CROSS-BORDER ESTATE PLANNING

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Mr. Rothschild distinguishes himself from many of his peers in that his estate planning recommendations are integrated with asset protection objectives. That is, by educating his clients on the non-tax benefits available with trusts and other vehicles and how they can be drafted in a flexible manner, his clients can achieve both tax savings and wealth preservation. Such benefits include protection from divorce, creditors or litigation exposure.

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I. INTRODUCTION

A. Non-resident alien taxation

1. Since a non-resident alien is generally not subject to taxation by the United States, the goal in counseling a NRA on United States tax issues is prophylactic; the counselor will seek to prevent the NRA from inadvertently subjecting himself to taxation by the United States while at the same time effectuating the NRA's non-tax goals.

2. Unlike United States persons who are taxed on their worldwide income and assets, a non-resident alien of the United States (a "NRA") is generally not subject to U.S. taxation, except as follows:

a. For income tax purposes, a NRA is subject to taxation by the United States only on the NRA's income which is derived from sources within the United States or income which is effectively connected with the conduct of a trade or business within the United States. See IRC § 872(a).

(1) Income tax on United States source income is generally withheld at a thirty (30%) rate.

b. For estate, gift and generation-skipping transfers tax purposes, a NRA is subject to taxation by the United States only on the NRA's assets which are situated in the United States.

(1) NRA is only entitled to a unified credit of $13,000, exempting $60,000 from U.S. estate tax.

(2) If the NRA leaves property to his U.S. citizen surviving spouse or if the property is transferred to a Qualified Domestic Trust for the benefit of his non-U.S. citizen spouse, it will qualify for the unlimited marital deduction.

(a) Notwithstanding the availability of a marital deduction, it would not be prudent to leave non-U.S. situs assets to a U.S. domiciliary spouse in a manner which would on the spouse's death be subject to estate tax. Such assets, instead, should be left in a trust for the spouse, the terms of which would not cause the trust to be subject to estate tax at the spouse's death.

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(3) The NRA's estate is entitled to take deductions under §§2053 and 2054. In a recent decision, the Tax Court held that a NRA's estate must include the full value of encumbered property rather than its net equity value, with the associated recourse mortgage allowed only to the extent of that proportion of deductions that his U.S. gross estate bears to the value of his entire gross estate worldwide. *Estate of Fung v. Comm.,* 117 T.C. No. 21 (December 2001). To avoid such adverse result, NRA's should be advised to obtain non-recourse mortgages.

(4) Non-resident aliens are not eligible for the portability election under IRC §2010(c).

(5) To obtain a marital deduction for transfers to non-US citizen spouses, a QDOT trust is required. IRC § 2056A.

(a) Marital deduction trust requirements;

(b) Requires U.S. Trustee or bond;

(c) Estate Tax withholding on principal distributions (unless exception applies);

(d) Timely election required; and

(e) Requires trust to be subject to administration in the U.S.

(f) If property is located outside the U.S. – particularly civil law jurisdictions - trust ownership may not be permitted.

(g) QDOT is not permitted for lifetime gifts – Annual exclusion gifts permitted up to $147,000 (indexed for 2015) to non-citizen spouses.

(h) If the portability election is made and QDOT created, DSUE amount is reduced when distributions are made or upon surviving spouse's death.

II. RESIDENCY/DOMICILE.

A. Determining residency and domicile

1. For income tax purposes, an individual is a resident alien of the United States only if the individual falls within one of the following scenarios:

a. The individual is a lawful permanent resident of the United States at any time during the calendar year at issue (i.e., the individual is a "green card" holder).

b. The individual meets the "substantial presence test" for determining residency under IRC § 7701(b)(3). The substantial presence test is met if either:

(1) The individual is present in the United States for at least thirty-one days during the current calendar year and the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:

IN THE CASE OF DAYS IN:	THE APPLICABLE MULTIPLIER IS:
Current year	1
1st preceding year	1/3
2nd preceding year	1/6

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or;

(2) The individual is present in the United States for at least 183 days in the current calendar year.

(3) An exception to the substantial presence test exists if the individual is present for less than 183 days and has a closer connection to another country.

c. The individual makes an election to be treated as a resident alien under IRC § 7701(b)(4).

2. By contrast, for purposes of the estate tax a "nonresident" decedent is "…a decedent who, at the time of his death, had his domicile outside the United States…"

3. Pursuant to Treas. Reg. § 20.0-1(b)(1), "[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."

4. Similarly, Treas. Reg. § 25.2501-1(b) provides that for purposes of the gift tax "[a] resident is an individual who has his domicile in the United States at the time of the gift" and that "[a]ll other individuals are nonresidents."

5. For purposes of determining whether an individual is a resident of the United States with regard to the gift tax, the term "domicile" is defined in the same manner as the term is defined under the estate tax regulations.

6. Note that because residency is determined objectively for purposes of the income tax, but is determined subjectively for purposes of the estate, gift and generation-skipping transfer taxes, it is possible for an individual to be deemed a resident of the United States for purposes of one tax and not another.

III. U.S. INCOME/ASSETS

A. Income tax

1. For purposes of the income tax, the following income is considered to be derived from sources within the United States:

a. Dividends from domestic corporations.

b. Rental income from real property located in the United States.

c. United States royalties.

d. Capital gain from the sale of real property located in the United States.

e. Interest on any debt obligation, the obligor of which is a United States person.

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(1) An important exception exists, however, for interest income on most publicly traded bonds (the "portfolio interest exception").

(2) Another important exception exits for interest on U.S. bank accounts.

f. Salary income for services performed within the United States.

B. Estate tax

1. For purposes of the estate tax, Treas. Reg. § 20.2104-1(a) provides that property of a NRA decedent is considered to be situated in the United State if it is:

a. Real property located in the United States.

b. Tangible personal property located in the United States, except certain works of art on loan for exhibition.

c. Shares of stock issued by a domestic corporation, irrespective of the location of the certificates.

d. Any debt obligation, including a bank deposit, the primary obligor of which is—

(1) A United States person, or

(2) The United States, a State or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government.

e. Deposits with a branch in the United States of a foreign corporation, if the branch is engaged in the commercial banking business, whether or not the decedent was engaged in business in the United States at the time of his death.

f. The situs of partnership interests (and presumably LLC interests electing to be taxed as partnerships) is somewhat uncertain. If the partnership is a separate, distinct legal entity and survives the death of a partner under the applicable local law the situs may be determined by the deceased partner's domicile or where the business of the partnership is conducted. [1] If the partnership does not survive the death of the partner or does not qualify as a separate legal entity, the partner's interest is deemed situated where the underlying partnership assets are.

g. Trust interests are includable for estate tax purposes if they would be includable in the estate of a U.S. domiciliary or citizen under IRC §§ 2033-2046 and the trust property is U.S. situs property.

2. Pursuant to Treas. Reg. § 20.2105-1(a), property of a NRA decedent is considered to be situated outside of the United States if it is:

a. Real property located outside the United States.

b. Tangible personal property located outside the United States.

c. Works of art owned by the decedent if they were—

(1) Imported into the United States solely for exhibition purposes,

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[1] *See Blodgett v. Silberman,* 277 U.S. 1 (1928); *See also Texas v. New Jersey*, 379 U.S. 674 (1965); Cf. Rev. Rul. 55-701, 1955-2 C.B. 836

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(2) Loaned for those purposes to a public gallery or museum, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and

(3) At the time of the death of the owner, on exhibition, or en route to or from exhibition, in such a public gallery or museum.

d. Shares of stock issued by a corporation which is not a domestic corporation, regardless of the location of the certificates.

e. Amounts receivable as insurance on the decedent's life.

f. 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. This paragraph applies whether or not the decedent was engaged in business in the United States at the time of his death, and whether or not the deposits, upon withdrawal, are payable in currency of the United States.

g. Any debt obligation, including a bank deposit, the primary obligor of which is neither—

(1) A United States person, nor

(2) The United States, a State or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government.

h. Any debt obligation to the extent that the primary obligor on the debt obligation is a domestic corporation, if any interest thereon, were the interest received from such obligor by the decedent at the time of his death, would be treated under IRC § 862(a)(1) as income from sources without the United States by reason of IRC § 861(a)(1)(B) (relating to interest received from a domestic corporation less than 20 percent of whose gross income for a 3-year period was derived from sources within the United States) and the regulations thereunder.

