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ADVANCED INTERNATIONAL
ESTATE PLANNING

General Rules

- For U.S. Income Tax purposes, Non-Resident Alien (“NRA”) subject to tax on:
 - income derived from sources within U.S.; or
 - income effectively connected with conduct of trade or business within U.S.
- For estate, gift and generation-skipping transfer tax purposes, NRA subject to tax only on NRA’s assets situated in the U.S.

General Rules (Continued)

- NRA entitled to a unified credit of \$13,000, exempting \$60,000 from U.S. estate tax. A taxable estate of \$1 million is subject to more than \$300,000 estate tax.
- Unlimited marital deduction for property transferred to non-U.S. citizen spouse only if is transferred to a Qualified Domestic Trust (“QDOT”)
- NRA’s estate is entitled to deductions on a proportionate basis under § 2053 and § 2054

Qualified Domestic Trust

- To obtain marital deduction for transfers to non-US citizen spouses, a QDOT trust is required. IRC § 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 U.S.
- If property located outside the U.S. – particularly civil law jurisdictions - trust ownership may not be permitted.
- QDOT not permitted for lifetime gifts – Annual exclusion gifts permitted up to \$155,000 (indexed for 2019) to non-citizen spouses.

Residency for Income Tax Purposes

- Lawful permanent resident of the U.S. at any time during the calendar year (i.e., a “green card” holder);
- Present in the U.S. for 183 days or more during the current calendar year;
- Present in the U.S. for more than 31 days and less than 183 days during the current calendar year but meets the “substantial presence test”; or
- Makes an election to be treated as a resident alien

Substantial Presence Test Met if:

- The sum of the days present in the U.S. during current year plus 1/3 of the days present in the U.S. in the immediately preceding year plus 1/6 of the days present in the U.S. in the second immediately preceding year equals or exceeds 183 days (unless the individual is present for less than 183 days and has a closer connection to another country)
- Example: NRA spent the following days in U.S.
 - 2018 120 * 1 = 120
 - 2017 150 * 1/3 = 50
 - 2016 90 * 1/6 = 15
 - Total 185

Residency for Estate and Gift Tax Purposes

- Classification depends upon domicile
- Domicile means (i) having a physical presence and (ii) present intention to remain indefinitely
- Subjective Test
- Possible to be treated as resident of U.S. for purposes of income tax and not estate and gift tax

Income Derived from Sources within U.S. for Income Tax Purposes

- Dividends from domestic corporations
- Rental income from real property located in U.S.
- U.S. royalties
- Capital gain from the sale of real property located in the U.S.
- Salary for services performed within the U.S.
- Interest on debt obligations. Exception for (i) portfolio interest, and (ii) bank deposit interest (but not money market accounts)

Property Situated within U.S. for Estate Tax Purposes

- Real property
- Tangible personal property
- Shares of domestic corporations
- Debt obligations issued by the U.S. or a U.S. person unless income would be exempt portfolio interest
- Deposits with a branch in U.S. of a foreign corporation, if the branch is engaged in the commercial banking business
- But consider treaty override provisions.

Property Situated Outside U.S. for Estate Tax Purposes

- Real property located outside U.S.
- Tangible personal property located outside U.S.
- 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 (i) a U.S. person, nor (ii) U.S. government

Gift Tax Considerations

- Subject to gift tax on tangible personal property situated in U.S.
- Transfers of intangible personal property (i.e., stock in U.S. corporations) not subject to gift tax
- NRA entitled to annual present interest exclusion
- NRA entitled to unlimited marital deduction on gift to U.S. citizen spouses
- Gift splitting not available
- Joint tenancies in real property between spouses (after 7/13/88) not deemed a taxable gift
- Joint tenancies with respect to personal property is subject to gift tax

Planning Techniques for NRA's with U.S. Assets

- Minimize contacts with U.S. to avoid resident status
- Form foreign corporation to hold U.S. assets
 - Ensure that corporate formalities are followed
 - Consider home country tax consequences
 - But § 2036 may be applicable
- Favor assets not subject to U.S. income tax (bank deposit) versus assets subject to U.S. income tax (deposit with U.S. broker)

Planning Techniques for NRA's with U.S. Real Property

- Foreign grantor trust
- Foreign corporation
- U.S. corporation owned by a foreign corporation
- Foreign partnership or LLC

Planning Techniques for NRA's with U.S. Beneficiaries

- Outright gifts of non-U.S. assets to U.S. beneficiaries
 - But see § 2801 if donor/decedent was a covered expatriate.
- Foreign Grantor Trust
 - Trust income can grow tax free (except for U.S. source income) during NRA's life
 - Subject to accumulation distribution penalties after grantor's death

Use of 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 U.S.; and
 - Trust is administered exclusively within the U.S; and
 - Trust does not have an automatic migration clauseor
- 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

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 § 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
- Fair rental value of property taxable to beneficiary
- Applicability of “throwback rules”
- Difficult, if not impossible, to cleanse the accumulated income

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. Treas. Reg. § 301.7701-7(d)(2)(i).
- How to cure – replace the person who caused the change in status.

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. § 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.

