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Foreign Affairs: A Primer on International Tax and Estate Planning (Part 1)

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INTRODUCTION

It should come as no surprise to tax practitioners that the world is becoming increasingly global. It has become commonplace for advisors to inquire, even in domestic practice, whether and to what extent a client may have foreign connections. Perhaps counterintuitively, many non-U.S. persons now view the United States as a friendly tax jurisdiction, which has resulted in a boom in foreign investment.[1] Indeed, the European Parliament recently identified the United States as one of the primary emerging ''tax havens.''[2] Global families now look to the United States as a safe place to invest capital, viewing the United States as having well-regulated, secure, and predictable investment markets backed by a modern and stable political system. Moreover, decades of global mobility have resulted in more and more international relationships, and many younger family members have traveled abroad to pursue educational or business opportunities, and have developed ties and broadened family footprints in the process.

As a result, there is an increasing need for domestic estate planning practitioners to have the ability to identify international planning opportunities and to cultivate an awareness of the various pitfalls that exist in the cross-border context. Many of the transfer tax and income tax rules that apply to global families can be thorny, unintuitive, and present traps for the unwary. Indeed, it is quite possible for unexpected tax consequences to occur in a situation in which one would think that a client representation involves purely domestic issues. Moreover, the push towards international financial transparency, with the introduction of the Foreign Account Tax Compliance Act (FATCA) by the United States, and the Common Reporting Standard (CRS) abroad, now requires practitioners to have a working knowledge of the information-exchange consequences and other compliance aspects of estate planning transactions.

This is the first in a series of articles providing a primer on international planning for domestic estate planners and tax practitioners. This series is intended to assist domestic advisors in identifying pitfalls that may unexpectedly arise during the course of a representation and in recognizing opportunities that can be leveraged to the benefit of the internationally-connected client.[3] Particularly in the context of investment structures, savvy planners have considerable flexibility to control the incidence and timing of vari-

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[1] LISI Archive Message #905 (Apr. 22, 2017), *available at* http://leimbergservices.com (''In the real world last week, investment into the US from abroad surged to $53.4 billion'').

[2] European Parliamentary Research Service, *EU-US trade and investment relations: effects on tax evasion, money laundering and tax transparency*, PE 598.602 (Mar. 2017) (''The United States of America is seen as an emerging leading tax and secrecy haven for rich foreigners'').

[3] For other excellent discussions on the U.S. taxation of foreign persons and trusts and related planning considerations see Ellen K. Harrison, Elyse G. Kirschner & Carlyn S. McCaffrey, *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*, SJ027 ALI-ABA 137 (2003); Michelle B. Graham, *Tax and Estate Planning Considerations for Foreign Persons Owning U.S. Assets*, 51 Heckerling Inst. on Est. Plan. (2017); Heimos, 854 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries*.

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ous taxes, and selecting the appropriate ownership structure can have a dramatic impact on the net economic result achieved. This first installment will begin by providing a broad overview of the international tax paradigm, opening with the transfer tax regime, moving on to the individual income tax regime and, finally, addressing the taxation of trusts in cross-border transactions.

INITIAL CONSIDERATIONS

Although common elements exist between domestic and international representations, there are also a broader class of questions and concerns that need to be evaluated with a global client. A key consideration in this regard should be the jurisdiction of both the client and the client's assets, a factor that is less likely to inform the relevant tax analysis in the domestic context. For these purposes, the ''residence'' of a client will need to be analyzed for both transfer tax and income tax purposes, based on very different rules and sometimes with unexpected results. Thus, the starting point in analyzing the global client's situation will involve taking into account the following:

- the client's residency status for U.S. transfer tax purposes;
- the client's residency status for U.S. income tax purposes;
- the nature and location of the client's primary assets;
- where trusts are involved, the residency status of beneficiaries, and the U.S. tax classification of the trust; and
- whether one or more bilateral tax treaties will inform the relevant tax analysis.

TRANSFER TAXES GENERALLY

Of course, when representing a U.S. citizen client, U.S. estate, gift and generation-skipping transfer (GST) taxes (referred to broadly in this article as ''transfer taxes'') will generally be relevant to the client's worldwide assets, regardless of where they are situated and regardless of whether those assets are tangible or intangible. In contrast, non-U.S. persons (sometimes referred to in this article as nonresident aliens, or NRAs), are subject to a jurisdictionally sensitive form of transfer taxation, meaning that U.S. transfer taxes will generally be applied only with respect to assets situated or deemed situated in the United States. Assets owned by an NRA and situated outside the United States will generally not be subject to U.S. transfer taxes.[4]

Accordingly, the threshold determination a practitioner must make is whether a client is a U.S. ''resident'' for U.S. transfer tax purposes, as only U.S. residents are subject to transfer taxation on their worldwide assets (i.e., in the same manner as a U.S. citizen). Although the term ''resident'' is used for both transfer tax and income tax purposes, the detailed objective tests used to define this term for income tax purposes[5] are irrelevant in the transfer tax context. Rather, for transfer tax purposes, residency is determined by the common law concept of ''domicile,'' meaning: (i) living in the United States, even for a brief period of time, and (ii) having no definite present intention of leaving the United States.[6] This determination is based upon all relevant facts and circumstances, with the ultimate objective of determining the taxpayer's intent.[7] It should be noted that, while obtaining a green card is generally considered a strong indicia of one's intent, it is not conclusive evidence of being domiciled in the United States. Generally speaking, a U.S. resident will be similarly situated to a domestic client as far as U.S. transfer tax planning is concerned. Interestingly, an NRA estate may sometimes find itself in the strange position of arguing in favor of U.S. resident status in order to take advantage of the larger unified credit available to U.S. residents.[8]

ESTATE TAXATION OF NRAs

The estate of a deceased NRA is generally subject to U.S. estate tax only with respect to those assets of the NRA situated or deemed situated in the United States.[9] For these purposes, assets situated in the United States and included in a NRA's gross estate for

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[4] Note that a special regime applies under §2801 to certain individuals who have relinquished their U.S. citizenship. Those issues will be addressed in a subsequent article in this series. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder.

[5] *See* §7701(b).

[6] Reg. §25.2501-1(b).

[7] *Estate of Nienhuys*, 17 T.C. 1149 (1952) (influential Dutch resident unable to return to Netherlands due to WWII was not a U.S. domiciliary because he retained an intent to return home); *see also Estate of Khan v. Commissioner*, T.C. Memo 1998-22 (green card holder who resided in the U.S. for less than two years before returning to Pakistan for business was a U.S. domiciliary because he had intended to return to the U.S., despite having died in Pakistan); *Estate of Jack v. United States*, 54 Fed. Cl. 590 (2002) (finding of domicile possible, although not certain, with respect to alien present in United States on temporary nonimmigrant visa).

[8] *Compare* §2010 *with* §2102.

[9] §2101(a), §2103.

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U.S. estate tax purposes may include both tangible and intangible assets owned by the NRA. Absent special circumstances, a NRA's assets situated outside the U.S. will generally not be subject to U.S. estate tax.

