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Estate planning for non-U.S. persons differs from domestic planning, not only in the specific rules that apply but also in the mental outlook that the planner must bring to the process. To put it simply, in planning for a U.S. person we begin with the assumption that all income and assets are subject to U.S. income, estate and gift taxes, and we then hunt for exceptions (aka "loopholes") that will shelter some income and assets from these taxes, e.g., municipal bond interest, charitable deductions, the estate tax marital deduction. Non-U.S. persons, on the other hand, start out in an environment in which no U.S. income or estate taxes are payable, and the planner's job is to keep an eye out for pitfalls (U.S. residence, U.S. source income and U.S. situs assets) that may create such taxes.

The following is an outline of the rules that apply in estate and tax planning for non-U.S. persons and trusts. It is not intended to be the exhaustive word on the subject — volumes are required for that task — but it is meant to serve as a general guide to the subject.

I. BASIC RULES

The following are the basic rules of international estate planning:

- U.S. persons are subject to U.S. income taxation on their worldwide income. (Internal Revenue Code [IRC] §§ 1, 61).
- Individuals who are U.S. persons are also subject to estate, gift and generation-skipping transfer taxes on their worldwide assets. (IRC §§ 2001, 2031-2046, 2601)
- Non-U.S. persons are subject to U.S. income tax only on their U.S. source income, including income that is effectively connected with a U.S. trade or business.
- Individuals who are non-U.S. persons are subject to estate, gift and generation-skipping transfer taxes only on U.S. situs assets.

These rules are elaborated on in the following sections of this outline.

1 The authors would like to thank Carl Merino for his contributions to this edition of the outline.
II. WHO IS A U.S. PERSON?

A. Individuals, Corporations and Trusts. The term "U.S. person" includes U.S. individuals as well as domestic corporations and U.S. trusts. (IRC § 7701(a)(30))

B. When Is an Individual a U.S. Person? An individual is a U.S. person if he or she is either:

- A U.S. citizen, regardless of residence, and including a dual citizen of the United States and one or more other countries; or

- A U.S. resident, regardless of citizenship.

C. Who Is a U.S. Resident?

1. Income Tax Resident: A resident for income tax purposes is:

   (a) A green card holder (or other lawful permanent resident). (IRC § 7701(b)(1)(A)) There are special rules for the first and last year of lawful residence. For the first year, if the individual was not a resident in the prior calendar year, the individual is treated as a resident only for the portion of the year starting when the residence began, i.e., when he or she was first physically present in the United States with a green card. (IRC § 7701(B)(2)(A)) For the last year of residence, if an individual turns in his or her green card and leaves the United States, is not a U.S. resident in the following year, and has a closer connection to another tax jurisdiction, he or she will be a U.S. income tax resident for only the portion of the year that he or she was a cardholder. (IRC § 7701(B)(2)(B)) (As for departing residents, however, there are special rules for long-term residents, discussed infra.)

   (b) Under the "substantial presence" test, a person is a U.S. resident for a given calendar year if he or she either (i) is present in the United States for 183 days or more in that year; or (ii) is present in the United States for at least 31 days of that year, and the total of the days present in the United States during the current tax year, plus one-third of the days present in the previous year, plus one-sixth of the days present in the second previous year, equals 183 days on a weighted basis. (A person who is never in the United States for more than 121 days per year will never exceed this figure.) (IRC § 7701 (b)(3)(A))

   Exceptions:

   (a) A full-time student, teacher or trainee visa (for a limited time); a person holding a diplomatic visa; or an employee of an international organization is not a U.S. resident, regardless of the number of days spent in the United States. (IRC § 7701 (b)(5)(A) and (B))

   (b) A person who is present in the United States for fewer than 183 days in the calendar year, but whose three-year weighted total is greater than 183 days, can avoid U.S. resident status by filing with the Internal Revenue Service (IRS) and demonstrating that he or she has a tax home in and a "closer connection" to a foreign country. (IRC § 7701(b)(3)(B))
(c) Treaties with some countries contain "tie breaker" provisions to resolve the issue of residence for a person who would otherwise be treated as a resident of both of the treaty countries.

2. **Estate and Gift Tax Resident:** A U.S. resident for estate and gift tax purposes is a person whose primary residence, or domicile, is in the United States. This means that the person lives in the United States and has no definite present intent to leave, as shown by the surrounding facts and circumstances. (Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-(1)(b))

Because a "bright line" test applies for income tax purposes and a "facts and circumstances" test applies for estate and gift tax purposes, it is possible for an individual to be a U.S. resident for purposes of one tax and not for the other.

D. **What Constitutes a Domestic Corporation?** A corporation that is organized or created in the United States. (IRC § 7701(a)(3)) It does not matter where the directors reside or meet, or where the corporation's assets are located.

E. **What Constitutes a Domestic Trust?** Under IRC §§ 7701(a)(30)(E) and (31)(B), every trust is a foreign trust unless both of the following are true:

1. A U.S. court can exercise *primary* supervision over the administration of the trust; and

2. One or more U.S. persons have the power to control *all* substantial decisions of the trust.

Under Treas. Reg. § 301.7701-7, the "United States" refers only to the 50 states and the District of Columbia. A safe harbor is created whereby a trust is a domestic trust if it is administered exclusively in the United States, has no provision directing administration outside the United States and has no automatic change of situs clause (except in case of foreign invasion or widespread confiscation of assets in the United States). If a person other than a trustee (such as a protector) has the power to control substantial decisions, that person's powers will be counted for purposes of the control test. Powers exercisable by a grantor or a beneficiary, such as a power to revoke or a power of appointment, will also be considered in determining substantial control.

The Treasury regulations provide a nonexclusive list of "substantial decisions," which include:

- Whether and when to distribute income or corpus
- The amount of any distribution
- The selection of a beneficiary
- The power to make investment decisions (However, if a U.S. person [trustee, protector, etc.] appoints a foreign investment advisor and can remove that advisor, the appointment of the foreign advisor will not make the trust foreign.)
Whether a receipt is allocable to income or principal

Whether to terminate the trust

Whether to compromise, arbitrate or abandon claims of the trust

Whether to sue on behalf of the trust or to defend suits against the trust

Whether to remove, add or name a successor to a trustee; provided, however, that the power solely to name a successor will not be considered a substantial decision if it is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa)

If a vacancy occurs through the death or sudden resignation of a trustee that would shift control of a substantial decision out of the hands of U.S. trustees, the trust has 12 months to reassert U.S. control by either a change of fiduciaries or a change of residence of a fiduciary. If such a change is made within 12 months, the trust will be treated as having remained a U.S. trust; if no such change is made, the trust will have become a foreign trust on the date the vacancy occurred.

This definition is heavily tilted toward a conclusion that a trust is foreign. For instance, if a New York resident creates a testamentary trust for his or her New York resident children by his or her will probated in New York, with a New York bank and an Irish cousin as trustees, and if principal distributions to the children can be made only by majority vote of the trustees, the trust is a foreign trust since substantial decisions are not controlled by the U.S. fiduciary.

III. TAXATION OF NON-U.S. PERSONS

Persons who are neither U.S. citizens nor U.S. residents (nonresident aliens, or NRAs) are subject to U.S. taxes as follows:

A. Income Tax: NRAs are subject to U.S. income tax only on U.S. source income, generally at a 30 percent withholding rate. (IRC § 871(a)(1))

**U.S. Source Income for Income Tax Purposes (IRC § 871(a)):**

- Dividends from U.S. corporations (including U.S. mutual funds), but not the proceeds of the sale of most U.S. securities.

- Rent from U.S. real property, and capital gains on the sale of U.S. real property or real property holding companies. (Foreign Investment in Real Property Tax Act of 1980 [FIRPTA], IRC § 891)

- Interest on debts of U.S. obligors. However, interest on most publicly traded bonds issued after July 18, 1984 (and private debts in registered form), constitutes "portfolio interest" and therefore qualifies for the portfolio exemption and is not taxed as U.S. source income. (IRC § 871(h))
Salaries paid by U.S. and non-U.S. entities for services performed by the recipient in the United States.

