U.S. INCOME AND TRANSFER TAX PLANNING FOR U.S. CITIZENS, RESIDENT AND NON-RESIDENT ALIENS, AND NON-CITIZENS, INTERNATIONAL ESTATE PLANNING AND THE USE OF FOREIGN TRUSTS

By

Frederick J. Tansill, Esq.
Frederick J. Tansill & Associates, LLC
Attorneys and Counselors at Law
1355 Beverly Road, Suite 215
McLean, Virginia 22101
www.fredtansill.com

2007 Tax & Financial Planning Expo

Sponsored by the

Virginia Society of
Certified Public Accountants

Monday, November 12, 2007 - Tuesday, November 13, 2007

Lansdowne Conference Center
Lansdowne, VA

FREDERICK J. TANSILL

After practicing 12 years as a tax/estate planning/trusts and estates partner at two large law firms, one in Washington, one in Virginia, Fred Tansill started his own firm, Frederick J. Tansill & Associates, in 1997 in McLean/Tysons. Fred graduated from Brown University and received both his law degree and his masters degree in tax law from Georgetown. He is the only person to ever Chair both the Virginia and D.C. Bar Sections on Wills, Trusts and Estates. He has been a Fellow of the American College of Trust and Estate Counsel (AACTEC@) since 1991 and was listed by *Washingtonian Magazine* in 2002 and 1997 as one of the ABest Lawyers in Washington@ under the Estates and Trusts category. He was just selected for the 10th year in a row to be listed in the book Best Lawyers in America. He is frequently quoted in *The Washington Post* on estate and trust and tax matters, and has been quoted in many other publications, including *The Wall Street Journal*. He lives in McLean, has three children, and has practiced in Northern Virginia for 24 years. He is celebrating his 33rd anniversary at the Bar.

Fred Tansill has specialized expertise in:

- $ Advance Medical Directives
- $ Durable General Powers of Attorney
- $ Wills, Revocable Trusts, Irrevocable Trusts
- $ Estate and Trust Administration, Probate
- $ Sophisticated Charitable Planning, including
    - S Private Foundations
    - S Charitable Lead Trusts
    - S Charitable Remainder Trusts
    - S Advised Funds at Community Foundations
- $ Asset Protection Planning, Domestic and Offshore
- $ International Estates and Offshore Trusts
- $ Closely-Held Businesses/Tax Planning
- $ Premarital and Post-Marital Agreements
- $ Sophisticated Planning to Reduce or Avoid Estate Tax, Gift Tax, Generation-Skipping Transfer Tax

TABLE OF CONTENTS

I. THE U.S. FEDERAL TRANSFER TAX SYSTEM AS IT APPLIES TO BOTH U.S. CITIZENS AND TO RESIDENT ALIENS: ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX

A. The U.S. has one integrated transfer tax system for lifetime gifts and transfers at death

1. A flat tax rate of 45% on excess over $2 million of cumulative lifetime gifts and death transfers in 2007

2. $12,000 annual gift tax exclusion per donee per year ($24,000 from couple) beginning 2006 (up from $11,000/$22,000)

3. An exemption is available during life to offset gift tax on cumulative lifetime gifts (above $12,000/$24,000 per year per donee annual gift tax exclusion) and at death to offset estate tax on testamentary transfers. The exemption is

$ $2 million for persons dying in 2006-2008 (but gift tax exemption remains frozen at $1 million indefinitely),
$ $3.5 million for persons dying in 2009 (will Congress postpone or accelerate this?)
$ (Estate tax exemption amount uncertain for persons dying in 2010 and thereafter, but not less than $2-$3.5 million)

Predictions: Especially because of the cost of the wars on Terror and in Iraq and Afghanistan and the burgeoning federal deficit and the impending claims of baby boomers upon social security and medicare --

X the estate tax will <u>not</u> disappear in 2010, or ever.
X the estate tax exemption will <u>not</u> revert to $1 million in 2011 as current law provides. It will never go below $2 million again.
X it is possible that the exemption may not go to $3.5 million in 2009 if large budget deficits continue and Democrats have influence, but, on the other hand, there is broad political consensus today for $3.5 million - $5 million exemption, and it is more likely than not that the exemption will go to $3.5 million in 2009, or soon

thereafter.

X Based on a bill that almost became law right before the last Congressional election in 2006, it is likely that for estates under $25 million, the top bracket will be reduced from 45% to something like 25%. And for estates over $25 million, the tax rate will be reduced to something like 35%. This will probably happen in 2008 or, more likely, in 2009 or 2010.

4. There is an unlimited exemption for lifetime or death transfers to spouse or to charity. Transfers to spouse may be outright or in trust (QTIP Trust) from which spouse must receive all income

B. The Federal Generation-Skipping Transfer Tax System

1. A separate, additional transfer tax on transfers to those two or more generations younger than the donor

2. $2 million aggregate exemption beginning 2006, $3.5 million exemption scheduled for 2009

3. the top estate tax rate above will be imposed <u>in addition to</u> the gift tax or estate tax

4. If combined estates of husband and wife in excess of $5 million and there are grandchildren or grandchildren are expected, use GST exemption and try to leverage the exemption. <u>Never exceed the GST exemption and incur GST tax</u>!

II. TRUSTS

Many tax planning, charitable and asset protection strategies require trusts. Always draft them with the flexibility to accommodate unexpected future events.

A. A creation of English Common Law

B. Available generally only in English-speaking countries (<u>not</u> France, Germany, Spain, Switzerland, Latin America)

C. You, the Settlor or Grantor, create the trust, which is a contract between you and a second party, the Trustee,

who agrees to hold certain property under agreed terms for the exclusive benefit of a third party, the Beneficiary. There may be two classes of Beneficiaries, one with an interest in the trust=s income for a fixed or determinable period -- the holder of the income interest -- and the other with the right to the remaining principal at the end of the income interest -- the remainderman. The trust describes whether the named trustee can be discharged and replaced and by whom, how long the trust arrangement lasts, under what circumstances the Beneficiaries receive income and principal, whether the Settlor may revoke or amend the trust or not.

D. Trustee must be more than prudent -- a fiduciary duty

1. of loyalty to Beneficiaries

2. to preserve principal of Trust

3. to balance interests of life tenants vs. interests of remaindermen

4. to invest prudently, in accordance with Portfolio Theory

E. Who May Serve

1. Institutional Trustees, e.g.,

a. Trust Companies

b. Banks with Trust Powers

c. Other Non-Bank Trust Companies

2. Lawyers, Accountants, Financial Planners
<u>Caution</u>: it is unethical for an attorney to suggest himself or herself as fiduciary

3. Friends

4. Family Members (but consider conflicts of interest and tax issues, e.g., not second spouse for children of first marriage)

F. Trustee Fees

1. Institutions typically charge 1% of value of assets per year, with declining %, maybe .5%, above $3 million, to serve as Trustee. This includes investment management. This is the same fee the institution would charge simply to manage the money if it was not the Trustee.

   In effect, there is no extra charge for the bank or trust company to serve as Trustee.

2. Individuals should probably charge on hourly basis, as trustee fee will be in addition to investment management fee. Generally there is no fee savings in naming an individual to serve as Trustee, because you hope the individual will engage an institution to manage the money, and the institution will charge to manage the assets the same as it would charge to serve as Trustee.

G. Who Should Be Trustee of a Discretionary Spendthrift Trust or QTIP Marital Trust

Consider whom do you want to trust, whom do you want to put in charge.

1. If you trust the beneficiary and want the beneficiary to control the Trust, for instance your spouse in a Marital Trust

2. Make the beneficiary Co-Trustee with an Aindependent@ Co-Trustee

3. Give the beneficiary the power to fire and replace the independent Co-Trustee (This is almost always a good idea in trusts.)

4. The beneficiary will have to agree to investments

5. Note: Only the independent trustee can make discretionary distributions; the beneficiary who is Co-Trustee may not participate in that decision

H. If you do not trust the beneficiary and want the Independent Trustee to control the Trust

1. Make an institutional fiduciary sole Trustee

2. Permit the beneficiary to replace the Trustee discharged only with another institutional fiduciary or an attorney (This is frequently a good idea in trusts.)

3. The Trustee will control investments and distributions as a completely neutral third party

III. OVERVIEW OF ESTATE AND GIFT TAXATION OF CITIZENS, RESIDENT AND NON-RESIDENT ALIENS

A. U.S. Citizens and Resident Aliens.

U.S. citizens and resident aliens of the U.S. are treated in an identical manner for purposes of U.S. estate and gift taxation. The same gift and estate tax rules, regulations and rates are applicable to both groups. See I.R.C. '2001(a), '2501(a).

