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International Traps For the U.S. Client

BIGSTOCK

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THE FOLLOWING are nine international fact patterns that the domestic practitioner may reasonably expect to encounter, and their sometimes unanticipated consequences under U.S. law.

The first step in analyzing any international fact pattern is to determine whether each individual involved is a "U.S. person" or a "non-U.S. person."

A U.S. citizen is always a U.S. person, regardless of where he or she resides. In addition, a resident of the United States is a U.S. person. ("Residency" has different definitions for income and estate tax purposes, but it will be assumed in this article that a person who is a U.S. resident for one purpose is also a resident for the other.)

Persons who are not U.S. citizens or U.S. residents are "non-U.S. persons" or "nonresident aliens."

1. A U.S. person receives a gift or bequest from a non-U.S. person. Generally speaking, a U.S. person is not taxed on a gift or bequest from a foreign person. However, if the gift or bequest consists of "U.S. situs property," the donor or the decedent's estate may incur U.S. gift or estate tax.

U.S. situs property for gift tax purposes includes U.S. situs real estate, tangible personal property located in the United States and cash drawn on a U.S. bank account. Treas. Reg. §25.2511-3(b).

U.S. situs property for estate tax purposes includes, among other assets, U.S. situs real estate and tangibles, and shares of U.S. corporations (unless exempt under an applicable death tax treaty between the U.S. and the country of the decedent's residence), but not U.S. bank accounts. Section 2104(a) and Treas. Reg. §20.2104-1(a); Section 2105 (b).[1] A credit for foreign death taxes may be available. Section 2014.

Gifts of U.S. situs property by a non-U.S. person qualify for the annual exclusion of $13,000 per recipient. However, there is no lifetime unified credit available for non-U.S. persons. (By contrast, U.S. persons now have a $5 million unified credit available.)

In addition, gifts and bequests from a foreign person who was previously a U.S. person may be subject to transfer tax. See point 8 below.

Recipients of gifts from a foreign person obtain the same basis in the property as the foreign owner (increased by any gift tax paid). Section 1015. Recipients of bequests from a foreign decedent receive a step up in basis (even if the property bequeathed was not subject to U.S. estate tax). Section 1014.

Even if there is no gift or estate tax due on gifts or bequests from foreign persons, the recipient must report such gifts and bequests to the IRS on Form 3520 if the amount received from a foreign person exceeds $100,000 in a calendar year. (For this purpose foreign donor spouses and descendants are aggregated; how-

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ever, the U.S. recipients are not aggregated, so that a U.S. husband and wife can each receive $100,000 from the husband's non-U.S. father without reporting.)

The practitioner will want to verify that his U.S. client actually received a gift or bequest from a foreign individual, rather than a distribution from a foreign corporation or a foreign trust that is being informally referred to as a "gift" or "bequest, " since the latter may be taxable as income and have a lower reporting threshold.

2. A U.S. person puts her house, bank account or securities portfolio into joint names with her non-citizen spouse. Gifts between spouses generally qualify for 100 percent gift tax marital deduction. This deduction is not allowed, however, when the recipient is not a U.S. citizen.

There is an increased annual exclusion for gifts to a non-citizen spouse, which is $136,000 for 2011. Rev. Proc. 2010-40. Lifetime gifts above this amount to a noncitizen spouse will consume the donor's lifetime exclusion and after that be subject to gift tax.

By transferring property into joint name, a U.S. person is arguably (depending upon local law) making a gift of one-half of the property to the non-citizen spouse. This gift can use up both annual exclusion and unified credit and result in the imposition of gift tax.

If one spouse dies and jointly held property passes to a non-citizen surviving spouse, the entire property will be presumed to be owned by the deceased spouse and the surviving spouse will have to transfer the property to a Qualified Domestic Trust in order to obtain the marital deduction. Section 2056(d).

The surviving spouse can seek to rebut this presumption by showing that he made contributions to the property, but this may be difficult many years after the fact. Sections 2040(a), 2056(d)(1)(B). Therefore, severing the tenancy is preferable.