- U.S. royalties.

**Income Effectively Connected With a U.S. Trade or Business (IRC § 871(b)):**

NRAs are also subject to income tax at the same graduated rates as U.S. persons on their income earned in connection with the conduct of a trade or business in the United States. (IRC § 871(b)) A foreign partner of a U.S. or foreign partnership that itself is engaged in a U.S. trade or business will be deemed to be so engaged through the partnership and will be subject to federal and possibly state return filing obligations. The partnership may be subject to withholding obligations with respect to U.S. source earnings allocated to its foreign partners. Further, the disposition of an interest in a partnership by a non-U.S. person may be taxable under IRC § 864(c)(8) and subject to withholding under IRC § 1446(f) if the partnership is engaged in a U.S. trade or business.

Interest on U.S. bank accounts, including time deposits and certificates of deposit, is not U.S. source income.

Income tax treaties between the United States and other countries can alter these rules, particularly the withholding rate.

**B. Estate Tax:** Estates of NRAs are subject to U.S. estate tax only on U.S. situs assets. The tax is assessed at the same rates as for U.S. citizens, up to 40 percent, but with only a $60,000 exemption (as opposed to the 2019 exemption of $11.4 million for a U.S. person). (IRC § 2106 (b)) Worldwide debts and administration expenses may be deducted, but only in the proportion that the U.S. assets bear to the decedent's worldwide assets. (Nonrecourse debts are allocated to the properties they secure, but most commercial lenders prefer a choice of remedies in the event of default, including imposition of personal liability against the borrower, so most third-party loans will be considered recourse debts for this purpose.) The unlimited marital deduction is available; however, if the surviving spouse is not a U.S. citizen, only property left to a qualified domestic trust will qualify (see Section VIII (B) below). The charitable deduction is available only for bequests to U.S. charities, with the exception of trusts that are required to use the funds within the United States.

**U.S. Situs Assets for Estate Tax Purposes (the following is a partial list):**

- Real property situated in the United States, including houses and condominiums. (Treas. Reg. §§ 20.2104-1(a)(2); 20.21051(a)(2))

- Tangible personal property situated in the United States, such as jewelry, antiques, artworks and cars, unless the items are in transit or on loan for an exhibition at a museum. (Treas. Reg. §§ 20.2104-1(a)(2); 20.21051(a)(2))

- Shares of stock of U.S. corporations, including shares of a U.S. cooperative corporation representing a co-op apartment. (IRC § 2104(a)) Shares of non-U.S. corporations are not U.S. situs property. The location of the certificate and the custody account are immaterial. Mutual funds (including money
market funds) organized in corporate form are U.S. situs property if incorporated in the United States. (IRC § 2104(a)) If the fund is structured as a grantor trust, the situs of the fund generally depends on the situs of the underlying assets of the fund.

- The situs rules are less clear for partnerships, which are not addressed in the Internal Revenue Code or Treasury regulations. Some older authorities suggest one would look to the underlying assets or where the partnership conducts its business (if any), while other authorities suggest one might look to where the partnership is organized. Therefore, one may generally assume that interests in limited or general partnerships that either do business in the United States or own assets in the United States will probably be considered U.S. situs assets.

- Cash deposits with U.S. brokers, money market accounts with U.S. mutual funds and cash in U.S. safe deposit boxes are U.S. situs property. (IRC § 2104(c))

- Debts of U.S. obligors are U.S. situs property. Once again, however, publicly traded bonds and registered private debt issued after July 18, 1984, qualify as "portfolio debt" and therefore are not subject to U.S. estate taxation if owned by an NRA decedent, provided that the decedent was also an NRA for income tax purposes. (IRC § 2105(b)(3))

- Life insurance proceeds paid by a U.S. insurer on the life of a non-U.S. person are not U.S. situs property. However, the cash surrender value of life insurance owned by a non-U.S. person on the life of another person is U.S. situs property if issued by a U.S. insurer. (Treas. Reg. § 20.2105-1(g))

Bank accounts maintained with U.S. banks are not U.S. situs property; this includes checking and savings accounts, time deposits, and certificates of deposit. (IRC § 2104(c))

Again, treaties with various countries can alter these rules, particularly as to whether U.S. stocks owned by a citizen and resident of another country will be taxed by the United States.

**Basis Step-Up at Death (IRC § 1014):**

Under IRC § 1014(a), the basis of property acquired by bequest, devise or inheritance or by the decedent’s estate from the decedent is stepped up or down to fair market value at the time of death.

- Non-U.S. situs property held by an NRA at death is eligible for a basis step-up (or step-down) under this provision even though it is not subject to estate tax. (Rev. Rul. 84-139)

- Property that is otherwise includable in the decedent’s taxable estate (for example, U.S. situs assets held in a trust settled by an NRA with certain “retained strings”) is eligible for a basis adjustment at death even if such property does not pass by bequest, devise or inheritance. (IRC § 1014(b)(9)
- Property transferred in trust that is not otherwise includable in the decedent's taxable estate (for example, non-U.S. situs assets held in a trust settled by an NRA) is eligible for a basis adjustment at death only if certain delineated powers are retained by the decedent during his or her lifetime. (IRC § 1014(b)(2)-(3).)

C. Gift Tax: NRAs are subject to gift tax only on gifts of U.S. situs real property and tangible personal property. The annual exclusion of $15,000 for gifts of a present interest may apply; however, the $60,000 credit afforded to NRAs for estate tax purposes may not be applied to gifts. Gifts of shares of stock of U.S. corporations are not subject to U.S. gift tax. However, gifts of cash (possibly including checks) that take place within the United States may be subject to gift tax; therefore, any gifts of cash by a non-U.S. person to a U.S. person should be made outside the United States. (IRC §§ 2501(a)(3); 2511(b))

D. Reporting of Gifts by NRAs to U.S. Persons: Any U.S. person who receives "large gifts" (more than $100,000) from a non-U.S. individual during any calendar year must file a report describing these gifts with his or her income tax return the following April 15. (IRC § 6039F; Form 3520) (No tax is due unless the gifts are of U.S. situs property (or the donor is a covered expatriate, discussed infra).)

The term "gifts" includes bequests from estates of non-U.S. individuals. (IRC § 6039F(b)) Qualified medical or educational payments under IRC § 2503(e) are not considered to be gifts and are not subject to reporting.

In determining whether a U.S. person has received gifts during the taxable year from a particular foreign donor in excess of $100,000, the U.S. donee must aggregate gifts from foreign persons that he or she knows or has reason to know are related, within the meaning of IRC § 643(i)(2)(B). For instance, if an NRA mother and father each give their U.S. son $60,000, the gifts are aggregated, the $100,000 reporting threshold is exceeded and the son must report both gifts. Once the $100,000 threshold has been met, the donee must separately identify each gift in excess of $5,000.

A U.S. person is required to report the receipt of purported gifts from foreign corporations and foreign partnerships as well if the aggregate amount of purported gifts from all such entities exceeds $10,000 in any year. (This threshold is indexed for inflation and is presently $16,076.) The use of the word "purported" gives an indication that the IRS may recharacterize those "gifts" from entities as taxable income to the U.S. recipient. (IRC § 672(f)(4))

The form used to report gifts from foreign persons (Form 3520) asks for a brief description of the property received as a gift; whether the foreign donor is an individual, corporation, partnership or estate; and whether the foreign donor was acting as a nominee or intermediary for another person. The form does not ask for the identity of a foreign individual donor, although the IRS could request this information.

While there is no tax on non-U.S. situs gifts from foreign persons, the penalty for failure to report the gifts is severe. If a gift is not reported on Form 3520, the tax consequences of the receipt of the gift shall be determined by the IRS. (IRC § 6039F(c)(1)(A)) In addition, the recipient is subject to a penalty equal to the greater of $10,000 and 5 percent of the value of the gift for each month in which the gift is not reported, not to exceed 25 percent. (IRC § 6039F(c)(1)(B)) The penalties can be waived if the failure to
file was due to reasonable cause and not willful neglect. Ignorance of the law is not reasonable cause.

