International Estate Planning: Crossing Borders, Navigating Cultures

ALI-CLE

Estate Planning in Depth

Chicago, Illinois

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Overview

- Determination of residency and U.S. income taxation of a U.S. Person as compared to a non-U.S. Person
- U.S. income taxation of a U.S. Person's interest in foreign entities
- Determination of residency and U.S. transfer taxation of a U.S. citizen or domiciliary as compared to non-U.S. citizens not domiciled in the United States
- Drafting considerations for U.S. Persons with cross-border issues
- Planning opportunities for non-U.S. citizens not domiciled in the United States (in-bound wealth planning)
- Distinguishing between domestic and foreign trusts, foreign grantor and non-grantor trusts and taxation of foreign trusts

U.S. Income Tax Nexus

- U.S. citizens and U.S. residents are subject to U.S. income taxation on their worldwide income
  - Extends to U.S. individuals, trusts and estates
- In the case of a U.S. citizen, residence alone is not necessarily determinative of taxation, so even U.S. citizens who have long since departed the United States may be subject to tax on their worldwide income
- In addition, persons who are considered "residents" of the United States for income tax purposes are subject to the vast reach of U.S. income taxation on their worldwide income even if they are not U.S. citizens
- Conversely, non-citizens not resident in the United States (often referred to for tax purposes as foreign persons or non-resident aliens ("NRAs")) and foreign trusts and estates are only subject to U.S. income taxation on their U.S. "source income"

Income Tax Basics: Who is a U.S. Person?

An individual is a U.S. Person for U.S. income tax purposes if the individual:

- Is a U.S. citizen
- Meets the Green Card Test
- Meets the Substantial Presence Test
- Makes an election in year one to be treated as a U.S. Person for income tax purposes

A U.S. Person also includes:

- A U.S. partnership
- A U.S. corporation
- A U.S. estate
- A U.S. trust

Income Tax Basics: Who is a U.S. Person? – Substantial Presence

An individual has Substantial Presence in the United States if:

- 183 Days - Present in the United States for 183 days or more during the current calendar year; or
- 3-Year Test - Present in the United States for:
  - At least 31 days during the current calendar year; AND
  - 183 days or more, after taking into account:
    - All days of calendar year at issue;
    - 1/3 of days of 1st preceding calendar year; and
    - 1/6 of days of 2nd preceding calendar year

Income Tax Basics: Who is a U.S. Person? - Substantial Presence Continued

Example: Individual spent the following days in the United States

2019	120 days x 1 =	120 days
2018	150 days x 1/3 =	50 days
2017	90 days x 1/6 =	15 days
Total		185 days

In 2019, was the individual a U.S. Person?

Exceptions to Substantial Presence Test

- Exempt individuals
- Closer connection to a foreign country
- Treaty-based return position

Non-U.S. Persons: Categories of Income Taxed

Not Taxed

- Foreign source income
- Capital gains (except from the sale of U.S. real estate)

Preferentially Taxed

- Fixed, include determinable and periodic ("FDAP") income
  - Examples include U.S. interest, dividends, rents, and royalties
  - Exceptions: portfolio interest and treaty benefits

Fully Taxed

- Income effectively connected with a U.S. trade or business ("ECI")
- Gains from sale of U.S. real estate

U.S. Source Income

Type of U.S. Source Income	General U.S. Tax Treatment
Capital Gains (except U.S. real property gains)	• Generally excluded from U.S. tax • If the NRA was in the United States for 183 days or more during the tax year, the net gain from sales or exchanges of capital assets is taxed at 30% • Capital gains are taxed also if they are effectively connected with a trade or business in the United States during the tax year
Capital Gains from the Sale of a Partnership Interest	• Capital Gains from the Sale of a Partnership Interest Gain or loss on the sale or exchange of all (or any portion of) a partnership interest will be taxed to the extent that the NRA partner would have had ECI if the partnership had sold all of its assets on the date of the sale and allocated the gain to partners • The buyer of the partnership interest is required to deduct and withhold tax equal to 10% of the amount realized on the sale of the partnership interest • If the buyer fails to withhold, the partnership itself must withhold the 10% tax
Dividends	• Generally included as U.S.-source taxable income subject to 30% withholding
Interest from Bank Accounts	• Excluded from NRA withholding tax
Interest from Bonds or Other Debt Obligations	• Taxable and subject to 30% withholding unless the portfolio interest exemption applies

U.S. Source Income - Continued

Portfolio Interest Exemption	• Excludes interest paid to NRAs on bonds and other debt obligations held for investment if: – The obligation identifies the payer (i.e., is in registered form); – The payee is a foreign individual or entity and is the beneficial owner of income; and – The foreign individual or entity provides a Form W-8 to the payer The portfolio interest exemption does not apply if: – The foreign investor owns 10% or more of the U.S. corporation or partnership that issued the obligation; – The interest payments are tied to the issuer's receipts, sales, cash flow, income, etc.; or – The registered debt is convertible to bearer form • The portfolio interest exemption does not mitigate FATCA withholding
Capital Gains from the Sale of Real Estate	• Under FIRPTA, capital gains are taxed on a net basis • However, 15% withholding is on the gross sale price, unless seller applies for reduced certification • See Forms 8288 and 8288-A
Rental Income	• Income generated by the use of U.S. real estate is subject to 30% withholding • However, a special election may be made to treat U.S. real property income as ECI so tax may be paid on only the net income (income less deductions attributable to rental income) • Timely U.S. tax returns must be filed to receive the benefit of this election

Additional Tax Considerations for U.S. Persons with Interests in Foreign Entities

- What the default classification of the entity would be for U.S. tax purposes and whether an election should be filed with the IRS to change the default classification
- Whether the entity is a Controlled Foreign Corporation (CFC) or Passive Foreign Investment Company (PFIC)
- Whether the entity has deferred repatriation tax
- Whether the entity is subject to tax on Global Intangible Low-Taxed Income (GILTI)