3. If a NRA is a resident of an estate tax treaty country (Australia, Austria, Canada, Denmark, Finland, France, Greece, Germany, Ireland, Italy, Japan, the Netherlands, Norway, South Africa Sweden, Switzerland, and the United Kingdom) U.S. equities may be exempt from estate tax.

C. **Gift tax**

1. A NRA is only subject to gift tax on tangible property situated in the U.S. Unlike the estate tax, transfers of intangible property such as stock in U.S. corporations are not subject to the gift tax.

2. Since U.S. situs intangible property is only subject to the estate tax, the NRA would be well advised to gift such property away during his lifetime. Additionally, the NRA should be advised to move personal property outside the U.S. prior to gifting it to avoid the gift tax.

3. The NRA is entitled to the annual present interest exclusion and marital deduction (for U.S. citizen spouses) but gift splitting and the unified credit are not available.

4. Joint tenancies in real property between spouses (including non-U.S. citizens or domiciliaries) created after July 13, 1988, will not be deemed a taxable gift, whereas with respect to personal property involving non-U.S. citizens such joint tenancies create an interest in each spouse of a one-half interest and subject to gift tax accordingly. The creation of joint bank accounts and brokerage accounts with non-U.S. citizen spouses do not become subject to gift tax until one spouse withdraws an amount in excess of his or her contribution for his or her own benefit.

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5. The foregoing rules may be modified by treaty provisions which are currently in effect with Australia, Austria, Denmark, France, Germany, Japan, Sweden and the U.K.

D. Generation-skipping tax

1. Generally, a NRA transferor will be subject to generation skipping tax if the transfer is a direct skip, or, if the transfer was made to a trust, to the extent that it is a taxable termination or taxable distribution and was subject to U.S. gift or estate tax. The NRA is allowed a $1,000,000 exemption therefrom.

IV. PLANNING TECHNIQUES

A. Avoid resident domicile status

B. Avoid direct ownership of US situs assets

1. The NRA should avoid holding assets situated in the United States in order to avoid (i) the potential imposition of United States estate and gift tax on those assets, and (ii) income tax on any income generated by those assets (assuming that the income generated by those assets is, in fact, subject to United States income tax).

2. The NRA can form a foreign corporation (often called an international business company or "IBC") to take title to the NRA's assets which are situated in the United States. Since the stock of a foreign corporation is deemed to be property without the United States pursuant to IRC § 2104(a) and Treas. Reg. § 20.2105-1(f), those assets will not be subject to United States estate tax when the NRA ultimately dies. Note, however, that the foregoing may be subject to challenge by the Internal Revenue Service if corporate formalities are not followed.

a. Consideration must also be given to the home country tax consequences of forming a corporation to hold U.S. securities. In this regard, most NRA's form such entities in "tax-haven" or low tax jurisdictions. This, however, could result in a loss of favorable tax treatment such as tax credits or reduced treaty tax rates. One possible solution is to utilize a foreign partnership. By "checking the box" so that the partnership is treated as a corporation for U.S. tax purposes, the NRA may get flow-through treatment under the home country tax laws. According to one commentator, a foreign partnership that does not elect to be taxed as a corporation may still avoid U.S. estate tax if it is not engaged in a U.S. trade or business.[2]

3. For United States income tax purposes, to the extent that the NRA must hold assets situated in the United States, the NRA should favor assets which are not subject to United States income tax (such as a cash deposit with a United States bank), in lieu of assets which are subject to United States income tax (such as that same cash deposit if held with a United States broker).

4. If the NRA invests in U.S. situs real property the NRA is subject to U.S. estate, gift and income tax. Several options exist to minimize the tax consequences.

a. Hold U.S. real property interest (USRPI) through a U.S. or foreign partnership or LLC (electing to be taxed as a partnership). Such entity will be subject to U.S. income tax

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[2] *See* Rubin and Hudson TM 912, Federal Taxation of Foreign Investment in U.S. Real Estate, pgs. A-107–A-110.

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and estate tax (but if held by a foreign partnership not engaged in a U.S. trade or business, *see supra*, Note 1).

b. Hold USRPI in a foreign grantor trust. Unless the trust is irrevocable and not subject to inclusion in the grantor's estate, no tax benefit is derived thereby.

c. Hold USRPI through a U.S. corporation. Such U.S. stock interest will be subject to U.S. estate tax and corporate income tax.

d. Hold USRPI through a foreign corporation. Such holding avoids U.S. estate tax but income derived therefrom will be subject to branch profits tax of 30%.

(1) It is preferable for the foreign corporation to acquire U.S. real property interests in the first instance as there may be income tax consequences if the NRA transfers appreciated real property to the foreign corporation. If the U.S. situs property is not subject to the FIRPTA rules, however, the property may be transferred income tax and gift and estate tax free to a wholly owned foreign corporation for consideration (i.e. shares of stock of the corporation)

e. Hold USRPI through a U.S. corporation owned by a foreign corporation. Such interest avoids estate and gift tax and subjects effectively connected income to corporate income tax rate.

5. A NRA who plans to emigrate to the U.S. can minimize the effect of U.S. taxes by advance planning. *See infra*, Section V.H.

V. PLANNING FOR NRA'S WITH U.S. BENEFICIARIES

A. Lifetime gift

1. Since a NRA is not subject to United States gift tax on assets which are not situated in the United States, the NRA can gift any amount of assets to a United States person totally gift tax free[3]; moreover, since a United States generation-skipping transfer tax is imposed on the transfer of property by a NRA only where the transfer would be subject to United States estate or gift tax, there is effectively no limitation on the generation-skipping transfers of a NRA and a NRA can create a perpetual trust of any amount which, if properly structured should be forever free of United States estate, gift and generation-skipping transfer tax (although not United States income tax).

2. If the trust is established inter-vivos, the trust should be structured as a foreign grantor trust during the NRA's lifetime so as to allow the trust to grow income tax free during that period (except for U.S. source income). When the NRA dies, however, consideration should be given to domesticating the trust in order to avoid the accumulation distribution penalty applicable to foreign non-grantor trusts.

(1) Domestication of the trust is most likely preferable to requiring that all of the net income be paid to the United States beneficiaries on a current basis; although both situations subject all of the net income to a current United States income tax (albeit at a higher effective tax rate if retained in a domesticated trust), accumulated distributions in the hands of the Untied States beneficiaries will most likely ultimately be subject to United States transfer tax, whereas assets retained in trust should not.

[3] This assumes that the NRA was not a "covered expatriate" from whom gifts or bequests would be subject to a tax on the donee/recipient when received. IRC §2801.

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(2) Even a domesticated trust can avoid United States income tax, by investing in assets which are not subject to United States income tax, although there may be some cost to doing so in terms of the return on those assets; an increasing popular choice in this regard, however, is variable life insurance.

3. Consider, however, whether the United States beneficiaries will ever need to receive anything from the foreign non-grantor trust in excess of the then current year's net income. If the answer is in the negative, then it may be preferable to maintain the trust as a foreign trust even after the non-resident alien grantor dies so that accumulated undistributed income can avoid taxation and allow the corpus to grow more rapidly, which in turn will increase the then current year's income of future years.

4. It may also be preferable to maintain the trust as a foreign trust if there is a likelihood that the United States beneficiaries may expatriate in the future.

B. Use of foreign trusts - general

1. Residence of Trust - IRC § 7701(a)(31)(B) defines a foreign trust as a trust which is not a U.S. person. IRC § 7701(a)(30)(E) defines a trust as a U.S. person if it meets *both* of the following requirements:

a. A court within the U.S. is able to exercise primary supervision over the administration of the trust (the "court test"), and

b. One or more U.S. persons have authority to control all substantial decisions of the trust (the "control test").