Tangible Property Included in Gross Estate

Tangible property subject to U.S. estate tax includes real property and tangible personal property physically located in the United States. With respect to tangible personal property, assets are generally deemed to be situated in the place where they are physically located — this might include items like jewelry, artwork, and other collectibles. Note that with respect to tangible personal property, certain exceptions exist for items that are "in transit," as well as for artwork and collectibles that are on loan or on exhibition for charitable purposes in the United States.[10]

Intangible Property Included in Gross Estate

U.S. estate tax is also imposed on intangible property situated within the United States. This includes stock of a domestic U.S. corporation (but not a foreign corporation), and may also include certain interests in partnerships or LLCs.[11] With respect to the latter entities, an element of tension exists with respect to whether the place of organization of the partnership, the residence of the interest holder, or the location of the partnership's underlying assets should control in making this determination.[12] The situs of an individual's beneficial interest in a trust or estate is generally determined by reference to the trust's underlying assets, rather than by place of administration or governing law of the trust.[13] Importantly, life insurance proceeds insuring the life of an NRA, no matter where the contract is issued, are not considered to be U.S. situs property, and accordingly are not subject to U.S. estate tax.[14]

Although the general rule for debt obligations is that a debt obligation is situated within the United States if the primary obligor is a U.S. person, this rule is subject to many exceptions. Among these exceptions are certain interests relating to bank deposits held in U.S. banks, foreign branches of U.S. banks, or U.S. branches of foreign banks; certain instruments subject to the OID rules; and, importantly, portfolio debt.[15] The rules relevant to determining whether a debt obligation qualifies as portfolio debt are discussed more fully in the income tax discussion, below.

Retained Interests Causing Gross Estate Inclusion

A special note is in order with respect to the rules under §2104(b) that can cause otherwise non-U.S. situated assets to be deemed U.S. situated, and, consequently, included in the gross estate of a NRA. These rules incorporate the provisions of §2035 through §2038, which should be familiar to the domestic planner, and provide that any property transferred by the decedent, and over which the decedent retained certain rights or powers, will be deemed to be situated in the United States (and thus subject to U.S. estate tax) if the property was so situated either at the time of the original transfer or at the time of the NRA's death. Thus, if any transfer is made by an NRA that would otherwise subject the transferred property to inclusion in the NRA's gross estate under §2035 through §2038 (if the decedent were a U.S. resident), then the transferred property will be deemed to be situated in the United States at the NRA's death and, therefore, subject to U.S. estate tax.[16] This is a little-known provision that can often catch unwary practitioners by surprise. Given the expansive application of §2036 as applied to family limited partnerships, practitioners need to be mindful of similar retained interest arguments under §2104(b).[17]

Basis Step-up at Death

Interestingly, NRAs are generally eligible for one of the most generous benefits afforded to U.S. citizen decedents — the basis step-up at death.[18] Property received directly from a NRA decedent will thus gener-

[10] *Delaney v. Murchie*, 177 F.2d 444 (1st Cir. 1949).

[11] *See* §2104(a). Stock in a foreign corporation is a non-U.S. situs intangible and is therefore *not* subject to U.S. estate tax.

[12] *Blodgett v. Silberman*, 277 U.S. 1 (1928); Rev. Rul. 55-143, 1955-1 C.B. 465; GCM 18718, 1937-2 C.B. 476.

[13] Rev. Rul. 82-193.

[14] §2105(a). Note that, because of some of the inherent uncertainties involving the estate taxation of entity structures, an NRA may prefer to simply purchase an insurance policy to mitigate the estate tax exposure attendant to ownership of U.S. assets rather than engaging in a complex entity-structuring exercise.

[15] §2104(c), §2105(b).

[16] §2104(b). *See also Estate of Swan*, 24 T.C. 829 (1955), *aff'd in part, rev'd in part*, 247 F.2d 144 (2d Cir. 1957) (holding that a transfer of assets by an NRA to Lichtenstein and Swiss stiftungs, which were amendable and revocable, were akin to transfers to a revocable trust and were therefore includible in the NRA's gross estate); TAM 9507044 (trust funded with U.S. assets, and over which grantor retained general power of appointment, was included in gross estate notwithstanding fact that it owned only non-U.S. property at decedent's death).

[17] *See* Edward J. Finley II, *Strangi's Stranglehold on Offshore Planning*, Tr. & Est. (Feb. 2004).

[18] Rev. Rul. 84-139, 1984-2 C.B. 168; PLR 9246030.

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ally take a basis in the hands of a beneficiary equal to the fair market value of the property as of the date of the NRA decedent's death.[19] This rule applies without regard to whether or to what extent the property was included in the NRA decedent's U.S. taxable estate.[20]

However, planners should be particularly sensitive to the basis step-up rules as they apply to assets that are not received *directly* from a NRA decedent at death, such as property held by the revocable trusts of NRAs. In the domestic context, the overarching rule of §1014(b)(9), which will ensure most assets included in a decedent's gross estate (including those held in a decedent's revocable trust) are eligible for a basis step-up; however, this rule does not apply to non-U.S. property owned by a NRA.[21] Accordingly, cautious planners often ensure that a NRA's revocable trusts provide for the payment of income to or at the direction of the NRA during his or her life and that upon revocation, title will revest in the grantor, thereby ensuring the basis step-up will be available under §1014(b)(2) and §1014(b)(3).[22]

Computing the Estate Tax

Different rules apply in computing a NRA's federal estate tax liability, as compared to the estate tax liability of a U.S. citizen. Estate tax deductions are generally available to a NRA's estate based only on the proportionate amount of U.S.-situated property versus worldwide property the NRA owned at death.[23] In order to claim the benefit of such deductions, a NRA's estate must disclose the NRA's worldwide assets on a timely filed federal estate tax return, Form 706-NR.[24] In practice, a natural hesitation may develop for fiduciaries of a NRA's estate to disclose substantial worldwide assets to the IRS. As a result, some fiduciaries may opt to forego otherwise valuable deductions.

Although the estate of a NRA will generally be subject to the same U.S. estate tax rates as the estate of a U.S. citizen or resident, the generous exclusion against the estate tax for U.S. citizens and residents is not available to the estate of a NRA.[25] Rather, the applicable exclusion amount available to the estate of a NRA is limited to $60,000.[26] While the applicable exclusion amount for U.S. citizens or residents has increased dramatically to $5,490,000, this very modest exclusion for a NRA has remained constant since 1988. As noted above, in some cases the fiduciaries of a NRA's estate may wish to consider arguing in favor of U.S. resident status in appropriate circumstances to achieve eligibility for the more generous exclusion available to U.S. residents.

Administration Expenses

Deductions for administration expenses are generally permitted, but are allocated on a proportionate basis based upon the ratio of the decedent's U.S. assets to non-U.S. assets.[27] Thus, for example, if the estate incurs an expense of $1,000, and the NRA's estate was comprised of $5 million of U.S. assets against total assets worldwide of $40 million, then only $125 would be deductible ($1,000*($5,000,000/$40,000,000)). For these purposes, the deductibility of the expense is not impacted by whether the expense was incurred within or outside the United States.[28]

Debts

Section 2106(a)(1) provides an estate tax deduction for debts of the decedent. For these purposes, the amount of the deduction may be affected by whether the debt is recourse or nonrecourse as to the decedent. In the case of recourse debts, the amount of the deduction will be based on a proportionate allocation of U.S. and non-U.S. assets, similar to the deduction of administration expenses discussed above. In the case of nonrecourse debts, on the other hand, a full deduction is permitted, meaning only the net equity of the asset will be included in the decedent's gross estate.[29]

Charitable Deduction

The estate tax charitable deduction is available to the estate of a NRA, but on more restrictive terms than in the case of the estate of a U.S. citizen or resident.[30] In order to be deductible, contributions must be made out of assets included in the NRA's U.S. estate and must be made to a U.S. domestic charity or

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[19] §1014(b).

[20] *Cinelli v. Commissoner*, T.C. Memo 1973-140; *Ujvari v. United States*, 212 F. Supp. 223 (S.D.N.Y. 1963); Rev. Rul. 84-139, 1984-2 C.B. 168. Note, however, that this will not be true in all circumstances. *See, e.g.,* §1014(b)(9); Reg. §1.1014-2.

[21] Reg. §1.1014-2(b)(2).

