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# Taxation and Trusts in the United States and Japan

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# Taxation and Trusts in the United States and Japan

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## Introduction

This paper examines and compares the trust laws and the trust taxation both in the United States and in Japan, focused on the treatment of future interests and contingent interests in trust taxation. Both in trust law and trust taxation, dealing with future interests is one of the most critical issues.

## Trust Law and Future Interests

In 2007, Japan made a major revision of trust taxation, responding to the new Trust Act enacted in late 2006.[2] A major purpose of the new Trust Act was to cope with various needs for trusts in Japan, including so-called "sequential beneficiary trusts." The revised Japanese tax law defines this type of trust as any trust of which instrument provides that the death of the current beneficiary causes the next beneficiary to take the place. One such example is an inter vivos trust created by a grantor for the benefit of his sister for the remainder of her life, then to pay the income to her children for the rest of their lives, and then to distribute the trust assets to her grandchildren. This is a common trust in Anglo-American countries. The sequential beneficiary trusts are no more than ordinary trusts in these countries.

However, the legal validity of the sequential beneficiary trusts in Japan, whether they last a long period or not, was uncertain until the new Act came into force, because they might infringe on each heir's legally secured portion of estate. Behind this notion, it should be recognized that in Japan and most of continental countries, the freedom of bequeath is limited. Equal sharing among children and a half for the spouse is the standard.

The sequential beneficiary trusts have a notable feature. Because they tend to last long and serve for future control of property by the decedent, they create future interests in the trust, including interests contingent upon future phenomena. For example, suppose the instrument of the above-mentioned trust provides that if the grantor survives his sister, the trust terminates and its assets go back to the grantor. In that case, the future interests of the sister's children and grandchildren

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[2] In this paper, titles and legal terms of Japanese laws follow the translation by Japanese Ministry of Justice. Some Japanese laws are translated and searchable via website below. http://www.japaneselawtranslation.go.jp/?re=02

become contingent. Moreover, grantors often hold a power to revoke or terminate the trust, or retain the right to change or designate the beneficiaries. These powers or rights of grantors also make the future interests uncertain.

Japanese Civil Code has long been unaware of "vest or fail," and has left little room for future interests. There is no "fee tail" in Japan. Although there are a variety of real rights (jus in re), including an easement, tenant right, surface right, lien (preferential right), mortgage, and so on, they are present and immediate rights, not future rights. The notion of future interests, whether vested or contingent, is relatively new to Japanese civil legal system. A sequential beneficiary trust slices an absolute ownership right along the time axis, creating pieces of temporal interests, such as an income interest and a remainder interest. It is also a feature of Japanese civil legal system that people cannot create a new kind of real right as they like, by contract or otherwise. There is a statutory catalogue in the Civil Code, and no other real rights are valid. This is one aspect of "the principle of absolute ownership right," a foundation of Japanese civil legal system.

## The Duration Limit

### The Duration of Trusts

The duration of future interests in trusts is limited. In the United States, the Rule Against Perpetuities (RAP) provides the duration limit. John Gray's classic statement reads: "No interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest."[3] Its core principle in modern world is that the settlors should not be able to control the non-charitable use of their property beyond the lifetimes of people they know personally, plus the minority of any children those known persons might have. The rule therefore limits the time during which property can be made subject to contingent interests to lives in being plus 21 years. Note that the rule prohibits merely those interests that may remain contingent beyond the perpetuities period. It does not limit all the future interests, nor does it limit the duration of a trust itself.

Japanese new Trust Act has a duration limit, but the method of limitation differs from the RAP. Under the limitation provision, the Trust Act article 91, a trust cannot last beyond the death of the beneficiary who obtains the current beneficial interest after the lapse of 30 years from the settlement of the trust. In other words, after 30 years from the settlement, only one more generation can become a beneficiary. Within 30 years, beneficiaries can change any times.