E. Generation-Skipping Transfer Taxes: A transfer by an NRA will be subject to generation-skipping transfer (GST) tax only if it is also subject to U.S. estate or gift tax, which will be the case only if it consists of U.S. situs property. (Treas. Reg. § 26.2663-2)

F. Treaties: Income and estate tax treaties with individual countries may alter some of these rules, particularly as to determination of residence, source of income, situs of assets and income tax withholding rates. Some treaties also give foreign residents a greater estate tax credit amount than $60,000, such as a share of the full U.S. unified credit equal to the proportion of assets located in the United States. Some treaties also give a marital deduction for bequests to a noncitizen spouse, up to a limit. Some treaties exempt shares of U.S. corporations held by residents of other countries from estate tax. The United States generally enters into treaties with countries that have significant taxes of their own to help avoid double taxation. Therefore, if a treaty allows an NRA to reduce his or her U.S. tax liability, there will usually be an offsetting tax in the NRA's country of residence.

The United States never enters into a treaty that exempts U.S. citizens from worldwide income, estate, gift or generation-skipping taxation.

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The estate tax treaties with the United Kingdom, France, Germany, Austria, Denmark and Sweden* are based on the unified system concept and in consequence cover taxes on gifts and generation-skipping transfers, as well as estate taxes.

The United States also has gift tax treaties with Australia and Japan.

*The estate tax treaty with Sweden is no longer in effect following the repeal of Sweden's inheritance tax in 2004.
IV. FOREIGN TRUSTS CREATED BY NRAs

A. Foreign Grantor Trusts

A foreign trust is generally not subject to U.S. income tax, except for withholding tax on any U.S. source income. However, distributions from the foreign trust to a U.S. person will carry out taxable income to that person, with adverse tax treatment of accumulated income, unless the trust qualifies as a "grantor trust" under U.S. tax law. (IRC §§ 671-677) With a grantor trust, the person who funded the trust (the grantor), is treated as the owner of the income, even if distributions are made to someone else. Therefore, a U.S. beneficiary of a foreign trust will greatly prefer that the trust be a grantor trust with an NRA individual as grantor.

Under the law in effect as of August 20, 1996, NRAs generally cannot be grantors of trusts except under limited circumstances. (IRC § 672(f)(1)) If an NRA sets up a trust for the benefit of a U.S. person, the U.S. person will be taxed on the income received unless a grantor trust exception applies.

There are three relevant exceptions to the law, which permit the NRA to be the income tax grantor:

1. The grantor has the full power to revoke the trust without the consent of any person, or with the consent of a related or subordinate person who is subservient to the grantor. (IRC § 672(f)(2)(A)(i)) (Upon the grantor's incapacity, his or her guardian or another person must possess the power to revoke in order for the trust to continue to qualify as a grantor trust.)

2. The grantor and/or the grantor's spouse are the sole beneficiaries of the trust during the life of the grantor. In this case, the grantor and/or the grantor's spouse could receive distributions from the trust and, from time to time, make gifts to the U.S. relative. The U.S. person would then have to report the receipt of the gifts if the gifts met the applicable threshold, but they would not be taxable. (IRC § 672(f)(2)(A)(ii))

3. The trust was created on or before September 19, 1995, but only as to funds already in the trust as of that date (which must be separately accounted for) and only if the trust was a grantor trust pursuant to either IRC § 676 (concerning the grantor's power to revoke) or IRC § 677 (concerning the grantor's retained possibility of receiving income), but excluding IRC § 677(a)(3) (income may be used to pay premiums on insurance policies on the grantor's life).

Once the NRA grantor dies, the foreign trust that previously qualified as a grantor trust under one of the exceptions will no longer be a grantor trust, and all income accrued after the grantor's death and distributed to the U.S. beneficiary will be taxed to him or her.

B. Foreign Nongrantor Trusts: Accumulations

The greatest disadvantage of a foreign nongrantor trust is the treatment of income that is accumulated in the trust and then distributed to a U.S. person in a subsequent year.
If a foreign trust falls into one of the above exceptions and so is a grantor trust, there is no accumulated income issue; any income accumulated in the trust may be added to the principal and distributed later without U.S. tax consequences.

If a foreign trust with U.S. beneficiaries does not fall within one of the exceptions and so is not a grantor trust, and if it distributes the current year’s income (including capital gains) to a U.S. beneficiary in the same calendar year, the income is taxed to the beneficiary and the income retains its character as ordinary income or capital gains. For foreign trusts, realized capital gains are included in distributable net income (DNI).

Any distribution from a discretionary nongrantor trust to a beneficiary carries out with it DNI to the extent that the trust has income. It makes no difference that the trustee characterizes the distribution as one of corpus or of capital gains. (U.S. tax law differs from the tax law of the United Kingdom in this respect.) If two beneficiaries receive distributions from the trust in the same calendar year, each is treated as receiving a proportionate share of the trust’s DNI for that year. After all current income of the trust has been carried out to the beneficiaries, further distributions are treated as distributions of corpus and are not taxed (assuming the trust has no accumulated income from prior years).

If a foreign trust accumulates income, the trust pays no U.S. income tax on that income (other than withholding tax on U.S. source income paid to the trust or income effectively connected with a U.S. trade or business) and there is no U.S. income tax currently payable by any potential beneficiary on that income. However, the trust is building up undistributed net income (UNI), which will have negative tax consequences if it is distributed to a U.S. beneficiary in a future year.

When a foreign trust has UNI from prior years and it distributes an amount not exceeding the greater of the current year’s DNI or fiduciary accounting income to the beneficiaries (including U.S. beneficiaries), the U.S. beneficiaries are taxed only on their share of the DNI. For foreign trusts (unlike domestic trusts), DNI includes realized capital gains, and the capital gains retain their character and are taxed at the lower capital gains rate (currently 20 percent).

When a foreign trust with UNI pays out to the beneficiaries in a calendar year an amount in excess of both the current year’s DNI and the current year’s fiduciary accounting income, UNI is carried out to the beneficiaries. UNI paid to U.S. beneficiaries is fully subject to U.S. income tax and has the following additional negative consequences:

1. All capital gains realized by the trust in prior years that constituted part of the trust’s DNI are now ordinary income, taxed at rates up to 37 percent.

2. An interest charge is imposed on the tax due by the beneficiary on the UNI from the date the income was originally earned by the trust. From 1996 forward, the interest charge is pegged to the rate applicable to underpayment of tax and is compounded daily.

3. Finally, the "throwback" rules apply, so the income may be taxed at the beneficiary's tax bracket for the years in which income was accumulated.
C. Use of Intermediaries

Because it is difficult for a foreign trust to qualify as a grantor trust, and because distributions of UNI from a foreign nongrantor trust to a U.S. beneficiary have such negative tax consequences, trustees will look for ways to "cleanse" accumulated income in a trust. One idea that has occurred to some is to distribute the accumulated income to a foreign intermediary (either an individual, corporation or another trust), which can then later pay it to the U.S. beneficiary in the guise of current income, principal distribution or a gift.

To address this, Treas. Reg. § 1.643(h)-1 sets out the circumstances in which such intermediaries will be disregarded and the treatment of structures that employ intermediaries. Essentially, when property is transferred to a U.S. person by another person (the intermediary) who has received property from a foreign trust, the U.S. person will be treated as having received the property directly from the foreign trust if the intermediary received the property from the foreign trust pursuant to a plan in which one of the principal purposes was the avoidance of U.S. tax. Such a principal plan of avoidance will be deemed to exist if:

1. The intermediary is "related" to the grantor of the foreign trust or has a relationship to the grantor that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer to the U.S. person;

2. The U.S. person receives from the intermediary, within the period beginning 24 months before and ending 24 months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property or property in substitution for such property; or

3. The U.S. person cannot establish that the intermediary acted independently, had a reason for making gratuitous transfers to the U.S. person and was not the agent of the U.S. person, and the U.S. person properly reported the gift.