Classification of Foreign Entities

Default classifications of foreign entities

- Partnership → if it has two or more members and at least one member does not have limited liability
- Association taxable as a corporation → if all members have limited liability (e.g., a foreign LLP)
- Disregarded entity → if it has a single owner that does not have limited liability

A foreign entity can elect to be classified differently from its default classification by filing Form 8832 within the prescribed time (generally not more than 75 days prior to the effective date and not more than 12 months after the effective date)

Taxation of a CFC

An entity is a CFC if:

- 50% of the stock is owned by U.S. Shareholders
- A U.S. Shareholder is a U.S. Person who owns directly, indirectly or constructively (see Code Section 958 (a) and (b)) 10% or more of the total combined voting power **or** 10% or more of the total value of shares of all classes of stock

Taxation of a CFC

- Passive "Subpart F" income is taxed to U.S. Shareholders annually as ordinary income even if not distributed
- Gain from the sale of CFC stock is treated as dividend income to the extent the CFC had earnings and profits attributable to the years the U.S. Shareholder owned the shares

Taxation of a PFIC

An entity is a PFIC if:

- 75% or more of the gross income is passive; or
- 50% or more of the assets produce passive income

Taxation of a PFIC

- Distributions taxed at ordinary income rates
  - Excess distributions (more than 125% of the average distributions over the prior 3 years) allocated pro rata to each day of the shareholder's holding period and treated as a unpaid tax that is subject to an "interest charge"
  - Non-excess distributions are treated like ordinary dividends
- Gain from the disposition of PFIC shares is treated as an excess distribution

Repatriation Tax (Code Section 965)

Prior to Tax Cuts and Jobs Act (TCJA), foreign income earned by U.S. Shareholders (10% or greater vote) through a foreign corporation (other than Subpart F "passive" income) generally was subject to tax only when the income was distributed to the shareholders as a dividend

Following the passage of TCJA, post-1986 accumulated E & P through 2017 is taxed as Subpart F income and subject to tax even though the income remains undistributed

Applicable to U.S. Shareholders (10% or greater vote **or value**) of a Specified Foreign Corporation (SFC). An SFC is a CFC or any foreign corporation with one or more U.S. corporate shareholders with 10% or greater vote or value

Repatriation Tax (Code Section 965) Continued

Tax Rates

- Corporate shareholder: 8% equivalent percentage (after deduction against 21% U.S. corporate rate) for accumulated E&P held in illiquid assets and 15.5% for cash and cash equivalents
- Individuals, estates and trusts: 9.05% for accumulated E&P held in illiquid assets and 17.5% for cash and cash equivalents

Planning opportunities implemented in 2018

- Deferral (8 years); and
- S Corporation election

GILTI Tax (Code Section 951A)

Generally, GILTI is defined to include most of the U.S. Shareholder's net income from the CFC, reduced by 10% of the shareholder's pro rata share of the adjusted tax basis of the CFC's depreciable tangible personal property (such as buildings and equipment but excluding land) less interest expense

Tax Rates

- Corporate shareholder: 10.5% (50% of 21% corporate rate) less foreign tax credits
- Individuals, estates and trusts: 37%

Planning opportunities

- Code Section 962 election
- Creation of C Corporation blocker

U.S. Transfer Tax Nexus

Citizenship and domicile are determinative of many aspects of U.S. gift, estate and generation-skipping transfer taxation:

- **U.S Citizens and "Residents":** U.S. citizens (wherever they live) and U.S. "residents" (regardless of their citizenship) are subject to U.S. gift, estate and generation-skipping transfer taxes on their worldwide assets

- **Non-Citizen Non-Domiciled:** Non-U.S. citizens not domiciled in the United States are subject to U.S. gift, estate and generation-skipping transfer tax on their U.S. situs assets

- **Treaties:** Additionally, the United States has estate and gift tax treaties with various countries

Determination of Domicile for Transfer Tax Purposes

Treasury Regulation 20.0-1(b)(1)

A "resident" decedent is a decedent who, at the time of his death, had his domicile in the United States. The term "United States", as used in the estate tax regulations, includes only the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to their admission as States […] A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal

Determination of Domicile for Transfer Tax Purposes Continued

Who is a U.S. domiciled individual?

A U.S. domiciled individual is an individual who has moved to the United States indefinitely, with no current intentions of leaving the United States

By contrast, a non-U.S. domiciled individual, is an individual who has no intentions of remaining in the United States and may be here temporarily (e.g., on a work Visa), simply own U.S. situs assets, or have children living in the United States

Residency Status for Income Tax – Objective Test

- Residence – requires physical presence
- Green Card Test
- Substantial Presence Test

"Residency" Status for Estate & Gift Tax – Subjective Test

- Domicile – requires intention to remain
- Establish U.S. domicile with no present intent to leave

Factors in Determining Domicile

- Duration of stay in United States vs. other countries
- Size and value of individual's houses and whether those houses are owned or rented
- Area in which houses are located
- Location of expensive and important personal belongings
- Location of individual's family and close friends
- Places where individual maintained church and club memberships and participated in community
- Location of business interests
- Declarations of residence/intent on visa applications, wills, etc. and visa status
- Where individual is registered to vote, maintains driver's license, etc.
- Motivation in selecting place to live

Calculation of Federal Estate Tax for Non-U.S. Domiciled Individuals

Non-U.S. domiciled individual is required to pay U.S. estate tax on his or her U.S. taxable estate at death

- Gross estate less deductions and credits
- Subchapter B Code Sections 2101-2108 Estates of Non Residents Not Citizens

Tax Rates – same rates as those which apply to estates of U.S. citizens or residents