[22] These provisions generally require that trust income be payable to or at the direction of the decedent during life, and that the trust be revocable at all times before the decedent's death. Some planners take the position that the power to revoke or amend a trust encompasses the power to direct the payment of income, and should thus entitle property in a revocable trust to a basis step-up. There is no decisive authority supporting this view, however, and the uncertainty can be avoided by simply including a requirement to pay the income for life to or on the order or direction of the decedent in the trust agreement.

[23] §2106(a)(1).

[24] §2106(b).

[25] §2102(a). Note that special rules apply in the case of certain U.S. possessions and that the terms of a bilateral estate tax treaty may inform the relevant analysis.

[26] *See* §2102(b).

[27] Reg. §20.2106-2(a)(2).

[28] *Id.*

[29] Reg. §20.2053-7; *Estate of Johnstone v. Commissioner*, 19 T.C. 44, 46 (1952).

[30] §2106(a)(2)(A).

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to a trust that will make use of the donation only within the United States.[31] Because the deduction is permitted only for property otherwise included in the NRA's gross estate, no proportionate allocation of the charitable deduction is required.

Marital Deduction — Qualified Domestic Trusts

Like U.S. citizens and residents, NRAs are entitled to an unlimited estate tax deduction for U.S. estate-taxable property transferred to a U.S. citizen spouse.[32] From a policy perspective this is sensible, as a transfer to a U.S. citizen spouse ensures that the property remains within the U.S. estate tax net. In contrast, though, transfers of U.S. estate-taxable property to a non-citizen spouse generally are not eligible for an estate tax marital deduction, and will therefore result in a first death estate tax. This treatment can be avoided if assets intended to benefit a non-citizen spouse are instead transferred to a ''qualified domestic trust'' (QDOT), which can achieve a limited deferral of U.S. estate tax.[33]

In order to qualify as a QDOT, certain technical requirements must be satisfied. As is the case with a domestic QTIP trust, an election to treat a trust as a QDOT must be made on a timely filed U.S. estate tax return, income from the trust must be paid the surviving spouse at least annually, and the surviving spouse must be the sole beneficiary of the trust during his or her lifetime.[34]

In addition, the QDOT must have at least one U.S. trustee, who must be empowered to withhold any estate tax due on distribution. If the assets of the QDOT equal or exceed $2 million, the U.S. trustee must be a qualified bank or an individual who has furnished to the Department of Treasury a bond or letter of credit to secure the payment of the estate tax.[35] Practically speaking, QDOTs that are large or are expected to become large will almost always appoint a U.S. corporate trustee.

During the surviving spouse's life, annual distributions of income from a QDOT will not be subject to U.S. estate tax; however, distributions of principal will be subject to a deferred estate tax upon distribution, subject only to an exception for instances of extreme hardship. If the tax due upon a principal distribution is paid by the QDOT trustee from QDOT assets, the tax paid is treated as an additional distribution to the beneficiary in that year, leading to a circular tax calculation.[36] As with a QTIP trust, at the surviving spouse's death, the remaining property in the QDOT will be subject to U.S. estate tax. It is important to note that, unlike with QTIP trusts, it is not possible to create a lifetime QDOT to achieve a marital deduction for gratuitous lifetime transfers to a NRA spouse that would otherwise be subject to U.S. gift tax.

GIFT TAXATION OF NRAs

Broadly speaking, as is the case with the estate tax, the imposition of U.S. gift tax is based upon the ''residency'' of the donor, or in the case of donors who are not U.S. residents, on the location in which transferred assets are situated for tax purposes. That is to say that although gifts made by U.S. citizens and residents are subject to gift tax regardless of where property is located, NRAs are only subject to U.S. gift tax on real or tangible property situated in the United States at the time of the transfer.[37]

In determining the situs of transferred property, general principles similar to those applied for estate tax purposes are applied for gift tax purposes, with a few exceptions. Notably, gifts of both U.S. and non-U.S. intangible property are not subject to the gift tax.[38] This exclusion from the gift tax includes items like stock of a U.S. corporation and nonqualified debt obligations of a U.S. person, which would otherwise be subject to U.S. estate tax if owned by a NRA at death.[39] Thus, to avoid the imposition of U.S. gift tax, a NRA simply needs to ensure that gifted assets consist of non-U.S. situated real estate, non-U.S. situated tangible personal property, or intangible assets, wherever situated.[40]

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[31] These conditions should be explicitly stated in the decedent's estate planning documents. *See* TAM 9135003 (deduction disallowed where executor distributed assets to U.S. charity, but had discretion to make contributions to non-U.S. charities as well).

[32] §2056(a), §2106(a)(3).

[33] Reg. §20.2056A-2.

[34] §2056A(a), §2056A(d); Reg. §20.2056A-2(a), §20.2056A-3. For these purposes ''income'' generally means fiduciary accounting income under §643(b).

[35] Reg. §20.2056A-2(d)(1). These requirements may be met in different combinations during administration, so long as one requirement is met at all times. Reg. §2056A-2(d)(1)(i).

[36] §2056A(b)(1)(A); Reg. §20.2056A-5(b). Hardship distributions are not subject to the deferred estate tax, but must be reported on Form 706-QDT. §2056A(b)(3)(B); Reg. §20.2056A-5(c)(1).

[37] §2501(a)(2), §2511(a).

[38] §2501(a)(2), §2511(b). Practitioners sometimes attempt to morph the characterization of otherwise tangible property into intangible form by utilizing entities like partnerships or limited liability companies. In considering such measures, practitioners should be mindful of recharacterization arguments that have been raised by the IRS under a step transaction type of analysis. *See* N. Todd Angkatavanich & Edward A. Vergara, *Gift Tax Cost Depends on Form and Substance*, 150 Tr. & Est. 20 (2011).

[39] PLR 8342106; PLR 7737063.

[40] §2501(a)(2); Reg. §25.2511-3(b). Commentators and the IRS continue to disagree as to whether cash constitutes tangible property for these purposes. Cautious practitioners will often try to

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Calculating Gift Tax Liability

Taxable gifts made by NRAs are taxed at the same rates as gifts made by U.S. residents. However, NRAs and U.S. residents are not treated similarly insofar as credits and exclusions against the gift tax are concerned.[41] For example, there is no unified lifetime gift tax credit available to NRAs (although NRAs are permitted to make annual exclusion gifts), and NRAs are not able to take advantage of gift splitting with a spouse.[42] Importantly, gifts to charity by a NRA consisting of real or tangible property situated in the U.S. will also be subject to the gift tax unless made to U.S. domestic charities or for exclusive use in the United States.[43]

As noted above, although U.S. persons are entitled to an unlimited marital deduction for gifts to U.S. citizen spouses, no such deduction is permitted for gifts to non-citizen spouses. Thus, tax-free gifts to non-citizen spouses are generally limited to ''present interest'' gifts falling beneath the annual exclusion amount, which is currently $149,000.[44] As in the estate tax context, however, these rules apply only with respect to ''outbound'' gifts. Direct gifts from a NRA to a U.S. citizen spouse will typically qualify for the unlimited gift tax marital deduction.

Joint Property

A special note is in order with respect to property jointly owned by a U.S. resident and his or her NRA spouse. For estate tax purposes, the full value of jointly owned property will be included in the taxable estate of a U.S. resident, unless and only to the extent the estate can establish that consideration for the joint property was furnished by a NRA spouse.[45] In other words, the tax law imposes a burden of proof on the estate of a U.S. resident to substantiate contributions to joint accounts or consideration furnished for jointly owned property.

For gift tax purposes, however, the rules for jointly owned property are somewhat more permissive. With respect to jointly owned real estate, no deemed gift will typically arise upon the creation of joint ownership; however, a gift may occur upon the sale or partition of property if proceeds are divided between spouses. With respect to jointly held financial accounts, a gift will generally occur immediately only if local law permits the noncontributing spouse to unilaterally discontinue joint ownership. As these implications are heavily dependent on local law, it may be important to consult with local counsel where substantial joint property is held by U.S. resident and NRA spouses.