If the intermediary can be viewed as an agent of the foreign trust, a distribution will be deemed to take place from the foreign trust to the U.S. beneficiary at the time the intermediary makes the distribution to the U.S. beneficiary. If the intermediary can be viewed as an agent of the U.S. beneficiary, a distribution will be deemed to have been made to the U.S. beneficiary when the foreign trust makes the distribution to the intermediary.

Trustees of foreign trusts often want to make distributions to U.S. beneficiaries out of trusts with substantial UNI. If a foreign trust with UNI distributes to a non-U.S. person or a distinguishable foreign trust distributes all of the trust's UNI, the original trust becomes "cleansed" and can make a large principal distribution to a U.S. beneficiary in the next calendar year without carrying out accumulated income. The question remains of what to do with the "tainted" funds if they are added to a new trust; they can remain with the offshore beneficiaries or trusts or go to charities, but it will be difficult for those funds to find their way to the U.S. beneficiaries without running afoul of the intermediary rules.
D. Loans From Foreign Trusts

Under IRC § 643(i), if a non-U.S. settlor creates a nongrantor offshore trust that then loans cash or marketable securities to a U.S. beneficiary or settlor or to a U.S. relative of the trust settlor, the loan will be treated as a distribution to the person receiving it and will be taxed accordingly, even if the loan is later repaid.

In Notice 97-34, the Treasury carved out an exception to this rule. This exception permits a foreign trust to lend money to a U.S. beneficiary without having it treated as a distribution if it is a “qualified obligation.” An obligation is a qualified obligation only if it meets the following requirements:

1. The obligation is set forth in a written agreement;
2. The term of the obligation does not exceed five years;
3. All payments on the obligation are denominated in U.S. dollars;
4. The yield to maturity of the obligation is not less than 100 percent and not greater than 130 percent of the applicable federal rate (IRC § 1274(d)) for the day on which the obligation is issued;
5. The U.S. borrower extends the period for assessment by the IRS of any income tax attributable to the loan 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; and
6. The U.S. obligor reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.

A loan cannot be rolled over at the end of five years, and a new loan from the trust to the same U.S. beneficiary raises the issue of whether it constitutes a rollover.

E. Uncompensated Use of Trust Property

Under Section 643(i), uncompensated use of trust property by a U.S. beneficiary of a foreign nongrantor trust is treated as a constructive distribution to the beneficiary to the extent of the fair rental value of the beneficiary’s use of the property. If there is DNI or UNI in the trust, the deemed distribution can carry out taxable income. However, if the trust’s only asset is residential property used by the beneficiary and the property is not rented out, there may not be any income to carry out, in which case the constructive distribution would be reportable by the U.S. beneficiary but not taxable.

F. Reporting Distributions From Foreign Trusts

Any U.S. person who receives any distribution from a foreign trust after August 20, 1996, including a constructive distribution as noted above, must report that distribution to the IRS on Form 3520.

The U.S. person must report the name of the trust and the amount of the distribution received from the trust during the taxable year, and indicate how such distribution is characterized, even if it is claimed that the distribution is not taxable because it came from a grantor trust or from a trust that had no income, or for some other reason.
Reporting is required under IRC § 6048(c) only if the U.S. person knows or has reason to know that the trust is a foreign trust.

If the distribution is not reported, the U.S. recipient may be subject to a penalty of the greater of $10,000 and 35 percent of the gross amount of the distribution. (IRC § 6677(a))

Any distribution from a foreign trust, whether from income or corpus, to a U.S. beneficiary may be treated as an accumulation distribution includible in the gross income of the U.S. beneficiary if adequate records are not provided to determine the proper treatment of the distribution (even if the trust would have qualified for grantor trust treatment). (IRC § 6048(c)(2))

The U.S. beneficiary will not be required to treat the entire distribution as an accumulation distribution if the beneficiary obtains from the foreign trustee either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement with respect to the distribution, which will provide full information about the trust. If a U.S. beneficiary cannot obtain such a beneficiary statement from the trustee, the U.S. beneficiary may still avoid treating the entire amount as an accumulation distribution if the U.S. beneficiary provides information regarding actual distributions from the trust for the prior three years. Under this "default treatment," the U.S. beneficiary will be allowed to treat a portion of the distribution as a distribution of ordinary income based on the average of distributions from the prior three years, with only the excess amount of the distribution treated as an accumulation distribution (and therefore subject to the interest charge of IRC § 668). (See generally IRS Notice 97-34, Form 3520.)

V. PLANNING FOR NON-U.S. PERSONS

A. NRAs Generally: Reducing U.S. Taxes

The three cardinal rules for NRAs who wish to minimize U.S. taxes are:

1. Minimize contacts with the United States to avoid becoming U.S. residents for income or estate tax purposes.

2. Minimize U.S. situs assets to avoid estate taxation. Typically, this means holding U.S. real estate, tangibles located in the United States and shares of stock of U.S. corporations through non-U.S. corporations (or entities that can elect to be treated as non-U.S. corporations). This step offers no protection from income taxes on U.S. source income; the income is still payable to a non-U.S. entity and thus subject to income tax withholding. Also, the transfer of U.S. real estate to the non-U.S. corporation may have income tax consequences. (In some cases, an irrevocable trust may be structured to serve as an effective estate tax blocker.)


The creation of an offshore revocable trust by an NRA to hold assets will not in itself reduce taxes payable by the NRA. U.S. source income paid to the trust will still be subject to U.S. withholding tax. Also, if the grantor has a retained interest in the trust (such as the power to revoke), it will not shield U.S. assets from U.S. estate tax. A foreign trust can own the shares of a foreign corporation that in turn holds financial
assets, in which case the corporation (provided it is appropriately administered) will shield U.S. stocks from U.S. estate tax.

However, the trust offers substantial nontax benefits: the retention of the wealth for future generations, with discretionary income and principal payments, which is not available in most civil law jurisdictions; protection from foreign taxes; protection from creditors; protection from nationalization and political risks; and protection from forced heirship and marital claims. The trust may also save estate and GST taxes for future generations.

A properly structured and administered irrevocable trust in an appropriate jurisdiction can also protect the U.S. assets from U.S. estate tax.

It is important to confirm with foreign counsel that holding assets through an offshore trust or corporation will not create tax complications in the NRA's home jurisdiction.

B. Estate, Gift and GST Taxes

As previously noted, transfers by an NRA to a U.S. beneficiary (including a U.S. trust) may be subject to reporting, but they are not subject to U.S. estate, gift or GST taxes except on assets that have U.S. situs. This is a significant benefit that should always be taken full advantage of when planning for NRAs.

C. Foreign Trust Planning

As noted, there are still great advantages to having an NRA create a multigenerational trust for the benefit of U.S. persons because the trust assets will not be subject to estate, gift or GST taxes. Moreover, there are strong reasons for the NRA to create a foreign grantor trust for the U.S. beneficiary in order to avoid U.S. income taxes during the life of the NRA.

An NRA can create a long-term trust for U.S. beneficiaries (which can be a foreign or U.S. trust) and escape all transfer taxes for the life of the trust on assets that remain in the trust. Because a longer term results in a longer avoidance of transfer taxes, the trust should be created in a jurisdiction that has a long perpetuities period.

For estate and gift tax purposes, it does not matter whether the trust is a U.S. trust or a foreign trust. However, for income tax purposes, if the trust is a domestic trust it will be subject to U.S. income taxes unless it is treated as a grantor trust with an NRA grantor. If the trust is a foreign nongrantor trust but the beneficiaries are in the United States and receive distributions, they will be subject to U.S. income tax on the distributions to them, with interest on the tax attributable to prior years’ UNI and additional reporting requirements (as described above). Therefore, if the trust cannot be structured to qualify as a grantor trust, and if it is expected that all beneficiaries will remain in the United States for the long term, there may be no disadvantage to the trust being in the United States, and it may actually be preferable in some cases.

