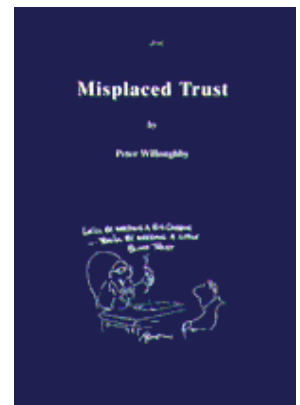
Book Review: *Misplaced Trust*

Peter Willoughby's *Misplaced Trust* is a book that should be required reading for every trust company director and officer, every financial advisor, every trust and estates lawyer and every potential trust settlor. Unfortunately, as "see no evil, hear no evil, speak no evil" seems to prevail in too much of the offshore world, chances are that won't happen. Many such potential readers wouldn't like reading Willoughby's take on the truth about trusts at the beginning of the 21st century.

Willoughby exposes the weak foundation upon which much of the offshore asset protection trust industry is built, asserting that many so-called "asset protection trusts" likely are not trusts at all, but rather nominee arrangements or resulting trusts in favor of the original settlor — certainly a disaster from an asset protection perspective, as well as perhaps from a tax perspective. He also points out other dangerous areas such as trustee exoneration, directors duties in relation to asset holding companies, problems with letters of wishes and protectors and professional advisor liability. Finally, he offers up some valuable tips.

The point of *Misplaced Trust* is not that trusts are bad, but simply that trusts must be designed and implemented with integrity at every stage with an understanding of the true nature of trusts. As an indication of the importance of the book, note that it was cited with favor by the Royal Court of Jersey in the *Rabaiotti* case analyzed earlier in this issue.

Order *Misplaced Trust* directly from the publisher at www.gostickhall.co.uk or by calling Gostick Hall Publications in Essex at +44-(0) 1799 541152. The book is also available from Amazon in the UK at www.amazon.co.uk and from Waterstones Online at www.waterstones.co.uk.



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