GST TAXATION OF NRAs

As a general proposition, the GST tax applies only to generation-skipping transfers made by NRAs where transferred property is situated or deemed situated in the United States for gift or estate tax purposes at the time of transfer.[46] This means that, with respect to direct skips, transfers are subject to GST tax only to the extent the transferor is otherwise presently subject to U.S. gift or estate tax. With respect to taxable terminations or taxable distributions, this means that GST tax will be imposed to the extent that the initial transfer in trust by the NRA was subject to U.S. estate or gift tax.[47]

It is important to note that, unlike in the gift and estate tax context, NRAs are eligible for the same exemption amount from GST tax as U.S. residents (currently $5,490,000). In addition to the generous exemption amount available to NRAs, planners should also remember that NRAs are essentially entitled to an unlimited exemption from GST tax for property that is not situated in the United States at the time of transfer, even if such assets are later brought into the United States.[48]

TRANSFER TAX TREATIES

Practitioners confronted with international issues should also consider whether the general rules described above might be altered by an applicable bilateral estate and/or gift tax treaty. To date, the U.S. has such treaties with 17 countries.[49] The provisions of a treaty will generally override contrary U.S. tax law

avoid this issue altogether by advising clients to make gratuitous transfers of cash exclusively from non-U.S. accounts. *See* PLR 200748008, PLR 200340015, PLR 7737063. *Cf.* PLR 9527025; PLR 8210055; PLR 8120030.

[41] *See* §2505(a).

[42] Section 2513(a)(1) requires that both spouses be U.S. citizens to take advantage of gift splitting.

[43] §2522(b).

[44] §2523(i); Reg. §25.2523(i)-1(a)(c)(2). The amount is indexed for inflation. *See, e.g.,* Rev. Proc. 2016-55, 2016-45 I.R.B. 707, §3.37(2).

[45] §2040(a).

[46] *See generally* Reg. §26.2663-2.

[47] PLR 200123045 (trust funded by NRA with non-U.S. assets not subject to GST tax upon death of last non-skip person beneficiary).

[48] Planners should be not be too cavalier, however, as the provisions of §2014(b) (discussed above) could result in otherwise non-U.S. assets being drawn back into a NRAs gross estate. Reg. §26.2663-2(d) *Ex. 6*.

[49] The U.S. has entered into combined estate and gift tax treaties with Austria, Denmark, France, Germany, Japan, and the United Kingdom. The U.S. has entered into separate estate tax treaties with Australia, Belgium, Finland, Greece, Ireland, Italy,

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and, in many cases, provide more favorable tax treatment for an eligible NRA.

These treaties are generally aimed at addressing instances of double taxation that may arise as the result of mismatches existing between the basis of taxation in two jurisdictions (for example, where one jurisdiction claims a right of taxation to worldwide assets based upon the domicile of a decedent and another claims a right of taxation based upon the situs of assets owned at death).[50] These treaties contain many similar elements, but can be broadly be divided into two conceptual frameworks: The first attempts to address double taxation by giving primary taxing authority to the jurisdiction in which assets are situated or deemed situated; the second attempts to address double taxation by giving primary taxing authority to the jurisdiction in which an individual maintains a ''fiscal domicile'' (essentially a nuanced tie-breaking procedure that attempts to ascertain an individual's appropriate residency for transfer tax purposes).

Two notes of caution are in order when treaty protection may be available. First, taxpayers wishing to avail themselves of treaty benefits must disclose on a U.S. return any position contrary to the general U.S. tax rules. Second, one cannot selectively apply the provisions of an estate or gift tax treaty; rather, if treaty protections are desired, they must be applied globally to all relevant tax items for a given year.[51]

INCOME TAXATION OF INTERNATIONAL TAXPAYERS

An individual's status as a U.S. ''resident'' for income tax purposes will significantly impact the manner and extent to which he or she is subject to U.S. income tax. Although U.S. residents are subject to federal income tax at graduated rates on their worldwide income, NRAs are subject to federal income tax only on income from U.S. sources. The following is a general description of the federal income tax rules applicable to NRAs.

It should be noted that special tax and reporting regimes generally apply to ''cross-border'' interests and transactions with U.S. tax relevance. Thus, for example, where U.S. residents own interests in foreign business entities, special tax rules and reporting obligations apply. Similarly, where U.S. residents establish or receive benefit from foreign trusts, special tax and reporting obligations apply. Conversely, NRAs owning interests in or receiving benefit from U.S. entities can also be subject to special U.S. tax and reporting obligations. Many of these special rules will be discussed in greater detail in subsequent installments of this series.

Income Tax Residency

Compared to the somewhat amorphous transfer tax rules used to determine residency, the standards for determining residency for U.S. income tax purposes are comparatively mechanical. As mentioned earlier, the term ''residency'' is used in both the transfer tax and income tax context, but has dramatically different meanings under each regime. For U.S. income tax purposes, a non-U.S. citizen will be treated as a U.S. resident (and will therefore be subject to U.S. income tax on a worldwide basis) if he or she: (i) is a lawful permanent resident (i.e., a green card holder),[52] (ii) satisfies the ''substantial presence test,''[53] or (iii) makes an affirmative election either to be treated as a U.S. resident in the year prior to which he or she satisfies the substantial presence or to file a joint return with his or her U.S. resident spouse for the relevant tax year.[54]

Lawful Permanent Residents

Being admitted to the United States as a lawful permanent resident and holding a U.S. green card is generally determinative of tax status for U.S. income tax purposes.[55] This is a departure from the transfer tax rules discussed above, under which holding a green card is a strong indicium of residency, but is not determinative. Thus, a green card holder will generally be subject to U.S. income tax in the same manner as a U.S. citizen, and this status will generally apply regardless of the amount of time the individual spends in the United States. In order to terminate this tax status, a green card holder must generally follow through with the administrative steps required to formally relinquish their status as a lawful permanent resident.

Substantial Presence Test

The substantial presence test is an objective test based on day counting that is used to determine

the Netherlands, Norway, South Africa, and Switzerland. The U.S. has entered into a separate gift tax treaty with Australia. The U.S.-Canada income tax treaty also addresses the transfer taxation of certain dispositions at death.

[50] In the U.S. context, it should be noted that deductions and credits may be available to offset such double taxation, even where treaty benefits are not available. For example, §2014 provides for a unilateral foreign tax credit to offset double taxation.

[51] Rev. Rul. 84-17.

[52] §7701(b)(1)(A)(i)

[53] §7701(b)(1)(A)(ii).

[54] §7701(b)(1)(A)(iii), §6013(g).

[55] §7701(b)(1)(A)(i). Technically, a lawful permanent resident can cease to be treated as a U.S. resident under the terms of an income tax treaty with another country. As discussed in later installments of this series, however, electing such treatment could result in a ''deemed expatriation'' in certain circumstances.

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whether an individual has spent enough time in the United States to qualify as a U.S. income tax resident. An individual will meet the substantial presence test if: (i) the individual is present in the United States for 183 days or more during a calendar year, or (ii) if the individual is present in the United States for 31 days or more during a calendar year, and a weighted average of the individual's time spent in the United States for the current year and the two prior years equals at least 183 days.[56] For purposes of calculating this weighted average, each day of presence in the United States in the current year counts for one day, each day of presence in the United States in the immediately preceding calendar year counts for 1/3 of a day, and each day of presence in the United States in the second preceding calendar year counts as 1/6 of a day.[57] In practice, if an individual is present in the United States for at least 121 days per year over a three year period, the individual will satisfy the substantial presence test.