The drafting committee of the Trust Act, which consisted of scholars and lawyers, thought that there should be some duration limit on the sequential

[3] John Chipman Gray, The Rule Against Perpetuities § 201, at 191 (4th ed. 1942).

beneficiary trusts, and the appropriate duration period was around 100 years from the settlement. The committee also thought that it is natural to terminate the sequential beneficiary trusts not by a lapse in time but by the death of the last beneficiary. The period of 30 years from the settlement plus one more generation comes from this consideration.[4]

Thus, the Trust Act limits the duration of trust itself. All the interests in trust, vested or contingent, become void at that time point. It is easily conceivable that the Act does not distinguish between vested and contingent interests, for these are unusual concepts for the committee members.

The Reasons for Limit

It is worthy to compare the reasons why perpetual trusts are prohibited, between the two countries. In the United States, two or three reasons are mentioned.[5] First, to limit "dead hand control" over the property, and let the present generation use the property as it sees fit. Second, to keep property marketable and available for productive development in accordance with market demands. And sometimes, one more reason is brought up: to curb trusts, which can protect wealthy beneficiary from bankruptcies and creditors, and decrease the amount of risk capital available for economic development. These reasons are mostly based on economic efficiency. It is pointed out that according to these reasons, imposing a duration limit on trust itself is better than the RAP's limitation on contingent interests only, since whenever future interests, vested or contingent, exist, theses objectives are compromised.

The duration limit of Japanese Trust Act shares these reasons. The drafting committee reported that it decided the duration limit by balancing these efficiency-based considerations against the freedom of the disposition of property.[6]

However, the drafting committee discussed another principled reason for prohibiting perpetuity in Japan. It comes from "the principle of absolute ownership right." That is, since an ownership right must be absolute (no fee tail) in Japan, no one can slice it without statutory authorization by the Civil Code. No one can create a new real right. However, if a trust could create an interest that is

[4] According to the average life span and the dynamic statistics of population of Japanese people, ordinary sequential beneficiary trusts are estimated to last 97.5 years if the last beneficiary is a male, or 104.5 years if female.

[5] Jesse Dukeminier, A Modern Guide to Perpetuities, 74 Calif. L. Rev. 1867 (1986).

[6] The drafting committee also reported that the 30 year period in the duration limit, the period in which beneficiaries can change any times, may be amended according to the needs of public, and that the committee examined 20 years, which is the period of acquisitive prescription, and 50 years, which is the duration period of copyright, instead of 30 years.

perpetual or lasts very long, such an interest could virtually be a new real right outside the catalogue of the Civil Code. This is a principle-based explanation of the duration limit.

In the discussion of the drafting committee, it is also pointed out that if a trust could create a right or interest equivalent of an ownership right but only for a limited period, such an interest conflicts with the absolute ownership right principle, because a right with limited period is not absolute. Although it is possible to distinguish the beneficial right in trust from the ownership right or real rights, this discussion suggests that trust, as a legal system, is not well settled in Japan.[7] The absolute ownership principle, which played a significant role historically and penetrates into Japanese civil legal system, restricts the Trust Act's ability to create a new class of interests.

The duration limit of the Trust Act requires that a single person hold an absolute property right after the provided period. The Rule Against Perpetuities also has this effect.

## The New Trust Taxation in Japan

### Three Types of Taxation

In Japanese new trust taxation, which is in the Inheritance and Gift Tax Act, Individual Income Tax Act, Corporate Income Tax Act, three methods of taxation can be identified.

1. The first method deems the current beneficiary to be the owner of the whole property in trust (corpus), and makes the deemed owner alone be subject to tax. This method can be called "the full corpus taxation."
2. The second method also deems the current beneficiary to be the owner of the corpus, and makes the deemed owner be subject to tax. However, there can be more than one beneficiary. Each beneficiary's share of the corpus is determined according to the content of the interest. The second method can be called "the divided corpus taxation."
3. The third method focuses on the beneficial interest of trust, not the property in trust, and treats the interest like stock of corporation. The third method can be called "the beneficial interest taxation."

