An Introduction to U.S. Advice for Non-residents and Non-citizens about International Estate Planning

Eleven Key Topics
or
What I Really Need to Know I Learned in the 3rd Grade

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Stay in your seat

1. The U.S. Tax System: Look Both Ways Before Crossing the Border

A person who is not a U.S. citizen should think twice (maybe three times) before becoming a resident of the U.S. for tax purposes.

A. NRAs from a no-tax jurisdiction: paying tax as a second language

Under the U.S. tax system, it is difficult enough for native taxpayers and their advisors to distinguish between creative tax planning and wishful thinking, and even the judiciary has difficulty drawing lines with consistency. It is not surprising then that persons who confront our elaborate tax system for the first time can experience "culture shock" if their home country does not levy any income or death taxes of any kind.

For these clients, the rules for paying taxes have to be communicated with utmost attention to simplicity -- yet without losing nuance and with a high level of confidence, without hiding the fact that the advice of reasonably experienced practitioners can differ from time to time. U.S. advisors must also accept the reality that these clients will tend to be disappointed with any U.S. tax plan that does not reduce taxes to zero.

B. NRAs from a higher-tax jurisdiction: you will pay, and may pay twice

For those individuals who come to stay or invest in the U.S. from a home country with a more highly developed tax system, the challenge will be to understand two new risks: unlike in many places in the world, tax rules are enforced in the U.S. and, if you also pay in your home country, you can end up paying twice. Despite the low audit percentages in recent years, and the tax shelter scandals, the U.S. government collects a serious level of taxes here; moreover, worldwide taxation is the rule, not the exception; and people do go to jail for failure to pay.

One more key message should be emphasized: although the U.S. tax laws and treaties make an effort to avoid double taxation, there is no inalienable right to avoid paying taxes twice, both in the U.S. and in the home country, on what appears to be the same assets, income or transaction.

C. The messenger needs a bullet proof vest

The U.S. advisor in international estate planning does not lack challenges.

- Inheritance and taxes in the U.S. means freedom of choice. Wealth is born on the frontier (including virtual frontiers), and we allow the wealth builders to control it, subject, of course, to the democratic and competitive principle that death taxes must be imposed to prevent undue concentrations of inherited wealth. Private philanthropy is encouraged, and particularly practical, at death. With our faith in the rule of law and high death tax rates, we tolerate and even cultivate an industry of various specialists who sell life insurance and clever tax planning. To

avoid fraud, waste and abuse, we relied for many years on a highly developed system of regulated estate administration, and even after modern probate and trust law reform, we have preserved fundamental concepts of fiduciary duty and provided a court system and a plaintiff's bar to enforce those duties. The result is a very large measure of complexity – a virtual synonym for estate planning – that is unknown in most other parts of the world.

- In contrast, the norm elsewhere, particularly in civil law countries, is quite simple: no testamentary document at all, or a holographic will of a few pages that cannot radically alter the shares specified by the forced heirship laws, which protect descendants even more than surviving spouses. In these jurisdictions, there is no probate system as we know it, no "estate administration" at all. People die, title passes in certain shares, a family member or other individual designated by law may deal with remaining debts using limited powers, and life moves on. Clients from these jurisdictions may not be sympathetic to complicated U.S. laws or what you consider to be customary solutions.

- International estate planning almost always involves conflict of laws, as to the disposition of property and also as to taxes if the home country imposes relevant taxes. Conflicts between state laws in U.S. estate planning are difficult enough, but these are minor annoyances compared to conflicts between cultures and country laws in international planning. This paper will focus on U.S. tax rules, but U.S. taxes are the beginning and not the end of international planning.

- Due to the need to address these conflicts, it is often important to acquire some working knowledge of the law of the other jurisdictions involved in the client's affairs, but reliance on experts in those jurisdictions is at least as important. Yet advisors in these other jurisdictions may (or may not) understand your language and may (or may not) patiently appreciate the constraints that you are facing under U.S. law.

- Ethics and financial crimes compliance in this field presents increasingly challenging issues. In the "good old days" the courts in the U.S. and elsewhere would not enforce the revenue laws of a foreign country. Now U.K. advisors are subject to directives that have expanded "know your client" ("KYC") into standards dealing with "reason to know" of tax crimes in other countries. In the U.S. (and elsewhere) rules such as under the Patriot Act have put hard teeth into the KYC inquiry because the fear of terrorist financing fronts has joined the classic drug money laundering concerns. Finally, as a practical matter, it is still unethical for U.S. lawyers (and sometimes criminal) to assist someone with their estate planning if they have not reported previously taxable U.S. income and refuse to correct clear non-compliance, for the reason that, among others, the estate planning process will inevitably involve related tax reporting (e.g., basis) and cross over into disposing of the fruits of the "tax savings" that resulted from the failure to report.

To counter balance this message, the U.S. advisor who serves as the messenger has one compelling justification for this complexity – it cannot be avoided, and at least in some cases, it offers the corresponding benefit of testamentary freedom of choice.

Get a Hall Pass

2. Estate and Gift Taxes While Investing in the U.S.

Investing in the U.S. without becoming tax resident here can get you a free pass from U.S. wealth transfer taxes - - if you plan ahead. Transfers of stock in non-U.S. corporations are exempt, as are gifts of intangibles.

A. NRAs Can Bypass the U.S. Wealth Transfer Tax System

The U.S. wealth transfer tax can be avoided by individuals who are not residents or citizens of the U.S. ("non-resident aliens" or "NRAs"), because the tax simply does not apply to non-U.S. property, such as stocks or bonds of non-U.S. companies even if those companies are offshore mutual funds or personal investment companies that invest in U.S. securities. It also does not apply to lifetime gifts of stocks and bonds and other intangible property. Moreover, modern treaties protect residents of the treaty country from transfer tax on their U.S. investments, generally by exempting even direct investments in U.S. securities from tax.

B. Gifts Usually Avoid Gift Tax

Transfers of intangibles by NRAs are not subject to U.S. gift tax, even if the intangibles are U.S. property (e.g., stock in a U.S. company). Code § 2501(a)(2). As a result, only real property and tangible personal property located in the U.S. are subject to the U.S. gift tax.

C. Clear Opportunities for Avoiding Estate Tax

The estate tax reaches a significantly broader list of property than the gift tax. Code §§ 2103-5. Generally, the property is subject to the estate tax if it has a U.S. situs (so-called "U.S. property" or property "located" in the U.S.). U.S. real estate and tangible property physically located in the U.S., and securities or obligations issued by U.S. persons or entities, are U.S. property and subject to tax unless specifically excluded by a special Code provision.

Most importantly, however, U.S. property includes stock in a U.S. company but not stock in a non-U.S. company. Thus, the NRA can avoid the estate tax by investing in U.S. property through an offshore holding company or mutual fund. The U.S. estate tax rules do not "look through" these offshore companies except in special circumstances, and as a result, it is commonly recommended that any investments in U.S. property by an NRA be made through offshore companies, usually owned in turn by an offshore trust.

D. GST Follows the Same Course

The reach of the GST matches the reach of the estate and gift tax on the underlying transfer. A transfer by an NRA of non-U.S. property is not subject to the GST, since it is not subject to estate or gift tax. Thus, the GST applies when an NRA transfers U.S.

property, other than intangibles transferred by gift. Treas. Reg. § 26.2663-2; § 26.2652-1(a)(2).

Most importantly, the time for testing whether the tax applies is the same time as under the estate or gift tax, even though the "skip" transfer would often occur later. Specifically, the character of the property, and the non-resident alien status of the transferor, is tested only at the time of the initial transfer as determined for estate tax purposes (at death) or for gift tax purposes (when the gift is complete). Thus, the GST does not apply to transfers involving transferors who are NRAs and property situated outside the U.S. as of the time of the initial transfer.

Example: NRA gifts non-U.S. real estate or intangible property (e.g., IBM stock) to a trust for children and grandchildren. The GST does not apply -- whether or not the beneficiaries are U.S. persons, and whether or not the trust property or the grantor becomes U.S. situated or domiciled before a taxable distribution or termination occurs in favor of a grandchild.

Given the limited reach of the GST, the so-called GST exemption is much less needed for NRAs than in domestic estate planning. For NRAs, when it is needed, its application is fairly straightforward, but some special rules apply. When the transfer by the NRA is fully subject to the GST, the same principles apply as for U.S. transferors, so the NRA will generally decide when the allocation is made. See Code § 2632. When the transfer by the NRA is not subject to the GST at all, then the exemption is not, and cannot, be allocated. This makes the GST rules for NRAs very realistic.

(1) Due to the rules described above on the scope of the GST, NRAs need not even be aware of the GST implications of their transfers unless the transfer otherwise requires the filing of U.S. gift or estate tax returns. For example, an NRA grandfather who has made a gift of non-U.S. property or intangibles worth $1 million to a U.S. grandchild need not file a U.S. gift tax return and need not allocate any GST exemption because the GST simply does not apply.

(2) Similarly, a bequest of non-U.S. property avoids the estate tax, and therefore the GST, so the GST exemption is not needed.