B. Gift Tax.

A U.S. citizen or a resident alien will be subject to tax on gifts of property, wherever situated, if the value of the gifts exceeds the $12,000 annual present interest exclusion of I.R.C. '2503. Regs. '25.2501-1(a).

C. Estate Tax.

The estate of a U.S. citizen or a resident alien will be subject to taxes on the value of its worldwide assets, not only those assets located in the United States. See Regs. '20.0-2(b)(2).

D. Non-Resident Aliens.

As a general rule, non-resident aliens are also subject to U.S. gift and estate taxes. I.R.C. '2101. However, they are taxed only on gifts or real and tangible personal property situated within and transferred within the United States, and their estates pay tax only on property situated or deemed to be situated in the United State

which the decedent owns at the time of his death. I.R.C. '2501(a)(2); I.R.C. '2106(a). Certain deductions and credit which are available to citizens and resident aliens to offset gift and estate tax are either curtailed or not available to non-resident aliens. I.R.C. '2106(b).

E. Caveat Re Treaties.

When planning the estate of a non-resident alien, it is very important to determine whether a gift and estate tax treaty is in force between the United States and the country of which the non-resident alien is a citizen, since treaty provisions often alter the statutory scheme for the taxation of these individuals. (See below.)

IV. PERSONS QUALIFYING AS NON-RESIDENT ALIENS: RULES OF DOMICILE

A planner should evaluate the status of clients to determine in every case whether the clients are U.S. citizens, and the status of non-citizen clients to determine whether the individual is considered a resident or a non-resident for estate and gift tax purposes and/or for income tax purposes, because his or her status could significantly affect the amount of federal taxes paid and the planning strategies to minimize the taxes.

A. Domicile for U.S. Transfer Tax Purposes.

The estate, gift and generation skipping provisions of the Internal Revenue Code and the Regulations do not use the term non-resident alien to describe an individual who is neither domiciled in nor a citizen of the United States. Rather they use the words "non-resident not a citizen of the United States." See e.g., Regs. '20.2105-1.

A non-resident alien is simply an individual not a citizen of the U.S. who was not domiciled in the fifty states or the District of Columbia at the time of his death. Regs. '20.0-1(b)(1) and (2).

The definition of domicile appearing in the regulations is not very long or comprehensive. It states:

> AA person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. Treas. Regs. '20.0-1 and '25.2501(b).@

It appears from this definition that the length of time spent in the United States is irrelevant for establishing domicile for transfer tax purposes. It would appear that a non-citizen testator would have to have been physically present in the United States in the period of time leading up to death or to the gift and during that time would have had the intent to remain indefinitely to be subject to U.S. estate or gift tax. But physical presence in the U.S. in the period of time leading up to death or to the gift, even for an extended period of time, is not sufficient to create a nexus for U.S. transfer tax without the requisite intent to remain in the U.S. Normally some affirmative act is required to confirm the intent to remain in the U.S. Rev. Rul. 58-70. Note that permanent resident status is not required.

B. Residence for U.S. Income Tax Purposes.

The definition of residency and domicile for U.S. income tax purposes is different than the definition for transfer tax purposes. Section 7701(b) of the Internal Revenue Code states that an individual is considered a resident of the United States for a

calendar year or not based on a number of highly mechanical rules: (i) if the individual is a lawful permanent resident for any portion of the year (i.e., if the individual holds a so-called "green card"); (ii) if the individual meets the substantial presence test; or (iii) if the individual makes a first year election to be treated as a resident under ' 7701(b)(4). See Regs. ' 301.7701(b)-1.

The substantial presence test is met if an individual is physically present in the United States for 183 days or more during a calendar year, or the sum of the days the alien is present during the calendar year, plus one-third the days the alien is present in the preceding calendar year and one-sixth the number of days the alien is present in the year before that equals or exceeds 183 days. The two exceptions to this rule are that an individual is not treated as a resident for income tax purposes if (1) he spent less than thirty-one days in the United States during the year in question, or (2) if, having spent more than 183 days in the United States, he can prove that he has "closer connections" -- more significant personal and economic ties -- and a tax home in a foreign country. The closer connection argument is not available to an alien who has applied for a "green card." Treaties may impact on the issue of residency, particularly in regard to the income tax rules.

For purposes of the "substantial presence" test, an alien individual's physical presence in the United States in the following capacities is disregarded:

- as a foreign government-related individual (A-visa and G-visa holders);
- as a teacher or trainee (but only for a limited number of years);
- as a student (but only for a limited number of years);

- as a professional athlete;
- as an individual with a medical condition which arose while he was in the U.S.;
- as a commuter from Canada or Mexico; or
- as an individual in transit between two foreign points.

C. Trap for the Unwary.

It is definitely possible to be a U.S. resident for income tax purposes and yet be considered not domiciled in the U.S. for transfer tax purposes. And vice versa.

V. INCOME TAXATION OF NON-RESIDENT ALIENS

If an individual qualifies as a non-resident alien for U.S. income tax purposes and is engaged in a trade or business in the United States, he is subject to income tax on gross income which is "effectively connected with the conduct of a trade or business in the United States, e.g., wages and self-employment income. I.R.C. '871(b)(2). The tax on such income is imposed according to the rate schedule used for the income taxation of U.S. citizens. I.R.C. '871(b)(1). If a non-resident alien is not engaged in a U.S. trade or business -- and a foreign investor in the U.S. normally is not -- the only income subject to U.S. income tax is fixed or determinable annual or periodical income ("FDAP") with a U.S. source. As a general rule, a non-resident alien's interest, dividend, rental and royalty income, salary, wages, and annuities from U.S. sources which is not "effectively connected with a trade or treaty business" is subject to a flat tax rate of thirty percent (30%) on gross income which is withheld at the source. I.R.C. '' 871(a)(1), 1441,1442. Treaties frequently reduce or eliminate the 30 percent withholding tax on

certain types of investment income.

For the listing of the countries with whom the U.S. currently has in effect income tax treaties, please see below.

A. Portfolio and Interest Income.

Section 871 (and '' 881, 864(c)(2), 1441, and 1442) exempts non-resident aliens from this thirty percent withholding tax for interest earned from certain portfolio debt investments and other interest producing investments. The interest exclusions almost swallow up the general rule as it pertains to interest income. As a result, investments which produce excluded and non-taxable interest income are tax-favored and popular instruments from non-resident aliens. The exclusions include the following.

1. Portfolio Interest. Portfolio investments are passive, as opposed to direct investments in which the investor influences or controls the investment. Portfolio interest income is exempt from taxation if it received by a foreign taxpayer who owns either directly or indirectly less than 10 percent of the stock of the obligor U.S. corporation and the interest is paid either on (1) an obligation which is not registered but is issued under arrangements intended to insure that it will not be sold to U.S. persons and satisfies certain other restrictions or (2) an obligation which is registered and a statement is provided that the beneficial owner is not a U.S. person. These portfolio investments are basically specifically qualified corporate bonds, debentures, and notes. The 1993 Tax Act clarified the law to the effect that contingent interest is generally not exempt. '' 871(h), 881(c), 1441 (c)(9), 1442, 2105 (b).

2. Certain Bank Deposit Interest. Certain interest-generating deposits

of non-resident aliens not involved in a U.S. trade or business are excluded from U.S. income tax. The deposits excluded are (i) deposits with banks, (ii) deposits with savings and loan institutions, and (iii) amounts held by an insurance company under an agreement to pay interest thereon.

3. Interest on Government Debt. Traditionally, interest from any state, territory or possession of the U.S. was not considered to be included in gross income so it was not taxable in the hands of a non-resident alien. This rule was codified in '871(g)(1)(B)(ii).

4. Original Issue Discount Income. Original issue discount (within the meaning of Code '1233) on any bond or other indebtedness is exempt from taxation if the debt instrument matures within 183 days from its issue, without regard to the taxpayer's holding period. Three- and six- month Treasury Bills produce original issue discount income that is not taxable to a foreign investor.

B. Dividend Income.

Non-resident aliens are subject to a flat 30 percent income tax (unless otherwise modified by applicable treaty, which frequently reduce the rate to 15% or even 5%) on U.S. source dividend income, to the extent such income is not effectively connected with a trade or business. Dividend income is considered to be U.S. source income if it paid with respect to stock in a U.S. corporation. Dividend income paid by a foreign corporation is considered to be sourced in the United States if 25 percent or more of a corporation's gross income for the period is income effectively connected with the corporation's U.S. business. The various types of dividend paying investments

available to non-resident aliens include the following when held for investment, not effectively connected with the conduct of U.S. trade or business:

1. Individual issues or mutual funds of common stock in U.S. corporation.

2. Individual issues or mutual funds of preferred stock in U.S. corporation.

3. Money-market mutual funds

C. Capital Gains.

Capital gains from U.S. sources other than U.S. real estate and business activities actively conducted by the non-resident alien in the U.S. are not subject to U.S. income tax.