[7] In this connection, it should be pointed out that there cannot be no man's property in Japan. The ownership right of trusted property belongs to the trustee in the civil legal system.

The Full Corpus Taxation

In the first method, the full corpus taxation, because the current beneficiary is deemed to own the whole property in trust, when a trust is settled or a beneficiary changes, all the property in trust is deemed to be transferred from the settlor to the first beneficiary, or from the former beneficiary to the next one. The characteristic of this method is the deemed ownership and deemed transfer of trust corpus.[8]

The first method applies in the inheritance and gift taxation on the sequential beneficiary trusts.[9] When the trust is settled or the beneficiary changes, the value of all property in trust is included in the tax base of the inheritance or gift tax, as the case may be. Note that Japanese inheritance tax and gift tax are imposed on the donee, not on the donor,[10] although the computation of the inheritance tax is based on the value of all property of the decedent at the death (gross estate), not the value of the property each heir acquires.

Because all the trust corpus is subject to tax at the settlement and every time the beneficiary changes, even if between the beneficiaries of the same generation, the first method depresses those trusts with same generation beneficiaries. This method also discourages the sequential beneficiary trusts with generational order beneficiaries, because gift or bequest of direct skip, for example, a bequest from a grandfather to a grandchild, is favorable unless it is subject to the Generation Skipping Transfer (GST) Tax. There is no such tax in Japan.

One important point is that because the current beneficiary is deemed to own all the property in trust, the subsequent beneficiary is deemed to acquire nothing, even if the interest is vested and marketable.

The Divided Corpus Taxation

The second method, the divided corpus taxation, is used in the inheritance and gift tax on trusts other than the sequential beneficiary trusts, and in the individual and corporate income tax generally. When a trust has more than one current beneficiary, the difference of each beneficiary's interest counts towards each one's taxable income. This method has a special significance in the taxation of so-called a grantor trust. A grantor trust is a trust over which the grantor has certain control. By deeming those grantors to be beneficiaries, the second method works. However, this second method shares the basic idea with the first method

[8] The result of this taxation is similar to that of I.R.C. §2702, which requires inclusion of the full value of trust corpus into the taxable gift in certain inter vivos trusts.

[9] Inheritance Tax Act Art. 9-3.

[10] The tax base is tax inclusive both in the inheritance tax and the gift tax.

(the full corpus taxation), in that only the current beneficiary is deemed to own the trust property. Thus, when a trust is settled or every time the beneficiary changes, the corpus in whole or in part is hypothetically transferred to or between the beneficiaries, and its value is subject to the inheritance or gift tax.

As for individual and corporate income taxation, a trust itself is not subject to tax in Japan. As a general rule, a trust is not a taxable entity, although there are exceptions in the third method, as explained later. Current beneficiaries, including certain grantors (deemed beneficiaries), are subject to tax on their shares of the trust income. If a beneficial interest is acquired by inheritance or gift, its basis, that is, the basis of the property hypothetically owned by the beneficiary, is carried over from the former beneficiary (deemed owner) or from the grantor.[11] Because this basis rule applies to the sequential beneficiary trusts in income taxation, avoidance opportunities arise.[12]

The Beneficial Interest Taxation

The third method, the beneficial interest taxation, treats a trust as a corporation, and its beneficial interests as shares of a corporation. This method applies mainly to certain corporate related business trusts and investment trusts that are substitutes for subsidiaries or investment vehicles. In this method, those trusts are subject to the corporate income tax. In addition, beneficial interests, not divided corpus, are subject to tax at the beneficiary level. Resulting double taxation is ameliorated only in some cases.

This third method is logical because beneficiaries hold interests, not corpus, and may be superior to other methods, especially if beneficial interests are circulated in the capital market, although the double taxation should be eliminated. However, for non-marketable interests, their valuation is difficult. This difficulty is apparent in the trusts related to family businesses or closely held corporations. Moreover, it is almost impossible to apply this method to future interests in the sequential beneficiary trusts, especially if the interest is contingent on someone's future action or intent.