(3) If the transfer is mixed, so that it is only partially subject to the GST, then a special rule for NRAs applies to calculate the inclusion ratio so that the tax can be imposed. The effect of this rule, as in the domestic context, is to encourage the creation of a separate trust in the amount of the allocated exemption, easing administration and minimizing taxes.

One last item on the checklist can be helpful for older trusts that were irrevocable as of September 25, 1985. Treas. Reg. § 26.2601-1(b)(4). The rules that protect "grandfathered trusts" from the GST apply with equal force to non-U.S. trust as domestic trusts, and powers of appointment under non-U.S. trusts tend to be written so that they cannot be used to extend vesting.

You can be squished

3. Gifts and Bequests: Red, Green and Yellow Warning Lights

Failure to plan around U.S. transfer taxes can be much more costly for NRAs than for U.S. citizens or residents.

A. Taxable Gifts are Very Expensive, Even Small Gifts

The gift tax is costly when it applies to an NRA, due to limitations on credits, exclusions and deductions, as compared to gifts by a U.S. person (i.e. U.S. citizen or resident for tax purposes).

(1) The unified credit applies only to U.S. citizens and residents. Code §2505(a).

(2) An NRA is entitled to the gift tax annual exclusion, but the NRA cannot double this amount by the common election to "split" gifts, even with a citizen spouse. Code § 2513(a)(1).

(3) The NRA's charitable gifts of U.S. property qualify for a gift tax deduction (i.e., tax free) only if made to a domestic U.S. charity. Code § 2522(b)(2).

(4) The U.S. gift tax marital deduction is also likely to be limited for NRAs as a practical matter. NRAs are entitled to tax-free transfers under the U.S. gift tax marital deduction, just as a U.S. citizen, but no such deduction applies if the recipient spouse is not a U.S. citizen, regardless of the transferor's status. Code § 2523(a). A donor can make tax-free gifts to a non-citizen spouse of up to $112,000 per year. Gifts free of trust will usually qualify for this exclusion. However, very careful planning is needed for gifts in trust since the spouse's interest must be both a deductible interest under marital deduction concepts and a "present interest" under the annual exclusion. Code § 2523(i)(2); Treas. Reg. § 25.2523(b)-1 and (c)-1. See Examples 3 and 4 in Treas. Reg. § 20.2523(i)-1.

B. Gift Planning & Property Conversions

Thus, avoiding the gift tax by avoiding gifts of U.S. tangible property is critical. Even if a treaty applies to the NRA, it is unlikely to change this critical distinction. Most modern treaties generally allow the situs country to tax such transfers, for example, gifts of real estate located in the U.S.

In view of the critical importance of the nature of the property at the time of the gift, the inevitable question arises whether it is possible to rely on a "last minute" conversion of the property from "taxable" property (tangible U.S. property) to "tax free" property prior to making the gift.

Absent unusual circumstances, a pre-gift conversion should be effective. Cf. Le Frak v. Comm'r, 93 T.C.M.(RIA) 2808, 2811-13(1993). See D. Kozusko and S. Vetter, Respect for "Form" as "Substance" in the U.S. Taxation of International Trusts, 32 Vanderbilt Journal

of Transnational Law 675, 686 (1999). Similarly, a gift of intangible property that is used by the donee to acquire tangible U.S. property should ordinarily escape gift tax, as long as the gift is not made on the condition that it be so used. See Davies v. Comm'r, 40 T.C. 525 (1963) where a gift of cash used to acquire U.S. real estate was taxed but not later cash used to pay off a purchase money note to the donor.

C. Costly Estate Tax Also

If the U.S. estate tax applies, the NRA's transfers are more severely taxed than those of a U.S. resident or citizen. The threshold level for tax free transfers is very low, and few estates qualify for the significant deductions applicable to U.S. residents.

(1) The NRA's estate tax credit under Code § 2102(c) exempts only the first $60,000 at the lowest tax brackets, rather than the first $1.5 million (and climbing) for U.S. citizens/residents. Thus, the net tax on an estate of $500,000 is almost $150,000.

(2) The deduction for debts and expenses of the estate is very limited. Only a proportion of recourse debts and the expenses of an NRA's estate is deductible, based on the value of the U.S. property and the value of the decedent's entire worldwide estate. Code § 2106(a)(1).

(3) The estate tax charitable and marital deductions are also limited. The NRA's charitable gifts qualify for an estate deduction only if to a domestic U.S. charity. Code § 2106(a)(2).

(4) Transfers to or for a surviving spouse can be sheltered completely from U.S. estate tax by the marital deduction, just as for a U.S. citizen -- except that if the surviving spouse is not a U.S. citizen, property must pass to a special trust (the so-called "QDOT") in order to qualify for the deduction, even if the spouse is domiciled in the U.S. This trust form is much more restrictive than the typical offshore trust used by NRAs. As a result, the marital deduction will continue to be much less important in estate planning for the assets of NRAs than for U.S. persons. The same QDOT rules apply to transfers by both NRAs and U.S. persons to non-citizen spouses, but the practical limitations of these rules seem so much more burdensome to an NRA, since the offshore company is so much more useful and flexible.

D. Estate Tax Planning: Careful Use of Non-U.S. Holding Company

The NRA investor who invests in U.S. property through a non-U.S. corporation (so that the shares are not subject to U.S. estate tax) needs to use an entity that has the characteristics of a corporation. This is entirely feasible if the form used is a business corporation, and the form is respected in actual practice by the shareholder. See Estate of Swan v. Comm'r, 247 F.2d 144 (2d Cir. 1957) (stiftungs formed and operated more like revocable trusts). (Remember that "checking the box" to have the entity disregarded for U.S. income tax purposes would also result in losing the corporate shield from the estate tax since the election applies for all purposes of the Code.)
It remains to be seen whether the IRS will try to use its domestic litigation position on FLPs under section 2036, as in Strangi v. Comm'r., T.C. Memo. 2003-145 (May 20, 2003), as

a tool for attacking the use of non-U.S. corporations for investing in U.S. property, arguing that the NRA's control as a shareholder is a retained interest in U.S. property.

Even without the application of a new threat, the retained interest issue has always been lurking in this structure in a different way, making it very important to follow a certain path in funding the corporation. Typically the shares in the offshore corporation will be owned by a revocable trust, rather than by the NRA directly, in order to make it feasible to manage share ownership during disability and after death, as a protection against forced heirship and political or family turmoil. In that plan, the corporation should acquire the U.S. property before the corporate stock is placed in the trust.

Otherwise, quite bizarre tax results can occur if, instead, the NRA's trust acquired the U.S. property and transferred it to the corporation as a shareholder contribution to capital. Suppose an NRA decedent originally funds a trust with U.S. property and, since the trust is revocable, the NRA retains the right to amend the trust or receive trust income, which would cause the trust assets to be recaptured in the grantor's estate under Code §§ 2036 or 2038. Unfortunately, due to Code § 2104(b), the taint created by the U.S. property will continue, even if the U.S. property is later converted to non-U.S. property <u>prior</u> to the grantor's actual death (by contribution to the non-U.S. corporation). The later conversion does <u>not</u> change the result under the literal language of the Code, because U.S. situs is tested not only at the time of death but at the time of a original "retained interest" transfer. <u>See also</u> TAM 9507044 (original transfer in 1923 while U.S. citizen; death in 1991, after grantor's expatriation).

E. GST Multiplies the Cost

As noted above, the GST tracks the estate and gift tax, and the application of the tax is tested at the time of the initial transfer, so it is doubly important to avoid the estate and gift tax if the transfer will skip generations. A costly gift or estate tax transfer will be that much more expensive due to the GST:

<u>Example</u>: NRA grandparent transfers U.S. real property in trust for child's benefit for life, remainder to grandchildren. Since the initial transfer to the trust was subject to the gift or estate tax, the trust is subject to the GST, which could be imposed, for example, when the child's trust interest terminates at the child's death. The GST applies whether or not the child is an NRA at the time of the initial transfer or later, and regardless of the grandchildren's connection, or lack of connection, to the U.S.

Note also, that since the GST tracks the estate and gift tax, the same principles should apply to property conversions as under the estate and gift tax; for example, to a gift of intangible or non-U.S. property that was promptly thereafter converted into U.S. tangible property, or to a pre-transfer conversion from "taxable" property to "non-taxable" property. A powerful statutory grant of authority to attack conversions was granted to the IRS by Congress but that was limited to income taxation of tax-motivated expatriates Code § 877(d)(2)(B). See also Code § 2701(b) and Code § 877(d)(2)(E).

4. Investing Here Free of Income Tax is Easy

The NRA who invests knowledgeably can avoid U.S. income tax. Generally speaking, it reaches only U.S. source income. Capital gains and so-called portfolio interest are exempt even if from U.S. sources. Most commonly the tax applies to dividends, rents, income from active businesses, and compensation for services, but that leaves many investment income sources untouched.