D. Real Estate.

U.S. real estate investments by foreign investors are subject to the highly complex provisions of the Foreign Investors in U.S. Real Property Tax Act (FIRPTA), Code ' 897, the terms of which are beyond the scope of this treatment. Suffice it to say that when a non-resident alien holds direct title to U.S. real estate, it is subject to U.S. estate tax, whereas, if he holds title through a foreign corporation, the real estate would not be taxed in the U.S. at his death. The thrust of FIRPTA is that on the sale of U.S. real estate by a non-resident alien, U.S. Capital gains tax is due.

VI. THE STATUTORY SCHEME OF ESTATE TAXATION IMPOSED ON NON-RESIDENT ALIENS, MARITAL DEDUCTION PLANNING FOR THE NON-CITIZEN SPOUSE

A. Determination of Gross Estate.

The general rule under the Code is that the gross estate of non-resident alien includes only property situated in the United States. I.R.C. '2103. In theory this rule is very simple but in practice determining the situs of a piece of property may prove to be very complicated. The Internal Revenue Code provides some rules for determining the situs of specific types of assets for transfer tax purposes, but there may be questions as to which country's situs rules should be applied. Furthermore, treaty provisions may also alter the rules for determining the situs of assets.

B. Property Within the United States.

1. Intangible Personal Property.

Generally speaking, intangible personal property is deemed to be situated within the U.S. if it is issued by, or enforceable against, a U.S. resident. Treas. Reg. '20.2104-1(a)(4). There are many nuances and variations of this rule.

a. Stock. Shares of stock owned and held by a non-resident alien at the time of death are deemed to be property situated within the United States and subject to U.S. estate tax only if they are issued by a U.S. corporation. I.R.C. '2104(a). However, if a non-resident alien holds shares issued by a U.S. corporation via a foreign holding company, the non-resident alien will not be subject to U.S. estate tax on account of that investment, because he will own only shares of a foreign corporation.

b. Trust Interests. For a trust interest of a non-resident alien to be subject to U.S. estate tax, his interest must be an indefeasibly vested interest that would be includible in the gross estate of a U.S. citizen or domiciliary under ''2033 -

2046. If it is, the situs rules of '' 2104 and 2105 apply to determine U.S. taxability. The rules apply equally to grantor or beneficiary. Therefore, any property which the decedent has transferred by trust or otherwise within the meaning of '' 2035 - 2038 is deemed to be situated in the United States if it was situated here at the time of the decedent's death (or at the time of the lifetime transfer, for gift tax purposes). I.R.C. '2104(b).

c. Debt Obligations. Those issued by a United States person or by the United States, a state or any political subdivision of a state, or the District of Columbia owned by a non-resident alien will be deemed to be situated in the United States. I.R.C. '2104(c). The situs of the actual instrument is irrelevant. Securities generating portfolio income exempt from U.S. income taxation are generally exempt from U.S. estate tax if owned by non-residents.

2. Real Property.

The situs of real property generally is determined by its physical locations. Regs. '20.2104-1(a); Regs. '20.2105-1(a)(1); Regs. '25.2511-3(b)(1). The law of the place where the property is located determines which interests are considered real property. Accordingly, U.S. real estate owned by a non-resident is subject to U.S. estate tax.

The full value of property subject to a mortgage is includable in the estate of a non-resident alien. The amount of the lien is generally deductible only to the extent the ratio U.S. situs property bears to worldwide assets. If worldwide assets are not disclosed -- and non-citizens are notoriously loath to disclose to any government their worldwide assets -- no deduction may be claimed. One case, however, held that only

the equity was includable in a non-resident alien's gross estate because the decedent was not personally liable for the mortgage, i.e., it was non-recourse. Estate of Johnstone v. Comr., 19 T.C. 44 (1952); See Regs. '20.2053.7.

3. Tangibles.

The situs of tangible personal property generally is determined by the physical location of the property at the time of death or the time the gift is made. Regs. '20.2104-1(a)(2); Regs. '2105-1(a)(2); Regs. '25.2511-3(b)(1). Therefore tangible personal property owned by a non-resident alien and physically located in the U.S. is subject to U.S. estate tax. Tangibles brought to the U.S. by a visitor who dies here are not subject to estate tax solely by reason of situs. Delaney v. Murchie, 177 F.2d 444 (1st Cir., 1947); Estate of Paquette v. Comm'r, 46 T.C.M. 1400 (1983).

C. Property Deemed Without the United States.

1. Life Insurance.

Any amount receivable as life insurance proceeds on the life of a non-resident alien is not deemed to be property located within the United States. I.R. C. '2105(a).

2. Bank Deposits.

Bank deposits in U.S. banks are deemed to be situated outside the United States unless the deposits are effectively connected with the conduct of a trade or business within the United States. I.R.C. '2105(b)(1). Note, however, that where a U.S. bank holds funds as a fiduciary or custodian, the deposit would be treated as U.S. property. Rev. Rul. 69-596. And cash in a U.S. safe deposit box would be subject to U.S. estate tax. Rev. Rul. 55-143.

3. Foreign Branch Bank Deposits.

Deposits with the foreign branch of domestic corporation or domestic partnership are deemed to be situated outside the United States, if such branch is engaged in the commercial banking business. I.R.C. '2105(b)(2).

4. Works of Art on Loan in the U.S..

Works of art owned by non-resident aliens are not deemed to be situated in the United States if such works are brought into the U.S. solely for exhibition purposes or loaned to a public gallery or museum for exhibition purposes or are in the process of being shipped to such a museum or gallery at the time the decedent died. I.R.C. '2105(c).

5. Portfolio Interest and Corporate Debt Obligations.

Debt instruments that generate interest qualifying as "portfolio interest" are excludible from the U.S. taxable estate of a non-resident alien. I.R.C. '2105(b)(3). The qualifications rules are complex I.R.C. '163(f)(2)(B). Debt obligations issued by U.S. corporations will not be considered U.S. situs property if the corporation meets the tests of I.R.C. '2104(c)(2).

D. Deductions and Credits.

Non-resident aliens are subject to different deductions and credits against their estate and gift taxes than U.S. citizens and resident aliens. The deductions and credits are sometimes allocated on the basis of United States and foreign situs property and sometimes based on a completely different set of rules.

1. Expenses, Losses and Taxes.

The estate of a non-resident alien is permitted a proportion of the deductions allowed in I.R.C. '' 2053 and 2054 for expenses, losses, indebtedness and taxes. The proportion is the value the decedent's estate located in the United States bears to the value of his gross estate worldwide. I.R.C. '2106(a)(1). If the personal representative cannot or will not reveal the extent of the decedent's worldwide estate, he cannot take the deduction permitted by this section. Id.

2. Charitable Contributions.

Unlike deductions for expenses, losses, indebtedness and taxes, the non-resident alien's estate may take as a deduction against estate taxes the full value of charitable gifts or bequests. Even though the deduction is not based on the proportion of the assets located in the United States, it is still subject to some restrictions. A charitable bequest will only be eligible for the estate tax deduction if it is made solely for public purposes to a governmental entity within the United States, a domestic corporation or a trustee, fraternal order or an association to be used within the United States. I.R.C. '2106(a)(2). Under these rules, while a charitable transfer made to a foreign organization is not eligible for the deduction, a transfer to a domestic organization for use abroad is allowed the deduction. See Estate of John Edgar McAllister, 54 T.C. 1407 (1970); see also Rev. Rul. 76-307, 1976-2 CB 56; cf. '2055(a)(2).

3. Marital Deduction.

Prior to the Technical and Miscellaneous Revenue Act of 1998 (“TAMRA”)

the citizenship or residence of the DECEDENT controlled whether the federal estate tax marital deduction was available. However, since November 10, 1998 the SURVIVING SPOUSE'S STATUS determines the availability of the federal estate tax marital deduction:

A. If the decedent is a Non-Resident Alien (NRA), the federal estate tax marital deduction is now permitted "under principles of Code '2056" if the surviving spouse is a U.S. citizen.

Code '2106(a)(3).

B. If the decedent is a U.S. citizen or resident, the federal estate tax marital deduction is <u>generally</u> disallowed if the surviving spouse is NOT A U.S. CITIZEN. Code '' 2056(d) and 2056A. However, there are <u>exceptions</u> to this rule. The federal estate tax marital deduction is <u>still</u> available with respect to transfers to non-citizen spouses if two requirements are met:

(a) The transfer would have qualified for the deduction if the surviving spouse had been a U.S. citizen. Treas. Reg. '20.2056A-2(b)

AND EITHER

(b-1) The surviving spouse becomes a U.S. citizen before the date on which the federal estate tax return is made. Code '2056(d)(4), Treas. Reg. '20.2056A-1(b). It is not sufficient simply to apply for citizenship before the return is made. PLR 9021037. This exception is not available if the surviving spouse was not a U.S. resident at all times after the spouse's death.