However, not all joint accounts are intended to create a gift, and the intention of the donor is paramount. Most donors who put property into joint names with a non-citizen spouse do not intend to make a present gift.

Rather than being forced to argue about intent with the Internal Revenue Service, joint tenancies with non-citizen spouses should be severed and the real property transferred to the names of the parties as tenants in common in proportion to their respective contributions. Joint bank and securities accounts should be transferred into separate accounts in the sole name of each spouse.

3. A U.S. client names a non-U.S. person as executor of his will. Naming a non-U.S. executor of the will of a U.S. person does not create any tax issues. Practical administrative problems, however, may arise.

Under SCPA §707, a non-resident of New York who is not a U.S. citizen may not act as executor except together with co-executors, at least one of whom is a resident of New York. (Many states, including New Jersey and Connecticut, do not have such a limitation on non-resident alien executors.)

Rather than being forced to **argue** about **intent** with the Internal Revenue Service, **joint tenancies** with **non-citizen spouses** should be severed and the real property transferred to the names of the parties as **tenants in common** in proportion to their respective contributions.

In addition, it may be cumbersome for a person in another country to fully carry out his or her duties as executor. In particular, having documents notarized is a much more difficult process in most other countries than it is in the United States.

4. A U.S. person names a non-U.S. person as co-trustee of his testamentary or inter vivos trust. A trust is foreign for income tax purposes unless (1) it is subject to the primary jurisdiction of a U.S. court, and (2) all of its substantial decisions are controlled by U.S. persons. Section 7701(a)(30)(E).

If a foreign person is a trustee, and that person cannot be outvoted by two U.S. trustees as to every substantial decision, the trust is a foreign trust, regardless of the fact that it is created under a New York trust agreement or a will probated in New York.

A foreign trust is not subject to U.S. income tax, except on its U.S. source income. This may sound like a great advantage, until it is recalled that any U.S. beneficiary who receives a distribution from a foreign non-grantor trust will be subject to income tax to the extent that the distribution carries out distributable net income (DNI). Section 643.

Moreover, if a foreign non-grantor trust accumulates income (including recognized capital gains) for several years and then makes distributions to U.S. beneficiaries in excess of DNI in a later year, the excess will be a distribution of "undistributed net income" (UNI). Section 665. This UNI will be taxed with interest going back to when it was originally accumulated, and preferential capital gains tax treatment will be lost. Sections 665-668.

Beneficiaries of a foreign trust also have additional filing requirements on Form 3520 that are not applicable to a domestic trust. The settlor of an inter vivos trust that is a foreign trust also has filing requirements both on the creation of the trust and for every year of its existence where he or she is the grantor. (It is likely that the U.S. person will be the grantor of the foreign inter vivos trust, since under §679 a foreign trust settled by a U.S. person that has or may have any U.S. beneficiaries is a grantor trust.)

Therefore, in most situations the practitioner will want to avoid accidentally creating a foreign trust by giving sole or joint power over any substantial decision to a foreign person. The foreign person need not be a trustee; a foreign beneficiary who can remove and replace a trustee will cause the trust to be foreign.

5. A U.S. person opens a Canadian bank account. If a U.S. person maintains ownership or signature power over foreign bank and financial accounts with an aggregate value exceeding $10,000 at any time during the year, he or she must file Form TDF 90-22.1 (the "FBAR" or Foreign Bank Account Report). It is not sufficient to merely report and pay tax on the interest on Form 1040. Failure to file the FBAR can result in a penalty of up to 50 percent of the balance in the account per year, even if all income taxes were paid.

It is likely that in 2011additional reporting requirements for foreign bank accounts will be instituted as a result of the Hiring Incentives to Restore Employment (HIRE) Act. 11 P.L. 147, §511 and Section 6038D.

6. A U.S. person owns shares in a mutual fund organized in Ireland. Nearly all foreign mutual funds constitute "passive foreign investment companies" (PFICs) for U.S. income tax because they are foreign corporations and have primarily passive income.