A. "Carve Outs" from U.S. Income Tax

There are numerous "carve-outs" from the income base for the NRA (as long as the income is not effectively connected with a U.S. trade or business). These special exemptions for income earned by NRAs were usually enacted either to promote investment in the U.S., to facilitate enforcement, or to avoid enacting rules that cannot be enforced or that conflict with international norms for taxation of non-residents. Two of these special exemptions are the most important:

(1) "**Portfolio Interest**." This exempts interest on U.S. bank accounts under Code § 871(i), and interest on certain so-called "portfolio debt" instruments under Code § 871(h). In general, Portfolio Interest is interest on a debt obligation issued by a U.S. taxpayer to a holder whose status as an NRA has been substantiated in a certain specified manner provided by the tax rules. The effect is that the interest is tax-free to the NRA, i.e., not subject to either regular U.S. income tax or to the withholding tax described below.

(2) **Capital Gains** and "**FIRPTA**" Exception. The second important exemption is that capital gains are generally exempt from U.S. tax under Code §§ 865 and 871. However, capital gains on real estate, or stock in U.S. real estate holding companies, are taxed under Code § 897 at a graduated rate, as a result of the Foreign Investment in Real Property Tax Act, which enacted the so-called FIRPTA tax on such gains. FIRPTA simply treats an NRA's gains from U.S. real estate as "effectively connected" with a U.S. trade or business, which means the gains are subject to the same tax regime as domestic taxpayers. This tax is backed up by a special withholding tax regime under Code § 1445.

B. Two Ways to Tax When Income Tax Applies

(1) "**Effectively Connected Income"** or "**ETB income**" means income that is treated as attributable to the conduct of a trade or business in the United States, based on rules that are generally (but not always) intuitively logical. Broadly speaking, this concept is designed to distinguish between "business" income and "investment" income. Thus, ETB income is taxable at graduated rates on a net basis that allows related deductions to be used in determining the amount subject to tax, as with the income of a U.S. citizen or resident. This result is considered by the tax law to be appropriate for income derived from assets that are used in an active U.S.-based business or when such a business was a

material factor in the production of the income, which essentially defines what is meant by "effectively-connected income". On the other hand, passive investment income, i.e., not attributed to trade or business activity, is either exempt entirely from U.S. tax under the special exceptions for capital gains and portfolio interest noted above, or otherwise is taxed at flat rates (as described below, at 30% withholding on what is called "fixed or determinable income" or "FDAP"). ETB income is subject generally to the same graduated rates as apply to all the income of U.S. citizens and residents; e.g., a maximum of 15% on capital gains, and about 35% on ordinary income. (Real estate assets often warrant a special election by the NRA owner, because they may or may not be considered a trade or business for this purpose, and thus rent may be taxed as fixed or determinable income taxed at a flat 30% rate rather than ETB income. Net taxation on ETB income will often result in lower tax, due to the benefit of deductions, as compared to the 30% withholding regime. This special election is the so-called "net basis" election.)

(2) "**Withholding Tax**" refers to a 30% flat rate of tax collected at the source by the U.S. payor of dividends, interest, rents, royalties, etc. (on a gross basis, without deductions, but generally reduced substantially by any applicable income tax treaty between the U.S. and the NRA's "home" country). The U.S. payor of this income is required to withhold the tax from each payment to the foreign taxpayer and then submits the withheld amount to the IRS. This withholding is often referred to as simply the "withholding tax" because that is usually the true result. (Many other tax systems around the world have a like concept, so the issue of the rate is often addressed in treaties on a mutual basis.) There is a roughly similar regime under Code § 1445 for real property transactions subject to the FIRPTA tax, but it applies different and varying rates and rules depending on the type of payment.

Know Your Fractions

5. When Do You Live Here? Tax Residence/Domicile

Unless a person acquires a green card, the only way to become a U.S. resident for income tax purposes is to spend too much time here. But that can happen inadvertently, based on what fraction of the year (and prior years) the person is physically present in the U.S. The test for transfer tax purposes (domicile) is not such a bright line, but it has an equally severe result. A person who becomes resident for income tax purposes will owe U.S. tax on worldwide income, and becoming a U.S. domiciliary means owing transfer taxes on assets regardless of location, just as if a U.S. citizen. So knowing the rules is important.

A. Income Tax

It is clearly possible to become resident in the U.S. for income tax purposes without any deliberate decision to do so, a costly tax result for the "accidental resident". Thus, the rules for becoming a U.S. income tax resident are critically important. U.S. income tax residency will readily be acquired by an individual who regularly conducts business, or otherwise maintains a physical presence, in the U.S. and does not engage in very deliberate planning to avoid exceeding the limit on days spent in the U.S., even if that person's permanent home is outside the U.S. This is due to the "substantial presence" test.[1]

The "substantial presence" test of Code § 7701(b) really consists of two separate and alternative tests: the 183-day test and the 3-year formula test.

(1) First, under the 183-day test, a person who is physically present in the U.S. for at least one-half of the year (i.e., 183 days or more) in a given calendar year and who does not qualify for any special treatment as a student, teacher, diplomat, etc., will be conclusively considered a U.S. income tax resident (unless a treaty "tie-breaker" is available).[2]

(2) Secondly, the NRA must also avoid the reach of the 3-year formula test, under which it will still be difficult for the NRA to avoid residency, even with fewer days of presence, once the limit applied under a mathematical formula is exceeded.

The formula limit is exceeded if the time spent in the U.S. is (i) at least 31 days in the

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[1] The alternative way that a person can become a U.S. income tax resident is the "green card" test: a lawful permanent resident of the U.S. for immigration purposes (a "green card" holder) is conclusively resident for income tax purposes. These persons will ordinarily also be considered domiciled in the U.S.

[2] Relief may be available to qualified residents of treaty countries. If a modern U.S. tax treaty applies, the income tax residency of an individual who is considered resident by the domestic law of both countries can be resolved under a treaty "tie-breaker" rule that generally looks first to where the individual has a permanent home, next to the center of vital interests, then to habitual abode, and then to citizenship. A person who is a U.S. income tax resident under the Code but not under the treaty "tie-breaker" rule can claim non-resident status for all purposes of computing his U.S. income tax liability, not just for treaty purposes. Treas. Reg. § 301.7701(b)(7)(a).

current calendar year, *and* (ii) the total days over the current year and the two prior calendar years equals or exceeds 183 days (after multiplying days in the immediately prior year by 1/3 and days in the next prior year by 1/6). If the formula limit is exceeded, the client will avoid U.S. income tax residency only if he or she can qualify for a treaty "tie-breaker", or qualify for the "closer connection/tax home" exception under Code § 7701(b)(3)(B)(ii), which applies if the taxpayer maintained closer ties to another country for the year in question and files the required statement substantiating that claim. Treas. Reg. § 301.7701(b)-2.

B. Transfer Tax

For this purpose, "residence" means "domicile," and a person acquires a U.S. "domicile" when physically present in the U.S. with the intention to permanently reside there. Treas. Reg. § 20.0-1(b)(1). Ordinarily this means that the immigrant must have also become a "lawful permanent resident" for visa purposes, but not necessarily. See, e.g., Rev. Rul. 80-363 (G-4 visa); Rev. Rul. 80-209 (illegal alien); Toll v. Moreno, 284 Md. 425 (1979) (G-4); Castellon-Contreras v. INS, 45 F.3d 149 (7th Cir. 1994).

Domicile, unlike income tax residency, is based on "facts and circumstances" in all cases. Most importantly, domicile is presumed to continue in the foreign jurisdiction until it is established in the U.S. This rule can decide a close case in the client's favor. See Estate of Paquette, T.C.M. 1983-571 (involving a Canadian who was much more than a "snowbird" in Florida, but held not domiciled there). The location of business or employment activities does not necessarily determine domicile. Since domicile is less clearly related to current income-producing activities than the U.S. income tax concept of residency, it may be easier to maintain a foreign domicile in a country to which the client currently has no prohibitively expensive tax-producing affiliation.[3]

[3] A treaty may also provide relief from the application of the U.S. transfer tax regime. Modern treaties (e.g., with the U.K., France, Germany) provide a "tie-breaker" rule much like the income tax treaties, but also provide a special protection (of varying degrees) for citizens of one country who had not been present in the other country for a substantial period of time before the gift or death.

BEHAVE DURING RECESS

6. Why QDOTs Fall Short

QDOT's are an extremely restrictive tool, useful only as a last resort.

QDOTs are almost useless in most cases for U.S. transfer tax planning by an NRA with a large tax exposure because of the restrictive rules and limited benefit.

The requirements for qualifying a trust as a QDOT with adequate security arrangements for the payment of the deferred tax are set out in detail in Treas. Reg. §20.2050A-2. They are restrictive enough for QDOTs of more than $2 million to warrant special tax planning designed solely to avoid the need to use a QDOT for assets valued at more than $2 million; typical valuation planning might be used to reduce value for estate tax purposes to stay under this threshold.

The more fundamental restrictions imposed by the Code are even more troublesome:

(1) The trust interest of the surviving spouse must qualify for the marital deduction (i.e., the spouse must be the sole beneficiary during his or her life and the trust must generally pay all income currently to the spouse).

(2) Under the special QDOT rule of Code § 2056A, a U.S. bank or U.S. citizen must be a trustee or co-trustee and must have the authority to withhold the deferred estate tax, pro rata, from almost all principal distributions.

The IRS is authorized to waive the requirement of a U.S. trustee, and to allow substitutes for the trust structure, but this will require alternative security arrangements to ensure that the deferred tax is collected and collectible.