OR

(b-2) The property passes from the decedent to the surviving spouse in a Qualified Domestic Trust ("QDOT") with respect to which an appropriate election is made. Code '2056(d)(2).

The alternative "passing to the surviving spouse in a QDOT" is satisfied in one of four ways:

(i) Direct transfer to a QDOT established by the decedent spouse, e.g., a QDOT set forth in decedent's will or revocable trust. Code '2056(d)(2)(A).

(ii) Direct transfer to a trust that is not a QDOT but is reformed in a timely manner, e.g., a QTIP trust which does not include the required QDOT provisions. Code '2056(d)(5); Treas. Reg. '20.2056A-4(a). There are elaborate rules governing this.

(iii) By transfer to the surviving spouse in an otherwise qualifying disposition, followed by a transfer or irrevocable assignment by the surviving spouse of the property to a QDOT before the federal estate tax return is filed. Code '2056(d)(2)(B); Treas. Reg. '20.2056A-4(b)

(iv) By satisfying various special requirements if the assets passing to the surviving spouse consist of non-assignable or non-transferable annuities, pension plan benefits or similar rights. Treas. Reg. '20.2056A-4(c). Again the Regulations provide elaborate requirements.

Note. Certain estate tax treaties recognize some form of marital deduction and the rules vary from treaty to treaty. It is critical, therefore, to review appropriate treaty provisions to determine the applicable marital deduction rules. The executor may

choose the rules and deduction of Code ' 2056A or the treaty provisions and deduction, but not both. Treas. Reg. ' 20.2056A-1(c).

C. Credit for Tax on Prior Transfers if Surviving Spouse Dies a U.S. Resident. If the decedent (U.S. citizen or alien) leaves property to his alien spouse which is taxed in his estate but would have qualified for the marital deduction had the surviving spouse been a citizen, and his spouse later dies a citizen or alien resident in the U.S., the surviving spouse's estate is entitled to a ' 2013 credit for the tax on the prior transfer irrespective of the amount of time that has passed since the first decedent's death (I.R.C. ' 2056(d)(3)).

D. Lifetime Gift to Non-Citizen Spouse. If an inter vivos gift is made to an alien spouse, no marital deduction is available, even if the transfer is to a trust which meets all the requirements for a qualified domestic trust. However, under ' 2523(i) a gift tax annual exclusion is available for gifts to a non-citizen spouse. The amount is indexed for inflation. In 2007 it is $125,000.

E. Joint Property Presumption. If a citizen or resident alien decedent's surviving spouse is an alien (resident or nonresident), and husband and wife had a tenancy by the entirety or joint tenancy with right of survivorship in real estate or a joint interest in personal property with right of survivorship, the rule (of I.R.C. ' 2040(b)) that one-half (l/2) of the value of the jointly-owned property shall be included in the gross estate of a decedent co-owner is inapplicable, and instead the decedent's estate will

be taxed on the entire value of the jointly-owned property except to the extent that the estate can show that the survivor provided consideration or the property was given or devised or bequeathed to them jointly by another person. See Treas. Reg. '2523(i)-2(b)(1), (b)(2)(i) and (b)(4)(ii) Ex. 1. (These are the old rules of now-otherwise-repealed Code '' 2515 and 2515A.). The rule applies whether the decedent is a citizen, a resident alien or a non-resident alien.

F. QDOT Exception to the General Rule. Basic Requirements. The exception to the disallowance of the marital deduction discussed in B. above involves the use of a "qualified domestic trust," defined in I.R.C. '2056A(a) as a trust meeting six basic requirements: (1) It must be an ordinary trust as defined in Treas. Reg. '' 301.7701-4(a) and 20.2056A-1(a); (2) The trust must be “maintained” under the laws of a state or the District of Columbia and the administration of the trust must be governed under the laws of such a jurisdiction. Treas. Reg. '20.2056A-2(a); (3) At least one trustee must be an individual U.S. citizen with a tax home in the U.S. or a domestic cooperation. Treas. Reg. 5205A-2(c); (4) The U.S. Trustee must have the right to withhold the special QDOT tax on any distribution subject to that tax. Code '2056A(a)(1)(B); (5) The trust must contain detailed requirements to ensure the collection of the QDOT tax. Treas. Reg. '20.2056A-2(d). The exact nature of these requirements turns on whether the adjusted fair market value of QDOT assets, as finally

determined at the decedent's death, exceeds $2 million, with the executor having the ability to exclude up to $600,000 attributable to a personal residence and furnishings. If total QDOT assets are less than $2 million, the less onerous rules are only applicable if foreign real estate holdings are less than 35% of the fair market value of the trust assets. The latter determination is made annually on the last day of the taxable year of the trust. Accordingly, foreign real estate holdings can cause a trust to move from one set of compliance requirements to another as asset valuations fluctuate. (6) The final requirement concerns an election to qualify the trust that must be made by the Executor. Treas. Reg. ' 20.2056A-3.

(i) *Timing*. The election must be made on the last federal estate tax return filed before the due date (including extensions granted), or if a timely return is not filed, the first return filed after the due date BUT IN ALL EVENTS no later than one year after the date that the return was required to be filed. Treas. Reg. ' 20.2056A-3(a).

(ii) *Partial elections not permitted*. The election cannot be partial, but if a single trust is severed into two or more trusts in a timely fashion, an election may be made with respect to one or more of the severed trusts. Treas. Reg. ' 20.2056A-3(b).

(iii) *Protective elections*. A protective election is permitted but only if the executor believes that there is a bona fide issue concerning the residency/citizenship of the decedent or the citizenship of the surviving spouse, or whether an asset is includable in the

decedent's estate, or the amount or nature of the property the surviving spouse is entitled to receive. Treas. Reg. ' 20.2056A-3(c).

(iv) *Irrevocable nature*. Once made, the election cannot be revoked. Treas. Reg. ' 20.2056A-3(a).

Taxation of QDOT Trust. The QDOT allows postponement of the estate tax until a subsequent taxable event, typically the death of the surviving spouse, but the tax that is ultimately assessed is that of the first spouse to die. (This should be contrasted with the treatment of QTIP trusts.) A QDOT tax is imposed at the following events:

- Lifetime distributions (plus the amount withheld by the U.S. Trustee to pay the tax, subject to important exceptions for hardship distributions." Treas. Reg. ' 20.2056A-5(b), (c). Hardship distributions are made in response to "immediate and substantial financial need relating to health, education, maintenance or support of the surviving spouse or anyone the surviving spouse is legally obligated to support." Code ' 2056(A)(b)(3)(B), Treas. Reg. ' 20.2056A-5(c)(1). The amount must not be obtainable from another reasonably available source.
- Distributions at the surviving spouse's later death.
- Cessation of QDOT status during the surviving spouse's lifetime.

G. Naturalization of Surviving Spouse After QDOT Election. If a spouse is a U.S. resident and becomes a citizen after the QDOT is established (and after the decedent's estate tax return was filed), I.R.C.

' 2056A(b)(12) provides that no additional tax will be incurred under I.R.C. '2056A; instead taxes will be incurred under the normal tax rules for a U.S. citizen or resident, as if the trust belonged to the surviving spouse, which is to say that there will be no income tax to the surviving spouse on a principal distribution.

The I.R.S. has in the past granted (to the author) an extension of time to file the Federal estate tax return because of pending but incomplete naturalization proceedings which, if successfully completed, would obviate the need for a QDOT election on the Form 706. Recognizing that surviving non-citizen spouses may want to become naturalized to be eligible to receive the principal distributions without onerous tax consequences, QDOTs should be drafted to anticipate the possible conversion to simple QTIP status in the event of naturalization, and to permit the principal distributions in the event the QDOT converts to a simple QTIP.

H. Income Distribution Requirement. A spouse must have a qualifying income interest for life in a trust in order to have it qualify for the marital deduction (see I.R.C. '2056(b)(7)), and besides meeting the requirements of I.R.C. '2056A, a QDOT must qualify for the marital deduction under I.R.C. '2056(a). A spouse has a qualifying income interest for life if such spouse is entitled to all of the income from the property payable at least annually, and no person has the power to appoint any part of the property to anyone other than the spouse. See I.R.C. '2056(b)(7)(B)(ii). Therefore

it will be necessary to express this income distribution requirement in a QDOT.

I. Treaty Exceptions. Bilateral estate tax treaties take precedence over the Internal Revenue Code, and treaties afford opportunities for marital deductions for property passing, for instance, to German and Swedish citizens under rules more liberal than I.R.C. '2056A.