Generally speaking, any portion of a day spent in the United States counts as a full day for purposes of the substantial presence test.[58] However, certain exceptions can apply to exclude periods of time spent in the United States from an individual's day count. One such exception exists for an individual in the United States as an ''exempt individual.'' Exempt individuals include certain individuals associated with foreign governments, teachers or teachers in training, students, and professional athletes participating in charitable sporting events.[59] Other regulatory exceptions exist for individuals receiving treatment for medical conditions arising while in the United States and individuals regularly commuting into the United States from Canada or Mexico.[60]

In light of the mechanical nature of these tests, clients for whom the substantial presence test might present an issue should be encouraged to maintain contemporaneous records detailing time spent in the United States and the activities carried out during each trip. Records of this sort can be invaluable to a practitioner attempting to determine or advise with respect to an individual's residency status, or for practitioners defending a client in connection with an income tax residency audit.

Closer Connection Exception

Notwithstanding the rules described above, an individual who would otherwise satisfy the substantial presence test (but who is not a lawful permanent resident) may still avoid classification as a U.S. income tax resident by establishing that they have ''closer connection'' to another jurisdiction. The closer connection exception is available if the taxpayer spends fewer than 183 days in the United States in the current year, maintains a ''tax home'' in a foreign country, and has a closer connection to the country that is the individual's tax home.[61] A tax home is generally an individual's regular or principal place of business, or, if no regular or principal place of business, the regular place of abode in a real and substantial sense. The determination is based on all relevant facts and circumstances. Claiming protection under the closer connection exception is accomplished by filing IRS Form 8840 with a timely filed U.S. income tax return.

Treaty Tie-Breaker Exception

An additional layer of protection may be provided to individuals under a bilateral income tax treaty. Under the residency ''tie-breaker'' provisions of most U.S. income tax treaties, an individual who might otherwise be classified as a U.S. tax resident can be classified as a NRA if the individual also qualifies as a tax resident of the other treaty country and the treaty's residency tie-breaker provisions resolve in the other country's favor.[62] As with the closer connection exception, treaty benefits are claimed by filing Form 8833.[63]

It should be noted that in the case of a lawful permanent resident, claiming residency in a foreign country under a treaty's tie-breaker provisions could potentially trigger a deemed expatriation from the United States for purposes of §877A. Therefore, careful consideration should be given to the implications of making such a filing.

General Treatment of Income of NRAs

An NRA is subject to U.S. income tax only with respect to two broad categories of income. First, a flat 30% withholding tax is imposed on a gross basis with

[56] Reg. §301.7701(b)-1(b), §301.7701(b)-1(c)(1).

[57] Reg. §301.7701(b)-1(b)(i)(C)(1).

[58] In determining days of presence, both the day of entry and the day of departure are included. *Lujan v. Commissioner*, T.C. Memo 2000-365.

[59] §7701(b)(5). As a general matter, therefore, individuals temporarily admitted to the United States under F, M, J, or Q visas who substantially comply with the terms of their visas will be considered exempt individuals.

[60] §7701(b)(3)(D), §7701(b)(7)(B); Reg. §301.7701(b)-3.

[61] §7701(b)(3)(B); Reg. §301.7701(b)-2.

[62] A typical treaty tie-breaker provision (for instance, the U.S.-Switzerland treaty) might apply the following tests to determine an individual's tax residence: (i) the place of the individual's permanent home, (ii) if an individual has a home in both countries, then his or her center of vital interests; (iii) if this is not determinative, the individual's place of habitual abode; (iv) if the individual has an abode in both countries, the individual's nationality; and (v) if all of the foregoing are inconclusive, the agreement of the competent authorities.

[63] §877A.

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respect to certain categories of U.S.-source investment income, including dividends, rents, royalties, dividends, annuities, and similar items. In technical parlance, these are referred to as fixed, determinable, annual, or periodical income items or ''FDAP.''[64] Note that capital gains realized by a NRA are not considered FDAP and are thus not generally subject to U.S. tax. However, if a NRA is present in the United States for 183 days or more during the year, capital gains are subject to U.S. income tax on the same basis as FDAP (notwithstanding the fact that in such case, such person may not necessarily be treated as a U.S. income tax resident).[65]

A special note is in order with respect to interest items, which are generally subject to the 30% withholding tax imposed on FDAP, but are eligible for numerous exceptions from U.S. income taxation. These exceptions include certain deposit interest, interest on certain short-term obligations and, importantly, portfolio interest.[66] Favorable treatment for portfolio interest is generally available with respect to obligations issued by U.S. borrowers, with respect to whom NRA lenders are mere portfolio investors who are not making loans in the ordinary course of a U.S. trade or business.[67] In order to be eligible for this treatment, an obligation must be in registered form, must not be issued by certain parties related to the borrower and must bear interest at a fixed rate that does not fluctuate with the borrower's profits.[68]

Second, NRAs are subject to U.S. income tax on income that is, or is deemed to be, effectively connected with the conduct of a U.S. trade or business. This income is often referred to simply as ''effectively connected income'' or ''ECI.'' ECI is generally subject to U.S. income tax at the same graduated rates applicable to U.S. citizens and residents.[69] Unlike FDAP income, ECI is taxed on a net basis. However, deductions are generally limited to those items associated with the ECI.[70]

The rules of §861 through §865 are generally applied in determining whether an item of income is properly sourced to the U.S. and thus potentially subject to U.S. income tax in accordance with the rules described above. These rules generally apply in the following manner, subject to numerous exceptions:

- interest is generally sourced to the United States if it is interest on an obligation issued by a U.S. person or entity;[71]
- dividends are generally sourced to the United States if from a domestic corporation;[72]
- rents and royalties are generally sourced to the United States if the property giving rise to the income is located or used in the United States;[73]
- compensation for services rendered is generally sourced to the place the services are performed;[74]
- income from the sale of inventory is generally sourced to the place in which the inventory is sold, although this general rule will be impacted by whether or not the inventory in question was produced by the taxpayer;[75] and
- income from the sale of personal property other than inventory is generally sourced to the United States if the seller is a U.S. resident or if the property is depreciable property.[76]

As noted above, the U.S. income tax regime for NRAs may apply differently based on the application of certain anti-abuse and enforcement regimes, including special rules applicable to gains associated with interests in U.S. real estate. Those rules will be discussed in a subsequent article in this series.

International Income Tax Treatment of U.S. Taxpayers

In an attempt to avoid or offset the incidence of double taxation on taxpayers living and working in multiple countries, the U.S. income tax law provides certain preferences to U.S. taxpayers living, working, or otherwise engaged in income producing activities outside the United States. These preferences include a credit for income taxes paid in foreign jurisdictions, as well as exclusions for certain amounts of income earned and housing expenses incurred by U.S. citizens living and working abroad.

Foreign Tax Credit

Section 901 provides that a U.S. taxpayer may elect to take a credit (as opposed to a deduction) against his or her annual U.S. federal income tax liability for for-

[64] §871(a).
[65] §871(a)(2).
[66] §871(h)(1).
[67] §871(h)(2).
[68] Note that the related party restrictions for portfolio interest have limited applicability vis-à-vis trusts and, therefore, can provide a powerful advantage in the estate planning context.
[69] §871(b).
[70] §873(a). Note that the charitable deduction, personal exemption, and deductions associated with certain U.S.-source losses are subject to less stringent restrictions.

[71] §861(a)(1).
[72] §861(a)(2).
[73] §861(a)(4).
[74] §861(a)(3).
[75] §861(a)(6).
[76] §861(a)(5).