A. Minimal Benefit from a QDOT

In many high net worth situations, a QDOT may produce, at best, only modest benefits, and at worst, unintended consequences. Planning for an NRA should therefore be used in many cases to try to eliminate the need for a QDOT.

Establishing a QDOT *merely postpones payment of tax. It does not reduce or avoid tax.* It will even increase the tax if the value of the trust property increases. This deferred tax feature has three key elements, since, as indicated above, the QDOT rules are designed to ensure that the deferred tax will be collected in the form of a special QDOT tax.

(1) First, the taxable events are broader than in a "normal" marital deduction trust. The entire trust is taxed if the trust ceases to qualify as a QDOT, e.g. if there is no longer a U.S. trustee. More importantly, distributions of principal from a QDOT are subject to tax, which might even include unsecured loans and other transfers that are considered a threat to the ultimate collection of the estate tax. There are two limited exceptions to this rule: a

distribution made "on account of hardship", which is defined restrictively, or made after the spouse becomes a U.S. citizen. The practical result is the surviving spouse cannot “spend down” the estate or plan to reduce the tax, and any trust property remaining at the death of the non-citizen spouse will then be subject to the special QDOT estate tax.

(2) The second element relates to the effective tax rates. Upon a taxable event, the tax is computed using then current value of the QDOT property, but using the same rate bracket as if the trust property had been taxed in the first decedent's estate. If the trust assets are also independently taxable at that time in the surviving spouse’s estate, a credit is provided so the property is taxed only once. But it is still taxed at the highest rate of the two estates, unlike with a “normal” marital deduction trust.

(3) The trustee’s personal liability is the final element to ensure that the deferred tax will be collected. All of the trust property is subject to the special QDOT estate tax, regardless of where it is situated, and the trustee is personally at risk if these assets are not available to pay all taxes when due. Similar liability is imposed on U.S. executors under the regular U.S. estate tax laws (with similar provisions for obtaining a release when the tax has been paid), but the practical burden seems higher in the case of a QDOT, because of the expected duration of the QDOT.

Thus, the assets placed in a QDOT avoid U.S. estate tax upon the first death, but are taxed on or before the spouse’s death. This may be acceptable if the surviving spouse remains domiciled in the U.S. but even in those cases the tax paid later is likely to be higher, as a practical matter, than under a typical domestic marital trust.

B. Possible Double Tax

Quite unlike the typical domestic marital trust, the QDOT may result in an unexpected double tax. For example, if the surviving spouse later becomes subject to wealth transfer tax in another country and the deferred QDOT tax is triggered by principal distributions to the spouse, the other country’s tax on the distributed assets will follow after the QDOT tax and not be creditable against it under the foreign tax credit rules even as the rules are augmented by Code section 2056A(b)(10). In addition, the foreign tax credit under section 2014 for residents of the U.S. does not grant a credit for non-U.S. tax on U.S. property, and it may be difficult to resolve issues between the two countries as to residency of the decedents and situs of property without considerable expense.

Recess is never enough

pizza in italy doesn't taste like pizza

7. Why Tax Treaties Aren't for Everyone: Lower Your Expectations

A modern treaty with the U.S. may provide substantial protection from the U.S. estate tax, although the number of countries with such treaties with the U.S. is limited.

The scope of the estate tax as described above under the Code is reduced significantly for NRAs who qualify as residents of treaty countries that have a modern treaty with the U.S. (U.K., France, Germany, etc., as compared to Japan, Switzerland, etc.). The estate and gift tax on their transfers is limited, generally, to transfers of U.S. real estate and to amounts associated with a "permanent establishment" located in the U.S. (a term of art akin to a fixed place of business of the decedent, e.g. a proprietorship or interest in a business partnership).

Thus, these persons can transfer U.S. equities free of the U.S. estate tax. (Under Code § 2102(c)(a), these residents may also be entitled to a pro rata share of the unified credit available to U.S. persons, but based on the ratio of U.S. property to all property, so it usually is not that important.) However, the treaty protection does not mean the assets of an NRA will actually pass free of tax. The U.S. tends to enter into treaties with countries with developed tax systems. If a treaty applies, that usually means the NRA is at risk for paying a high tax in the home country, as a practical matter, unless special planning is available under the other country's laws.

Persons who remain in the U.S. for an extended period are unlikely to obtain any such treaty relief, even if there is a treaty between the U.S. and their "home" country. As a practical matter, these individuals are unlikely to still qualify under the treaty as residents of their original "home" country, rather than as residents of the U.S.

These treaties also still allow the U.S. to tax its citizens wherever resident. A U.S. citizen who moves to a treaty country will not change his or her U.S. estate tax liability for U.S. assets; the non-U.S. assets would ordinarily be subject to tax in the new domicile and that tax would be credited against the U.S. estate tax on those assets..

Sometimes being sorry isn't enough

8. Why Trusts Should Be More Popular

When Norm Dacey wrote the original pitch for using revocable trusts to avoid probate, he overlooked his best opportunity. While avoiding probate in the U.S. is a useful goal even under modern probate laws, it is virtually imperative in international estate planning to use a lifetime trust (not necessarily fully revocable). The owner of international wealth who does not use a trust will, at worst, leave a legacy of disputes, and at best, will miss opportunities and instead leave behind a very expensive succession process. Why?

- Throughout the world (including in the U.S.) the systems of estate administration are ill-equipped to deal with multi-national property holdings and family affiliations. Particularly as to disposition of property, these issues tend to be very specific to the nature of the property and persons involved, so their resolution cannot be dictated by any simple rules. For example, generally speaking, as to property dispositions, U.S. conflicts of law rules treat conflicts with foreign country law the same way as conflicts between state laws. But those rules are complicated and do not control the law to be applied in a foreign forum that is not bound by a common constitution or legal culture.

- Worse yet, in civil law countries in general, the forced heirship laws and the failure to recognize fully (or at all) the concept of a trust creates major obstacles. There is little room for sophisticated planning to deal with multiple tax systems and manage wealth across generations. Except for a certain portion of the estate owned at death (sometimes called the "free share"), the assets must pass in a line of succession to descendants and, usually to a lesser extent, to the surviving spouse (although the equivalent of a pre-nuptial agreement is usually recognized, such agreements tend to be designed in the negative and do not fill in the blank as to what will/should happen instead).

Without a remedy for these obstacles, being sorry will not be enough. Fortunately the remedy was created quite deliberately and successfully some 30 years ago when the "foreign elements" law was enacted in the offshore jurisdictions. These laws declared essentially that property held in a trust by a Cayman Islands trustee, for example, would be controlled by the trust document, independent of any forced heirship law or other succession law of the settlor's home country. Coupled with an asset holding company owned by the trust (since often the law of the situs of the assets did not necessarily recognize the trust concept) this structure provided a means to manage the passage of title at death and to control assets for the benefit of generations to come.

The challenge today is not whether a trust should be used but how should the structure be designed and placed to work around laws designed to curb tax avoidance, money laundering and exchange controls (and to deal with the settlor's control that might imperil the validity of the trust).

Clean up your room

9. When Trusts Don't Avoid Taxes

Non-U.S. trusts are often designed to hold safe haven assets and maximize flexibility over an extended time. As a result, they tend to rely on discretionary powers and be filled with accumulated income. These characteristics make the trust look messy when viewed through the logic of the U.S. tax system. A non-U.S. trust needs a heavy cleaning if any grantor or beneficiary is likely to become, or already has become, a U.S. citizen or resident. The income tax rules can cause particularly harsh results when applied to such trusts.

A. Trusts "owned" by the grantor (grantor trusts).

In the international context, U.S. grantor trust status will often produce favorable results for U.S. income tax purposes. If a trust funded by an NRA is treated as a grantor trust, then it is likely that neither the trust nor the beneficiaries would pay U.S. income tax on its income.

(1) The grantor trust rules would cause the NRA grantor to be treated as the owner of the trust and attributed the trust's income and/or gains. Code § 671. As explained above, an NRA is subject to U.S. tax only on certain kinds of income.

(2) It is clear that distributions made from such a grantor trust are not taxable income to the U.S. beneficiaries receiving the distributions. Rev. Rul. 69-70, 1969-1 C.B. 182; e.g., PLR 9152011 (September 23, 1991) (U.S. grantor trust). The income and gains of a grantor trust are considered earned by the grantor, and do not become part of the accumulated income history of the *trust* (i.e., not part of DNI), and a trust beneficiary will be taxed upon a later distribution only if the foreign trust has such accumulated income (i.e., UNI). The distribution is considered a gift from the NRA and not income from the trust, and gifts are excluded from taxable income under Code § 102.

(3) Similarly, the ownership of corporate stock (e.g. a foreign holding company) held by such a "grantor trust" should also be attributed to the NRA, not to the U.S. beneficiaries of the trust. But see Reg. § 1.958-2(f)(2). As a result, a corporation owned by the grantor trust would generally not be considered a tainted foreign corporation (as explained below) so that this generally adverse treatment is avoided.

B. Inbound Grantor Trust Rules

In view of these favorable results, the Code restricts the opportunity for non-U.S. trusts to be treated as grantor trusts, thus increasing the tax liability of U.S. beneficiaries of these trusts by shifting the tax consequences away from the NRA who funded it.