Determination of Gross Estate of Non-U.S. Domiciled Individuals

- Made up in same way as the gross estate of a U.S. citizen or resident
- Apply Code Sections 2036 through 2046 to determine assets included in gross estate
- Apply estate tax situs rules to determine assets situated within United States
- Joint Tenancy Property Between Spouses
  - If surviving spouse is U.S. citizen – ½ of value of joint property included in non-U.S. domiciled individual's estate
  - If surviving spouse is non-U.S. citizen – full value of joint property included in non-U.S. domiciled individual's estate, except to extent estate can prove surviving spouse provided consideration for acquisition of property

Assets Included in Gross Estate of Non-U.S. Domiciled Individual – U.S. Situs Assets

Property situated within the United States for Estate Tax Purposes

- Real property
- Tangible personal property
- Shares of domestic corporations
- Debt obligations issued by the United States or a U.S. Person unless income would be exempt portfolio interest
- Deposits with a branch in the United States of a foreign corporation, if the branch is engaged in the commercial banking business
- Trust interests which are includable for estate tax purposes if they would be includable in estate of U.S. domiciliary or citizen under Code Sections 2033-2046 & trust property is U.S. situs property
- Code Section 2104(b) clawback of property with retained interests

But consider treaty override provisions

Assets Excluded from Gross Estate of Non-U.S. Domiciled Individual – Non-U.S. Situs

The value of the gross estate does not include certain property, even though physically in the United States:

- Property deemed to be "without the United States"
  - Real property located outside United States
  - Tangible personal property located outside United States
  - Shares of stock issued by a corporation which is not a domestic corporation
  - Amounts receivable as insurance on the decedent's life
  - Deposits with a branch outside of the United States of a domestic corporation or domestic partnership if the branch is engaged in the commercial banking business
  - Any debt obligation, the primary obligor of which is neither a U.S. Person, nor U.S. government

Deductions Available to Non-U.S. Domiciled Individuals

- Deductions for expenses, losses, debts, and taxes are pro-rated using a ratio of U.S. to worldwide assets
- Charitable deduction is allowed, but only for bequests to U.S. charitable organizations
- Marital Deduction:
  - Transfer to U.S. citizen spouse – estate entitled to unlimited marital deduction under same rules of Code Section 2056
  - Transfer to non-U.S. citizen spouse – estate entitled to unlimited marital deduction only if:
    - Surviving spouse becomes a U.S. citizen before U.S. estate tax return is filed **<u>and</u>** was a U.S. domiciliary between decedent's death and naturalization; or
    - The transfer is to a Qualified Domestic Trust ("QDOT") under Code Section 2056A

Qualified Domestic Trust

- To obtain marital deduction for transfers to non-U.S. citizen spouses, a QDOT trust is required under Code Section 2056A
  - Marital deduction trust requirements
  - Requires U.S. Trustee or bond
  - Estate Tax withholding on principal distributions (unless exception applies)
  - Timely election required
  - Requires trust to be subject to administration in the United States
- If property located outside the United States – particularly civil law jurisdictions - trust ownership may not be permitted
- QDOT not permitted for lifetime gifts

Credits Available to Non-U.S. Domiciled Individuals

- Entitled to a unified credit of $13,000, which exempts $60,000 of property from U.S. estate tax
- Entitled to other credits:
  - Credit related to Code Sections 2012 and 2013 (relating to gift tax and tax on prior transfers)
  - Credit related to Code Sections 2015 and 2016 (relating respectively to the credit for death taxes on remainders and the recovery of taxes claimed as a credit), subject to certain limitations
- Foreign death tax credit only allowed for the estates of U.S. citizens and U.S. resident decedents

Estate and Gift Tax Treaties Available for Non-U.S. Domiciled Individuals

- Code vs. Tax Treaty
- 17 U.S. Estate and Gift Tax Treaties
  - OECD Treaties: France, Germany, Netherlands, United Kingdom, Austria and Denmark
  - Other Treaties: Australia, Finland, Greece, Ireland, Italy, Japan, Norway, South Africa, Sweden, Switzerland
  - Canada (covered by Income Tax Treaty)

Gift Tax Basics for Non-U.S. Domiciled Individuals

Property subject to U.S. gift tax

- Real property situated in the United States
- Tangible personal property situated in the United States

Property not subject to U.S. gift tax

- Intangible property, even if property has a connection to the United States, such as corporate stock, bonds, notes, patents, partnership interests and goodwill

Tax Rates – same gift tax rates as those which apply to gifts made by U.S. citizens or residents

U.S. Gift Tax Exclusions and Deductions Available for Non-U.S. Domiciled Individuals

- There is no applicable or basic exclusion for lifetime gifts, although the annual exclusion ($15,000 in 2019) does apply
- Gift-splitting not available to a married foreign donor
- There is no unlimited gift tax marital deduction from a U.S. spouse to a non-U.S. citizen spouse
  – A U.S. or non-U.S. spouse can gift up to $155,000 in 2019 annually to a non-U.S. citizen spouse, as the annual exclusion amount is increased for non-U.S. citizen spouses
- Joint tenancy property between spouses
  – Joint tenancies in real property between spouses (after July 13, 1988) not deemed a taxable gift
  – Joint tenancies in personal property is subject to gift tax
- Charitable deduction is allowed, but only for bequests to U.S. charitable organizations

Gift and Estate Tax Comparison of Citizen/ Resident and Non-Citizen Non-Domiciled