The marital provisions contained in Article 10(4) of the West German treaty and Article 8(8) of the Swedish treaty state that noncommunity property of a person who died a domiciliary of one of those countries (in the case of Germany, a German citizen) which passes to the decedent's spouse is included in U.S. gross estate only to the extent that its value exceeds fifty percent (50%) of all property included in the U.S. gross estate, provided that the tax will be calculated at rates applicable to U.S. citizens and residents. This provision appears to give Germans and Swedes a tax advantage over domiciliaries of other countries, whether covered by treaty or not, since the exception is available regardless of the spouse's citizenship.

4. Unified Credit.

As a result of TAMRA, the same tax rates are now applicable to the estate of non-resident aliens as are applicable to the estate of citizens and resident aliens. I.R.C. '2101(b). The lower rates which used to apply to non-resident aliens are no longer

applicable. Every non-resident alien is allowed a unified credit in the amount of $13,000 which can be used as a credit against the first $60,000 of estate taxes, not gift taxes. I.R.C. '2102(c)(1); I.R.C. '2505(a). An estate tax treaty between the United States and the country of which the decedent is a citizen may provide for a unified credit equal to a proportionate share of the $2 million estate tax exemption available to citizens and resident aliens, the proportion being the value the decedent's estate located in the United States bears to the value of the decedent's estate around the world. I.R.C. '2102(c)(3)(A).

In one case, Estate of Burghardt v. Commissioner, 80 T.C. 705 (1983), aff'd 734 F.2d 3 (3d Cir. 1984), the U.S. Court of Appeals for the Third Circuit affirmed that a non-resident alien was entitled to the unified credit allowed resident aliens and U.S. citizens under '2010 on the basis of an Italian Treaty. The Italian treaty contained the phrase "specific exemptions" which was read to include the unified credit. However, Revenue Ruling 81-303 concluded that the term exemptions found in the Australian, Finnish, Greek, Italian, Japanese, Norwegian and Swiss estate treaties did not encompass any portion of the unified credit allowed by '2010.

In a more recent case, Arnaud v. Commissioner, 90 T.C. (1988), aff'd 895 F2d 624 (9th Cir., 1990), the U.S. Court of Appeals for the Ninth Circuit did not permit a French non-resident alien to use the unified credit available to American citizens and residents. The court held that the Estate Tax Treaty between France and the United States did not permit the estate of a non-resident alien to be taxed as a domiciliary of the U.S. It distinguished this case from Burghardt by holding that the French Treaty did not use the term "specific exemptions" so there was no ambiguity present requiring the

court to read the term as including the unified credit.

Because only U.S. property of a non-resident alien is subject to U.S. estate tax, whereas all worldwide property of a resident alien is subject to the estate tax, unless almost all property of the alien is in the U.S. so that using the full unified credit is of overwhelming importance, an alien will normally have a strong incentive to avoid qualifying as resident for estate tax purposes.

E. Treaties.

Estate and gift tax treaty provisions may override many of the rules discussed in this outline. As of August 2005, the U.S. had estate tax treaties with

- Australia (G)
- Austria (G) (GST)
- Canada (income tax treaty has estate tax aspects)
- Denmark (G) (GST)
- Finland
- France (G) (GST)
- Germany (G) (GST)
- Greece
- Ireland
- Italy
- Japan (G)
- Netherlands
- Norway
- South Africa

- Sweden (G) (GST)
- Switzerland
- United Kingdom (G) (GST)

As of the same date the U.S. had gift tax treaties with those listed above followed by "(G)". The estate and gift tax treaties with those followed by "(GST)" contain provisions relating to generation-skipping transfer tax. Income tax treaties are in effect with all of the above plus Barbados, Belgium, Bermuda, Czech Republic, Canada, China, Cyprus, Egypt, Hungary, Iceland, India, Indonesia, Israel, Jamaica, Kazakstan, Korea, Luxembourg, Mexico, Morocco, New Zealand, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovak Republic, Spain, Thailand, Turkey, Trinidad and Tobago, and Tunisia.

VII. GIFT TAXATION OF NON-RESIDENT ALIENS

A. Taxable Gifts.

Unlike gifts by U.S. citizens or resident aliens, gifts made by non-resident aliens of tangible or real property are taxable only if the property is situated in the United States at the time the gift is made. I.R.C. ' ' 2501(a)(1), 2511(a). Treas. Reg. '25.2511-1(b). Gifts of intangible property, for example, and importantly, stock in a U.S. corporation and debt obligations like bonds and notes (but not cash, which is considered "tangible" for this purpose), by non-resident aliens are not subject to the gift tax. I.R.C. '2501(a)(2). Even though the gift tax rates for non-resident aliens are identical to those for U.S. citizens and resident aliens, the former group is not entitled to use any portion of the unified credit for inter vivos transfers.

B. Tax Exempt Gifts.

Non-resident aliens, like citizens and resident aliens, are entitled to the $12,000 present interest exclusion from gift tax for gifts to any person and are entitled to the unlimited exclusion for gifts to defray educational and medical expenses and the unlimited exclusion for gifts to citizen spouses. I.R.C. '2503(b), 2503(e). Treas. Reg. '25.2523(i)-1(a) and (c)(2). Furthermore, a donor, whatever his personal status, may make annual tax free gifts of up to $125,000 to a spouse who is not a citizen. I.R.C. ' 2523(i)(2). However, gift-splitting is not permitted unless both spouses are U.S. citizens or resident aliens. I.R.C. '2513(a)(1).

VIII. GENERATION-SKIPPING TRANSFER TAXATION OF NON-RESIDENT ALIENS

A. Introduction.

Section 2662 of the Code requires the Secretary of the Treasury to prescribe Regulations providing for the application of GST tax to nonresident alien transferors that are "consistent with the principles of Chapters 11 and 12." The legislative history of the Tax Reform Act of 1986 contains no further comments as to the congressional intent regarding this issue. So all of the rules are found in the “legislative” Treas. Reg. '26.2663-2.

As discussed above, Section 2103 of the Code provides that the gross estate of a nonresident alien is the gross estate (as determined under '2031) that is situated in the United States at the time of death. Sections 2104 and 2105 contain specific situs rules for different types of property. Applicable treaty provisions override these statutory provisions. Under '2511, nonresident aliens are subject to gift tax on transfers of property (other than intangible property) that is situated in the United States.

The only exception to this rule appears in ' 2501(a)(3) which subjects intangible property of a nonresident alien to gift tax if the donor expatriated within ten years of the gift where one of the principal purposes of expatriation was the avoidance of taxes. Section 2511(b) provides a special definition for the situs of intangible property of an expatriate whose intangible property is not exempt from gift tax.

a. Imposition of GST Tax.

A direct skip by an NRA transferor will be subject to GST tax only if it is also subject to estate or gift tax, and a taxable termination or taxable distribution of which an NRA is the transferor will be subject to GST tax only if the initial transfer by the NRA was subject to estate or gift tax. In other words, if in planning for the NRA one has successfully avoided any estate or gift tax, one will also by definition have successfully avoided the GST tax.

IX. INCOME TAXATION OF FOREIGN TRUSTS, NON-TAX ISSUES

A. Brief History.

Before 1976, a properly designed foreign trust could provide significant income tax deferral and, in some cases, complete tax avoidance.

At one time, prior to 1976, a foreign accumulation trust established in a tax haven (imposing no income tax on trusts) by a U.S. grantor for a U.S. beneficiary was not subject to income tax in the U.S. or in the trust situs. Moreover, undistributed trust funds could be made "available" to the grantor, the beneficiaries, and their families through such benefits as loans, private annuities and like-kind exchanges. The Tax Reform Act of 1976 and the Revenue Act of 1978, however, altered substantially the tax treatment of foreign trusts, narrowing their utility and creating a major trap for the

unwary.

In 1996 Congress redefined the term Aforeign trust@ in Code '' 7701 (a)(30)(E) and (31)(B). There is a strong bias in U.S. tax law to find a trust with foreign elements to be a Aforeign@ trust. Such a trust is foreign unless both of the following conditions are satisfied:

(1) A court within the U.S. will be able to exercise primary supervision over the administration of the trust; AND

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

Under this test, a trust may be Aforeign@ for U.S. tax purposes even if it was created by a U.S. person, all of its assets are located in the U.S. and all of its beneficiaries are U.S. persons. All it takes to qualify as foreign is one foreign person whose control over one Asubstantial@ type of trust decision.

One of the principal purposes of the 1996 act was to level the competitive playing field for trust business between U.S. and foreign institutions. Under the 1996 law a foreign person can use a U.S. financial institution as trustee without creating a U.S. trust.

Transfers by U.S. persons to foreign trusts with U.S. beneficiaries which the Settlor is deemed to control -- e.g., to an offshore asset protection trust -- are perfectly legal and have no adverse tax consequences but must be reported to the IRS on pain of confiscatory penalties. But under other circumstances Code '684 will treat transfers to a foreign trust by a U.S. person as a taxable sale of the asset for its fair market value.