Due to the special grantor trust rules of Code § 672(f), and the grandfather protection for trusts in existence on September 19, 1995, a non-U.S. trust will be considered a grantor trust only if it falls into one of basically two categories.

(1) The first category is where the trust is "revocable." If the trust is "revocable," it must be revocable by the grantor or the grantor's spouse either (i) without anyone else's consent or (ii) only with the consent of someone who is a "subservient" and "related" party (or someone who is merely a nonadverse party if the trust is "grandfathered," in which case the trust can have other beneficiaries as well). Offshore trusts that are drafted as "revocable" trusts, however, traditionally are written to require the consent of a "protector," who is unlikely in most instances to qualify as a "related" and "subservient" party. Reg. § 1.672(f)–3(a).

(2) The second category is a trust that permits distributions only to the grantor or the grantor's spouse during the grantor's life (unless the trust is "grandfathered" in which case the trust can have other beneficiaries as well). Reg.§ 1.672(f)-3(b).[4]

Special rules articulate principles for determining who is the grantor. An accommodation grantor, i.e. person who creates or funds a trust on behalf of another, both persons are treated as grantor for purposes of Code § 671. Reg. § 1.671-2(e)(1). As grantor, the accommodating party will have a reporting obligation under Code § 6048. See Code §§ 6048(a)(3) and 6048(a)(4). Similarly, if a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust is generally treated as the grantor of the transferee trust to that extent. Reg. § 1.671-2(e)(5).

Certain persons may also be "deemed" a grantor under Subsection (5) of Code § 672 (f). This special rule limits the tax effectiveness of certain grantor trusts, established by non-U.S. persons for the benefit of U.S. beneficiaries, by treating the U.S. beneficiary as the grantor to the extent he has made direct or indirect gifts to the non-U.S. grantor. This is true whether or not the gift or the trust were prearranged or had a tax avoidance motive. As noted above, in Rul. 69-70, the Treasury accepted a taxpayer favorable result in the context of a grantor trust with a foreign grantor and a U.S. beneficiary. The abuse arose when this concept was used to establish trusts for wealthy U.S. immigrants without regard to who was the true grantor, and Treasury concluded that proof of prearrangement and tax avoidance was too difficult to obtain in this context. A simple example will illustrate the abuse (which might be colloquially referred to as the "Give and Go"). A and B are non-U.S. persons. A plans to immigrate to the U.S. A makes a substantial gift to B. B uses those funds to establish a trust in which A is a discretionary income beneficiary. The trust is designed so that B would be treated as the owner of the trust under the grantor trust rules. A moves to the U.S. and then receives tax-free distributions from the trust. Code § 672(f)(5) puts an end to this perceived abuse. It treats A (not B) as the grantor, unless it can be demonstrated to the satisfaction of the IRS that the events were "wholly unrelated." Reg. § 1.672-f(5).

[4] The "grandfather" exception applies to trusts in existence on September 19, 1995, and that have not been funded since then or for which a separate account has been maintained for all such additions. Reg. § 1.672(f)-3(a)(3).

Yet another rule – under Code § 679 -- limits the benefits of non-U.S. trusts by taking an entirely different approach when the grantor has immigrated to the U.S. It automatically causes, rather than limits, grantor trust treatment. If the NRA funded the non-U.S. trust within five years of immigration to the U.S., then the NRA will be deemed to have made a transfer to the foreign trust on the date the NRA becomes a U.S. income tax resident. To that extent, the NRA will be treated as the owner of the assets and fully subject to tax on the income from them regardless of where the assets are considered located, and the trust will be a foreign grantor trust, assuming that income could be distributed or used for future distribution to a U.S. person. See Code §§ 679(a)(4)(A) and 679(a)(1) discussed below.

The five year limitation is critical to the scope of this rule. If the NRA has not transferred assets to the foreign trust within the five years prior to immigration, then there will be no deemed transfer to the trust upon NRA's immigration to the U.S. Assuming no transfers are in fact later made while income tax resident, Code § 679 does not apply. Code § 679 would also not apply if the trust could not benefit any U.S. persons, or if the trust were not a non-U.S. trust.

Nevertheless, many non-U.S. trusts will become grantor trusts if the grantor becomes a U.S. income tax resident, even if Code § 679 does not apply. That is the practical effect of the grantor becoming subject to the "regular" grantor trust rules and the trust no longer being governed by the above-noted restrictions under Code § 672(f) when the grantor is an NRA. Many non-U.S. trusts grant substantial discretion to either the grantor, the trustee, or certain other parties, such as a protector. These trusts would ordinarily be grantor trusts, but for the application of Code § 672(f) when the grantor is an NRA. Thus, when the NRA becomes U.S. income tax resident, most of these trusts will become grantor trusts, usually under Code §§ 674, 677 or 678.

C. Outbound Grantor Trust Rules

The NRA must also be aware of the outbound foreign grantor trust rules. A U.S. person who transfers property to foreign trust is treated as the owner of the transferred property if the trust has a U.S. beneficiary. Code § 679(a)(1). The trust is treated as having a U.S. beneficiary for the tax year unless (1) the trust terms provide that no part of the income or corpus of the trust may be paid to or accumulated for the benefit of a U.S. person, and (2) no part of the income or corpus of the trust may be paid to or for the benefit of a U.S. person if the trust terminates. Code § 679(c)(1). (A special exception applies if a beneficiary who was not a U.S. person becomes one more than five years after the transfer.)

As noted above, the outbound foreign grantor trust rules of Code § 679 may apply to a foreign grantor. For transfers after February 6, 1995, a foreign grantor who becomes a U.S. resident within five years of directly or indirectly transferring property to a foreign trust is treated as a U.S. transferor for purposes of Code § 679(a)(1). Code § 679(a)(4). Such a person is treated as transferring the property to the non-U.S. trust on the grantor's residency starting date (as determined under Code § 7701(b)(2)(A)). The amount deemed transferred is the portion of the trust (including nondistributed earnings) attributable to the property previously transferred. § 679 (a)(4)(B).

The provisions of Code § 679 contain an exception for fair market value transfers. A transferor is not treated as the owner of a foreign trust with U.S. beneficiaries if the trust

paid fair market value to the transferor for the property transferred. Code § 679(a)(2)(b). Obligations issued by the trust, by any grantor, owner, or beneficiary of the trust, or certain related persons, are generally not taken into account when applying this exception unless the obligation carries arm's-length terms and is expected to be repaid. H.R. Conf. Rep. No. 737, 104th Congress, 2d Sess. 335 (1996); see also IRS Notice at 97-34, 1997-1 C.B. 422 (referring to this obligation as a "qualified obligation"). Principal payments by the trust on any such obligations are taken into account as paid in determining the portion of the trust attributable to the property transferred. Code § 679(a)(3)(B).

D. Inbound Non-Grantor Trust Rules

A complex set of rules impose U.S. income taxes on U.S. beneficiaries who receive distributions of accumulated income from a non-U.S. trust, and add a non-deductible interest charge to offset the benefit of the previous deferral of U.S. income tax, since in many cases the trust itself will have earned and accumulated the income in a tax-free environment.

(1) Current income distributions from non-grantor trusts

A non-grantor trust that is not resident in the United States for income tax purposes (a "foreign trust") is nevertheless governed by the same basic "distributable net income" (DNI) regime as domestic trusts when it makes a distribution. The foreign trust will be regarded for federal income tax purposes as a mere "conduit," to the extent it distributes (or is deemed to distribute) only amounts attributable to its DNI for the current tax year.[5] The tax treatment therefore will "flow through" to the beneficiaries, and the beneficiary will be taxed in roughly the same manner as if he had earned that "distributed" income directly.[6] This is the "traditional" rule for DNI, as defined in Code § 643, which is roughly equivalent to the trust's net ordinary income, capital gains if currently paid or payable, and other taxable income, as determined under U.S. income tax principles.

(2) Accumulation distributions from non-grantor trusts

A number of special rules apply to distributions by a *foreign* non-grantor trust to a U.S. beneficiary if the trust has accumulated income. These rules basically levy an income tax at ordinary income tax rates, plus an interest charge on this tax that was previously deferred, to the extent there is an "accumulation distribution."

An "accumulation distribution" occurs when two conditions are satisfied: (a) distributions for the year exceed the current year's income (as measured for both income tax purposes and accounting purposes), and (b) there is undistributed net income (UNI) in the trust from prior years, *including undistributed capital gains*. Code §§ 643(b), 665(b) and 666(a). This is the same principle that applied to U.S. trusts prior to the 1997 repeal of the "throwback rule" for most domestic trusts.

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[5] Code § 651(b) (limiting deduction to amount of DNI for the taxable year).

[6] Code § 652 (requiring that the amount of income for the taxable year that is required to be distributed by a trust under Code § 651 shall "be included in the gross income of the beneficiaries to whom the income is required to be distributed").

Such an accumulation distribution can be extremely costly for a U.S. beneficiary.

- Since the foreign trust is not taxed currently by the United States on its net worldwide income (Code § 641(b)), the Code provides that U.S. beneficiaries will be taxed upon later accumulation distributions on a worldwide basis.