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[11] However, a gift by a corporation or other legal entity to an individual is subject to individual income tax, not to gift tax.

[12] For example, the beneficiary of the future remainder interest (X) could give the interest to a low-income family member (Y), and buy back the interest at the arm's-length price. Because the value of the future interest is zero for the gift tax purpose, no gift tax to Y. (The donee is subject to gift tax.) Y's basis of the interest is zero, so Y has to pay income tax without basis deduction, but Y is in low bracket. X can step up the basis, and because X has acquired the interest not by gift but by purchase, X is not subject to gift or inheritance tax when X becomes a current beneficiary.

The Reform

From the observation above, the first method obviously discourages the use of the sequential beneficiary trusts. Those trusts, although common and ordinary in the United Sates, will not grow in Japan.[13] However, applying the second method does not change the result, since it takes up only the current beneficiary. Applying the third method is very difficult or makes inaccurate results, and may invite abuse, such as estate freeze in the United States. The difficulty of valuation explains why the first method is adopted.

In order to utilize the sequential beneficiary trusts, a fundamental reform of the current inheritance and gift taxation, and probably of the income taxation is necessary. The reform should ameliorate the valuation problem of future interests, especially contingent interests in trusts.

In my opinion, an accessions tax with lifetime adjustment seems promising, because with lifetime adjustment, the actual (realized) benefit the beneficiary received from the interests, whether future, contingent or not, can be calculated at the death. This kind of lifetime adjustment is impossible in the existing estate and gift taxes in the United States even though they are unified, since the decedent leaves future or contingent interests, and their actual value is not certain until the trust terminates. On the contrary, an accessions tax is on the donee, and no interest can provide enjoyment after a person's death.

If the individual income tax develops lifetime adjustment of a person's income, in which future interests, once taxed (when acquired by inheritance or gift) but not realized any benefit, are excluded from the tax payer's lifetime income, that income tax may be better than the accessions tax with lifetime adjustment, because of broader tax base of income tax.

**Conclusion**

A comparison between the duration limit by the RAP or Japanese Trust Act, and the taxation on the sequential beneficiary trust (the first method in Japan or I.R.C. § 2702 in the United States) shows two common points.

First, both the trust rules and the tax rules require that a single person hold, or be deemed to hold, a complete property right at least every few generations.

Second, both the reason for the trust rule's duration limit in Japan, which is based on the principle of absolute ownership right, and the reason for the tax rule's deemed ownership method, which is based on the valuation problem, come from inside the law, that is, from legal principle or legal technique, rather than economic efficiency or social engineering.

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[13] Assume § 2702 of the Internal Revenue Code applies in the estate tax and the GST tax without the exception of the qualified interest. This would bring almost the same result as Japanese first method taxation.

These points suggest that in order to utilize the sequential beneficiary trust in Japan, the notion that a beneficiary holds the absolute right and full value of trust corpus should be changed both in the civil legal system and taxation. This is a fundamental change, but the change is inside the legal system.

This paper concludes by pointing out tax rule's effect on the civil legal system. Although Japanese taxation stifles the sequential beneficiary trusts, as discussed above, it is argued in the United States that the introduction of the GST tax in 1986 led to increased interest in abolishing duration limits on trusts, and boosted private trusts in the states without the RAP. This seems ridiculous, because the purpose of the GST tax is to stop large amounts of property from passing to successive generations free of transfer taxes especially through trusts. The reason why long lasting trusts proliferate is because the GST tax has significant amount of exclusion that can be further magnified by the "inclusion ratio." Trust industries exploited that loophole, and customers and state's legislatures responded. More than half of the states have abolished the RAP literally or effectively.

This occurrence indicates that it is taxation, rather than trust rule, that principally affects the feasibility and attractiveness of long lasting trusts, and that a significant loophole in taxation would change the civil legal system.