No U.S. income tax is imposed on the transfer to a foreign trust by a non-U.S.

person.

If a non-U.S. person (e.g., grandfather) creates a foreign trust for U.S. beneficiaries, a complex regime of rules determines whether and when U.S. taxes are imposed on the income of the foreign trust, even if not distributed to the U.S. person.

C. I.R.C. Section 679.

Code '679, added by the Tax Reform Act of 1976, treats the U.S. grantor of a foreign trust which has a U.S. beneficiary as the trust's owner. Section 679 applies in addition to the regular grantor trust rules of '' 671-677. The grantor trust rules of '679 may often apply in unexpected situations and can be a particularly crippling blow to the U.S. grantor of a foreign trust, who may find that (quite unintentionally) he or she has become taxable on the income of a foreign trust from which no distributions have ever been received and over which no control or power has ever been exercised. Section 679 has no application to the transfer to a foreign trust upon the death of the transferor. Nor does it apply to arm's length sales of property to a foreign trust. Most foreign trusts which U.S. residents will be involved with will be grantor trusts under the rules of '679.

1. Amount Taxable. Once a U.S. person has made a gratuitous transfer of property to a foreign trust which has a U.S. beneficiary, that person is treated as the "owner" for his taxable year of the portion of such trust attributable to such property.

2. Reporting Requirements. The fiduciary of a foreign trust the income of which is taxable to the grantor is still required to file an annual income tax return, Form 1040 NR. This is an abbreviated return form.

Whenever a foreign trust is created by a U.S. person, an information return must be filed on Form 3520. Any person treated as a grantor of a foreign trust under '679

must file an annual return on Form 3520-A. There may be a penalty for grantors who fail to file equal to 5% of the corpus but no less than $1,000.

Additionally, a notation must be made on Part III of Schedule B of the grantor's Form 1040 that the grantor has made a transfer of assets to a foreign trust. A supplementary Form 90221 must be filed as well.

D. Taxes on the Creation and Funding of a Nongrantor Foreign Trust.

The creation and funding of a foreign trust which is not a grantor trust under '679 by a U.S. citizen or resident alien may give rise to transfer, excise and income tax liabilities, depending upon the method by which the trust is funded. Such trust will rarely be used or encountered except when established by non-resident aliens.

1. Gratuitous Transfer/Gift. If the foreign trust created by a U.S. citizen or resident alien is funded by a gift, the grantor may incur a gift tax liability, a generation-skipping transfer tax liability, an income tax liability and an excise tax liability.

2. Gift Tax Liability. This may be incurred on a gift or transfer by a U.S. citizen or resident alien for insufficient consideration, just as if the trust were a domestic entity. That is to say, gifts to the trust are potentially taxable gifts. They are gifts of future interests not subject to the annual exclusion unless and to the extent that the trust provides for Crummey withdrawal powers. The unified credit, gift splitting and gift tax marital deduction may be used as with gifts to a domestic trust.

If the donor is a nonresident alien, U.S. gift tax is imposed only on gifts of tangible property -- realty and tangible personalty -- situated in the

U.S. The $12,000 per donee annual exclusion is available for present interest gifts by nonresident aliens, but gift-splitting, gift tax marital deduction and united credit are not available.

In addition to gift tax, if a foreign trust is a "skip person," the U.S. citizen or resident alien grantor may incur a generation-skipping transfer tax on a gratuitous transfer to the trust. A foreign trust will be a skip person if all of its beneficiaries with present interests are individuals assigned to generations at least two below the grantor or if none of the beneficiaries have present interests and the trust can make no distributions to persons other than individuals in such generations. The $1 million lifetime exemption would be available.

3. Income Tax could be recognized by a U.S. citizen or resident alien grantor who gives an installment obligation to a nongrantor foreign trust. (I.R.C. ' 453B). The income would be the unrecognized gain on the sale in which the installment obligation arose. This income tax rule does not apply to foreign grantor trusts as defined by I.R.C. ' 679.

If a U.S. grantor makes a gift of appreciated property to a nongrantor foreign trust, tax may be imposed on the unrealized appreciation under I.R.C. ' 684.

E. Income Taxation of a Nongrantor Foreign Trust Established by U.S. Citizens and Resident Aliens.

The rules governing the income taxation of nongrantor foreign trusts are a combination of the rules on income taxation of domestic trusts and the rules on the

income taxation of non-resident alien individuals.

A foreign trust that is owned entirely by the grantor or a third party under the rules of '' 671-679 is deemed not to exist for income tax purposes.

Distinct from such a foreign grantor trust is a "nongrantor foreign trust" created, for example, by a nonresident alien individual, or which comes into being on the death of a U.S. grantor of a foreign grantor trust, or which is established by a U.S. grantor for foreign beneficiaries.

As in the case of a domestic trust, the income of a nongrantor foreign trust is taxed to the trust or to the beneficiaries or partly to each. The allocation of taxable income between the trust and the beneficiary is made by the trust's deduction for distributions of current income, up to its distributable net income.

Like a domestic trust, a nongrantor foreign trust may be either a simple trust or a complex trust. It is a simple trust if (1) the trust instrument requires all income to be distributed currently, (2) the trust instrument does not provide that any amounts are to be paid, permanently set aside for or used for a charitable beneficiary, and (3) the trust makes no distributions other than of current income (i.e., no distributions of accumulated income or corpus). If a nongrantor foreign trust is a simple trust, its income will be taxable to its beneficiaries, and the trust will receive a deduction for its current income that it is required to pay to the beneficiaries, whether or not the income is actually distributed.

A nongrantor foreign trust that is not required to distribute all of its income currently or that has a charitable beneficiary is known as a "complex" trust. A complex nongrantor foreign trust receives a deduction for that portion of its current income that

the trustee actually distributes to the beneficiaries. The trust's deduction is limited to the amount of its distributable net income. In a corresponding fashion, the beneficiaries must include in their income all income that a complex nongrantor foreign trust is required to distribute and all income actually distributed to the beneficiaries in the trustees discretion.

A foreign trust is, by definition, a trust which is taxed like a nonresident alien individual. Its income, therefore, is divided into four categories for tax purposes:

a. foreign source income;

b. U.S. income effectively connected with the conduct of a U.S. trade or business;

c. gains from the sale of U.S. real estate; and

d. other U.S. income not effectively connected with a U.S. trade or business, including both fixed and determinable annual or periodic income and other capital gains.

1. Foreign Source Income. A nongrantor foreign trust is not normally subject to U.S. income taxes on its foreign source income.

2. Effectively Connected Income. A nongrantor foreign trust will rarely have effectively connected income, because such a trust will rarely be engaged in the active conduct of a trade or business. In fact, the existence of such an activity would suggest a corporate form of entity rather than a trust. If a nongrantor foreign trust is engaged in a U.S. trade or business, it is fully taxable on all of its U.S. source income effectively connected with the trade or business in the same manner as if it were earned by a domestic trust.

3. Gains from Sales of U.S. Real Estate. A nongrantor foreign trust selling U.S. real estate (including interests in U.S. real property holding companies) is subject to tax as if a U.S. trust. Withholding of such taxes at the source is also required.

4. Periodic Fixed and Determinable Income. A nongrantor foreign trust with periodic fixed and determinable income from U.S. sources not effectively connected with a U.S. trade or business is subject to tax on such income at a flat thirty percent (30%) rate on the gross amount of such income.

Capital gain of a nongrantor foreign trust derived from U.S. sales and exchanges other than from sales of U.S. real property interests and not effectively connected with a U.S. trade or business are not taxable unless the fiduciary is "present" in the U.S. for at least 183 days of the taxable years.

In some circumstances a nongrantor foreign trust can elect to have passive income from certain U.S. real estate activities treated as effectively connected with a U.S. trade or business, under either the I.R.C. or certain treaties, and gain the advantage of deductions and graduated rates.

F. Income Taxation of Beneficiaries of a Foreign Trust

As previously noted, the beneficiaries of a nongrantor foreign trust are taxed on the trust's current income which either must be distributed under the governing instrument or which the trust actually distributes to the beneficiaries.

1. Foreign Trust's Foreign Beneficiaries. A foreign beneficiary of a nongrantor foreign trust is not normally subject to U.S. income taxes on the trust's foreign source income, since there is no U.S. activity or nexus upon which to predicate U.S. income taxation. In this situation, neither the trust nor the beneficiary is taxable by

the U.S. on the trust's current income.