2. Thus, a foreign trust is a trust that fails to meet one of these requirements unless it qualifies for one of the grandfathering provisions in Reg. § 301.7701-7.

3. Court test – Under Reg. § 301.7701-7(c)(1) a trust will fall within a safe harbor if the following three conditions are met:

a. the trust instrument does not direct that the trust be administered outside the United States;

b. the trust is actually administered exclusively within the United States; and

c. the trust does not have an automatic migration or "flee" clause. The trust will not be considered to have an automatic migration clause if the trust instrument provides that the trust will migrate from the U.S. only in the case of foreign invasion or widespread confiscation or nationalization of property.

4. If the trust cannot come within the safe harbor, it may still qualify as a domestic trust if it can show that a U.S. court is able to exercise primary supervision over the administration of the trust.

a. "Primary supervision" means a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. "Primary supervision," and thus the court test, is not defeated by the fact that another court has jurisdiction over a trustee, a beneficiary, or any trust property, or that both a U.S. and foreign court are able to exercise primary supervision over the administration of the trust.

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b. "Administration" means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets, defending suits by creditors, and determining the amount and timing of distributions.

5. Control test - requires that one or more U.S. persons have the authority to control *all* substantial decisions of the trust. For this purpose, "U.S. person" has the same meaning as defined in § 7701(a)(30) and includes a U.S. citizen, a U.S. resident or a domestic corporation.

a. "Substantial decisions" are those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law, and that are not ministerial. Substantial decisions include, but are not limited to, decisions with respect to: (1) whether and when to distribute income or corpus; (2) the amount of any distribution; (3) the selection of beneficiaries; (4) whether a receipt is allocable to principal or income; (5) whether to terminate the trust; (6) whether to compromise, arbitrate or abandon claims of the trust; (7) whether to sue on behalf of the trust or to defend suits against the trust; (8) whether to remove, add or replace a trustee; (9) decisions regarding the appointment of successor trustees, unless the power to appoint trustees is limited so that its exercise would not have the effect of changing the residence of the trust from domestic to foreign, or vice versa; and (10) investment decisions.

b. With regard to investment decisions, if a U.S. trustee hires the services of an investment advisor for the trust, investment decisions made by that person will be considered substantial decisions controlled by the U.S. person, and thus the trust will be treated as a U.S. trust as long as the U.S. trustee retains the power to terminate the investment advisor's employment at will.

c. "Control" is defined as having the power, by vote or otherwise, to make all substantial decisions of the trust, with no other person having a power to veto any of those substantial decisions. To determine whether a U.S. person has control, it is necessary to consider all persons who have authority to make a substantial decision, not just the trustees.

(1) If there are three or more trustees, the majority of which are U.S. persons, but at least one of which is foreign, then if the trust provides that substantial decisions must be made by unanimous vote, the control test cannot be met. Alternatively, if the trust provides that the foreign trustee is to make all the investment decisions, for example, but the remaining majority coalition of U.S. trustees have only a veto power with respect to such decisions and cannot make any such decisions on their own, then the control test is not satisfied. In each case, U.S. persons do not control all substantial decisions of the trust.

d. A U.S. person will not be considered to control all substantial decisions of the trust if an attempt by any government agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by the U.S. person.

e. If a change in trustees should inadvertently cause the trust to fail the control test, the trust will have a 12-month grace period in which to make the necessary changes to avoid a change in the trust's residence. An example would be the change of residence of a U.S. trustee or the replacement of a U.S. trustee by a foreign trustee. The district director may grant an extension of time to take the necessary actions if they cannot be reasonably completed within the 12-month period.

6. For purposes of this discussion there are effectively three types of foreign trusts:

a. A foreign grantor trust with a United States person as grantor;

b. A foreign non-grantor trust; and

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c. A foreign grantor trust with a non-resident alien grantor.

C. Foreign grantor trust

1. A foreign grantor trust which has a United States person as grantor will be subject to United States income taxation in exactly the same manner as a domestic grantor trust (since in each case, pursuant to the so-called "grantor trust rules" of IRC §§ 671-679, the trust will not be taxed as an entity distinct from the grantor).

D. Foreign non-grantor trust

1. A foreign non-grantor trust, will not be subject to United States income tax except on its United States source income, if any. However, any distributions to a United States beneficiary will carry out distributable net income which will be taxable income to the United States beneficiary. Moreover, to the extent that a distribution from a foreign trust to a United States beneficiary represents the accumulated income of prior years, an interest charge at market rates, compounded daily, is imposed on the accumulated income pursuant to a FIFO regime in order to counter what would otherwise be an effective deferral of United States income tax on the accumulated income.

a. Accumulated income is taxed to the beneficiary at the bracket which applied to the beneficiary in the year in which the income was earned, rather than at the bracket which applies in the year the income is distributed (the "throwback rules").

b. Unlike domestic trusts, a foreign trust includes realized capital gains in distributable net income.

c. If the capital gain is not distributed currently, but instead is accumulated and then distributed in a later year, it will be taxed to the beneficiary as ordinary income.

(1) ***EXAMPLE:*** Assume capital gain of $100,000 was realized in 2001, only current income is distributed until 2020 and a distribution in excess of current income in the amount of $100,000 is distributed in 2020.

Beneficiary tax rate = 39.6%
Tax on $100,000 = $39,600
Interest @ 8% (compounded) x 20 years = $184,573
Tax plus interest = $224,173 (but limited to amount distributed of $100,000)

d. It is difficult, if not impossible, to cleanse the accumulated income of a foreign non-grantor trust.

(1) A distribution by a foreign non-grantor trust to a foreign intermediary with a subsequent transfer to a United State person will be re-characterized as a direct transfer by the foreign non-grantor trust if, pursuant to Treas. Reg. § 1.643(h)-1, the transfers are pursuant to a plan one of the principal purposes of which was the avoidance of United States tax.

(2) A transfer will be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of United States tax if the United States person –

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(a) Is related to the grantor of the foreign trust, or has another relationship with the grantor of the foreign trust that serves as a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer to the United States person;

(b) Receives from the intermediary, within two years before or two years after the intermediary's receipt of property from the foreign trust, either the property which the intermediary received, proceeds from such property or property in substitution of such property; and

(c) Cannot demonstrate to the satisfaction of the Commissioner, among other things, that –

(i) the intermediary has a relationship with the United States person that establishes a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the United States person; and

(ii) the intermediary is not an agent of the United States person.

(3) Pursuant to IRC § 643(i), a loan of cash or marketable securities, directly or indirectly, by a foreign non-grantor trust to a United States beneficiary or a person that is related to a beneficiary will be re-characterized as a distribution, even if the loan is later repaid. An exception to this general rule was set forth under Notice 97-34 and Reg. § 1.679-4 for a "qualified obligation".

(a) An obligation is a qualified obligation only if:

(i) The obligation is reduced to writing by an express written agreement;

(ii) The term of the obligation does not exceed five years for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation);

(iii) All payments on the obligation are denominated in U.S. dollars;

(iv) The yield to maturity of the obligation is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under IRC § 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin);

(v) The U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. person's taxable year and is paid within such period); when properly executed and filed, such an agreement will be deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of IRC § 301.6501(c)-1(d); and

(vi) The U.S. transferor reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.

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(4) In 2010, the HEART ACT expanded § 643(i) to include, to the extent of distributable net income (DNI), the fair market value of the rental use of trust property.

