

Reviewing Revocable Trusts in International Estate Planning

Revocable trusts have become an increasingly key component in the international estate plans of many families. These trusts are established, in part, to avoid the accumulation penalty tax that would otherwise apply to distributions of accumulated income made from a foreign *irrevocable* trust.

During the more than eight years since the enactment of the legislative changes that favored the use of revocable trusts, various income tax aspects of revocable trusts that were not well settled at that time have become more clearly established.

For example, the U.S. income tax consequences upon the death of a person holding a power of revocation over a revocable trust (the “revoker”) have significant implications. By using a revocable trust, upon the death of the revoker all of the accumulated income in the trust will be regarded as capital. Such income will not be deemed accumulated income within the trust for purposes of the accumulation penalty tax. Any distribution of this accumulated income made from the trust after the death of the revoker would be regarded as an income tax-free distribution of capital.

However, this same rule may not necessarily apply with respect to the unrealized capital appreciation of the assets held by the trust at the death of the revoker. The realization of such income after the death of the revoker will cause the trust to recognize a gain for income tax purposes based upon the basis of such assets, unaffected by the death of the revoker. This income would also be included in the income of the trust and taxed upon its distribution to the U.S. beneficiaries of the trust. If the income is also deemed to be accumulated income, it will also be subject to the accumulation penalty tax.

With a properly constructed trust provision, the revoker shall have the power to direct who shall receive payments of income. As a result, the beneficiaries of the trust will be able to receive a fair market value step-up in income tax basis for any unrealized appreciation of the assets held by the trust as of the death of the revoker. For example, if an asset held by the trust has appreciated in value, but such appreciation has not been realized prior to the revoker’s death, the trust would nevertheless be entitled to receive a step-up in the income tax basis in that asset up to the date of death value. As a result, the appreciation that had occurred prior to the death of the revoker would be regarded as capital. Upon the ultimate disposition of the asset after the death of the revoker, only the gain, if any, on the appreciation that occurs *after* the death of the revoker would be recognized.

In addition to the foregoing issue, other factors may necessitate revisiting a family’s international estate plan at this time. For instance, changes due to an increased focus on global tax transparency may, in certain circumstances, result in the disclosure of information previously thought to be protected by the secrecy laws of foreign jurisdictions. In addition, a family’s country of origin may have enacted changes to its own tax laws that

may have consequences not foreseen at the time a family's revocable trust was established.

Finally, insofar as South African revokers are concerned, they should also be aware of the subsequent relaxation in the Exchange Control Regulations of the Republic of South Africa.

Clearly, these changes may require that the international estate plans of families be reviewed. Please feel free to contact us if you would like a review of your family's international estate plan.

For Further Information

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