- Furthermore, a distribution of more than the current year's income is almost certain to include an accumulation distribution because in calculating UNI, "income" includes foreign-source income even though such income is not taxable to the trust because it is not resident in the United States. Code § 643(a)(6).

- Capital gains also are taxed adversely when accumulated and later distributed from the foreign trusts. They are added to UNI in foreign trusts, and the substantially lower effective U.S. income tax rate on long-term capital gains as compared to ordinary income is lost because such accumulation distributions from a foreign trust are all taxed as ordinary income. Code §§ 643(a)(6), 667(e).

- Finally, the trust may have expenses that are not deductible against income under U.S. tax law (e.g., expenses of maintaining a personal residence). Thus, income that is not taxable to the foreign trust, but that is taxable to the U.S. beneficiaries and not used for expenses that are *deductible* to the trust, will be considered UNI for this purpose.

- An accumulation distribution from a foreign trust also triggers an interest charge. The nondeductible interest charge is applied to the amount of tax that was effectively deferred during the time that the beneficiary receiving the distribution was a U.S. person (regardless of the beneficiary's age). The interest rate is six percent per year for distributions from accumulations attributed to the period prior to 1996, and that rate is applied on a compound basis as of January 1, 1996. For income earned and accumulated thereafter, the varying rate for tax underpayments applies. Code §§ 665(b) (defining "accumulation distribution"), 667(a)(3), 668, 6621(a)(2) (explaining that the determination of interest rates is the rate applicable to underpayments of tax).

- The practical result is that a substantial accumulation can never be distributed to a U.S. person without a confiscatory tax, indirect distributions made through non-U.S. nominees are screened out by special rules (Code § 643(h) and Reg. § 1.643(h)-(1) applying presumptions as to tax motivation) and loans are not a realistic alternative (treated as distributions if long term under Code § 643(i) and Notice 97-34, 1997-1 CB 422, 6/02/1997). Thus the accumulation becomes retained capital, on which to earn income over time.

E. Outbound Transfers to Non-Grantor Trusts

In order to plainly discourage U.S. persons from using non-U.S. trusts to avoid U.S. income tax, the Code contains a special rule that taxes transfers of appreciated property by U.S. persons to non-U.S. trusts. This rule could be considered primarily as a mere back-stop to Code § 679 discussed above, since that section would treat such a trust as a grantor trust,

assuming it had U.S. beneficiaries, and thus attribute all later income realized by the trust back to the U.S. grantor in any event. It also serves to limit the opportunities for pre-expatriation planning by persons who are considering surrendering their citizenship or residency in the U.S.

Code § 684 provides that any transfer of property by a U.S. person to a foreign trust is taxable, unless and to the extent the U.S. transferor (or other person) is considered to be the owner of the trust under the grantor trust rules. See Code § 684(b). A transfer that is taxable under Code § 684 is treated as a sale or exchange of the property for its fair market value, and the U.S. transferor must recognize gain equal to the excess of the property's fair market value over its adjusted basis in the hands of the transferor.

This section carries some risk of odd results:

(1) It is possible that this section would cause a deemed taxable transfer when a person leaves the U.S. for income tax purposes, but had earlier funded a non-U.S. trust prior to coming to the U.S. This process involves the reverse of the process described above by which a trust can be changed from a non-grantor trust to a grantor trust when and because the NRA grantor has become a U.S. resident. Here, when the "round-trip NRA" now returns to his or her home country and abandons U.S. taxpayer status, the foreign trust would no longer be a grantor trust due to Code § 672(f), and it appears that Code § 684 could require gain recognition upon departure from the U.S. The IRS may simply argue that the NRA's departure from the U.S. should be deemed a taxable transfer by a U.S. taxpayer (i.e. the round-trip NRA prior to abandoning U.S. taxpayer status) to a foreign non-grantor trust under Code § 684. This result is hard to justify.

(2) In a somewhat similar vein, this section might trigger a tax when a grantor dies as a U.S. person and had previously funded a non-U.S. trust that was treated as a grantor trust under the special grantor trust rule of Code § 679 discussed above. The death causes the trust to no longer be a grantor trust, and this would itself cause a deemed transfer from the grantor to a non-U.S. trust that is taxable under Code § 684 as a sale or exchange. Assuming that the trust property receives a step up in basis by reason of the grantor's death, there should not be a tax under Code § 684 any more than there is a tax under section 1001 when a real estate owner dies holding property in a revocable trust that has liabilities in excess of basis. However, not all such cases will involve a step up in basis (depending on the facts of the particular trust) and, without the step up, the U.S. grantor's final income tax return must include gain equal to the excess of the property's fair market value over its cost basis in the hands of the grantor.

If you don't stop, the whole class will be punished

10. Why Trusts and Foreign Corporations Don't Mix

The U.S. income tax risks are raised if a non-U.S. trust owns shares in a non-U.S. corporation. One or more of the U.S. beneficiaries could be punished by the threat of having to pay income tax on phantom income that they never in fact receive.

A. U.S. Income Tax on U.S. Shareholders of Foreign Corporations

Several special U.S. tax provisions address ownership in non-U.S. corporations by U.S. persons, particularly investment companies or companies in a tax haven. Since the U.S. generally does not tax non-U.S. corporations on foreign-source income, these special U.S. tax rules are designed to prevent U.S. persons from using non-U.S. corporations to avoid tax by accumulating income offshore. These rules are principally, though not entirely, directed at the passive investment assets of non-U.S. corporations that are controlled by U.S. persons. The impact of these rules can be particularly disruptive if, for example, a non-U.S. trust in a tax haven jurisdiction owns one or more such passive investment corporations, and the trust has one or more U.S. beneficiaries governed by these rules. Similarly, an NRA shareholder's plan to immigrate to the U.S. triggers a serious need for planning.

(1) CFC. The controlled foreign corporation (CFC) rules require closely held U.S. ownership of the stock, but include corporations with a much wider variety of assets and activities than the foreign personal holding company (FPHC) rules. In broad outline, a foreign corporation is a CFC if more than fifty percent of its stock, by value or vote, is owned directly or indirectly by U.S. shareholders who, for CFC purposes, hold ten percent or more of the company's stock by vote. Code § 957 (delineating what constitutes a CFC). Such a U.S. shareholder of a CFC must include in his own income the pro rata share of the CFC's income, including "Subpart F income" (which in turn includes FPHC income with certain modifications, and sales and services income derived from transactions with related parties) and certain other items, (such as any increase in the company's earnings invested in U.S. property). Code § 951. Such U.S. shareholders are generally not simultaneously subject to the passive foreign investment company rules on the same stock. Code § 1296, *amended by* Code § 1121 of Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

(2) FPHC. Under the foreign personal holding company (FPHC) rules, a U.S. person who owns stock in a FPHC will be taxed as if a dividend equal to his pro rata share of undistributed FPHC income had been paid to him. For this purpose, FPHC income is essentially undistributed income, and income that is paid to a foreign intermediary such as a foreign non-grantor trust. Code § 551(a), (f). In addition, a gain on the disposition of shares by U.S. shareholders is taxed as a dividend rather than as capital gain. Code § 1248(a). Losses are not similarly passed out to the shareholder, so there is no netting of entity level results if the U.S. shareholder owns stock in more than one FPHC. An FPHC generally means a foreign corporation (i.e., non-U.S.) in which more than fifty percent of the stock, by value or vote, is owned by five or fewer U.S. citizens or residents, after

applying attribution rules, and whose income is at least sixty percent attributable to interest, dividends, rents, royalties, stock or securities gains, and similar passive income (reduced to fifty percent once the corporation becomes a FPHC). Code § 552.

(3) PFIC. During the early 1980's, investments in offshore mutual funds had been actively marketed in the U.S. as a tax-deferred investment since the FPHC and CFC rules did not apply due to the lack of control by U.S. persons. This changed with the passage of the passive foreign investment company (PFIC) rules in the Tax Reform Act of 1986. A PFIC is characterized by a passive income/assets test (very differently, and more broadly, defined than in the FPHC rules), but the stock ownership can be *closely or widely held* and the percentage of U.S. ownership is irrelevant. Unlike the FPHC, there is no automatic "deemed distribution," but a U.S. shareholder of a PFIC, such as a foreign mutual fund, must now choose among unappealing alternatives: (i) current inclusion in income of the U.S. shareholder's pro rata share of current ordinary income and capital gains of the PFIC pursuant to a shareholder election (a so-called "qualified electing fund" or "QEF" election), under Code § 1295, (ii) a "mark-to-market" election for marketable PFIC securities where gain is taxed annually at ordinary income rates, under Code § 1296, or (iii) upon a sale of the PFIC stock (or certain special distributions to the shareholders), the imposition of ordinary income tax treatment and an interest charge. Code § 1291. Importantly, the interest charge is calculated on certain assumptions that are purportedly designed to estimate the deferral of U.S. tax on undistributed gains and income, but seem instead to assume the greatest possible deferral and corresponding interest charge by treating the gain as earned equally over the deferral period rather than as a compound annual return.

It is likely that sometime in 2004 Congress will enact a tax bill that, among other changes, simplifies these rules by repealing the FPHC regime (and the foreign investment company rules not mentioned here). See S. 1637 and H.R. 4520. The FPHC rules are largely duplicated in the CFC rules (except for tougher FPHC rules on the basis step up and the attribution to U.S. persons who also own stock).