In light of the foregoing, a good strategy for an NRA grantor who wants to benefit a U.S. beneficiary through an offshore trust would be the following:

1. Make the trust revocable by the grantor or, if it is irrevocable, make the grantor (and/or the grantor’s spouse) the sole trust beneficiaries during their lives. They can receive trust distributions and make gifts to the U.S. beneficiary as needed. The U.S.
beneficiary must report the gifts if they exceed $100,000, but no income or gift tax is due.

Alternatively, the trust could be fully revocable by the grantor, making it a grantor trust, and could then make payments directly to a U.S. beneficiary without being subject to U.S. income tax. In this case, the beneficiary would be required to report receipt of any trust distributions identify the trust and appoint a U.S. agent or else have the foreign trustee represent to the IRS that it will allow access the trust’s books and records to prove that it is in fact a grantor trust. The grantor may not want this for privacy purposes. (Alternatively, the grantor could partially revoke the trust on certain assets and then make a gift of those assets to the U.S. beneficiary.)

2. After the death of the grantor and the grantor’s spouse, the trust should continue for the U.S. beneficiary and descendants for the longest term permissible, possibly with a limited power of appointment granted to the beneficiaries at each generational level. For income tax purposes, the following options are available:

(a) Pay all current income (including capital gains) to the U.S. beneficiary, who then pays U.S. income tax on the income, thus avoiding any accumulations problem. This, however, increases the assets that are distributed to the U.S. beneficiary and will ultimately be subject to estate tax on the beneficiary’s death, particularly if there are high realized capital gains that must be distributed. Paying all income annually to a U.S. trust avoids this.

(b) Move the trust situs to the United States. If this is done, all income will be taxed annually, but income can be accumulated without resulting in an interest charge and realized gains can be accumulated without being converted to ordinary income when later distributed.

(c) If the U.S. beneficiary is not a U.S. citizen and expects to leave the United States in the future, or is a citizen who expects to expatriate and so will no longer be subject to U.S. income tax, the trustee should leave the trust offshore, accumulate the trust income free of U.S. income tax and make a qualified loan to the beneficiary if necessary. Once the beneficiary leaves the United States, the trust can pay out current and accumulated income without U.S. income tax. (However, this may not be the case if the beneficiary is a covered expatriate, as discussed below.)

(d) Invest the trust assets in annuity or variable life insurance products. Investments in policies that are qualified for tax purposes can build up income and avoid the interest charge on accumulations. In addition, if non-modified endowment contract life insurance policies are used, distributions can be made to the beneficiaries without U.S. income tax up to the amount of the premiums.

Underlying Entities: During the grantor’s lifetime, the trust should hold assets through one or more underlying offshore corporations to avoid U.S. estate tax. (Many other countries also levy death taxes on their domestic securities if held outright by foreign individuals but recognize a foreign corporation as a shield against such taxes; therefore, an underlying corporation may be advisable even if the assets are not U.S. situs assets.)

However, after the death of the NRA grantor, if the trust has U.S. beneficiaries, the underlying corporation may become a controlled foreign corporation (CFC) or a passive foreign investment company (PFIC), with negative tax consequences for the U.S.
beneficiaries. To avoid this problem, after the grantor's death, the corporation should elect to be disregarded for U.S. tax purposes and possibly liquidated outright. Under the U.S. "Check the Box" regulations (Treas. Reg. §§ 301.7701-1, 301.7701-2 and 301.7701-3), it is possible to simply elect for most foreign corporations to be treated as a pass-through for U.S. tax purposes. However, not all foreign corporations are eligible to make this election, so it is important when setting up the structure to choose an entity type that has not been designated as a "per se" corporation by the IRS. (Treas. Reg. § 301.7701-2(b)(8)) Additionally, this election must not be made during the grantor's lifetime if the corporation holds U.S. situs assets, since the pass-through treatment will apply for estate tax purposes as well and could eliminate the estate tax shelter for U.S. assets that the foreign corporation is intended to provide.

Note: An election postmortem may result in some phantom income inclusions for the U.S. beneficiaries due to changes in the rules governing CFCs introduced by the Tax Cuts and Jobs Act of 2017 (TCJA). However, the phantom income inclusion can usually be minimized with proper planning and in most cases will result in a much lower overall tax liability than the estate tax inclusion that could result from a pre-mortem election.

D. Non-U.S. Person Who Is Moving to the United States

If a non-U.S. person (the "pre-immigrant") is planning to become a U.S. resident in the near future, he or she should consider taking the following steps (in coordination with a tax advisor in his or her current country of residence) before becoming a U.S. resident for income or estate tax purposes:

1. **Make Gifts to Non-U.S. Persons:** The pre-immigrant should make irrevocable gifts to non-U.S. persons either outright or in the form of a trust that is for a closed class of beneficiaries, none of whom are U.S. person and is not permitted to be amended to have any U.S. beneficiaries. In addition, the pre-immigrant should not retain any other powers or interests that would otherwise cause the trust to be considered to be a grantor trust after he or she becomes a U.S. person. This will avoid U.S. income taxes on future income earned by the gifted assets and will also avoid later gift and estate taxes on the transfer of those assets.

2. **Make Gifts to U.S. Persons:** The pre-immigrant should make irrevocable gifts to U.S. persons and to long-term trusts for U.S. beneficiaries. Although the pre-immigrant can use either a U.S. or a foreign trust, a U.S. trust may be preferable if the U.S. beneficiaries anticipate receiving distributions. These gifts in trust will avoid later gift, estate and GST taxes.

   A foreign trust with any permissible U.S. beneficiaries that is created or funded by the pre-immigrant will be a grantor trust if the pre-immigrant becomes a U.S. person within five years after creating it, and so will not avoid U.S. income taxes on the income that the gifts generate.

3. **Create Irrevocable Discretionary Trusts:** The pre-immigrant should consider transferring a portion of his or her assets to an irrevocable discretionary trust of which the pre-immigrant and other family members are permissible discretionary beneficiaries. If the transfer is properly structured and administered in a jurisdiction (either U.S. or foreign) which protects such a trust from the claims of creditors, the assets should not be subject to U.S. estate tax on the pre-immigrant's death. Note that it often will be preferable to structure the trust as a U.S. trust for tax purposes (in which case it will have to be administered in the U.S.). The reason for this is that
when a foreign grantor trust with a U.S. grantor becomes a foreign nongrantor trust (for example, upon the grantor's death), gain may be recognized if there are appreciated assets in the trust. (IRC § 684) This outcome may be avoided by setting up the trust in the U.S. (or later domesticating the trust if it is already a foreign trust).

The trust will become a grantor trust for U.S. income tax purposes and its income will be subject to U.S. income tax.

4. **Sell Appreciated Assets:** The pre-immigrant should not own appreciated assets when he or she becomes a U.S. resident or citizen, since the United States will tax the entire capital gain on the later sale of the asset, regardless of when it was bought or acquired. The pre-immigrant should sell appreciated marketable securities before entering the United States and reinvest the proceeds. The pre-immigrant should also sell or otherwise dispose of appreciated residences and closely held securities, possibly to other family members.

5. **Dispose of Interests in Foreign Corporations:** The pre-immigrant should try to dispose of all interests in foreign corporations that are closely held by U.S. persons or that have primarily passive income, or should consider filing entity classification elections to treat such corporations as pass-through entities (if they are not per se corporations) and possibly step up the inside basis of the underlying assets.

6. **Make Gifts Between Married Couples:** If a married pre-immigrant couple become U.S. residents but not U.S. citizens, any gifts made between them in excess of $155,000 per year (2019 figure) will be subject to gift tax. Therefore, any gifts that will be made between the spouses should be made before they enter the United States with non-U.S. assets.