2. By reason of IRC § 679 and IRC § 684, a United States person cannot obtain an income tax benefit by transferring property to a foreign trust.

a. To the extent that a United States person creates a foreign non-grantor trust and transfers appreciated assets thereto, IRC § 684(a) deems such transfer to be a sale or exchange of the property and, therefore, capital gain will have to be recognized.

b. In addition, IRC § 679 provides, in general, that where a United States person transfers property to a foreign trust, the United States person will be deemed to be the "owner" of the foreign trust for United States income tax purposes, irrespective of whether he has retained any power under IRC §§ 673 through 677, for any tax year in which the foreign trust has a United States beneficiary.

c. Alternatively, under §662(a), a pecuniary amount paid in not more than three installments is not subject to the throwback rules. See §662(a) and §663(a)(2). See Treas. Reg. §1.663(c)-1(c)(2) Ex. 1.[4]

> **Example**: Client establishes a foreign trust (FT) and transfers $3,000,000 thereto. FT provides for distributions of $1 million to a domestic GST exempt trust 25, 50 and 75 years after death.

E. Foreign grantor trust – foreign grantor

1. By far the most tax beneficial foreign trust is the foreign grantor trust with a non-resident alien as the grantor since (i) no United States income tax will be imposed except on United States source income, and (ii) a distribution to a United States beneficiary will neither carry out distributable net income to the United States beneficiary nor, be subject to an interest charge if it represents accumulated income from prior years.

2. Due to the tax benefit afforded by foreign grantor trusts with a non-resident alien grantor, more stringent grantor trust rules apply to non-resident aliens than apply to United States persons.

a. The general rule under IRC § 672(f)(1) is that a non-resident alien cannot be deemed the grantor of a grantor trust.

(1) An exception to the general rule applies if the grantor has the sole power to revest absolutely in himself the title to the trust property, or if he has such power with the consent of a related or subordinate party who is subservient to him (i.e., the trust is revocable). See IRC § 672(f)(2)(A)(i); or

(2) If the grantor and/or the grantor's spouse are the sole beneficiaries of the trust during the grantor's lifetime. See IRC § 672(f)(2)(A)(ii).

b. Note that the Grantor, upon receipt of trust property, could then gift the property to a United States person without any United States tax consequences.

c. If the NRA grantor becomes a U.S. resident within 5 years of the transfer he will be treated as a US grantor.

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[4] For an in-depth review of this technique see Kurlander, Glenn and Delgass, Michael "Pecuniary Dynastic Offshore Trusts", Trusts and Estates, July 1999.

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F. Estate taxation

1. The grantor of a foreign trust will be subject to United States estate taxation on the trust's assets only if the trust assets are determined to be includable in the foreign grantor's gross estate.

2. Pursuant to IRC § 2103, the gross estate of a NRA decedent is determined in the same manner as the gross estate of a resident decedent (i.e., IRC §§ 2036 and 2038 apply to determine whether the trust's assets are includable in the NRA decedent's gross estate).

a. Note, therefore, that U.S. situs assets of a foreign grantor trust with a NRA grantor will almost always be includable in the NRA decedent's gross estate, since an NRA will not be deemed the grantor of a foreign grantor trust unless the trust is either revocable (and hence includable in his estate under IRC § 2038) or the grantor is a beneficiary thereof (and hence, most likely includable in his estate under IRC § 2036). However, it may be possible to establish a purely discretionary trust in a jurisdiction that recognizes self-settled spendthrift trusts (*i.e.*, Alaska) without causing estate inclusion.

G. Foreign grantor trust – U.S. grantor.

1. IRC § 679 provides, in general, that where a United States person transfers property to a foreign trust, the United States person will be deemed to be the "owner" of the foreign trust for United States income tax purposes, irrespective of whether he has retained any power under IRC §§ 673 through 677, for any tax year in which the foreign trust has a United States beneficiary.

a. It is important to note that IRC § 679 applies only for income tax purposes and not for purposes of the United States estate, gift and generation-skipping transfer taxes.

2. Prior to the enactment of IRC § 679, a United States person could establish a foreign non-grantor trust in a no-tax jurisdiction with the direction that it invest in assets that generate only foreign-source income. Since a foreign non-grantor trust is taxed in the same manner as a non-resident alien individual (i.e., only on United States source income), such a trust could accumulate income free of United States income tax.

3. A "U.S. transferor" is defined as any U.S. person who transfers property, whether directly, indirectly, or constructively, to a foreign trust. Reg. § 1.679-1(c)(1).

a. The term "U.S. person" may apply not only to individuals but also to entities. The Regulations also include as U.S. persons a nonresident alien individual who elects under IRC § 6013(g) to be treated as a resident of the United States, and an individual who is a dual resident taxpayer, within the meaning of Treas. Reg. § 301.7701(b)-7(a).

4. A foreign trust will be deemed to have a "U.S. beneficiary" for purposes of § 679 unless, during the taxable year at issue of the U.S. transferor, both prongs of the following two prong test are satisfied:

a. No part of the income or principal of the foreign trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and

b. If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.

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(1) A person with a contingent interest who is not named as a beneficiary and is not a member of a class of beneficiaries is not taken into consideration for purposes of determining whether a foreign trust has a U.S. Beneficiary if the U.S. transferor can demonstrate to the satisfaction of the Commissioner that the person's contingent interest is so remote as to be negligible.

(a) The foregoing does not apply, however, where a distribution to the U.S. person is within the exercise of discretion by the Trustee. Reg. § 1.679-2(a)(2)(ii); Reg. § 1.679-2(a)(2)(iii), Example 10.

(b) The foregoing also does not apply where a person can appoint the property to a U.S. person even where a U.S. person is not originally named as a beneficiary. Reg. § 1.679-2(a)(2)(iii), Example 11.

(2) If a foreign trust provides that no income or principal are distributable to a U.S. person, but can be used to satisfy a U.S. person's legal obligation to a third party by making a payment directly to the third party, the foreign trust will be considered as providing a constructive benefit to a U.S. person. Reg. § 1.679-2(a)(2)(iii), Example 6.

(3) The determination as to whether a foreign trust has a U.S. beneficiary is made annually. Reg. § 1.679-2(a)(1).

(4) The determination as to whether income or principal may be paid or accumulated to or for the benefit of a U.S. person is also made under the following miscellaneous rules:

(a) It is irrelevant whether any income or principal is actually distributed to a U.S. person. Reg. § 1.679-2(a)(2)(i).

(b) It is irrelevant whether a U.S. person's interest in the foreign trust is merely a contingent interest. Reg. § 1.679-2(a)(2)(i).

(c) A class of beneficiaries does not include heirs who can only benefit from the foreign trust pursuant to the laws of intestate distribution. Reg. § 1.679-2(a)(2)(ii).

(5) The fact that a non-U.S. person that is a beneficiary of the foreign trust may become a U.S. person will not cause the foreign trust to be deemed as having a U.S. beneficiary until the tax year of the U.S. transferor in which the foreign person actually becomes a U.S. person. Reg. § 1.679-2(a)(3).

(a) Notwithstanding the foregoing, however, if the non-U.S. person becomes a U.S. person more than five years after the date of the transfer to the foreign trust by a U.S. transferor, the trust will not be deemed as having a U.S. beneficiary even after the non-U.S. person becomes a U.S. person. Reg. § 1.679-2(a)(3).

(6) Even where a foreign trust is not treated as having a U.S. beneficiary pursuant to the terms of the trust agreement, pursuant to Reg. § 1.679-2(a)(4)(i), the foreign trust will nevertheless be treated as having a U.S. beneficiary if it has a U.S. beneficiary based upon any of the following:

(a) A written or oral agreement or understanding relating to the trust.

(b) A memorandum or letter of wishes.

(c) Any other document that relates to the trust whether or not of any purported legal effect.

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(7) Similarly, pursuant to Reg. § 1.679-2(a)(4)(ii), a foreign trust can be treated as having a U.S. beneficiary if:

(a) The terms of the foreign trust could be amended to benefit a U.S. person; or

(b) The law applicable to the foreign trust may require payments or accumulations of income or principal to or for the benefit of a U.S. person (for example, by judicial reformation), unless the U.S. transferor demonstrates to the satisfaction of the Commissioner that the law is not reasonably expected to be applied or invoked under the facts and circumstances.

(c) If the parties to the foreign trust ignore the terms of the trust agreement, or if it is reasonably expected that they will do so.