	Non-U.S. Citizen and Non-U.S. Domiciled	**U.S. Citizen or U.S. Domiciled**
U.S. Estate Tax	• Taxed on U.S. situs assets (real, tangible, intangible)	• Taxed on worldwide assets
Estate Tax Applicable Exclusion Amount	• $60,000, subject to treaty modified pro-rata rules • Only available for estate tax purposes, not available for lifetime gifts	• $11.4 million in 2019 • Available for estate, gift, and generation-skipping transfer tax purposes
U.S. Gift Tax	• Taxed on gratuitous transfers of U.S. situs assets (real, tangible)	• Taxed on all gratuitous transfers
Annual Gift Tax Exclusion	• $15,000 in 2019 • Gift splitting with spouse not allowed	• $15,000 in 2019 • Gift splitting with U.S. citizen/resident spouse allowed
Transfers to a Non-U.S. Citizen Spouse	• Estate tax marital deduction for transfers to U.S. citizen spouse or QDOT • No unlimited marital deduction for transfers to non-U.S. citizen spouse • Annual exclusion amount for gifts to non-U.S. citizen spouse is $155,000 in 2019	

Drafting Considerations for U.S. Persons with Cross-Border Issues

Adopting an "international" frame of mind:

- Coordinate with foreign counsel. Be humble and ready to learn
- Consider how the client's affairs are likely to evolve over the next 5, 10, 15 years
- Remember that U.S. planning techniques often do not "translate"
- Be skeptical of the use of trusts
- Learn as much as possible about the client's intended beneficiaries and their respective plans

Fundamental Issues to be Addressed

- What limitations, if any, does foreign law place on the client's ability to dispose of foreign assets? (Forced heirship)
- What is the situs of the property?
- What is the nature of the foreign property interest? Real property? Personal property? Tangible? Intangible? Marital property? Community property?
- What country's law applies to the disposition of the foreign asset?
- What tools are available to dispose of the foreign asset?
- Whether a foreign marital agreement governs the property?
- Whether there are any foreign "trust constructs" involved (e.g., Stiftung, Anstalt, usufruct)
- What extra steps, if any, should the client take to "bulletproof" his disposition strategy?

Characteristics of Civil Law Systems

Most countries (apart from the Anglosphere) have civil law systems that do not allow complete testamentary freedom. For a U.S. client owning real estate in a civil law country, the implications are:

- Local law may provide that the client's children have fixed rights to inherit a share of the client's property
- The size of the share to which the children (or other heirs) are entitled varies greatly among countries
- A simple bequest of real estate to a surviving spouse may be set aside, invalid, or subject to challenge
- Co-ownership of real estate by a surviving spouse and children (perhaps from a prior marriage) is often problematic
- U.S. estate tax may be incurred unexpectedly due to a share of the property passing directly to children

Comparison of U.S. Estate Tax and European Inheritance Tax

European or other civil law inheritance tax systems impose a tax on the receipt of property. Some things to keep in mind in view of such a system:

- In some systems, property received by surviving spouse is subject to tax
- Typically, the rate of tax is higher when the legatee is not directly descended from the decedent
- Often, the legatee will not pay tax on an exemption amount, but these personal exemptions are negligible compared to U.S. estate tax exemptions
- Assets passing to a trust for a child or grandchild may be taxed at the highest rate, e.g., as if an unrelated individual or distant relative had inherited the asset

Comparison of U.S. Estate Tax and European Inheritance Tax - Continued

Brussels IV enables a U.S. client to choose what law applies to the succession of his assets in most European countries. BEFORE Brussels IV, the law that would apply to different types of property varied by country:

- In France, real estate passed in accordance with French law while law of the decedent's domicile at the time of death governed the transfer of movable property
- In Germany, Italy, and Spain, the decedent's nationality was paramount
- U.S. clients who sought to avoid forced heirship had to engage in special planning, such as owning French real estate through a company to convert it to moveable property

Comparison of U.S. Estate Tax and European Inheritance Tax - Continued

Brussels IV seeks to create a uniform law of succession for Member States. U.S. citizens or residents who own property in a Member State also benefit:

- Generally, the "law applicable to the succession as a whole shall be the law of the State in which the deceased has his habitual residence at the time of death." The default rule will not apply when:
  - "[I]t is clear from all the circumstances . . . that, at the time of death, the deceased was manifestly more closely connected with" another country; or
  - The decedent has chosen the law of his nationality to govern his succession
- A U.S. citizen (even one with multiple nationalities) may choose the law of a particular State to govern his entire succession

Comparison of U.S. Estate Tax and European Inheritance Tax - Continued

1.01 **Governing Law**. The internal laws of the State of Illinois govern the validity and interpretation of this will and the administration of my domiciliary probate estate

1.02 **European Union Reference**. I choose the laws of the State of Illinois (without regard to its choice of law rules) to govern the succession to my assets, rights and obligations as a whole, including any not disposed of by this will, and I declare that my will and all matters arising under or relating to my will, shall be governed by and construed according to the laws of the State of Illinois (without regard to its choice of law rules) and that all matters relating to the devolution and administration of my assets shall be governed by the said laws of the State of Illinois (without regard to its choice of law rules) and such choice and such declarations are made pursuant to, inter alia, Article 22 of Regulation (EU) No. 650/2012. I am a United States citizen who is most closely connected with the jurisdiction of the State of Illinois

Non-Tax Considerations

Other non-tax considerations affecting planning:

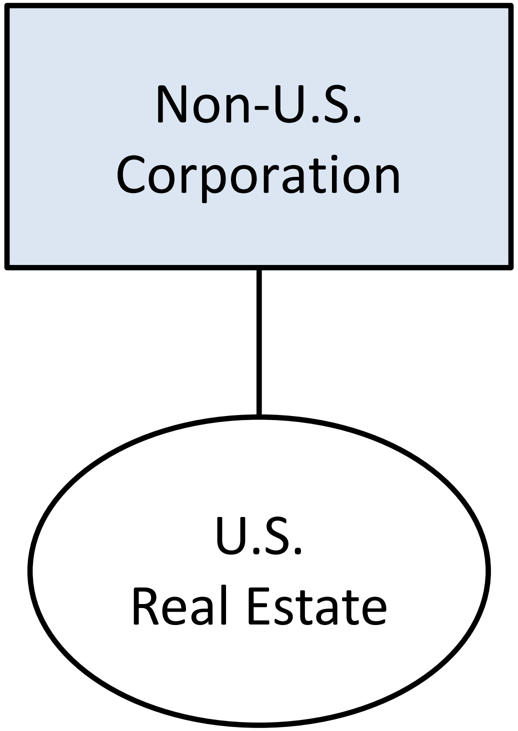
- Treatment of non-traditional marriages from foreign countries
- Health care coverage
- Treatment of pre- and post- marital agreements
- Rights and interests of adopted family members and assisted reproductive family members
- Home country issues related to pre-immigration property transfers between spouse and other family into trusts or other entities

Gift Strategies

- Gifts of intangible property, *i.e.*, stock, bonds or mutual fund shares are not subject to U.S. gift tax upon transfer
- This creates a great planning opportunity:
  - A non-U.S. domiciled individual may gift stock prior to death without incurring gift tax
  - The U.S. stock is out of the decedent's U.S. taxable estate – subject to Code Sections 2035 through 2038
- Cash and currency are considered tangible assets
- U.S. real property is tangible property which if transferred would be subject to U.S. gift tax
  - If placed into an entity structure, the transfer of the entity interest would be an interest in an intangible not subject to U.S. gift tax

Planning for U.S. Real Estate

- Consider acquiring U.S. situs assets in a non-U.S. entity
- If a non-U.S. domiciled individual already owns a U.S. situs asset, a subsequent transfer to a non-U.S. entity must be carefully executed (e.g., three year clawback rule in Code Section 2104(b))



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Distinguishing between Domestic and Foreign Trusts

- A trust is a foreign trust if it fails either:
  - Court Test or
  - Control Test

Court Test

- Safe harbor:
  - Trust instrument does not direct that trust be administered outside United States; and
  - Trust is administered exclusively within the U.S; and
  - Trust does not have an automatic migration clause; or
- U.S. court is able to exercise *primary* supervision over administration of trust

Control Test

- One or more U.S. Persons have authority to control all substantial decisions of the trust
- Substantial decisions include:
  – Distribution decisions
  – Selection of beneficiaries
  – Power to terminate
  – Power to remove, add or replace trustees
  – Investment decisions

Choosing Fiduciaries

- To prevent a trust intended to be domestic from becoming foreign, the following fiduciaries should be U.S. Persons:
  - Trustee
  - Protector
  - Investment Director
  - Distribution Director
- However, if a non-U.S. Person is to serve as one of the fiduciaries listed above, the trust will **<u>not</u>** become a foreign trust if:
  - A majority of the persons serving in the fiduciary role are U.S. Persons (e.g., two additional U.S. Persons are appointed to serve with the non-U.S. Person); and
  - Decisions require majority (rather than unanimous) consent

Curing Inadvertent Trust Migrations

- IRS recognizes that a domestic trust unintentionally may become a foreign trust through changes in identity of individuals who control substantial decisions
- If “death, incapacity, resignation, change in residency or other change” with respect to such an individual would cause the trust to flunk the control test, trust has 12 months to “cure” the migration (Treasury Regulation Section 301.7701-7(d)(2)(i))
- How to cure – replace the person who caused the change in status, or, that person becomes a U.S. Person during the 12-month period

Foreign Trusts

- Foreign grantor trust with U.S. grantor and U.S. beneficiaries
- Foreign non-grantor trust
- Foreign grantor trust with NRA grantor

Taxation of Foreign Grantor Trust with U.S. Person as Grantor

- Taxed in same manner as a domestic grantor trust
- Foreign trust will be deemed to have a U.S. beneficiary unless both of the following tests are satisfied:
  - No part of income or principal of trust may be paid or accumulated for the direct or indirect benefit of a U.S. Person; and
  - If the trust is terminated, no part of the income or principal can be paid, either directly or indirectly, to a U.S. Person
- Determination of whether trust has U.S. beneficiary is made annually

Foreign Trusts with U.S. Grantor

- Exceptions to the general rule under Code Section 679 include:
  - Transfer to a foreign trust by reason of the death of the U.S. transferor
  - Transfer to various tax-exempt foreign trusts
  - Transfer to a foreign trust in exchange for the property's fair market value
- If NRA transfers property to a foreign trust and becomes U.S. Person within 5 years, the transfer is deemed to take place on date NRA became U.S. Person

Taxation of Foreign Non-Grantor Trust

- Trust is taxed as NRA
- U.S. source income is subject to U.S. income tax
- Distributions to U.S. beneficiary taxable to U.S. beneficiary
- Applicability of “throwback rules”
- Difficult, if not impossible, to cleanse the accumulated income

Distributions from Foreign Trusts

- U.S. beneficiary must treat receipt of any distribution from foreign trust as a distribution from a non-grantor trust unless beneficiary can establish otherwise (Code Section 6048(c)(2))
- If distribution from foreign non-grantor trust does not exceed trust's DNI, beneficiary includes DNI deemed distributed on his U.S. tax return
  - Foreign trust's DNI includes trust's realized capital gains
  - Like a nonresident alien, foreign non-grantor trust not subject to U.S. income tax on capital gains from sale of U.S. assets (excluding real property)
  - Inclusion of foreign trust's realized capital gain in its DNI effectively makes its capital gains subject to U.S. income tax to the extent the trustee makes a distribution to a U.S. beneficiary