7. **Invest in Annuity or Life Insurance Policy:** The pre-immigrant can purchase a U.S.-compliant commercial annuity or life insurance policy and will not be subject to U.S. income tax on the earnings. If the pre-immigrant stays in the United States for a number of years without withdrawing any funds from the annuity and then leaves the United States, the funds invested in the annuity will never be subject to U.S. income tax and will not be considered a U.S. situs asset subject to estate tax if it is only on the (now non-U.S.) holder's life. A life insurance policy that is a non-modified endowment contract can provide funds while the pre-immigrant is a U.S. resident, without payment of U.S. income tax.

**VI. INTERNATIONAL ESTATE PLANNING FOR U.S. PERSONS**

A. **Basic Rule**

As previously noted, the general rule is that U.S. persons are subject to income taxation on their worldwide income, and individuals who are U.S. persons are also subject to gift and estate taxation on their worldwide assets. The fact that the assets are located offshore or the income is paid offshore does not make a difference.

B. **U.S. Citizen Who Resides Abroad**

U.S. citizens who are not U.S. residents are taxed on their worldwide income and assets for income and estate tax purposes in the same way as if they resided in the United States. The only significant advantage is that U.S. citizens residing abroad may exclude
the first $105,900 (for 2019) of foreign earned income from U.S. income taxation. (IRC § 911(b))

In addition, treaties with various countries often provide relief from double taxation, as do foreign tax credits that are generally available for both income and estate taxes paid to other countries, subject to certain limitations. (IRC §§ 901, 2104)

The United States generally does not allow a credit to U.S. persons for gift taxes paid to foreign jurisdictions. However, at least three treaties (with France, Germany and the United Kingdom) do provide for such a credit.

C. U.S. Person Who Creates Foreign Trusts

What are the advantages and consequences for a U.S. person in creating an offshore trust for the benefit of him- or herself and his or her family in a non-U.S. jurisdiction?

1. Income tax: As a general rule, a foreign trust, like any other non-U.S. person, pays no U.S. income tax except for withholding tax on U.S. source income. However, the grantor trust rules prevent this result in most cases where the settlor is a U.S. person. (IRC §§ 671-679) If the U.S. settlor or the trustee of the trust retains a power or interest that is specified in those rules, the trust will be a grantor trust for income tax purposes and all trust income will be taxed to the settlor (or the person who transferred assets to the trust), regardless of whether the income is accumulated in the trust or distributed to another beneficiary. Among the provisions that will cause the trust to be a grantor trust: if either the grantor or the grantor's spouse is a permissible beneficiary of the trust (IRC § 677) or if the trust permits any U.S. person to be a beneficiary. (IRC § 679) Therefore, unless a U.S. settlor is willing to eliminate him- or herself, his or her spouse, and all other U.S. persons as permissible beneficiaries of the trust, as well as give up any power to control or direct the trust asset, the trust will be a grantor trust and all income will be taxed to the settlor.

When the settlor dies, the trust will become a foreign grantor trust. If the trust has been drafted so that the trust assets are not includible in the settlor’s estate, then any appreciated assets held in the trust will be deemed to have been sold immediately prior to the settlor’s death, causing the settlor to recognize gain (but not loss) on the deemed sale. (IRC § 684)

2. Estate, Gift and GST Taxes: U.S. persons are fully subject to gift and estate taxes on their worldwide gifts and assets, including completed gifts to foreign trusts. A foreign trust created by a U.S. settlor is fully subject to GST tax.

In making a transfer to a trust, whether foreign or domestic, the settlor must choose one of the following options:

(a) Make a completed gift to the trust. This will result in gift tax (or the application of the settlor's unified credit and annual exclusion for gift taxes). However, the trust assets, including future appreciation and income, will not be includible in the settlor's estate at death. To make the gift complete, the trust may not be revocable (alone or with the consent of another person), the settlor cannot have power as trustee or otherwise to control beneficial enjoyment, and the settlor may not have a reversionary interest or retain a testamentary power of appointment (including a limited power) over the trust. As previously noted, the cost of making a completed gift is potential gain recognition at the settlor's
death (or sooner if the trust becomes a foreign nongrantor trust during the grantor's lifetime).

(b) Make an incomplete gift to the trust. In this case, no gift tax will be payable and no credits need to be used up. However, the assets will be fully subject to U.S. estate taxation at the settlor's death. On the other hand, if the assets are includible in the settlor's estate (or otherwise eligible for a basis step-up under IRC § 1014(a)), then no gain will be recognized on the appreciated assets if the trust becomes a foreign nongrantor trust by reason of the settlor's death. (Treas. Reg. § 1.684-3(c)) To make the gift incomplete, the settlor must retain some power or control over the trust assets, such as making the trust revocable (alone or with the consent of another person) or retaining a testamentary power of appointment over the trust.

For settlors who want to make a completed gift, one option is available in some foreign jurisdictions and a limited number of U.S. jurisdictions: the settlor may remain as one of the permissible beneficiaries of a sprinkle trust. Under the laws of most U.S. states, creditors can reach such a "self-settled" trust and, therefore, the transfer to the trust is not complete for U.S. gift tax purposes and is subject to U.S. estate tax at the settlor's death. But in certain offshore jurisdictions (such as the Bahamas, the Cayman Islands, Jersey, Guernsey, the Cook Islands and others) and certain U.S. jurisdictions (Alaska, Delaware, Nevada, New Hampshire, South Dakota, Wyoming and a few others), the fact that a settlor is a discretionary beneficiary of a trust prevents creditors from reaching the trust, and therefore a gift to the trust can be a completed gift, even though the settlor can receive distributions in case of emergency.

3. Reporting: The creation of a foreign trust and the transfer of assets to a foreign trust by a U.S. person, must be reported to the IRS annually on Form 3520 by the U.S. settlor. If the trust is a grantor trust, the settlor and foreign trust also have annual information reporting on Form 3520 and 3520-A respectively. The penalties for failure to report are significant: up to the greater of $10,000 or 35 percent of the amount transferred to the trust (IRC §§ 6048; 677(a)) and up to 5 percent of the portion of the trust treated as owned by the U.S. settlor under the grantor trust rules. The settlor of the trust is encouraged (but not required) to appoint a U.S. person as "agent" for the trust, with the responsibility to supply the IRS with information about the trust. If no agent is appointed, the foreign trustee is required to represent to the IRS that it will provide access to the trust's books and records, on request and if necessary, to determine the tax consequences of the distribution.

4. FBAR and Other Filings: A U.S. citizen or resident is permitted to own assets and maintain bank and securities accounts abroad. However, all such accounts are subject to U.S. income, gift and estate taxes in the same way as U.S. assets. In addition, for financial accounts that exceed $10,000 in the aggregate the U.S. person who has a financial interest or signature power over the account must check the appropriate box on Schedule B of Form 1040 (interest in or signature power over a foreign account) and must file electronically with the Treasury FinCEN Form 114, often referred to as the "FBAR" or Foreign Bank Account Report, disclosing the offshore accounts. Failure to comply with all filing requirements may result in significant penalties, even if all taxes have been paid. Entities that are created or organized in the United States, such as trusts, corporations, partnerships and limited liability companies (including single-member limited liability companies that are
otherwise disregarded for most federal tax purposes), must also file an FBAR if they maintain foreign accounts.

In addition, Form 8938, which is filed with the taxpayer's U.S. income tax return, also requires reporting of a wide range of foreign assets. Foreign real estate owned directly (not through a corporation or trust) is not required to be reported, although all income on foreign real estate and the gift or ownership at death of foreign real estate must be reported.