(8) Pursuant to Reg. § 1.679-2(b), a foreign trust will be deemed as having a U.S. beneficiary if the income or principal of the foreign trust is payable to or accumulated for the benefit of:

(a) A controlled foreign corporation.

(b) A foreign partnership, if a U.S. person is a partner of such partnership.

(c) A foreign trust or estate, if such trust or estate has a U.S. beneficiary.

(d) An intermediary, such as an agent or nominee, or any other means whereby a U.S. person may obtain an actual or constructive benefit.

(1) As noted, a transfer by a U.S. transferor to a foreign trust for purposes of IRC § 679 includes any direct, indirect or constructive transfer of property. Reg. § 1.679-3(a).

(9) Direct transfers

(a) A transfer from a grantor trust to a foreign trust is treated as a transfer by the grantor to the foreign trust. Reg. § 1.679-3(b).

(10) Indirect transfers

(a) If a U.S. transferor transfers property to an intermediary who then transfers the property to a foreign trust, the U.S. transferor will be deemed as having transferred the property to the foreign trust if one of the principal purposes of the transfers was the avoidance of United States tax. Reg. § 1.679-3(c)(1).

(b) Pursuant to Reg. § 1.679-3(c)(2) a principal purpose of avoiding United States tax will be deemed to exist where:

(i) The U.S. person is related to a beneficiary of the foreign trust, or has another relationship with a beneficiary of the foreign trust that serves as a reasonable basis for the U.S. person to have transferred property to the foreign trust; or

(ii) The U.S. person cannot demonstrate to the satisfaction of the Commissioner that:

(iii) The intermediary has a relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the intermediary would make a transfer to the foreign trust;

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(iv) The intermediary's actions were independent of the U.S. person;

(v) The intermediary is not an agent of the U.S. person under generally applicable United States agency principles; and

(vi) The intermediary timely complied with the reporting requirements of IRC § 6048, if applicable.

(c) A U.S. transferor will be treated as related to a U.S. beneficiary of a foreign trust if the U.S. transferor and the beneficiary are related for purposes of IRC § 643(i)(2)(B) (which is turn references IRC § 267 and IRC § 707(b)), with certain modifications extending the scope of that section. Reg. § 1.679-3(c)(4).

(d) If it is determined that a U.S. person transferred property to a foreign trust through an intermediary, the intermediary is generally treated as an agent of the U.S. transferor and, consequently, the transfer is deemed as having been made only when the property is transferred by the intermediary to the foreign trust. Reg. § 1.679-3(c)(3)(i).

(e) In contrast, a special determination by the commissioner, or a special showing by the taxpayer, is required to treat the intermediary as an agent of the foreign trust (which would have the effect of treating the transfer as having been made upon receipt of the property by the intermediary. Reg. § 1.679-3(c)(3)(ii).

(11) Constructive transfers

(a) A constructive transfer includes any assumption or satisfaction of a foreign trust's obligation to a third party. Reg. § 1.679-3(d).

(b) If a U.S. person that is a related person with respect to a foreign trust guarantees an obligation of the foreign trust, the guarantee is deemed to be a transfer falling under IRC § 679. Reg. § 1.679-3(e).

(c) If a U.S. person is a related person with respect to a foreign trust, a transfer by the U.S. person to an entity which is owned in whole or in part by a foreign trust is deemed to be a transfer by the U.S. person to the foreign trust unless the U.S. person can demonstrate to the satisfaction of the Commissioner that the transfer is properly attributable to an ownership interest in the entity by the U.S. person. Reg. § 1.679-3(f).

5. Exceptions to the general rule

a. Reg. § 1.679-4(a) enumerates four exceptions to the general rule that a U.S. transferor of property to a foreign trust will be treated as the owner of the portion of the trust attributable to his transfer if there is a U.S. beneficiary of any portion of the trust. Those exceptions are as follows:

(1) A transfer to a foreign trust by reason of the death of the U.S. transferor.

(2) A transfer to various tax exempt foreign trusts described in IRC § 402(b) (addressing the taxability of employees' nonexempt trusts), IRC § 404(a)(4) (addressing stock bonus, pension and profit-sharing trusts organized outside the United States), or IRC § 404A (addressing foreign deferred compensation plan trusts).

(3) A transfer to a foreign trust that has received a ruling or a determination letter (which has neither been revoked nor modified) whereby the Internal Revenue Service has recognized the foreign trust's tax exempt status under IRC § 501(c)(3).

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(4) A transfer to a foreign trust to the extent that it is for fair market value.

(a) A transfer is for fair market value only to the extent of property received from the trust, services rendered by the trust or the right to use property of the trust. Reg.1.679-4(b)(1)

(b) An interest in the trust is not property received from the trust for this purpose. Reg.1.679-4(b)(1).

b. Pursuant to Reg. § 1.679-4(c), in determining whether fair market value is received upon a transfer by a U.S. person to a foreign trust, certain obligations are not taken into account. Pursuant to Reg. § 1.679-4(d) "qualified obligations" are obligations which meet the following criteria:

(1) The obligation is pursuant to an express written agreement;

(2) The term of the obligation does not exceed five years;

(a) As a consequence, an obligation which is payable "on demand" necessarily cannot be a "qualified obligation." Reg. § 1.679-4(d)(7), Example 1.

(b) If, while the obligation remains outstanding, a new obligation is, directly or indirectly, issued to the U.S. transferor by the foreign trust, the original obligation will be deemed to have the maturity date of the subsequent obligation. Reg. § 1.679-4(d)(2).

(3) All payments on the obligation must be denominated in U.S. dollars;

(4) The yield to maturity may not be less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal Rate;

(5) The U.S. transferor must extend the period for assessment of any income or transfer tax attributable to the transfer to a date not earlier than three years after the maturity date of the obligation (unless the maturity date does not extend beyond the current year); and

(6) The U.S. transferor reports the loan, including principal and income payments, on Form 3520 for every year that it is outstanding.

H. <u>Pre-immigration trusts</u>

1. If a non-resident alien transfers property to a foreign trust, and the non-resident alien then becomes a U.S. person within five years of the transfer, the transfer will be deemed as having been made on the date on which the non-resident alien became a U.S. person. Reg. § 1.679-5(a).

2. For this purpose, if a non-resident alien is treated as the grantor of a foreign trust under the grantor trust rules, and subsequently ceases to be so treated, the non-resident alien will be deemed to have transferred the property to the foreign trust on the date that the non-resident alien ceases to be treated as the grantor of the foreign trust. Reg. § 1.679-5(b).

I. <u>Outbound migration of domestic trusts</u>

1. If a U.S. person transfers property to a domestic trust and that trust subsequently becomes a foreign trust during such person's lifetime, such person will be treated as a U.S. transferor and is deemed to have transferred the property to the trust on the date that the domestic trust becomes a foreign trust. Reg. § 1.679-6.

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J. Transfers to foreign trusts

1. Prior to the Taxpayer Relief Act of 1997, an excise tax equal to thirty five (35%) percent of unrecognized gain was imposed on the transfer of property by a United States person to, *inter alia*, a foreign trust. See §§ 1491 through 1494 (repealed).

2. The Taxpayer Relief Act repealed the excise tax of IRC § 1491 and substituted in its place §684 which imposes a capital gains tax upon such transfers.

3. The general rule of IRC § 684 and the Regulations thereunder is one of immediate gain recognition upon the transfer of appreciated property by a United States person to a foreign trust. Reg. § 1.684-1(a)(1).

a. Reg. § 1.684-1(a)(1) also provides that the amount of gain recognized is determined on an asset-by-asset basis; presumably to foreclose the possibility of the United States person who is transferring property to a foreign trust from negating the effect of the statute by offsetting unrecognized gain in some assets against unrecognized losses in other assets.

b. Similarly, Reg. § 1.684-1(a)(2) prevents a United States person from recognizing loss on the transfer of depreciated property to a foreign trust.

c. Like Reg. § 1.684-1(a)(1), Reg. § 1.684-1(a)(2) also provides that "…a U.S. person may not offset gain realized on the transfer of an appreciated asset to a foreign trust or foreign estate by a loss realized on the transfer of a depreciated asset to the foreign trust or foreign estate."