A U.S. owner of a PFIC will be taxed at ordinary income rates together with a substantial interest rate when she receives a distribution from the PFIC, or upon disposition of her interest such as by selling the shares. To avoid this, the fund must make a QEF (qualifying electing fund) election to report the income of the fund annually. If the fund is publicly traded, the U.S. person may report the increase in value each year as ordinary income to avoid the PFIC tax.

In addition, under the HIRE Act, U.S. persons must report their ownership of a PFIC even if they do not receive any distributions from it. 111 P.L. 147, §521 and Section 1298(f) (effective as of date of enactment).

7. A non-U.S. citizen returns to his home country and retains his U.S. green card. The holding of a U.S. green card makes the holder a U.S. person for income tax purposes. Section 7701(b)(6). This is not changed if the person does not actually reside in the U.S., or even if the green card expires for immigration purposes.

Therefore, the person must continue to file U.S. income tax returns and pay U.S. income tax on his worldwide income every year. (He will, however, receive a credit for income taxes he pays to his home country.)

A green card holder who moves to another country can, without giving up the green card, take a position with the IRS that he is resident in the other country if that country has an income tax treaty with the United States that includes a "tiebreaker" provision. The taxpayer must file Form 8833 annually with the IRS to take this position. In addition, taking such a position is an act of expatriation. (See point 8.)

Holding of a green card is not conclusive proof of a person's residence or domicile for estate and gift tax purposes, although it is one factor that will be taken into consideration.

8. A non-U.S. citizen moves out of the United States and surrenders her green card. If a non-U.S. citizen has held a U.S. green card for all or part of at least eight out of the past 15 calendar years, and then surrenders it, this is considered an act of expatriation equivalent to a U.S. citizen giving up her citizenship. I.R.C. 877A(g)(2).

The green card holder (or the citizen) will then be a "covered expatriate" if she has a net worth of at least $2 million (including certain trusts for her benefit), or (for calendar year 2011) if she has paid an average $147,000 of U.S. income tax over the past five years, or if she fails to certify under penalty of perjury that she has complied with all U.S. tax obligations for the last five years. (In other words, even a person who is under the net worth and income tax thresholds will be a covered expatriate if she fails to make this certification.) Sections 877A(g)(1)(A), 877(a)(2).

The **holder** of a U.S. **green card** is a U.S. person for income tax purposes, which is **not changed** if the person does **not** actually **reside** here, or even if the green card **expires** for immigration purposes; thus the person must **continue** to **file** U.S. income tax **returns** and **pay** U.S. **income tax** on worldwide income.

A covered expatriate is treated as having sold all of her assets on the date of expatriation and will recognize capital gain on the transaction. The first $600,000 of gain is exempt from tax. The tax on any asset can be deferred, by agreement with the IRS, until the asset is sold or the expatriate dies (in which case interest will be imposed and adequate security must be provided). Section 877A(a) and (b). This gain recognition applies to all worldwide assets of the expatriate and is not limited to U.S. assets. Notice 2009-85, Section 3.

In addition, any U.S. person who receives a gift or bequest from a covered expatriate will be subject to tax at a rate equal to the highest transfer tax rate (currently 35 percent). Section 2801. A credit for foreign gift or estate taxes may be available to offset this tax. Section 2801(d).

9. A dual citizen of the United States and France moves to France, stops filing U.S. income tax returns and files only French income tax returns. Citizens of the United States are subject to U.S. income and estate tax on their worldwide income and assets. It makes no difference where they reside. It also makes no difference whether they are dual citizens of the U.S. and another country.

If the U.S. citizen resides in France, he must file French income tax return reporting his global income. However, this does not relieve him of the obligation to file a U.S. return.

The U.S. allows a credit against U.S. income tax for foreign income taxes paid. (This credit is available under §901, and is not dependent on whether or not there is an income tax treaty in force between the two countries; a treaty will only determine the priority of payment of tax.)

Since French income taxes are generally higher than those of the United States, it is likely that he will owe little or no U.S. income tax. Nevertheless, a return must be filed each year reporting all income and claiming the credit for foreign income taxes. If no return is filed, and the IRS later discovers this, it may only allow him to claim a credit for the last three years, and could assess tax for earlier years without a credit. No statute of limitation will have run since no returns were filed.

1. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.