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eign income taxes paid or accrued by the taxpayer.[77] In principle, this foreign tax credit (FTC) is intended to protect U.S. taxpayers from exposure to double-taxation by allowing them to offset U.S. tax liability by the amount of foreign taxes paid, on a dollar-for-dollar basis. However, §904 limits the amount of foreign income taxes that may be credited in a given tax year to the amount of U.S. income tax that would have been imposed on the taxpayer's foreign income without application of the credit. Under §904, FTCs for a given year are limited to a taxpayer's tentative U.S. federal income tax liability for the tax year multiplied by a fraction, which is (i) the taxpayer's net foreign source income for the tax year over (ii) the taxpayer's net worldwide income for the tax year. Section 909 imposes an additional limitation, and attempts to avoid timing distortions by deferring the creditability of foreign taxes until the associated income has been taken into account for U.S. income tax purposes. Excess FTCs not used in the current year may be carried back one year and carried forward for the 10 succeeding years.[78]

The annual limitation under §904 is calculated separately for two different categories of net foreign source income, referred to as ''general category income'' and ''passive category income.'' In general terms, passive income includes all portfolio investment income,[79] and general category income is everything else. As a result of the separate limitations for general and passive category income, FTCs in the general category income basket can only reduce U.S. federal income tax liability to the extent there is sufficient net foreign source general category income, and FTCs in the passive category income basket can only reduce U.S. federal income tax liability to the extent there is sufficient net foreign source passive category income.

Foreign Earned Income and Housing Exclusions

While U.S. citizens and lawful permanent residents are generally subject to U.S. income tax on their worldwide income, §911 allows U.S. taxpayers to exclude from income limited amounts (currently up to $102,100) attributable to services performed abroad if certain qualifications are met.[80] To qualify for the foreign earned income exclusion, a U.S. taxpayer must be a ''qualified individual,'' which means that one of two tests must be satisfied: (1) the taxpayer was a bona fide resident of a foreign country or countries for an uninterrupted period including an entire tax year (sometimes referred to as the ''bona fide residence test''); or (2) the taxpayer was present in a foreign country or countries for at least 330 full days during 12 consecutive months and has a tax home in a foreign country (sometimes referred to as the ''330-day test'').[81] An individual's tax home is generally his or her regular or principal place of business, or if none, his or her regular place of abode in a real and substantial sense.[82]

An individual who is a ''qualified individual'' may elect to exclude up to $102,100 of his or her foreign earned income from gross income for U.S. income tax purposes. Foreign earned income is generally all income attributable to services performed outside the United States during the relevant period (excluding items of deferred compensation), regardless of where and when the taxpayer receives payment.[83] The dollar ceiling for the exclusion is pro-rated if the taxpayer qualifies for the exclusion for only a portion of the year, such that the resulting exclusion amount is reduced proportionately.[84] Note that the foreign earned income exclusion is claimed in lieu of, rather than in addition to, any other credits or deductions that might be related to the foreign income in question (including the FTC).[85]

Qualified individuals may also elect to exclude a portion of foreign housing costs from gross income if certain qualifications are met.[86] The availability of this exclusion reflects a policy recognition that U.S. taxpayers living abroad are often subject to additional housing costs, and often receive additional compensation to offset these costs. The excludable amount is determined using a mechanical calculation that generally captures a taxpayer's housing costs attributable to living in a foreign country to the extent that: (i) the costs exceed a floor equal to 16% of a set exclusion

[77] To be creditable, a foreign tax must have the ''predominant character'' of ''an income tax in the U.S. sense.'' Reg. §1.901-2(a)(3). This means that a creditable foreign tax must generally attempt to reach net gain in normal circumstances, rather than having the character of a ''soak-up'' tax. Note also that §901(j) denies the foreign tax credit for taxes paid to certain countries identified as bad actors, including Afghanistan, Iran, North Korea, and Syria. *See* Rev. Rul. 2005-3, 2005-1 C.B. 334, *modified by* Rev. Rul. 2016-8, 2016-11 I.R.B. 426 (removing Cuba effective January 1, 2016).

[78] §904(c).

[79] Passive category income is defined as foreign personal holding company income as defined in §954(c). §904(d)(2)(B)(i).

[80] §911(a)(1). Note that the exclusion amount is indexed to inflation and adjusted annually. For purposes of the foreign earned income exclusion, foreign earned income includes wages, salaries, professional fees, and other income items attributable to the provision of services by a U.S. taxpayer (other than pension and related payments).

[81] §911(d); Reg. §1.911-2(c).

[82] Reg. §1.911-2(b).

[83] §911(b)(1)(B); Reg. §1.911-3(a).

[84] Reg. §1.911-3(d)(2).

[85] §911(d)(6).

[86] §911(a)(2).

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amount, and (ii) the costs do not exceed a ceiling equal to 30% of a set exclusion amount.[87] To be eligible for the exclusion, housing costs must be reasonable and may not be ''lavish or extravagant.''[88] Both the foreign earned income and foreign housing exclusions are claimed by filing Form 2555.

Effect of U.S. Income Tax Treaties

As in the transfer tax context, the tax result determined under the general rules described above may be altered in a particular circumstance by a bilateral income tax treaty, which can operate to modify certain provisions of U.S. income tax law. The United States has entered into over 60 such treaties pursuant to which residents of one country may be eligible for tax exemptions or reduced rates with respect to income derived from activities in the other country.[89]

Treaty provisions can be particularly beneficial for NRAs, as they may act to exempt or reduce the rate of taxation imposed on certain items of U.S. source income, or to reduce or eliminate withholding taxes on FDAP income. Moreover, income tax treaties are generally designed with an express goal of precluding the incidence of double taxation, and include procedures for addressing such issues as they may arise. This is generally accomplished by way of an exemption or by providing a uniform set of sourcing rules as between two countries to ensure that an offsetting credit or exemption is always available.

Although a full review of the detailed provisions of U.S. income tax treaties is beyond the scope of this article, it is advisable for practitioners representing international clients to account for the existence of an applicable treaty in analyzing a client's circumstances and proactively seek out opportunities that might improve the net tax result achieved by a client residing or conducting activities in a treaty jurisdiction.

INCOME TAXATION OF FOREIGN TRUSTS

In the domestic context, the income tax treatment of a trust is broadly dependent on whether the trust is treated as a grantor trust or a non-grantor trust. If a trust is a grantor trust, it will essentially be disregarded for income tax purposes, and its income, gains, and losses will be taxable to the grantor. Of course, in the domestic estate planning context this provides many planning advantages from a transfer tax standpoint, as the requirement that the grantor pay the income tax liability attributed to the trust allows the grantor to reduce his or her otherwise estate taxable assets while allowing the grantor trust to effectively grow on a tax-free basis. A domestic non-grantor trust, on the other hand, is treated as a separate taxable entity and is obligated to pay the tax associated with its undistributed income.

An additional layer of complexity exists in the case of taxation of foreign trusts. In addition to the classification of a trust as grantor or non-grantor, the practitioner must determine whether a trust is a foreign trust or domestic trust. Thus, it is possible for a trust to have four different classifications for U.S. income tax purposes, the status of which is determined on an annual basis, which are as follows:

- U.S. grantor trust;
- U.S. non-grantor trust;
- foreign grantor trust; or
- foreign non-grantor trust.

The practitioner's determination of the appropriate classification for a trust will have a significant impact on the relevant tax rules. Moreover, it is quite possible for the status of a trust to change periodically based on certain mechanical rules, and the change of status can result in income tax triggers that can have unexpected results. For instance, the simple change in residency status of a trust fiduciary might result in a change of status, regardless of whether the change is intended. Lastly, planners should be aware that the requirements for creation of a grantor trust by a NRA are radically different from the requirements for the creation of a grantor trust by a U.S. person. Accordingly, these special rules must be considered as this planning is undertaken with foreign trusts.

Foreign or Domestic Trust?