4. The fact that the United States person transferring property to the foreign trust might otherwise have been able to defer the recognition of gain (for example, via an installment sale of the property to the foreign trust) does not defeat the rule of IRC § 684 requiring the immediate recognition of gain. See, e.g., Reg. § 1.684-1(d), Examples 4 and 5.

5. The rule of IRC § 684 requiring the immediate recognition of gain applies regardless of whether the transfer by a United States person to a foreign trust is direct, indirect or constructive. Reg. § 1.684-2(a).

a. Reg. § 1.679-3(c), discussed *supra*, applies to determine if a transfer to a foreign trust or foreign estate, by any person, is treated as an indirect transfer by a United States person to the foreign trust.

(1) Examples of Indirect Transfers under Reg. § 1.684-2(b)(2):

(a) A United States person creates and funds a foreign trust. In a subsequent year, and pursuant to a plan the principal purpose of which is to avoid the application of IRC § 684, the United States person transfers to his brother, a non-resident alien of the United States, additional property which the brother then transfers to the foreign trust. Pursuant to Reg. § 1.684-2(b)(2), Example 1, the United States person is treated as having transferred the property to the foreign trust.

(b) A United States person creates and funds a foreign trust. In a subsequent year the United States person transfers to his brother, a non-resident alien of the United States, additional property. Three years later, the brother transfers the property to the foreign trust and the United States person is unable to demonstrate to the satisfaction of the Commissioner pursuant to Reg. § 1.679-3(c)(2)(ii) that the brother acted independently of the United States person in effecting the subsequent transfer to the foreign trust. Pursuant to Reg. § 1.684-2(b)(2), Example 2, the United States person is treated as having transferred the property to the foreign trust.

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b. Whether a constructive transfer has occurred is determined pursuant to Reg. § 1.679-3(d), discussed *supra*. Reg. § 1.684-2(c).

c. Where property is transferred from a trust deemed owned by a United States person to a foreign trust, the transfer is treated as if it had been made from the owner of that trust to the foreign trust. Reg. § 1.684-(2)(d).

d. A similar rule applies where the trust which was deemed owned by a United States person is no longer deemed as though owned by a United States person. Reg. § 1.684-1(2)(e).

(1) A trust might fail to continue to be deemed as though owned by a United States person by reason of the death of the last United States beneficiary.

(2) In the alternative, a trust might fail to continue to be deemed as though owned by a United States person by reason of the death of the grantor of the trust who was a United States person.

(a) Note, however, the possible application of Reg. § 1.684-3(c), *infra*.

(3) A transfer of property by a United States person to an entity owned by a foreign trust is the equivalent of a transfer of property by a United States person to a foreign trust for purposes of IRC § 684. Reg. § 1.684-2(f).

(4) If a United States person transfers property to a domestic trust which subsequently becomes a foreign trust, the trust is treated as having transferred all of its assets to a foreign trust and is required to recognize gain on the transfer pursuant to Reg. § 1.684-1(a). Reg. § 1.684-4(a).

(a) The transfer is deemed as having occurred on the date that the trust becomes a foreign trust, but immediately before that occurrence. Reg. § 1.684-4(b).

(b) A domestic trust which is inadvertently converted to a foreign trust within the meaning of Treas. Reg. § 301.7701(d)(2) may avoid the recognition of gain by complying with the procedures set forth under Treas. Reg. § 301.7701-7(d)(2) necessary to remain a domestic trust.

6. Notwithstanding the foregoing, however, the Regulations provide four important exceptions to the general rule of immediate gain recognition. Those exceptions are as follows:

a. A transfer to a foreign trust which is a grantor trust pursuant to IRC § 671. Reg. § 1.684-3(a).

b. A transfer to a foreign trust which has received an exemption ruling under IRC 501(c)(3). Reg. § 1.684-3(b).

c. A transfer by a United States person to a foreign trust by reason of the death of the United States person if the property is included in the United States person's gross estate for United States federal estate tax purposes and the basis of the property in the hands of the foreign trust is stepped-up pursuant to IRC § 1014(a). Reg. § 1.684-3(c).

(1) This provision is significant, notwithstanding the fact that it seems obvious that property with a stepped-up basis cannot be the source of a capital gain. This is because IRC § 684(c) provides that a trust which is not originally a foreign trust, but which later becomes a foreign trust, is considered as having transferred all of its assets to a foreign trust *immediately* before the trust became a foreign trust. Where it is the death of the United States person that triggers the transfer of

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property to a foreign trust (most often pursuant to IRC § 684(b)), a deemed transfer of property immediately before the trust became a foreign trust would, absent Reg. § 1.684-3(c), otherwise seem to preclude application of IRC § 1014(a).

d. A transfer to an unrelated foreign trust in exchange for the property's fair market value. Reg. § 1.684-3(d).

(1) For this purpose, fair market value is defined under Treas. Reg. § 1.671-2(e)(2)(ii).

e. A distribution to a foreign trust by an non-trust entity which is owned, in whole or in part, by the foreign trust. Reg. § 1.684-3(e).

7. If a domestic trust becomes a foreign trust during the U.S. grantor's life the trust will continue to be a grantor trust under IRC §679. If, however, the trust becomes a foreign trust upon the death of the U.S. grantor or if it has no U.S. beneficiaries and is not treated as owned by another person within the meaning of IRC §671, the trust will be treated as having transferred its assets to a foreign trust under IRC §684(c) and such transfer shall be treated as a sale of its assets for an amount equal to their fair market value.

a. Note that under EGGTRA, IRC §684 was amended to provide that transfers made after December 31, 2009 by U.S. persons to nonresident aliens (excluding lifetime transfers) will also be treated as a sale.

b. Regs. §1.684-1(a)(2) prohibits the recognition of losses and does not permit an offset against any gain realized.

c. An exception is provided under Reg. §1.684-3 (c) for transfers by reason of death of the U.S. grantor if such property is included in the gross estate of the transferor and the basis is determined under §1014(a).

VI. USE OF DOMESTIC-SITUS TRUSTS FOR NON-U.S. BENEFICIARIES.

A. Non-tax reasons

1. The grantor and/or the non-US beneficiaries may be domiciled in civil law jurisdictions, thereby precluding the establishment of a trust under the law of such familiar jurisdictions.

2. The United States likely provides a more stable political and economic environment for the trust.

3. The law of trusts in the States is well established and contains modern concepts such as Prudent Investor standards and Unitrust provisions.

4. A number of States within the United States permit a trust to continue in perpetuity.

5. All States within the United States recognize spendthrift trust protections vis-à-vis a beneficiary's creditors (and most without any significant limitations whatsoever); a small minority of States even extend spendthrift trust protections to the settlor of the trust.

6. A United States corporate trustee or investment manager may provide greater sophistication, lower fees, and greater economies of scale than tax haven institutions.

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7. If the trust is a grantor trust with a NRA grantor, or if the trust has chosen investments situated in the United States, the fact that the trust is a domestic trust does not result in any greater exposure to United States income or estate tax than if the trust were a foreign-situs trust (at least while the NRA grantor is alive) provided it is a foreign trust pursuant to IRC § 7701(a)(31). It is fairly easy to structure the trust to be a foreign trust by giving a non-U.S. person the power to make one or more "substantial decisions." This can be accomplished by designating a foreign trust protector.