A foreign beneficiary of a nongrantor foreign trust is subject to U.S. income taxes on the trust's U.S. source income to the extent distributed to the beneficiary. The character of the U.S. income of a foreign trust, as effectively connected or fixed and determinable periodic income, establishes the beneficiary's U.S. tax liability in the same manner in which it determines the tax liability of a foreign trust on undistributed income. The conduct of a U.S. trade or business by the fiduciary is clearly imputed to the beneficiaries (I.R.C. 875).

Some tax treaties reduce the rate of tax due on periodic fixed and determinable income. If income is retained and taxed to the trust, the treaty rate for the trust situs country should control the tax rate applicable to the trust. If income is distributed, the treaty rate for the country in which the beneficiary resides should control.

The foreign beneficiaries of a nongrantor foreign trust should be entitled to a credit for U.S. income taxes withheld at the source on payments made to the trustee.

2. Foreign Trust's U.S. Beneficiaries. The U.S. beneficiaries of a nongrantor foreign trust must include in their income any distributions of current U.S. and foreign income to the extent of the trust's worldwide distributable net income. U.S. beneficiaries receive a credit for the trust's U.S. and foreign tax payments.

There are special rules restricting the use of foreign trust to accumulate undistributed income and thereby avoid U.S. taxes.

G. Returns Required Relative to a Foreign Trust.

1. Grantor. U.S. grantors of a foreign trust and U.S. transferors of property to a foreign trust are required to report these transfers on Schedule B. Part III

of their individual Form 1040, and to file up to three supplementary forms.

a. Form 3250. Creation of or Transfers to Certain Foreign Trusts.

b. Form 3250-A. Annual Return of Foreign Trust with U.S. Beneficiaries. By U. S. persons taxable as owners of foreign trusts under I.R.S. '679.

There are substantial penalties associated with failure to file Forms 3250 and 3250-A.

2. Trustee. The trustee of a foreign trust must file three returns and statements if the trust has U.S. income.

A. Form 56. Notice Concerning Fiduciary Relationship.

B. Form 1040 NR. Nonresident Alien Income Tax Return.

C. Beneficiary. The beneficiary of a foreign trust must file Form 1040 to report income; Schedule B, Part III to note any beneficial interest in a foreign trust.

H. Selecting Situs.

A number of factors must be considered in selecting the situs for a foreign trust.

1. Developed Trust Law. It is impossible to establish a foreign trust in a nation which does not recognize the common law concept of a trust. Many civil law countries do not recognize trusts as legal entitles. While some common law countries have adopted the trust concept, one should not necessarily equate the mere adoption of the common law concept of a trust with the existence of a mature and developed law of trusts. Even if a prospective situs nation has a well developed law of trusts, it is necessary to examine those aspects of its trust law that may be particularly important to the ease of management and the financial success of a foreign trust. Even countries

with strong common law ties may differ with respect to their perpetuities and accumulative rules, which may determine the trust's ability to make a desired sequence of interests or to make the accumulations necessary for financial success.

2. Tax Burden. It is important to examine closely the tax burden of the situs nation on foreign trusts, since one of the few remaining tax benefits of a nongrantor foreign trust is tax-free growth and accumulation of income (the advantage of which, to some extent, is offset by the harsh rules on accumulation distributions to U.S. beneficiaries). The absence of income taxes in the situs nation means that there will be no income tax treaty with the U.S., with the result that U.S. passive investments will be subject to the full thirty percent (30%) withholding tax rather than any lower treaty rate. Moreover, a foreign trust subject to tax in the U.S. under the grantor trust rules of ' 679 should at least avoid taxation in the foreign jurisdiction.

It is also necessary to examine the imposition of organizational taxes on the establishment and funding of a trust. These may be documentary or stamp taxes. Normally such taxes will be minimal.

I. Repatriating to U.S.

A trust's return to the U.S. may give rise to significant U.S. income, estate and gift tax consequences. Generally the tax consequences of repatriation of a foreign trust depend on the form of domestication and how the I.R.S. or the courts view the transaction.

J. Drafting, Executing and Administration. While foreign trust documents are quite similar to domestic instruments, the multiplicity of special problems makes it useful to have a competent local attorney draft, or at least review, the trust document.

Most important in drafting a foreign trust are:

- to insure it is a foreign entity;
- to avoid future unfavorable situs;
- investment provisions;
- other administrative provisions; and
- funding the trust.

K. Force Majeure/Flight Clause.

It has been previously noted that civil and economic and political stability should be considered in selecting the situs for a foreign trust. However, there is always the possibility of unexpected serious problems that will make the country an undesirable situs for the trust. This possibility makes it important that the trust be able to alter its situs when necessary. Absent such a provision, known as a force majeure clause, the beneficiaries and trustee would always face the latent threat of the seizure of trust investments in the wake of civil disturbances.

Care should be taken to ensure maximum flexibility in the clause, because of the potentially adverse income tax consequences in the event of an injudicious change in the situs of a foreign trust. The trust instrument should expressly permit a change in the situs of the trust by either the trustee, with or without requiring the trustee's resignation, by the beneficiary, or by a "trust protector." The instrument should also permit the trust's situs to be shifted to the U.S., but only if the trustee finds compelling reasons for such a change.

The trustee instrument should enumerate the factors the trustee should consider in making such a change.

L. Planning for Using Foreign Trusts.

1. U.S. Grantors and Beneficiaries. Generally the least useful combination for a foreign trust from a tax planning perspective is a U.S. grantor and one or more U.S. beneficiaries. The trust will normally be a grantor trust under '679. This combination is usually involved in asset preservation planning.

2. Foreign Grantors and Beneficiaries. Because the trust, the grantor and the beneficiaries are all foreign, there is no U.S. nexus upon which taxes can be imposed, other than with respect to investments in the U.S. Furthermore, many foreign countries do not tax worldwide income, so that a foreign trust may provide a means by which investments can grow without taxation, ultimately to be withdrawn by the foreign grantor or beneficiaries.

3. Foreign Grantors and U.S. Beneficiaries. Foreign trusts may be exceptionally useful planning devices for foreign grantors whose children or other potential donees are U.S. residents or citizens. A foreign grantor can use a foreign trust to convert a gift to U.S. beneficiaries of assets producing taxable income into a gift of non-taxable cash flow. Rev. Rul. 69-70. If the trust is a grantor trust, the grantor will be deemed to own it and be taxable, but the grantor will be beyond U.S. tax jurisdiction.

A foreign grantor could even create a foreign trust in anticipation of his or her adopting U.S. residency. Such a trust should not be a grantor trust under '679, because it was created by a foreign individual, notwithstanding his or her later change of situs.

4. U.S. Grantors and Foreign Beneficiaries. Such a trust could be used for non-tax reasons, or to accumulate tax-free income for ultimate distribution to

beneficiaries who live in a foreign country. A trust created by U.S. grantor for foreign beneficiaries would not be a grantor trust under ' 679 unless there could at some future date be U.S. beneficiaries.

M. Tightening of the Foreign Grantor Trust Rules:

The Tax Compliance Act of 1995. Section 679 presently treats a foreign trust created by a U.S. person and having a U.S. beneficiary as a grantor trust. This law made four significant changes in the grantor trust rules regarding these foreign trusts:

1. Property transferred to a foreign trust at a grantor's death (including property already in the trust at the grantor's death) is treated as having been transferred to the trust by the beneficiaries at the grantor's death. This causes U.S. beneficiaries to be substituted as grantors of their shares of the trust for purposes of '679. Thus, the U.S. beneficiaries are currently taxable on the trust's foreign source income.

2. A grantor's sale of property to a foreign trust by a U.S. person is not exempt from '679, unless the price paid by the trust was the full fair market value of the property, without regard to any debt obligation issued or guaranteed by the trust, the grantor, a beneficiary, or a person related to the grantor or beneficiary. The grantor's election to recognize gain on the transfer under section 1057 would not be treated as the equivalent of the payment of the fair market value for the transferred assets.

3. Section 679 applies to a foreign person who transfers property to a foreign trust that has U.S. beneficiaries, if the transferor becomes a U.S. person within five years of the transfer. The new U.S. person would only own that portion of the trust

attributable to the assets transferred within the past five years.

4. The expatriation of a U.S. trust is treated as if the trust assets had been transferred to the trust by its beneficiaries. Therefore, any U.S. beneficiaries become the grantors of their respective portions of the trust under '679. If it were determined that a domestic trust was established pursuant to a plan to retransfer assets to a foreign trust, the IRS could treat the U.S. grantor of the domestic trust as the grantor of the foreign trust for purposes of '679. The interest of a beneficiary who became the deemed grantor of a foreign trust under these new rules is determined on the basis of all relevant facts and circumstances, including the terms of the trust instrument, letters of wishes or similar documents, patterns of historical trust distributions, and the existence of and functions performed by a trust protector or any similar advisor. If the interests of beneficiaries in a discretionary trust could not otherwise be determined, those beneficiaries with the closest degree of family affiliation to the settlor could be presumed to have equal proportionate interests in the trust.