The Code classifies a foreign trust in the negative, providing that a trust will default to being treated as a foreign trust unless it qualifies as a U.S. trust, meaning it satisfies both the ''court test'' and the ''control test.''[90] Expressed another way, if a trust fails either of these two tests, it will be considered a foreign trust. Only if a trust meets both of these two tests, will it be considered a domestic trust.

Court Test

The court test requires that a U.S. court be able to exercise primary supervision over the administration

[87] §911(c).

[88] §911(c)(3)(A). Note that the total amount excluded under the foreign earned income and foreign housing exclusions may not exceed the taxpayer's foreign earned income for the year.

[89] *See* https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.

[90] Reg. §301.7701-7(a)(2).

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of the trust.[91] This test will be deemed to have been met if the three criteria of a safe harbor are satisfied: (i) the trust instrument does not direct that the trust be administered outside the United States, (ii) the trust is actually administered in the United States, and (iii) the trust does not include an automatic migration, or ''flee,'' provision.[92] The court test is also deemed satisfied by trusts registered with a U.S. court, testamentary trusts with trustees qualified by a U.S. court, and by trusts actively supervised by a U.S. court.[93]

Control Test

The second test (and indeed, the one more likely to result in a non-intuitive foreign trust status), is the ''control test.'' The control test essentially provides that if a foreign person, or a group consisting of a majority of foreign persons, has authority with respect to any substantial decision of the trust, the trust will fail the control test and will be a foreign trust.[94] The following are considered ''substantial decisions'' of a trust: (i) whether and when to make distributions; (ii) the amount of distributions; (iii) selecting beneficiaries; (iv) allocating receipts to income or principal; (v) revoking or terminating the trust; (vi) compromising, arbitrating, or abandoning claims to the trust; (vii) suing on behalf of or defending suits against the trust, (viii) removing, adding or replacing trustees, or appointing successor trustees, and (ix) making investment decisions.[95] These powers will typically be held by a trustee, protector, veto holder, or investment advisor, and the residency status of these individuals should be verified during the planning process in order to minimize the risk that the control test might be inadvertently failed.

Relief for Accidental Foreign Trusts

As mentioned above, because these are mechanical rules that can be triggered without intent or even awareness, it is quite possible to trigger an unexpected change in classification. The regulations recognize this possibility and provide that an unintended loss in status as a domestic trust can be corrected by taking remedial steps within 12 months to give control over all substantial decisions to U.S. persons.[96] If the trust can establish reasonable cause for this process taking longer than 12 months, the IRS has the authority to extend the time period.[97]

[91] Reg. §301.7701-7(a)(1).
[92] Reg. §301.7701-7(c)(1).
[93] Reg. §301.7701-7(c)(4).
[94] Reg. §301.7701-7(a)(1)(ii).
[95] Reg. §301.7701-7(d)(1)(ii).
[96] Reg. §301.7701-7(d)(2)(i).
[97] Reg. §301.7701-7(d)(2)(ii).

Grantor or Non-Grantor Trust?

Special rules apply to NRA grantors in determining whether a trust is properly classified as a grantor trust or non-grantor trust. To address certain perceived abuses with respect to foreign grantor trusts, Congress enacted rules in 1996 to narrow the circumstances under which a NRA may create a grantor trust. Under these rules, a trust will be treated as a grantor trust with respect to a NRA grantor only if: (i) the trust is revocable by the grantor, or (ii) distributions from the trust during the grantor's lifetime may only be made to the grantor or the grantor's spouse.[98] A revocation power will be effective to create a foreign grantor trust (FGT) even if it is subject to the consent of another person, as long as that other person is a related or subordinate party who is subservient to the grantor. A foreign trust that does not qualify as a foreign grantor trust will be classified as a foreign non-grantor trust (FNGT).

Foreign Grantor Trusts

As is the case with a domestic grantor trust, a foreign grantor trust is essentially disregarded for U.S. income tax purposes, meaning the grantor will be liable to pay the U.S. income tax, if any, attributable to the trust's assets. Because a FGT will be taxed to the NRA grantor, and therefore will only be subject to U.S. income tax on certain U.S. source income, and because distributions from FGTs are not subject to the throwback tax (discussed below), a FGT can provide a very income tax-efficient means to hold assets for the benefit U.S. taxpayers.

Anti-Conduit Rules

Care should be taken to ensure that certain ''anti-conduit rules'' are not triggered with respect to a FGT.[99] These rules can have the effect of treating a U.S. beneficiary as the grantor of a purported FGT where the U.S. beneficiary previously made a transfer of assets to the nominal NRA grantor. For example, if A transfers assets to G, a NRA, before becoming a U.S. person and G subsequently creates a trust for the benefit of A that would otherwise be treated as a FGT as to G, A may be treated as the owner of the trust for U.S. income tax purposes once he becomes a U.S. person. It should be noted that this rule applies without regard to whether the beneficiary was a U.S. person at the time of the initial transfer of assets to the NRA.[100]

Accidental Grantor Trusts

Under §679, a U.S. person who directly or indirectly makes a gratuitous transfer of property to a for-

[98] §672(f).
[99] §672(f)(5).
[100] Reg. §1.672(f)-5(a).

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eign trust with one or more U.S. beneficiaries will be treated as the owner of the trust for income tax purposes to the extent of the transfer. For these purposes, a trust is treated as having a U.S. beneficiary unless: (i) the trust prohibits distributions to U.S. persons, or (ii) no U.S. person could benefit from a current termination of the trust.[101] This determination must be made on an annual basis, taking into consideration not only the trust instrument itself, but also things such as letters of wishes and even implied understandings.[102]

Section 679 applies not only to direct transfers in trust, but also to indirect or constructive transfers. This might include a transfer made by a U.S. person to an NRA friend who subsequently funds a trust for the benefit of the U.S. person's U.S. family members. If it cannot be established that the transfer to the NRA friend was unrelated to the funding of the trust, §679 would result in the trust being treated as a grantor trust with respect to the U.S. person. Section 679 will also apply to any loan made to a foreign trust unless the loan constitutes a qualified obligation.[103]

The policy rationale behind these rules was to prevent the abuse of so called ''drop off'' trusts — foreign trusts in which a U.S. grantor, or a NRA grantor who planned to become a U.S. income tax resident in the foreseeable future, would ''park'' assets in an attempt to shelter the trust's non-U.S. source income from U.S. taxation (because, in the absence of §679, the trust would be a foreign non-grantor trust that would be subject to U.S. income tax only on its U.S.-source income), while enabling U.S. beneficiaries to receive distributions. The rule avoids this perceived abuse by causing a U.S. grantor, or NRA grantor who becomes a U.S. income tax resident within five years of trust funding, to be treated as the owner of the trust assets for income tax purposes.

Although the rule seems sensible on its face, it can create unanticipated complications where a NRA transfers property to a foreign trust and subsequently becomes a U.S. resident within a five-year period. In such case, the trust will be characterized as a grantor trust to the extent of the contribution.[104] Of course, because of the five-year look-back, if the timing of the grantor's plans are flexible, this ''drop-off'' planning can still be achieved by creating the trust more than five years before the NRA grantor becomes a U.S. resident. If the NRA grantor becomes a U.S. income tax resident within the five-year look-back period, he or she will be treated as the owner of the trust beginning on his or her U.S. residency starting date, regardless of whether the trust in question might or might not qualify as a grantor trust under the general grantor trust rules.