Throwback Tax on Accumulation Distributions

- Distribution from foreign non-grantor trust in excess of trust's DNI is an "accumulation distribution" and triggers "throwback tax"
- Accumulation distribution is based on trust's undistributed net income ("UNI") for prior years
- Because a foreign trust's DNI includes its realized gains, trust could have substantial amounts of UNI, causing a large accumulation distribution
- Purpose of throwback tax is to capture the U.S. tax that would have been paid had the trust distributed accumulated income to the U.S. beneficiary on a current basis

Throwback Tax on Accumulation Distributions - Continued

- Throwback tax triggers income tax for previous years even though beneficiary may never have received a distribution from trust in previous years
- Interest payments on tax could wipe out much of the accumulation distribution
- Throwback tax applies without regard to whether the UNI was capital gain or ordinary income, thereby eliminating benefit of lower capital gains tax rates for U.S. beneficiary

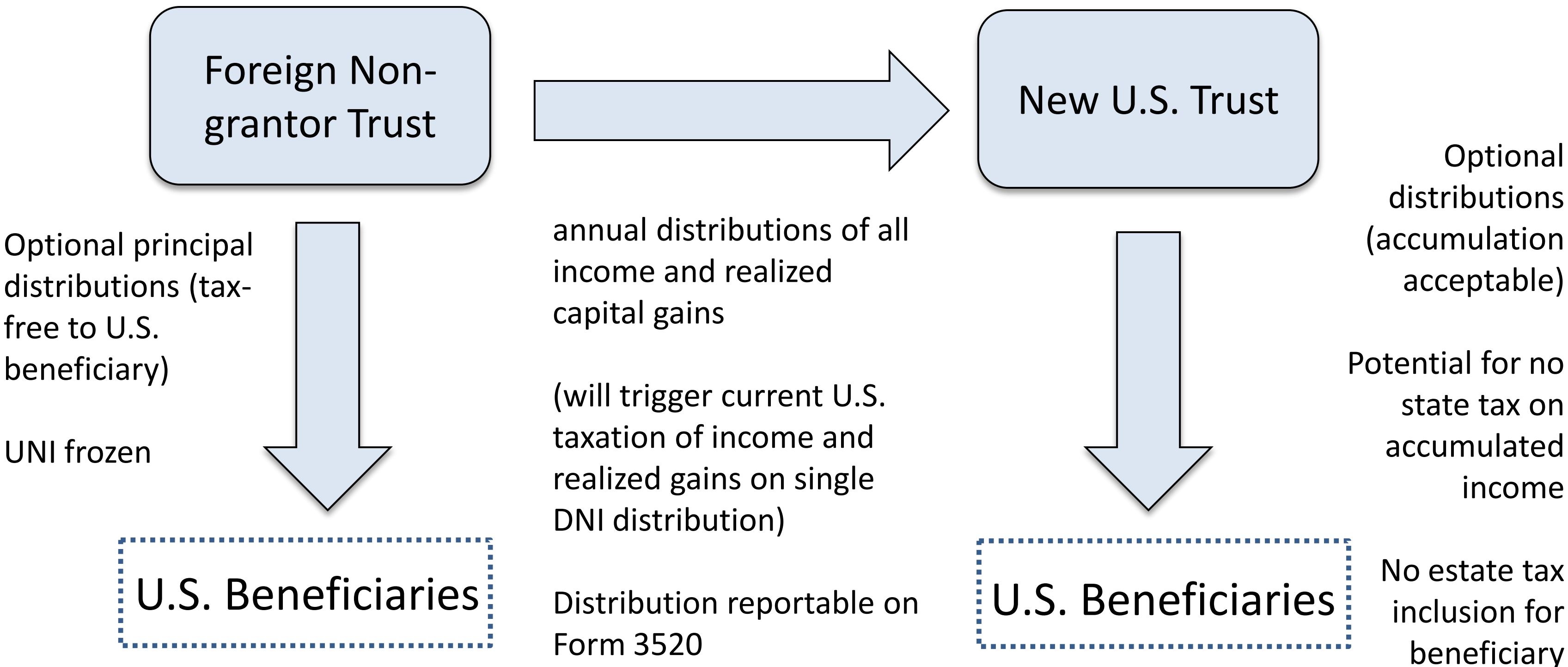
Avoiding Throwback Tax

- Distributing all DNI to U.S. beneficiary on annual basis avoids build-up of UNI and avoids throwback tax on accumulation distributions.
- But U.S. beneficiary may not want or need all DNI
- U.S. beneficiary might prefer to keep assets out of her estate:
  - for U.S. estate tax purposes
  - for creditor protection purposes
- Also, policy of distributing all DNI to beneficiaries may not be desirable if foreign trust also has non-U.S. beneficiaries

Solution: Distribute Excess DNI to U.S. Receptacle Trust

- Trustee of foreign non-grantor trust can distribute excess DNI to a domestic non-grantor trust for the beneficiary ("receptacle trust")
- If desirable, income and gains can accumulate in receptacle trust without attracting throwback tax
- Terms of receptacle trust may (but need not) mirror terms of foreign trust
- Trust may be structured so as not to be includible in U.S. beneficiary's estate
- U.S. beneficiary may have non-general power of appointment on death

Distribution of Excess DNI to U.S. Receptacle Trust



Taxation of Foreign Grantor Trust with NRA Grantor

- Most beneficial from a tax perspective
- No U.S. income tax except on U.S. source income
- Distributions to U.S. Person do not carry out DNI

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Taxation of Foreign Grantor Trust with NRA as Grantor – Code Section 672(f)(2)

- Revocable without consent of another or with consent of subservient person; or
- The grantor and/or the grantor’s spouse are the sole beneficiaries of the trust during grantor’s lifetime

Classification of Trust: An Example

- Please review the separate handout regarding classification of trust
- Is the trust established for Cora Monroe:
  - a domestic trust or a foreign trust? Why?
  - a grantor trust or a non-grantor trust? Why?