The law also provides that only a U.S. citizen, resident, or domestic corporation can be taxed as the owner of a trust under the grantor trust rules. A trust created by a foreign grantor cannot be a grantor trust under this law. The legislative history indicates that the IRS will establish rules for applying the grantor trust rules to partnerships, trusts, and estates that are the grantors of trusts, so that the beneficial interests in such entities owned by U.S. citizens, U.S. residents, or domestic corporations will allow the continued application of the grantor trust rules.

Note. This closes what had become a popular loophole in international estate planning, under which a foreign donor would create a foreign trust and direct that it pay

all of its income to U.S. beneficiaries. If the foreign grantor retained or gave to a related party sufficient powers to cause the trust to be a grantor trust under '671, the grantor, rather than the trust or the beneficiaries, would be the only person on whom the U.S. could impose income tax. See Rev. Rul. 69-70, 1969-1 C.B. 182. However, if the trust were invested in foreign-situs assets, the foreign grantor was not taxed in the United States, and the U.S. beneficiaries received the trust income without any U.S. income taxes.

X. EXPATRIATION TO AVOID U.S. INCOME AND ESTATE TAX

A. Introduction. One approach to planning for the U.S. Income and transfer tax system has long been for a U.S. citizen to renounce U.S. citizenship and emigrate to a country with a more desirable income and/or inheritance tax system. If a U.S. citizen were able to renounce his U.S. citizenship and become a citizen of a country that did not have a, or an effective and onerous, income and transfer tax system, he and his family would significantly increase their long term ability to accumulate and retain wealth. By the same token, the tax base of the United States would be denuded by the escape of income and assets from U.S. soil.

Congress has tinkered with the expatriation rules several times in the past decade, most recently in 2004. These rules seek to delay the tax effects of expatriation for a 10-year waiting period, during which the expatriate will continue to be subject to U.S. income and transfer tax. The rules are found principally in Code '' 877, 2107, and 2501.

Further comment is beyond the scope of this outline.

XI. TYPICAL TAX-FAVORED INVESTMENT STRUCTURE OF NON-RESIDENT

ALIEN INVESTMENT IN U.S.

A. Foreign Trust.

Frequently, non-resident aliens who wish to invest in the U.S. first establish a trust in a tax haven jurisdiction, e.g., The Bahamas, Nevis, Cayman Islands, Netherlands Antilles, British Virgin Islands, Bermuda, etc.

1. An institution or its officers will serve as trustees.

2. The trust document is confidential: the grantor and beneficiaries cannot be disclosed. In some cases, a Declaration of Trust is used, whereby the trustee is also grantor. This further insulates the confidentiality of the "true grantor's" identity.

3. There is a mechanism for moving trust situs if the jurisdiction adopts onerous taxes on the trust or becomes politically unstable.

4. The document will provide for administration of the assets during the grantor's lifetime and for orderly distribution or continuing trust at his death.

5. The situs jurisdiction would normally have (a) no tax on trust income, (b) no currency exchange controls, (c) maximum bank secrecy laws, (d) low organization and trust maintenance and administrative costs, and (e) political stability.

B. Foreign Corporation.

The Foreign Trust would then create a corporation in the same or another tax haven jurisdiction and take title to its shares, but in "bearer" form.

1. The officers and directors will be professionals unrelated to the "true grantor" and beneficial owners.

2. The identity of the shareholder (i.e., the trust) will be totally confidential, thereby providing two levels of secrecy.

3. The situs jurisdictions would normally have (a) no tax on corporate income, (b) no currency exchange controls, (c) maximum bank secrecy laws, (d) low organization and corporate maintenance costs, (e) availability of reliable management, and (f) political stability.

4. All investments by the "true grantor" in the U.S. will be funneled through the trust and then the corporation. Only the foreign corporation will hold title to U.S. assets. This should completely avoid exposure to U.S. estate taxation of investment assets in the U.S. It will also avoid the need for probate proceedings in the U.S. Moreover, the country in which the nonresident alien is domiciled will have no ability to obtain information about these "foreign" investments.

However, if a non-resident alien becomes a resident, this structure can cause significant U.S. income tax problems under the rules for Foreign Personal Holding Companies, Controlled Foreign Corporation, or Passive Foreign Investment Companies. I.R.C. ' ' 951-964; I.R.C. ' ' 1291-1297.

C. Estate Tax Planning for Non-Resident Alien Investors.

The U.S. estate tax is a tax imposed on the value of property transferred at death. When the decedent is a U.S. citizen or resident, the tax is imposed on the value of his or her worldwide estate. When the decedent is not a U.S. citizen or resident, the tax is imposed only on the value of any property held by the decedent that was situated in the United States at the time of death. Shares of stock in a corporation are deemed to be situated in the United States only if issued by a domestic corporation. Therefore, the simplest and most expedient strategy for a foreign investor to entirely avoid U.S. estate taxes on assets situated in the United States has traditionally been to own those

assets through a foreign corporation, which typically owns a U.S. LLC which owns the U.S. asset e.g., real estate, brokerage or investment management account, etc. In that manner, since the only property that would be transferred at death is stock in a foreign corporation, the investor's indirect holdings of U.S. property are effectively insulated from the U.S. estate tax. Failure to properly insulate U.S. property from the U.S. estate tax could result in tax at rates as high as 45 percent applied to the gross value of the decedent's property.

XII. U.S. TAX PLANNING FOR THE NON-RESIDENT PREPARING TO ESTABLISH RESIDENCE OR DOMICILE IN THE U.S.

Consideration should be given to:

- Acceleration of foreign income, including arrangements to receive payments of bonuses for past services before becoming a U.S. resident for tax purposes.
- Exercise stock options to avoid U.S. tax on the appreciation existing on the date of exercise
- Deferral of expenses that will be deductible for U.S. income tax purposes.
- Sale of appreciated assets to avoid U.S. tax on the appreciation, including sales on the installment method (but elect out)
- Sell and repurchase an asset to establish high cost basis
- Deferral of sale of capital asset at a loss to allow deduction for U.S. tax purposes
- Sale of foreign residence to avoid U.S. tax on any gain.
- Deferral of purchase of U.S. residence to obtain deduction of points on

closing

- Establish "drop-off trust" outside U.S. at least five years before becoming U.S. domiciliary to minimize U.S. estate tax.

XIII. INTERNATIONAL WILLS

A. Virginia Law.

As of July 1, 1995, Virginia adopted the Uniform International Wills Act. Accordingly, a will executed in conformity with the Uniform Act will be valid as to form regardless of the place where it is made, the location of the assets, and the testator's nationality, domicile or residence.

An international will for a peripatetic individual with assets in multiple jurisdictions must comply with formal requirements:

1. The will must be in writing.
2. The testator must declare in the presence of two witnesses and an "authorized person" that the document is his will and that he knows its contents:
   (a) The authorized person may be a Virginia lawyer or a member of the U.S. diplomatic or consular service designated by Foreign Service Regulations;
   (b) The witnesses must meet conditions required for witnessing a will in Virginia.
3. The testator must sign or acknowledge the will in the presence of the witnesses and the authorized person.
4. The witnesses and the authorized person must attest the will by

signing it in the testator's presence.

5. There are specific procedures if a testator is unable to sign for himself.

The authorized person is to sign and attach to the will a certificate establishing that the requirements of the Act have been met. The form is reproduced in B. below.

B. Form of Certificate at End of Will

CERTIFICATE

1. I, _____ (name, address and capacity), a person authorized to act in connection with international wills

2. Certify that on _____ (date) _____ (place)

3. (testator) _____ (name, address, date and place of birth) in my presence and that of the witnesses

4. (a) _____ (name, address, date and place of birth of witness)
(b) _____ (name, address, date and place of birth of witness)
has declared that the attached document is his will and that he knows the contents thereof.

5. I furthermore certify that:
6. (a) in my presence and in that of the witnesses
(1) the testator has signed the will or has acknowledged his signature previously affixed.
*(2) following a declaration of the testator stating that he was unable to sign his will for the following reason _____ I have mentioned this declaration on the will *and the signature has been affixed by _____ (name and address)

7. (b) the witnesses and I have signed the will;

8. *(c) each page of the will has been signed by _____ and numbered;

9. (d) I have satisfied myself as to the identity of the testator and of the witnesses as designated above;

1. (e) the witnesses met the conditions requisite to act as such according to the law under which I am acting;

2. (f) the testator has requested me to include the following statement concerning the safekeeping of his will:

3. PLACE OF EXECUTION

4. DATE

5. SIGNATURE and, if necessary, SEAL.
*to be completed if appropriate

The District of Columbia has adopted a similar law.