B. Attribution of Investment Company Stock to U.S. Beneficiaries

In each of these offshore investment company provisions, Congress addressed ownership by foreign trusts. The FPHC, CFC, and PFIC rules all attribute stock owned by a trust to the beneficial owners of the trust. When such an investment company is held by a non-U.S., non-grantor trust, the rule makes the trust transparent, *so that income is includable and taxable to the U.S. beneficiary as if the stock were owned directly*. Code §§ 551(f), 958(a)(2), 1298(b)(5); Reg. § 1.951-1 (as amended in 1983). This is very problematic. For example, distributions from the trust may be needed by the U.S. beneficiary to pay the resulting taxes. These tax payments to the U.S. Government, and related reporting of information on the trust and the underlying corporation, can be disruptive to the confidentiality concerns of other branches of the family who may not have any similar obligation. Also, even if no distributions are required, a detailed information return may still be required by these foreign corporation rules. Yet, this rule clearly applies even if no U.S. resident ever personally made a transfer to the trust, and if taken literally, it applies to a U.S. beneficiary who has no clearly-enforceable right to trust distributions.

The Code provides a very comprehensive statutory scheme for trust attribution to beneficiaries. In applying these rules, it is important to distinguish between attribution for testing status and attribution for including income. The CFC and FPHC rules have broad

and detailed provisions attributing ownership among family members and to and from entities (trusts, corporations, partnerships) in order to test for CFC or FPHC status. Attribution for income inclusion purposes is much more limited, but ownership by foreign entities generally cannot be used to shield the U.S. shareholder from having to include FPHC or CFC income in his personal income tax obligation. As indicated below, if a trust owns the shares, the Code provides that this ownership can be attributed to U.S. beneficiaries for all purposes.

The FPHC attribution rules contain a unique inbound attribution provision. Unlike the CFC rules regarding family attribution and attribution to entities under Code § 958(b), the FPHC rules will actually attribute the share ownership of a *non-U.S.* shareholder to a *U.S.* shareholder in determining whether the company meets the closely held U.S. ownership test. The only limit is that stock owned by an NRA is still not attributed to a U.S. family member who does not otherwise own any stock at all, in fact or through non-family attribution. This limit does not apply if the U.S. family member is the NRA's spouse, so stock can be attributed to a U.S. spouse who does not otherwise own stock in any other way. Code § 554(c).

The application of the attribution rules remains unclear when stock is attributed to beneficiaries of a foreign trust, despite the fact that trust attribution to beneficiaries has been part of the Code now for over ten years. In each part of the FPHC, CFC, and PFIC regime, the statute calls for the stock to be attributed "proportionately" to the beneficiaries. This begs the obvious question: in proportion to what? Regulatory guidance has been long delayed. Sometimes the existing regulations refer again to attributing ownership to the beneficiaries "proportionately," without defining the term. *See* Reg. § 1.958-1(c)(2) (as amended in 1983); Reg. § 1.958-2(c)(1)(ii)(a); *see also* Rev. Rul. 90-106, 1990-2 C.B. 162 (grantor trust); Prop. Reg. 1.1291-1(b)(8), preamble of Apr. 1, 1992 (suggestion to define "proportionate" for PFIC purposes by reference to the attribution rules in Reg. § 25.2701-6 concerning estate freezes).

The lack of guidance on applying the attribution rules leads to uncertainty in determining income tax liability. The most difficult issue is determining whether a U.S. beneficiary of a foreign non-grantor trust will be subject to current taxation on "phantom" income under the FPHC, PFIC, or CFC anti-deferral regimes. The issue is made especially difficult because, as indicated above, there is a risk that taxable income may be allocated to trust beneficiaries who are not receiving it currently and may *never* receive it, especially in view of the fact that beneficial interests in the customary offshore trust are largely indeterminate, since the trust language usually follows the British tradition of granting enormous discretion to the trustee over distributions. The answer depends on the method of stock attribution under those sections. Arguably, one of three stock attribution methods will be used to attribute stock of a foreign corporation owned by a foreign trust to the trust beneficiaries: (1) actuarial, (2) pure current distributions, or (3) facts and circumstances. Yet it remains unclear which method applies to a particular set of facts. See D. Kozusko and S. Vetter, *Respect for "Form" as "Substance" in U.S. Taxation of International Trusts*, 32 Vanderbilt Journal of Transnational Law at 700-703 (applying the various attribution methods).

Attribution of ownership is generally not as important under the PFIC rules because closely held ownership or U.S. control is irrelevant for defining a PFIC. However, the PFIC

attribution rules Code § 1298 do attribute ownership of PFIC stock held by an entity to the owner of the entity, proportionately, through multiple tiers, in order to impute ownership to a U.S. person for purposes of applying the alternative taxing regimes. As a result, investments in holding companies which in turn invest in third-party pooled funds in corporate form can lead to tiers of PFIC issues. In addition, when the PFIC rules measure the critical time period for computing the tax deferral and the related interest charge, Code §§ 1291(a)(3) and 1223(2) provide for "tacking" whenever the transferor passed on a carry-over basis. Thus, a transfer from one generation to the next by gift (or bequest, Code § 1291(e)) will not purge the taint of the deferred tax and accumulating interest charge due on sale by an ultimate U.S. resident or citizen owner.

Worse still, the PFIC attribution rules and related provisions in Code § 1298 can be inexplicably harsh as applied to shares of stock held by a foreign non-grantor trust. The PFIC regime ordinarily does not cause phantom income in the absence of a cashless disposition of stock. Prop. Reg. 1.1291-3(b). There is also no automatic deemed distribution to the shareholder, which is consistent with the concept that closely-held ownership or U.S. control is irrelevant for defining a PFIC. However, a U.S. beneficiary could be attributed ownership of the PFIC stock owned by a foreign trust, and can then be attributed phantom income when the PFIC pays a dividend *to the trust* if Code § 1298(b)(5) is applied literally. The beneficiary could be charged with income as if the beneficiary had actually received from the PFIC the portion of the dividend attributed to the beneficiary from the trust, even though the beneficiary may not actually be receiving any comparable distributions from the trust. The result is quite different than the treatment of a U.S. beneficiary whose beneficial interest in a foreign non-grantor trust is swelling with income accumulated from other sources (e.g., not investment companies, but, say, investment partnerships). This result is also quite different from the treatment of an outright U.S. owner of PFIC shares. These persons are generally free of U.S. tax liability on the income until it is received. See D. Kozusko and S. Vetter, supra.

You're Not My Friend

11. Changing Places: Residency without Domicile, Leaving, Returning, and Other Oddities

In addition to the risk of becoming subject to worldwide taxation as described above, certain other U.S. tax rules can cause unexpected adverse results in an international context.

A. Effect of U.S. income tax residency without U.S. domicile

Acquiring U.S. income tax residency without a U.S. domicile usually means that non-U.S. property can still avoid the estate and gift tax, but will generate income tax liability. Moreover, there are special rules for such cases that can lead to the following odd results.

(1) Bank accounts and portfolio debt will lose not only the special exemption from income taxes, but also from estate taxes, due solely to the U.S. income tax residency. Code § 2105(b).

(2) The fact that interest on municipal bonds (issued by state and local governments) is exempt from the income tax under Code § 103, which applies to taxpayers in general, does not mean that the bonds pass free from U.S. estate tax.

(3) Gifts of intangibles and non-U.S. property by such a person will still be exempt from gift taxes even if the gift is made while the person is physically present in the U.S. But it has been suggested from time to time that cash gifts do not qualify for this exception for intangibles, so it is prudent to plan to make such gifts outside the U.S.

(4) Transfers of property by such a person to non-U.S. corporations (Code § 367) and non-U.S. trusts (Code § 684) could trigger taxable gain as if the property were sold, because of income tax residency.

B. Temporary loss of residency

The U.S. tax laws contain a special anti-avoidance rule under Code § 7701(b)(10) that applies to certain non-U.S. citizens who temporarily abandon their status as a U.S. income tax resident alien. This provision applies to any alien individual who (a) is resident in the United States for a period of at least three consecutive years (the "initial residency period"), and (b) thereafter ceases to be resident, but subsequently becomes a resident again before the close of the third calendar year after the close of the initial residency period. For example, if an alien individual resident in the United States from 1998 through 2000 abandoned his U.S. residence on January 1, 2001, and subsequently re-established residence on or before December 31, 2003, he would be covered by this provision.

This anti-avoidance rule can have a serious impact. An alien individual who falls within this provision generally will be subject to tax in the same manner as a resident alien on all U.S. source income or gains derived during the intervening period of nonresidence --

including for this purpose all of the special source rules applicable to expatriated citizens and long-term residents. Thus, U.S. income tax will apply to interest income on so-called portfolio debt and any gains from the sale or exchange of (a) property situated in the United States, and (b) securities of U.S. issuers. (In computing gain the IRS has allowed the special step-up provision of § 877 (e) to apply, so the original pre-residency appreciation can avoid tax.) Notice 97-19, 1997-1 C.B. Part XI. Also, as is true for U.S. persons who surrender their U.S. citizenship, gains on U.S. property cannot be avoided by exchanging the property tax-free for non-U.S. property, and certain income in controlled foreign corporations will be attributed to the alien. See part D.(1). below.