Reporting Requirements

Below is a summary of some of the significant reporting forms. This is an ever-changing area of the law that requires diligent attention to ongoing developments:

- Reporting and Withholding on Distributions from U.S. Trusts to Non-resident Alien Beneficiaries
- Report of Foreign Bank and Financial Accounts (FBAR) (FinCEN Report 114 now supersedes FBAR form)
- Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520)
- Annual Information Return of Foreign Trust with a U.S. Owner (Form 3520-A)
- Foreign Account Tax Compliance Act (FATCA) and Statement of Specified Foreign Financial Assets (Form 8938)

Considerations for U.S. Clients Who Want to Expatriate

What does it mean to expatriate?

- To expatriate is to irrevocably relinquish U.S. citizenship, with all of its attendant obligations and privileges
- At the time of expatriation, a potential expatriate must be a citizen of at least one other country, so that she is not rendered stateless by the act of relinquishing citizenship
- Expatriation can have numerous tax consequences, including an immediate capital gains tax on all of the expatriate's assets, and ongoing long-term taxation of:
  - The expatriate's employee benefits; and
  - The expatriate's beneficial interests in trusts (existing or to be created)

Considerations for U.S. Clients Who Want to Expatriate - Continued

- Expatriation also has implications for:
  - The expatriate's estate planning for her spouse and descendants; and
  - Closely-held businesses in which the expatriate has a direct or beneficial ownership interest
- Consideration should be given both to whether the taxpayer should expatriate and, alternatively, to whether her children might expatriate

Overview of Expatriation Tax Regime

- The United States imposes a mark-to-market “exit tax” on certain citizens who expatriate
- The exit tax applies to individuals who meet the definition of a “covered expatriate” (“CE”)
- The United States also imposes a “succession tax” on U.S. citizens or residents who receive a “covered gift or bequest” from a CE
- A direct or indirect distribution from a nongrantor trust to a CE who was a beneficiary of that trust at the time of her expatriation will be subject to 30% withholding tax (unless the CE elects to include the value of her interest in the trust in her exit tax base)

Who is a Covered Expatriate?

- An expatriate will be a "covered expatriate" if she meets *either*:
  - an income tax liability test (an average annual net U.S. income tax of $168,000 for the five years preceding expatriation),
  - a net worth test (a net worth of $2,000,000 or more), or either:
    - fails to certify under perjury on IRS Form 8854 that she has been in compliance with all U.S. federal tax laws for the five years preceding expatriation, or
    - fails to submit evidence of such compliance as the Secretary of the U.S. Treasury may require

Exceptions to Covered Expatriate Status

- A child will not be a CE is she expatriates prior to age 18-1/2:
  - having never been a U.S. resident, or
  - having been a resident of the United States for not more than 10 taxable years before the date of relinquishment
- Special Exception for Dual Nationals from Birth. An individual who is a dual national from birth may expatriate at any time subsequent to attaining age 18 without becoming a CE

Exceptions to Covered Expatriate Status - Continued

- Specifically, an individual who is a dual national from birth will not be a "covered expatriate" if the individual later relinquishes U.S. citizenship and the following conditions apply:
  - the individual became at birth a U.S. citizen and a citizen of another country, and
  - as of the expatriation date, continues to be a citizen of, and is taxed as a resident of, such other country, and
  - has never been a resident of the United States, or has been a resident of the United States for not more than 10 taxable years during the last 15-taxable year period ending with the taxable year during which the expatriation date occurs
- "Residence" in the United States is determined under the "substantial presence" test. This is a mechanical, day-counting test

Exceptions to Covered Expatriate Status - Continued

- To have a substantial presence in the United States for calendar year 2019, for example, an individual must be present in the United States on at least:
  - 31 days in 2019; and
  - 183 days during the three-year period that includes 2019, 2018 and 2017, counting
    - all the days the individual was present in 2019;
    - 1/3 of the days the individual was present in 2018; and
    - 1/6 of the days the individual was present in 2017

Exceptions to Covered Expatriate Status - Continued

- Thus, if an individual was in the United States for 120 days in each of 2019, 2018 and 2017, under the test, that individual is present 120 days in 2019, 40 days in 2018 and 20 days in 2017
- So that individual would be in the United States for only 180 days (120+40+20) and thus would not have a substantial presence in the United States in 2019
- Thus, if a dual citizen from birth spends much of her adult life in the United States and later wishes to expatriate, she can do so without becoming a CE if she reduces her presence in the United States such that she ceases to be a resident under the substantial presence test and then waits until she can satisfy the “not more than 10 of the last 15 years” prong of the exception for dual citizens

Expatriation by a Minor

- A child may expatriate upon attaining age 18
- Again, a child will not be a CE if she expatriates prior to age 18-1/2
  - having never been a U.S. resident, or
  - having been a resident of the United States for not more than 10 taxable years before the date of relinquishment
- It may be possible for a minor to relinquish U.S. citizenship prior to age 18 in certain limited circumstances
- A parent cannot renounce citizenship on behalf of a minor child
- Therefore, the U.S. consular officer with whom the child interacts must be satisfied that the child understands the nature and consequences of her actions and is not acting under duress or the influence of a parent or guardian

Expatriation by a Minor - Continued

- The State Department's Foreign Affairs Manual currently creates a presumption that a child younger than 16 would not have the "requisite maturity and knowing intent" to voluntarily expatriate
  - Presumably, this presumption can be overcome by a "mature" child under the age of 16
- If a minor were to expatriate, she first would acquire citizenship of another country so as not to become stateless