5. Asset Protection: A foreign trust may afford asset protection advantages. If a U.S. person makes an irrevocable gift to a U.S. trust of which the settlor and his family are discretionary beneficiaries, with an independent trustee, the trust can still be reached by subsequent creditors of the grantor under the self-settled trust rules of most U.S. states. As previously noted, Alaska, Delaware, South Dakota, Wyoming, Nevada, New Hampshire and a few other states have enacted legislation overturning this rule as to trusts that are sited in those states; whether a trust created in one of those states will be defeated by a creditor from another state under the "full faith and credit" doctrine of the U.S. Constitution remains to be tested. However, the laws of the Cayman Islands, the Bahamas, Bermuda, the Cook Islands and some other offshore jurisdictions provide that if the settlor gives up the power to revoke or withdraw funds from such a trust, its assets cannot be reached by creditors whose claims arose after the transfer of assets to the trust. Moreover, creditors whose claims arose prior to the transfer of assets to the trust have a limited period (two years in the Bahamas, six years in the Cayman Islands) within which to bring their claim against the trust in the jurisdiction in which it is set up. Therefore, offshore asset protection trusts have become a popular vehicle for U.S. persons who are concerned about future claims.

Normally, a transfer to an asset protection trust is structured as an incomplete gift for U.S. gift tax purposes by prohibiting distributions to persons other than the grantor without the grantor's consent and by giving the grantor a testamentary power of appointment. Therefore, the transfer to the asset protection trust generates no gift tax, but the trust assets are includible in the grantor's estate at death. As previously noted, it is possible to structure the transfer to the asset protection trust as a completed gift, for which gift tax may be due, and then have the trust excluded from the grantor's gross estate at death, even though the grantor has remained a permissible beneficiary during his or her life. This is possible because creditors cannot reach such a trust in an asset protection jurisdiction (as they can if the trust is governed by the laws of most U.S. states). However, if the trust is settled in a non-U.S. jurisdiction, the asset protection and estate tax exclusion come at the cost of potential gain recognition when the trust becomes a foreign nongrantor trust on the settlor's death. The settlor may want to consider a U.S. asset protection jurisdiction in order to avoid potential gain recognition at death (and ongoing foreign asset reporting obligations).

D. U.S. Person Who Wishes to Benefit Non-U.S. Persons

If a U.S. person makes gifts to a non-U.S. person, either outright or to an offshore trust, the U.S. donor is still subject to U.S. gift tax in the same manner as with gifts to U.S. persons. However, after the transfer is made to a foreign individual, future income and appreciation of the assets are not subject to U.S. income, estate or gift taxation, except as to U.S. source income and U.S. situs assets. A transfer to a foreign trust solely for
foreign beneficiaries is also free of future U.S. income, estate and gift taxes, provided the U.S. donor does not retain any strings, such as a power to recover the assets or to control their distribution, that either could make the trust a grantor trust for U.S. income tax purposes or could bring the assets back into the estate of the U.S. person for estate tax purposes. However, such a trust will remain subject to U.S. GST tax.

As previously noted, if a U.S. person creates or transfers funds to a foreign trust, the trust is a grantor trust during any year that the trust may have a U.S. person as a beneficiary. (IRC § 679) Therefore, the trust agreement should provide that no U.S. citizen or resident may be a beneficiary. The U.S. person also should be careful to avoid transferring appreciated property to the trust so as to avoid forced gain recognition. (IRC § 684)

E. U.S. Person Who Owns Interests in Non-U.S. Corporations

The general rule is that U.S. shareholders of non-U.S. corporations are taxed only on distributions in the same manner as shareholders of U.S. C corporations. However, there are several important exceptions that ensnare many U.S. shareholders of foreign corporations in the U.S. tax net. It should be noted that in each case attribution rules among U.S. family members are applied in determining ownership.

**Passive Foreign Investment Company (PFIC):** Whether a foreign corporation constitutes a PFIC is determined by a passive income and assets test, but the shares can be publicly held. (IRC § 1296) A foreign corporation is a PFIC if either (i) 75 percent or more of its gross income is passive income or (ii) 50 percent or more of the average value of its assets are held for the production of passive income. Under this definition, most foreign mutual funds would be considered PFICs. The U.S. shareholder may elect to include in current income the pro rata share of ordinary income and capital gains of a PFIC. (This is a "qualified electing fund," or QEF, election.) If such an election is not made, then on the sale of the shares of the PFIC, the U.S. shareholder will recognize ordinary income on the gain, plus an interest charge under IRC § 1291. In order to make and maintain a QEF election, the U.S. shareholder must report certain financial information regarding the PFIC, which the offshore fund managers may not be willing to provide.

**Controlled Foreign Corporation (CFC):** A CFC is generally a foreign corporation owned more than 50 percent (in value or voting control) by "U.S. shareholders," who are defined as U.S. persons who hold at least 10 percent of the corporation’s stock by voting control or value. (IRC § 957) (Prior to the TCJA, a U.S. person had to own voting stock in order to be considered a U.S. shareholder.) Unlike PFICs, CFCs are not limited to companies with primarily passive income.

**Subpart F Income and GILTI Inclusions:** If the corporation is a CFC during any part of the taxable year, each U.S. person who is a U.S. shareholder on the last day of the CFC’s taxable year may be taxed on his or her pro rata share of the CFC's "subpart F" income under IRC §951(a) and "global intangible low-taxed income" (GILTI) under IRC §951A.
Subpart F income includes the following:

- Insurance income (as defined under IRC § 953).

- The foreign base company income (as determined under IRC § 954), which includes most types of passive investment income, as well as certain types of related party sales and services income (with carve-outs for de minimis amounts and "high taxed" income).

- Income derived from illegal international boycotts.

- Illegal bribes, kickbacks or other payments that would be unlawful under the Foreign Corrupt Practices Act of 1977.

- The income of such corporation derived from any foreign country that the United States does not recognize, or with which the United States has severed diplomatic relations or which repeatedly provides support for acts of international terrorisms.

GILTI, a new regime introduced by the TCJA, picks up most other types of income earned by the CFC. Under the GILTI regime, a U.S. shareholder of one or more CFCs is taxed on his or her share of the excess of (1) the CFCs' modified gross income (excluding certain items) over (2) a benchmark return of 10 percent of the CFCs' adjusted bases in depreciable tangible property placed in service (with certain adjustments for interest income and expense).

- The GILTI regime eliminated a long-standing distinction under the CFC rules between operating income of a bona fide business overseas (which until now was not picked up under these rules) and passive income.

- This will not have a significant impact on a typical foreign blocker structure that holds mostly marketable securities, as such income would already have been subject to the subpart F regime. However, trusts that hold stock in closely held operating companies could be impacted.

**Elimination of 30-Day Rule:** Until the TCJA went into effect, a foreign corporation had to be a CFC for at least 30 consecutive days in order for the CFC rules to apply. However, this 30-day rule was repealed by the TCJA. Now, even a day of CFC status can expose U.S. shareholders to phantom income inclusions, albeit on a fractional basis. As previously noted, this can present complications with the unwind of a foreign blocker structure after the death of a non-U.S. settlor.

**VII. U.S. CITIZEN OR RESIDENT WHO EXPATRIATES**

The United States revised its tax laws, effective June 17, 2008, covering U.S. citizens who on or after that date renounce their citizenship and persons who on or after that date renounce their green card after holding it for part or all of at least eight of the prior 15 years. For expatriations on or after June 17, 2008, the laws impose a capital gains tax on all appreciation in the value of a covered expatriate's worldwide assets as of the day of expatriation. (IRC § 877A) They also provide that gifts and bequests from a covered expatriate to a U.S. person are subject to a new transfer tax. (IRC § 2801)
Many provisions of the prior law no longer apply. These include the 10-year alternative regime of U.S. income, gift and estate taxation of a broad list of U.S. source income and U.S. situs assets, and the provision that an expatriate who spends 30 or more days in the United States in any of the 10 years following expatriation will be taxed as a U.S. person on his or her worldwide income and assets for that year.