The principal purpose of this anti-avoidance provision is to prevent resident aliens from avoiding tax on nonrecurring U.S. source capital gains by temporarily abandoning resident status. Apart from this rule, U.S. domiciliaries or income tax residents who are not U.S. citizens and not long-term residents (see below) can immediately shift from worldwide taxation to the limited taxation applicable to NRAs described above. This rule is of particular importance for persons who are not invested in immovable U.S. property (i.e., real estate) and who can leave the U.S. for a longer period of time and thus avoid the rule.

C. Another 183-Day Rule: Capital Gains if NRA has U.S. Tax Home

As noted earlier, the substantial presence test of Code § 7701(b) applies bright line rules for determining the U.S. income tax residence. Under the separate rule of Code § 871(a)(2), however, capital gains of a person physically present in the U.S. (but not solely through an agent) for 183 days or more can be subject to tax. It can cover persons who are otherwise non-residents under the test of Code § 7701(b), and even under a treaty tie-breaker residence rule.

Only U.S. source capital gains are taxed, but under Code § 865(g), U.S. source includes gains of sellers who have a "tax home" in the U.S. While the tax home concept is very confused in the law due to the myriad of contexts in which it has been used, many people who would otherwise fall within the 183-day rule--having "lived" or "worked" in the U.S. that much—would usually be treated as having a tax home in the U.S.

Thus, section 871 seems to apply to persons who are non-resident under the test of Code § 7701(b) for other income tax purposes as a result of the exemptions from the substantial presence test for diplomats, students, etc. Section 871 would impose a special 30% tax on their net annual capital gains. This special 183 day rule was apparently prompted originally by the tax advantages available to refugees who were inadvertently stuck in the United States during World War II. See, e.g., Commissioner v. Nubar, 185 F.2d 584 (1950), reversing 13 T.C. 566 (1949). Its modern application, as just described here, has been heavily criticized, and there is a distinct possibility that the rule will be repealed (see S. 1637, 108th Congress, section 216). In the meantime, those persons who are not otherwise resident in the U.S. can invest through a foreign corporation in order to avoid the rule.

D. Ten-year transition if tax-motivated surrender of citizenship or long-term residence.

U.S. tax liability extends for 10 years to many U.S. citizens and long-term residents who surrender their citizenship or green cards while owning significant U.S. assets or earning significant U.S. income. The resulting tax burden, including tax reporting, seems to be motivated not by tax policies but by an effort to score political points by retaliating against "economic Benedict Arnolds".

Additional U.S. tax exposure applies to an NRA for ten years after a tax-motivated loss of citizenship, or long-term residence; and tax motivation is presumed (though not conclusively) based upon a specific net worth and income formula. Code § 877(a). For purposes of this discussion, we will refer to these persons as "tax-motivated expatriates." As a result of changes to the Code enacted in August 1996, these persons for the first time include a so-called "long-term" U.S. tax resident, which means someone who terminates U.S. income tax residency after holding a "green card" for at least 8 of the last 15 years ending with the year of expatriation. This change has a somewhat retroactive affect. Even though the green card was acquired prior to the 1996 Code changes, the unrealized capital gain built up by a long-term resident while in green-card status over these past years is now subject to the new law. Code § 877(e).

(1) Broader U.S. liability for income tax.

During the ten-year period, several special rules apply to the tax-motivated expatriate: (a) U.S. source income is taxed in the U.S. at the normal U.S. income tax rates if (as is normally the case) that usually produces a higher tax than the typical 30% flat tax imposed on U.S. gross income earned by NRAs, and (b) the exemption from U.S. capital gains tax for NRAs does not apply to a sale of U.S. situs property or U.S.-issued securities. Taxes generally cannot be avoided by a post-departure tax-free conversion of assets producing U.S. source income into assets producing non-U.S. source income.

Tax-deferred like-kind exchanges are curtailed (Code § 1031(h)) and, together with post-departure capital contributions of appreciated U.S. property to foreign corporations, are taxed in any event unless the expatriate signs a 10 to 15 year agreement to pay the deferred tax out of later income and gain derived from the property (Code § 877(d)(2)). These provisions target the gain as of the date of the exchange or contribution, and basically extend the reach of Sections 367 and 684 beyond the period of actual income tax residency. In addition, a controlled foreign corporation (specially defined) cannot be used to incorporate such assets and earn income from them at the corporate level in order to shield the NRA from what would otherwise be U.S. source income. All such income will be treated as received by the expatriate shareholder when received by the corporation, including all post-contribution income of any kind received or accrued from those assets for the 10 year period, and a sale of stock in such a corporation will be treated as a pro rata sale of such assets by the corporation. Code § 877(d)(2) and (4). In effect, this provision extends the duration of the CFC rules for another 10 years as if the departing NRA was still a U.S. person.

Under the Code § 877(d)(2) resourcing rules, a transfer of property that would produce U.S. source income in exchange for property that would produce foreign source income is treated as

a taxable exchange in which gain is recognized as if the U.S. sourced property had been sold for its fair market value. Apparently, this rule applies whether or not the property that would produce foreign source income is of comparable value to the transferred property that would have produced U.S. sourced income. See Health Insurance Portability and Accountability Act of 1996, House Report No. 104-496; Notice 97-19, 1997-1 C.B. 394, Part V, example 8. Code § 877 accomplishes this result by treating certain items of gross income as being sourced from the United States. Code § 877(d)(2). Note also that the Internal Revenue Service intends to resource gains from an exchange that occurred as much as five years prior to expatriation. Code § 877(d)(2)(D). Notice 97-19.

(2) Transfer tax broadened.

Under the transfer tax, special rules "look through" a non-U.S. holding company and impose tax on its U.S. assets, and expand the gift tax. More specifically, a non-U.S. corporation controlled directly or indirectly by such a tax-motivated expatriate NRA will be treated as transparent at death, so that any U.S. situs assets then owned by the company would trigger U.S. estate tax as if owned directly by the NRA. For this purpose, "control" means a minimum of 10% of the company's voting power before applying attribution rules and at least 50% of the voting power or stock value after applying the family attribution rules. Code § 2107(b). This special situs rule does not apply for gift tax purposes, but that tax is also expanded in scope: the gift tax applies during this ten-year period to all actual U.S. situs property, with no special exclusion for intangibles. Code § 2501(a)(2). This expanded estate and gift tax coverage also makes more transfers subject to the GST because the estate or gift tax applies. (Also, the expanded transfer tax rules apply even without a specific finding that the individual had been domiciled in the U.S.)

(3) Still not taxed on worldwide basis.

Note that the 10-year expatriation rule generally does not tax income and assets that do not have a U.S. "source" or "situs" or that were not derived from such assets through a tax-free restructuring (such as contribution to a foreign holding company). As a result, the expatriate who does not have such assets or income to any degree is not "caught" by the 10-year rule (and should not be, as a matter of tax policy, in view of the person's limited financial connection to the U.S.). For example, immediately after the expatriation, the newly minted NRA could (1) make gifts of non-U.S. situated property free of U.S. gift tax, e.g., stock in a foreign public company or controlled corporation, (2) bequeath non-U.S. situated property free of estate tax, other than that held through a controlled corporation, and (3) receive dividends and realize capital gains on publicly traded non-U.S. stocks with the same limited taxation as any other NRA. Also, the U.S. estate tax is avoidable if, for example, the tax-motivated expatriate is willing to incur U.S. income taxes to convert U.S. to non-U.S. property prior to death.

As a result, there is still one more chapter to be written in the hunt for the economic Benedict Arnolds. Several proposals have been passed by at least the Senate or the House at various times to tighten these rules, including by imposing a tax on a deemed sale of appreciated property (including beneficial interests in trusts) at the time of expatriation (unless the taxpayer agrees to full worldwide income taxation for the ensuing ten years), and even taxing expatriates who return to the U.S. for even very short periods of time (e.g., 30 days) as if they were U.S. citizens, and in addition, imposing transfer taxes or income

tax on all their gifts and bequests back into the U.S. See, e.g., S. 1637, section 442, and HR. 4520, section 604, 108th Congress.

(4) Treaty application.

Historically, the IRS seemed to take the position that these special rules for expatriates are not overridden by a treaty unless there is very specific language to that effect. U.S. tax treaties typically reserve the right to tax on the basis of citizenship. The IRS has taken the view that this reserved right applies also to taxing *former* citizens under the ten-year rule, even when the treaty language makes no reference to the ten-year rule. Rev. Rul. 79-152. The U.S. Tax Court has rejected this IRS position under the U.S./Canadian Treaty in force as of 1978. Crow v. Comm'r, 85 T.C. 376 (1985). More recently, in the legislative history to the major expansion of the expatriation rules in 1996, Congress declared its "belief" that the rules as amended did not conflict with existing U.S. treaties, and called upon the Treasury Department to identify and resolve any such conflicts by future treaty negotiations, and stated that any conflicts still remaining after ten years would be resolved in favor of the treaty. Explanation of Conferees on H.R. 3448, p. 244.