8. The United States is not on the OECD "Blacklist" and the trust would not raise tax haven suspicions.

VII. REPORTING REQUIREMENTS.

A. Beneficiaries of foreign trusts and U.S. recipients of foreign gifts

1. Under § 6039F, foreign gifts received by a U.S. person which in the aggregate exceed $10,000 (indexed) for the taxable year are to be reported by the recipient to the IRS on Form 3520. For this purpose, "foreign gift" means any amount received from a non-U.S. person which the recipient treats as a gift or bequest. If a gift is not reported on Form 3520, the tax consequences of the receipt of the gift shall be determined by the IRS. In addition, the recipient is subject to a penalty equal to 5% of the value of the gift for each month in which the gift is not reported (not to exceed 25%). However, a foreign gift does not include any distribution to which § 6048(c) applies. Under § 6048(c), a U.S. person who receives a distribution, directly or indirectly, from a foreign trust is required to report on Form 3520 the name of the trust, the aggregate amount of distributions received during the taxable year, and such other information as the Secretary may prescribe. If the U.S. beneficiary fails to report the distribution, he or she will be subject to a 35% penalty on the gross amount of the distribution.

2. Notice 97-34 provides guidance on the application and interaction of IRC § 6039F and IRC § 6048(c). Under both sections, the gift or distribution is required to be reported if it is either actually or constructively received. Also, if a beneficiary receives a payment from a foreign trust in exchange for property transferred or services rendered to the trust, and the fair market value of the payment received exceeds the fair market value of property exchanged or services rendered, the excess will be deemed a distribution that must be reported under § 6048(c). Finally, reporting is required under both sections only if the U.S. person knows or has reason to know that the trust is a foreign trust or that the donor is a foreign donor.

3. As to the interaction of §§ 6039F and 6048(c), the recipient of a distribution from a foreign trust will likely have to report solely under §6048(c). Notice 97-34 states that if a foreign trust makes a distribution to a U.S. beneficiary, the beneficiary should report the amount as a distribution from the trust under § 6048(c), rather than as a gift under § 6039F. Finally if the gifts are received from a foreign individual (and not a trust or entity) the disclosure of required information reporting threshold is increased to $100,000 in aggregate gifts.

4. Penalties for Failure to Provide Information - Substantial penalties under §§ 6677 and 6039F(c) apply if information required by §6048 or §6039F is not reported or is reported inaccurately. Generally, the penalty depends on the "gross value" or "gross amount" of the property involved.

5. Penalties under §§ 6677(a) and 6039F will not be imposed if the failure to file was due to reasonable cause and not willful neglect. A taxpayer will not have reasonable cause merely because a foreign country would impose a civil or criminal penalty on the trustee (or other person) for disclosing the required information. Also, under Notice 97-34, refusal on the part of a foreign trustee to

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provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure will not be considered reasonable cause.

B. Statement of specified foreign financial assets

1. Form 8938 is required to be filed by US individuals, beginning in years ending in 2011 (and certain other taxpayers for later years).

2. Form 8938 is due with the individual's income tax return and has a minimum filing threshold of $50,000 of aggregate value of foreign financial assets, which amount varies depending on the individual's marital status and residence.

3. Specified foreign financial assets includes stocks in foreign entities, other securities and financial instruments issued by non-U.S. person, and interests in foreign trusts or estates if the U.S. person knows (or has reason to know) of the existence of the interest.

4. Information required to be reported includes the date of acquisition, sale, amount of income, deductions and credits and a listing of which returns such amounts were reported.

5. The scope of assets required to be reported is broader than those required under the FBAR rules, which, for example, do not require reporting foreign mutual funds, hedge funds or other private equity funds.

C. U.S. grantors of foreign trusts

1. Foreign Trust Reporting - Once a trust is deemed to be a foreign trust additional forms must be filed. These include Department of the Treasury Form TDF 90-22.1 and IRS Forms 56, 3520, 3520-A and Customs Form 4970. Reporting requirements for years ending after August 20, 1996 are imposed on the grantor and U.S. beneficiaries receiving distributions therefrom. The information required to be reported must generally include: (1) the amount of money or other property (if any) transferred to the trust and (2) the identity of the trust and of each trustee and beneficiary. Any person who fails to comply with the reporting requirement with respect to a transfer occurring after August 20, 1996, will be subject to a 35 percent penalty of the gross value of the property transferred.

a. Notice 97-34 explains the types of gratuitous transfers to foreign trusts that must be reported on Form 3520, the treatment of certain trust obligations as transfers, the interaction of the reporting requirements under § 6048 and former § 1491, and the exemption from reporting for transfers involving deferred compensation and charitable trusts. A gratuitous transfer is any transfer other than: (1) a transfer for fair market value or (2) a corporate or partnership distribution. However, a transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is a gift for gift tax purposes. Thus, incomplete gifts will also be required to be reported.

b. Form 3520 is to be filed by the U.S. grantor of a foreign trust on an annual basis to report any transfers to the trust that occurred during the taxable year. After having made a transfer, the grantor must continue to file Form 3520 every year, even for those years when no transfer is made. The form is due on the same date as the taxpayer's personal income tax return, including any extensions, and should be attached to such income tax return. A copy of the Form 3520 must also be filed with the Philadelphia Service Center.

(1) If a husband and wife both have made transfers to the same foreign trust, they may file a joint Form 3520 provided that they also file a joint income tax return.

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c. Each U.S. person treated as an owner of a foreign trust under the grantor trust rules is responsible for ensuring that the foreign trust: (1) files an annual return on Form 3520-A setting forth a full and complete accounting of all trust activities and operations for the year, the name of the U.S. agent for the trust, and other relevant information; and (2) furnish such information as the Secretary may prescribe to each U.S. owner and U.S. beneficiary of the trust. If the trust does not furnish this information, the U.S. owner is subject to a penalty equal to 5 percent of the gross value of the portion of the trust's assets treated as owned by that person.

(1) Form 3520-A requires, among other things, the trust to send a "Foreign Grantor Trust Ownership Statement" to each U.S. owner and a "Foreign Grantor Trust Beneficiary Statement" to each U.S. beneficiary who received a distribution from the trust during the taxable year. These statements form part of the "Foreign Grantor Trust Information Statement," which must be attached to Form 3520-A.

(2) Form 3520-A must be filed with the Philadelphia Service Center by the 15th day of the third month following the end of the trust's taxable year. Copies of the owner and beneficiary statements must be furnished to the U.S. owners and beneficiaries by the same date. An extension of time to file Form 3520-A and the statements may be requested on Form 2758.

2. Appointment of U.S. Agent - The owner of a foreign grantor trust must ensure that the trust makes a return stating the name of the U.S. agent for the trust for purposes of applying §§ 7602, 7603, and 7604 with respect to a request by the IRS to examine records or produce testimony, or issue a summons for such records or testimony. Any U.S. citizen, resident alien, or domestic corporation (including a U.S. grantor or U.S. beneficiary of a foreign trust) may act as the U.S. agent of the trust In general, failure to have an information agent appointed generally gives the IRS wide discretion to estimate the trust's income and send the grantor a corresponding tax bill.

VIII. PRE-IMMIGRATION PLANNING.

A. Planning to minimize U.S. taxes

1. Where a NRA settles a foreign trust, IRC § 679(a)(4) provides that the settlor is treated as the owner for U.S. income tax purposes of any transfer (including undistributed income therefrom) made within 5 years of becoming a U.S. resident of trust has or may have U.S. beneficiaries.

a. If the transfer to the trust were made more than 5 years prior to establishing U.S. residency, the settlor would be taxed on trust income only if the trust was a grantor trust (under § 671-679).

2. Realize all gains on appreciated securities prior to establishing residency. Realization of losses should be deferred until after residency is established

3. Make gifts to NRA spouse before residency to avoid subsequent limitation of $100,000 (indexed) per year and QDOT requirements

4. Consider transfers to irrevocable trusts to remove from donor's estate

a. Grantor can remain discretionary beneficiary if assets are not subject to creditors of grantor under local law (e.g., Nevis, Cook Islands).

5. Consider offshore life insurance

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a. To obtain favorable tax benefits it must qualify as life insurance under IRC §7702 and comply with the diversification rules of §817 and investors control rules.[5]

(1) Must meet either the

(a) Cash value accumulation test; or

(b) Guideline premium limitation.

b. No income tax on cash value build up.

c. Can withdraw/borrow principal tax-free (except for Modified Endowment Contracts).

d. Allows for accumulation during U.S. residency period.