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

Taxation of Foreign Grantor Trust with NRA as Grantor (Cont'd)

- 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

Recognition of Gain on Transfers to Foreign Trusts and § 684

- Immediate recognition of gain upon transfer of appreciated property by a U.S. person to a foreign trust
- Applies to direct, indirect and constructive transfers to a foreign trust

Recognition of Gain on Transfers to Foreign Trusts and § 684 (Cont'd)

- Exceptions:
 - A transfer to a foreign trust which is a grantor trust
 - A transfer to a foreign trust which is exempt under 501(c)(3)
 - A transfer to a foreign trust by reason of death of the U.S. person if property is includable in the transferor's estate
 - A transfer to a foreign trust in exchange for fair market value

Use of Domestic Situs Trusts for Non-U.S. Beneficiaries

- Advantages:
 - Grantor/Beneficiaries may be domiciled in civil law jurisdictions that do not recognize trusts
 - Stable political/economic environment
 - Well established trust law
 - Several states offer ability to continue in perpetuity
 - Creditor protection

Reporting Requirements – Form 3520

- Foreign gifts received by U.S. person which in aggregate exceed \$100,000 (or if from non-individual \$16,076 in 2018)
- U.S. person receiving a distribution from a foreign trust
- U.S. grantor must report transfers to trust
- Return due on same date as the taxpayer's personal income tax return
- 35% penalty for failure to report

Reporting Requirements – Form 3520-A

- U.S. person treated as owner of foreign trust must ensure that foreign trust files Form 3520-A annually
- Return due on March 15th
- Penalty equal to 5% of gross value of trust's assets

Gifts/Inheritances from Covered Expatriates

- IRC § 2801 provides for tax (equal to gift tax rate) to be paid by a US person on receipt of gift or inheritance from a covered expatriate after June 17, 2008.
- Proposed regulations issued September 2015 provide for reporting of such transfers by the donee/heir on new Form 708 (to be issued).
- 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.
- The tax is imposed on worldwide assets even if accumulated after the donor's expatriations.

Gifts/Inheritances from Covered Expatriates (cont'd)

- Any transfer otherwise subject to U.S. gift or estate tax is excluded as a covered gift.
- Only one annual exclusion is available for a single donee per year.
- Gifts to a U.S. citizen spouse qualify for the marital deduction.
- Domestic trusts – Trust is treated as a U.S. citizen and subject to IRC § 2801 tax in the year the transfer is received.
- 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.

Gifts/Inheritances from Covered Expatriates (cont'd)

- Transfers to Foreign trusts – IRC § 2801 tax is deferred until the foreign trust actually makes a distribution attributable to such gift to a U.S. citizen or resident whether from income or corpus.
 - 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.
 - A foreign trust may make an election, solely for purposes of IRC § 2801, to be treated as a domestic trust.

Gifts/Inheritances from Covered Expatriates (cont'd)

- 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.
 - U.S. situs property could be left to U.S. citizens/residents, and non-U.S. situs property could be left to non-U.S. citizens/residents.
 - Prior to expatriation, the individual should consider using up full lifetime gifting amount to transfer assets to U.S. persons gift-tax free.
 - Gift tax exemption is no longer available after expatriation.
 - After expatriation, the covered expatriate can make unlimited gifts of non-U.S. property to non-U.S. persons.

Gifts/Inheritances from Covered Expatriates (cont'd)

– Tax basis considerations

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

Pre-Immigration Planning

- Realize gains on appreciated securities prior to establishing residency
- Make gifts to NRA spouse before residency to avoid limitations
- Make gifts to third parties
- Liquidate or reorganize foreign corporations to avoid CFC or PFIC
- Consider transfers to irrevocable trust to remove from donor's estate
- Consider purchasing offshore life insurance

Property Law Considerations

- Marital property
- Community property
- Foreign marital agreements
- Civil law versus common law
- Choice of law
- Situs of property
- Impact of applicable treaty
- Foreign “trust constructs” (stiftung, anstalt, usufruct, etc.)
- Planning for disposition of foreign property

Succession Law Considerations

- Domicile
- Application of treaties
- Intestate succession
- Forced heirship
- Use of multiple wills
- To use or not to use a trust?
- Know when to involve foreign counsel

EU Regulation

- Uniform approach to succession in EU
 - covers the transfer of property at death that would otherwise be subject to forced heirship or other succession laws.
 - comes into effect from August 17, 2015 in all EU member states except UK, Ireland and Denmark.
 - 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.
 - The law applicable to succession as a whole shall be the law of the state in which decedent had his/her habitual residence.
 - 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.

EU Regulation – (cont'd)

– Habitual residence

- 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.
 - Center of interests, country of nationality or location of assets are all relevant in determining habitual residence.
- 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. Effect on planning for U.S. citizens with assets in EU states.
- The courts where the U.S. citizen had a habitual residence have jurisdiction to rule on decedent’s succession as a whole regardless of where his/her assets are located.
- 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.

EU Regulation – (cont'd)

- 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.
 - 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.
 - Choice of law is limited to the testator's nationality at time of Will execution or at death.
 - Choice of law will also apply to validity of Will.
 - Exception to the foregoing applies (1) to immovable property or other assets in an EU state which is subject to special rules based on economic or family considerations and (2) "in rem" property rights under the law of a member state.
- 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.
 - 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.

Questions?

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