Imposition of Mark-to-Market Exit Tax

- A CE is exposed to a U.S. federal income tax liability in the form of an immediate exit tax whereby her personal worldwide property is deemed sold and tax is paid on the resulting notional gain in excess of $725,000 (the inflation-adjusted amount for 2019) at the applicable capital gains rate
- So, only a CE who has more than $725,000 of net appreciation in her worldwide property will have an exit tax liability; conversely, CEs who are in a net loss position will not be liable for an exit tax
- A CE includes in her exit tax base any interest in property that would have been taxable as part of her gross estate for U.S. federal estate tax purposes had she died a U.S. citizen on the day before expatriating. Generally, this is the taxpayer's worldwide property, but certain trust interests and items of deferred compensation will be treated differently

Imposition of Mark-to-Market Exit Tax - Continued

- A CE must obtain fair market value appraisals of her worldwide property and attach the appraisals to her final U.S. income tax return
- An appraisal is only required for assets for which a ready market value is not available, e.g., real estate or closely-held assets. Quoted market prices on the day prior to expatriation will suffice for marketable securities
- A taxpayer may elect to defer the exit tax payable with respect to a particular asset, provided that security for the ultimate payment of the tax is posted and interest is paid over the deferral period
- A CE must file a detailed Expatriation Information Statement of IRS Form 8854 with her final year U.S. federal income tax return, certifying under penalties of perjury that she has been in compliance with all U.S. federal tax laws for the five years preceding the date of expatriation

Distributions from Nongrantor Trusts

If a CE is a beneficiary of a nongrantor trust on the day before the day of expatriation:

- No exit tax will be imposed automatically on the assets held in trust for her benefit
- Instead, with respect to any direct or indirect distribution to the CE from the trust, the trustee must deduct and withhold an amount equal to 30% of such part of the distribution as would have been includible in the CE's cross income if she were subject to U.S. income tax
- A CE will remain taxable on distributions she receives from a nongrantor trust years after the expatriation event
- Note, also, that a nongrantor trust must recognize gain on distributions of appreciated property to a CE

Distributions from Nongrantor Trusts

- A CE may opt out of the withholding regime for distributions from a nongrantor trust by electing to include her interest in the trust in her exit tax base (thereby exposing herself to the exit tax on the present value of her beneficial interest)
- A CE may opt out of the withholding regime for distributions from a nongrantor trust by electing to include her interest in the trust in her exit tax base (thereby exposing herself to the exit tax on the present value of her beneficial interest)
- Obtaining a private letter ruling is a precondition of making this election

Inheriting from a Covered Expatriate

A U.S. citizen or resident who receives a "covered gift or bequest" from a CE will be subject to a "succession tax" on that gift or bequest at the highest applicable rate of gift or estate tax

- Not all gifts or bequests from a CE are "covered gifts and bequests." For example, succession tax is not imposed on annual exclusion gifts or on gifts or bequests to a U.S. spouse or charity
- Also, the term does not include:
  - property reported on a timely filed gift tax return that is a taxable gift by the covered expatriate, or
  - property included in the gross estate of the covered expatriate and reported on her timely filed estate tax return

Inheriting from a Covered Expatriate - Continued

- Thus, for example, if a CE made a gift or bequest of U.S. real estate to her U.S. citizen child, that gift or bequest would be reportable on a gift or estate tax return and would be subject to U.S. gift or estate tax, but would not be subject to the succession tax in the hands of the U.S. citizen child
- However, a CE's bequest to a U.S. citizen child of a portfolio of non-U.S. securities would be subject to the succession tax, because that property would not be subject to U.S. estate tax
- Receipt of a covered gift or bequest by a domestic trust is treated no differently than if an individual had received it, but the trustee must pay the tax from the trust

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Andrew Stone is a partner in the law firm of Kozusko Harris Duncan and is based in the Firm's Chicago office.

Andrew counsels individuals, families, fiduciaries and family offices on all aspects of estate planning, estate administration and wealth transfer planning. Andrew's practice includes significant experience with closely-held family businesses and the multi-generational families that own and control these businesses. He also focuses on international aspects of tax and estate planning for U.S. beneficiaries of foreign trusts, non-U.S. families with U.S. connections, foreign executives in the U.S. and U.S. citizens residing abroad.

Andrew is a Fellow of the American College of Trust and Estate Counsel (ACTEC) and a member of its International Estate Planning Committee. He is past Chair of the Chicago Branch of the Society of Trust and Estate Practitioners (STEP). He is past co-chair of the International Tax Planning Committee of the Section of Real Property, Trust and Estate Law of the American Bar Association. Since 2005, he has served on the Board of Trustees of the John C. Proctor Endowment in Peoria, Illinois. From 2012-2018, Andrew taught International Estate Planning in Northwestern University School of Law's Tax LLM program.

He is a graduate of Cornell Law School and Washington University in St. Louis. While in law school, Andrew was a John M. Olin Scholar in Law and Economics and was an articles editor for the *Cornell Journal of Law & Public Policy.* Prior to law school, he studied history at the Westfälische Wilhelms-Universität, Münster, Germany, as a recipient of a German Academic Exchange Service Scholarship.

Andrew speaks regularly on tax and estate planning topics and is a co-author of "Role of the Trustee" (Illinois Institute of Continuing Legal Education-*Trust Administration Handbook*). Prior to joining KHD in May of 2014, Andrew was a partner at McDermott Will & Emery LLP. He is admitted to practice in Illinois.

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Olivia focuses her practice on domestic and international estate and tax planning for high-net-worth individuals, their families and closely-held businesses, including trust and estate administration and wealth transfer planning. She also assists clients in the formation and administration of non-profit entities. Olivia works with her clients to identify their short-term and long-term wealth transfer goals, develops strategies to meet those goals and ensures that the strategies are properly implemented.

Prior to joining the firm, Olivia was an associate at a Chicago boutique law firm, where she worked closely with clients on estate planning, trust administration and charitable planning. Olivia began her career at a national independent tax accounting firm focusing on income and estate tax consulting and income and gift tax compliance for ultra-high-net-worth individuals, their families and closely-held businesses.

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