6. Convert foreign trust to U.S. trust or retain foreign status

a. Maintaining foreign trust status exposes trust to accumulation penalty and other tax consequences, including reporting requirements.

b. However, if client expects to leave the U.S. in the future, it may be advisable to retain foreign trust status and pay out current income while a U.S. resident or purchase life insurance to defer tax and accumulation charge.

IX. EU SUCCESSION REGULATION (NO. 650/2012)

A. Uniform approach to succession in EU

1. EU Regulation covers the transfer of property at death that would otherwise be subject to forced heirship or other succession laws.

2. EU Regulation comes into effect from August 17 2015 in all EU member states except UK, Ireland and Denmark.

3. The court of each member state in which decedent has his/her "habitual residence" at time of death has jurisdiction on succession as a whole (Article 4).

4. The law applicable to succession as a whole shall be the law of the state in which decedent had his/her habitual residence.

5. Decedent can have law of another jurisdiction apply provided he/she chooses the law of the state whose nationality he/she possesses at time of Will execution or at time of death (Article 22).

6. EU Regulation does not apply national laws regarding taxation, *inter vivos* gifts, trusts and matrimonial property regimes.

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[5] *See Webber v. Commisioner*, No. 14336-11 (U.S. Tax Court, June 30, 2015), where income of private placement life insurance was held taxable due to investor control.

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B. Habitual residence

1. Though not defined in the Regulations, the Preamble provides that all relevant facts be taken into account to determine the place in which the "close and stable" connection existed.

a. Center of interests, country of nationality or location of assets are all relevant in determining habitual residence.

b. Even if a U.S. citizen moves to the EU to work, if he maintains assets and social life in the U.S., his habitual residence can still be the U.S.

C. Effect on planning for U.S. citizens with assets in EU states

1. The courts where the U.S. citizen had a habitual residence has jurisdiction to rule on decedent's succession as a whole regardless of where his/her assets are located.

2. If the U.S. citizen does not want a court of the EU state to rule on matters regarding U.S. property, consider having separate Wills for property in the U.S. and for EU property.

3. An exception to the general rule of using the law of habitual residence authorizes a testator to select the law of his/her nationality to govern the succession as a whole (Article 22).

a. The choice must be made in a Will and if the testator selects U.S. law, that law will govern all property including EU assets.

b. Choice of law is limited to the testator's nationality at time of Will execution or at death.

c. Choice of law will also apply to validity of Will.

d. Exception to the foregoing applies (i) to immovable property or other assets in an EU state which is subject to special rules based on economic or family considerations (Article 30) and (2) "in rem" property rights under the law of a member state (Article 1.2).

4. Since Regulation refers to the law of one's nationality, it is unclear, in the case of a U.S. citizen, which law governs the disposition since the laws differ among the states.

a. Consider including a statement in the Will that selects the laws of a state in the U.S. to govern successions because the testator has closest connections thereto.

X. EXPATRIATIONS

A. Tax history

1. Prior to 2001, citizenship deemed relinquished for tax purposes effective when taxpayer voluntarily expatriated pursuant to the Immigration and Nationality Act.

2. In 2001, Congress enacted IRC§7701(n) providing that a person continues to be treated as a U.S. citizen until they notify the IRS of intent to relinquish citizenship.

3. In 2008, the HEART Act enacted an exit tax where a "covered expatriate" is deemed to have sold all property at fair market value on day prior to expatriation (IRC §877A). It also modified the date for which a citizen (or long term green card holder) is deemed to have relinquished his/her citizenship (§877A(g)(4).

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B. Covered expatriate

1. Code Section 877A defines a "covered expatriate" to mean any U.S. citizen who relinquishes U.S. citizenship or long term green card holder[6] who relinquishes their green card and who:

a. Has an average annual net U.S. income tax of $160,000[7] for the five years prior to expatriation; or

b. Has a net worth of $2,000,000 or more; or

c. Either (i) fails to certify that he/she has been in compliance with all U.S. tax laws for prior five years or (ii) fails to submit evidence of such compliance as U.S. Treasury may require.

C. Gifts and bequests from covered expatriates

1. IRC § 2801, enacted in 2008, imposes a tax on U.S. citizens or residents who receive certain gifts or bequests from certain covered expatriates.

2. The tax is imposed on the recipient at the highest estate and gift tax rates reduced by any gift or estate taxes paid to a foreign country.

3. The tax is imposed on worldwide assets even if accumulated after the donor's expatriations.

4. Any transfer otherwise subject to U.S. gift or estate tax is excluded as a covered gift.

5. Only one annual exclusion is available for a single donee per year.

6. Gifts to a U.S. citizen spouse qualify for the marital deduction.

7. Domestic trusts - Trust is treated as a U.S. citizen and subject to IRC § 2801 tax in the year the transfer is received.

8. Transfer to Foreign trusts - IRC § 2801 tax is deferred until the foreign trust actually makes a distribution attributable to such gift or buyout to a U.S. citizen or resident whether from income or corpus.

(a) To the extent the distribution from a foreign trust is included in the beneficiary's gross income, the beneficiary is allowed an income tax deduction for the IRC § 2801 taxes paid.

(b) A foreign trust may make an election, solely for purposes of IRC § 2801, to be treated as a domestic trust.

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[6] Green card holder after more than 7 years during the 15 years ending with the year of relinquishment.

[7] IRS §877(a)(2)A. This is indexed for inflation.

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9. Chapter 15 of the Code does not provide an additional tax on generation-skipping transfers. Thus gifts or bequests to U.S. persons who are more than one generation below the covered expatriates only incur one level of tax.

10. Chapter 15 of the Code imposes a tax on gifts or bequests from covered expatriates that are made to U.S. citizens or residents only. If a wealthy individual does not intend to makes gifts or leave inheritances to U.S. persons, then expatriating can result in substantial transfer tax savings.

a. If a covered expatriate intends to make gifts or leave inheritances to U.S. persons and non-U.S. persons, appropriate tax planning can minimize U.S. transfer taxes.

(1) U.S. sitused property could be left to U.S. citizens/residents, and non-U.S. sitused property could be left to non-U.S. citizens/residents.

(2) Prior to expatriation, the individual should consider using up full lifetime gifting amount to transfer assets to U.S. persons gift-tax free.

(a) Gift tax exemption is no longer available after expatriation.

(b) After expatriation, the covered expatriate can make unlimited gifts of non-U.S. property to non-U.S. persons.

D. <u>Tax basis considerations</u>

1. Income tax provisions of the Code do not provide for an income tax basis increase attributable to gift tax paid on the gift under Chapter 15.

2. Careful consideration must be given to assets selected to be gifted to U.S. persons, including the income tax implications to the covered expatriate and the donee.

(1) It may be advisable to gift high-basis property, or to sell low-basis property and gift the proceeds.

E. <u>Additional planning by covered expatriates</u>

1. Interplay of Chapters 11 and 12 with Chapter 15 must be carefully considered.

a. GRATs

(1) Pre-expatriation GRAT should be effective in avoiding the imposition of Chapter 15 tax on the recipient, even if the grantor expatriates during the GRAT term.

(2) Questions exist as to whether Chapter 15 tax applies to post-expatriation transfers to GRATs, and whether such GRATs are treated as domestic or foreign trusts.

F. <u>Regulations on covered gifts</u>

1. Proposed Regulations were issued on September 10, 2015 which provide the following significant items:

a. Form 708 will be released to report covered gifts/bequests. No gift tax payment will be due until a reasonable period after final regulations are issued.

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b. Non U.S. citizens are only subject to the tax if they are domiciled in the U.S. under the estate and gift tax rules.

c. Distributions from a foreign trust that did not elect domestic status to a US citizen spouse do not qualify for the marital deduction and thus are subject to tax.

d. The regulations define indirect transfers and when they are deemed gifts to U.S. persons.

e. The regulations describe the requirements for a foreign trust to elect domestic status.

f. There is no basis adjustment permitted for gift tax paid.

g. There remain many unanswered questions which will hopefully be addressed in the final regulations.

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