To be a "covered expatriate" subject to the new law, the renouncing person must also meet one of the following three tests in IRC § 877 (a)(2):

(A) his or her average net income tax liability for the prior five years exceeds $168,000 (amount for individuals who expatriate in 2019, indexed each year for inflation);

(B) his or her net worth exceeds $2 million (including interests in trusts); or

(C) he or she fails to certify under penalty of perjury that he or she has complied with all federal tax obligations for the previous five years. (In other words, even if the expatriate does not meet the income tax or net worth tests, he or she must certify compliance with U.S. tax laws for the past five years or else be subject to the new taxes.)

There are exceptions for the following persons, provided they can make the certification as to tax compliance for the previous five years:

(i) persons who were dual citizens of the United States and another country from birth, are tax residents of that country at the date of expatriation and have not been U.S. income tax residents for more than 10 of the past 15 years; and

(ii) persons who expatriate before age 18½ and have not been U.S. income tax residents for more than 10 years.

**Computation of Tax:** To compute the tax, the expatriate determines what would have been the capital gains tax if he or she had sold all his or her worldwide assets for their fair market value the day before he or she expatriated. Losses are taken into account, but the "wash sale" rules, which provide that a loss is not recognized in the case of a sale and purchase within 30 days (IRC § 1091), do not apply.

The first $725,000 of net appreciation (2019 figure, indexed annually for inflation) is exempt from the tax. In addition, the covered expatriate may elect to defer the tax on any asset until that asset is sold or until the death of the covered expatriate, if sooner. A satisfactory security arrangement such as posting a bond must be reached with the IRS in the case of any such deferral.

For a person who moved into the United States and is now leaving and renouncing citizenship or a green card, the cost basis of assets that he or she owned on the date he or she first became a U.S. resident is their fair market value on that date for purposes of the expatriation tax.

Deferred compensation items and tax-deferred retirement accounts are not subject to the immediate expatriation tax but are subject to their own special rules, which generally amount to a withholding tax of 30 percent on distributions to the covered expatriate. 401(k) plans and IRAs are generally deemed to have distributed their assets to the covered expatriate immediately prior to expatriation, resulting in ordinary income inclusion (unless the plan is a Roth 401(k) or Roth IRA) but no early distribution penalty.
Beneficial Interests in Trusts: Grantor trusts of which the covered expatriate is treated as the owner under the grantor trust rules and that are included in the grantor's estate are subject to the mark-to-market tax. For nongrantor trusts (both domestic and foreign) of which the covered expatriate was a beneficiary immediately before expatriation, there is a withholding requirement on the trustee of 30 percent on the "taxable portion" of all distributions to the covered expatriate. The taxable portion of a distribution is the portion that would have been includible in gross income if the expatriate were still a U.S. person. In addition, if a nongrantor trust distributes appreciated assets to a covered expatriate beneficiary, the trust is taxed by the United States on the gain.

New Transfer Tax: IRC § 2801 imposes a special transfer tax on all covered gifts and bequests from a covered expatriate (made during the rest of his or her life after expatriation and at death) to a U.S. citizen or resident. The U.S. recipient is liable for payment of the tax, at a rate equal to the highest estate tax rate under IRC § 2001 or, if higher, the highest gift tax rate under IRC § 2502(a) (currently, both are 40 percent). The amount of the annual gift tax exclusion under IRC § 2503(b) (currently $15,000) is exempt, and gifts and bequests that are subject to U.S. estate tax, or that pass to a surviving spouse or a charity, are not covered gifts. (If the spouse is not a U.S. citizen, the bequests must pass to a qualified domestic trust and gifts will qualify for the exception up to only $155,000 per year, 2019 figure, indexed for inflation.) The tax is payable by the recipient.

Covered gifts or bequests to U.S. trusts are taxed in the same manner as gifts to U.S. persons. If covered gifts or bequests are made to a foreign trust, then distributions of income or principal from that trust to a U.S. person are taxed as covered gifts to that person.

VIII. NONCITIZEN SPOUSE

A. Qualified Domestic Trust

A U.S. person is entitled to a 100 percent estate tax marital deduction for assets left to his or her surviving spouse if the spouse is a U.S. citizen. This applies also to an NRA who leaves U.S. situs assets to the surviving U.S. citizen spouse. However, in either case, if the surviving spouse is not a U.S. citizen, the estate tax marital deduction is not available unless the assets pass to a qualified domestic trust (QDT). (IRC § 2056 (d)(2)(A))

To qualify, a QDT must meet the following requirements:

1. The trust must pay all income to the surviving spouse for life.

2. The trust may not permit principal distributions to anyone other than the surviving spouse during his or her life. Any principal distributions to the surviving spouse (except distributions for hardship) will be subject to estate tax at the time of distribution at the top bracket of the deceased spouse's estate. The remaining principal in the trust on the death of the second spouse will also be subject to estate tax on the estate of the first spouse.

3. The trust must have at least one U.S. trustee, and the U.S. trustee or trustees must have the power to withhold estate tax on any such distribution.

4. For trusts of more than $2 million, there must be either a U.S. institutional trustee (a U.S. bank or U.S. branch of a foreign bank) or the posting of a bond or letter of credit in an amount equal to 65 percent of the initial value of the trust assets. In
determining whether the trust has more than $2 million in assets, and also in
determining the amount of the bond or letter of credit, there is an exclusion for up
to $600,000 of real property (not, apparently, cooperative apartments)
constituting one or two residences and their contents used by the surviving

5. For trusts of $2 million or less, if more than 65 percent of the trust assets
constitute offshore real property, there must be either a U.S. institutional trustee
or the posting of a bond or letter of credit in an amount equal to 65 percent of the
initial value of the trust assets. (Proposed Treas. Reg. § 1.015-5(d))

No partial marital deduction election may be made over a QDT.

Assets owned jointly with a noncitizen spouse are fully includible in the estate of the first
spouse to die, except to the extent that the surviving spouse can prove contribution to
the property.

Outright bequests to a noncitizen spouse will qualify for the marital deduction without the
need for a QDT if the surviving spouse becomes a U.S. citizen before the decedent’s
estate tax return is filed. If the surviving spouse becomes a U.S. citizen at any time after
the return is filed, the QDT can be terminated and all assets paid outright to the surviving
spouse, but any principal distributions that were made to the spouse prior to becoming a
citizen will be taxed.

B. Gifts to Noncitizen Spouse

A U.S. person or an NRA may make unlimited gifts to his or her U.S. citizen spouse
without gift tax consequences. However, if the donee spouse is a non-U.S. citizen
(regardless of whether or not the donee spouse is a U.S. citizen or resident), the donor
spouse may give up to only $155,000 (2019 amount) per year to the donee spouse
without gift tax consequences. These annual gifts must be either outright or in a trust
that qualifies them as gifts of a present interest. They must also be in a form that would
qualify for the marital deduction if the spouse were a U.S. person. Any gifts in excess of
this amount will be subject to gift tax, although the unified credit is available if the donor
spouse is a U.S. citizen or resident. (IRC § 2523(i)(2))
G. Warren Whitaker advises high net worth individuals and multinational families with complex domestic and international estate planning and related income tax, corporate and personal financial planning. Clients seek his experience with sophisticated international transactions, trust and estate, family office, and trust services and fiduciary compliance issues. Warren is a prolific writer and international speaker. He has been published or cited in respected news sources, such as The New York Times. Warren served as the U.S. chair of the Society of Trusts and Estates Practitioners (STEP) and as chair of the Trusts and Estates Section of the NYSBA, and is a fellow of the American College of Trusts and Estates Counsel (ACTEC).

Dina Kapur Sanna has over 20 years of experience in advising U.S. and non-U.S. taxpayers on wealth management structures which accommodate multi-jurisdictional tax and legal considerations. Her practice involves foreign trusts, pre-immigration and expatriation planning, planning for the purchase of U.S. property by non-U.S. persons and compliance with tax and reporting obligations for those with overseas interests in foreign accounts, corporations and trusts. Dina is a frequent speaker at estate planning seminars and has written numerous published articles. She is an ACTEC Fellow and a member of its International Estate Planning Committee, as well as an Academician of The International Academy of Estate and Trust Law.