Death of Grantor

Practitioners should keep in mind that a grantor trust will necessarily become a non-grantor trust upon the death of the grantor, and should plan for this eventuality. For income tax purposes, the death of the grantor of a grantor trust is treated as a transfer of the trust property by the grantor.[105] Absent effective planning, this could result in gain recognition on assets within the trust, either with respect to assets with liabilities in excess of basis, or under the special deemed disposition rules of §684 (discussed in greater detail below) if the grantor is a U.S. person. An exception to the latter provision will prevent gain recognition with respect to certain assets included in the grantor's gross estate for estate tax purposes.[106]

An additional consideration is whether to migrate or domesticate a foreign trust after the grantor's death. This could produce income tax efficiencies as to U.S. beneficiaries by avoiding the imposition of the throwback tax, but would necessarily subject all trust income to current U.S. taxation. This may, however, limit some ongoing flexibility for future planning, particularly if it is anticipated that current U.S. beneficiaries may not remain U.S. tax residents. Practitioners should undertake a holistic analysis of the trust and its beneficiaries prior to any change in status.

Foreign Non-Grantor Trusts

A foreign non-grantor trust (FNGT) is generally subject to U.S. income taxation in the same manner as a NRA, subject to certain modifications. Thus, a FNGT will only be subject to U.S. income tax on certain U.S.-sourced income, namely: (i) FDAP, which is subject to a 30% gross withholding tax, and (ii) ECI, which is subject to tax at marginal rates on a net basis.

Foreign Trust Accounting

Development of a thorough understanding of the special tax rules applicable to foreign trusts and their beneficiaries requires a basic facility with three separate accounting concepts: fiduciary accounting income (FAI), distributable net income (DNI) and undistributed net income (UNI). FAI is effectively a property law concept that defines the character of a trust's receipts as either income or principal for purposes of the trust instrument. FAI is determined under local law

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[101] §679(c); Reg. §1.679-2(a).

[102] Reg. §1.679-2(a)(4)(i). If the trustee has the power to add a U.S. person as a beneficiary, the trust will also be deemed to have a U.S. beneficiary. Reg. §1.679-2(a)(4)(ii)(A).

[103] §679(a)(3).

[104] §679(a)(4).

[105] Reg. §1.1001-2(c) *Ex.* 5.

[106] Reg. §1.684-3(c).

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and, in most cases, will not include realized capital gains. DNI is a tax concept that generally amounts to the trust's net taxable income under U.S. principles.[107] UNI is defined in broad terms as any net, after-tax DNI that has not been distributed.

These concepts become important because FNGTs are subject in certain circumstances to draconian tax consequences when making distributions to U.S. beneficiaries that are deemed to come from trust UNI. Distributions subject to these tax rules are referred to in the Code as ''accumulation distributions'' and they are subject to a tax regime commonly referred to as the ''throwback tax.''

Distributions from FNGTs

As is the case with a domestic non-grantor trust, distributions of DNI from a FNGT will generally carry out taxable income, and the trust beneficiary will inherit tax attributes corresponding to the beneficiary's proportionate share of trust income. Accumulation distributions, on the other hand, are subject to the punitive throwback tax regime, which is intended to discourage the deferral of taxable income through the use of foreign trusts.

The receipt of an accumulation distribution by a beneficiary has two practical effects for income tax purposes: first, the entire distribution is subject to income tax at the highest marginal rate, regardless of whether the distribution would otherwise have been eligible for preferential treatment; and second, a punitive interest charge is imposed that relates back to the years in which the distributed UNI was first accumulated, on a first in, first out basis. In the worst case scenario, the throwback tax can essentially become confiscatory and reach 100% of the distribution.

Accumulation distributions can occur not only upon outright transfers from a trust to a U.S. beneficiary, but also by way of a trust making loans, permitting rent-free use of trust property, or making distributions indirectly through intermediaries.[108] These special provisions are designed to prevent creative maneuvers that might otherwise avoid the imposition of the throwback tax.

Deemed Distributions from FNGTs

Section 643(h) was designed to prevent maneuvers whereby distributions are made indirectly from a FNGT to a U.S. beneficiary through a nominee. The effect of this rule is to deem such payments to be distributions directly from the FNGT. For example, if a FNGT makes a distribution of $100 to X, a foreign beneficiary, and X subsequently pays such amounts to A, a U.S. beneficiary, §643(h) will treat the transaction as a distribution from the trust to A.[109]

Section 643(i) provides that if a foreign trust permits the use of trust property by any grantor or U.S. beneficiary of the trust (or a related person), such use will be treated for tax purposes as a deemed distribution by the foreign trust in an amount equal to the fair market value of such use. Section 643(i) further provides that if a foreign trust directly or indirectly makes a loan to or by any grantor or U.S. beneficiary of the trust (or a related person), the amount of such loan will be treated for tax purposes as a deemed distribution unless the loan meets the specific requirements of a ''qualified obligation.''[110]

Distribution Planning for FNGTs

As one might imagine, a cautious trustee will often desire to avoid making accumulation distributions to U.S. beneficiaries altogether, as the tax consequences could be quite harsh. Fortunately, there are four common strategies trustees can rely on to avoid triggering the throwback tax. Distributions made in accordance with one of the following will generally escape the imposition of the throwback tax.

Distributions Not in Excess of DNI / 65-Day Election

Distributions from a FNGT are deemed to initially carry out current year DNI and, thus, are necessarily not considered accumulation distributions. To avoid the uncertainties that may arise in attempting to make such calculations before the end of a taxable year, a trustee may make a special tax election to treat amounts distributed to beneficiaries within the first 65 days of a tax year as having been distributed on the last day of the preceding tax year.[111] Note that amounts to which the election applies cannot exceed the greater of the FNGT's FAI and DNI for the year with respect to which the election is made.

Distributions Not in Excess of FAI

Distributions from a FNGT that do not exceed current year FAI will likewise not be considered accumu-

[107] It should be noted that the DNI of a FNGT generally includes realized capital gains. §643(a)(6)(C).

[108] §643(h), §643(i).

[109] For additional examples of the application of these rules, see Reg. §1.643(h)-1(g).

[110] A qualified obligation is a debt instrument that meets the following requirements: (i) must be in writing, (ii) must not have a term exceeding five years, (iii) must provide for payments denominated in U.S. dollars, (iv) must bear interest at a rate between 100% and 130% of the applicable federal rate, (iv) the U.S. beneficiary must extend the period for assessment of tax to a least three years following the maturity of the obligation, and (v) the U.S. beneficiary must report the loan on Form 3520 for each year the obligation is outstanding. Notice 93-34, 1993-2 C.B. 328.

[111] §663(b).

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lation distributions.[112] Thus, for example, if a FNGT has $1,000 of FAI in a particular year, but only $900 of DNI, a distribution of $1,000 would still not be treated as an accumulation distribution and would not be subject to the throwback tax, as it would not exceed the $1,000 of FAI.

Specific Distributions

A distribution from a FNGT will not be considered an accumulation distribution to the extent the distribution is in satisfaction of a gift of a specific sum of money or of specific property.[113] Distributions of this sort may be made in installments, but will nonetheless be considered accumulation distributions if made in more than three installments.

Default Distributions

As one might imagine, the information needed to calculate the throwback tax will very often not be available and, thus, the calculation of the throwback tax can pose an accounting and administrative nightmare. Notice 97-34 and the instructions for Form 3520 acknowledge this difficulty by providing for a ''default method'' to determine whether an accumulation distribution has been made.[114]

This methodology amounts to a safe harbor, allowing a beneficiary of a FNGT to avoid treating a distribution as an accumulation distribution. The safe harbor provides that, to the extent a current year's distribution does not exceed 125% of the average distributions from the trust over the prior three years, the distribution will not be considered an accumulation distribution.[115] For example, if in the prior three years, distributions from a FNGT were $100, $110, and $150, the total distributions over the prior three years would be $360, 125% of which is equal to $450. Therefore, in Year 4 the FNGT could make a distribution of up to $150 ($450/3) without having made an accumulation distribution.

The default method can provide a planning opportunity over time, in that increasingly larger distributions in prior years, although potentially attracting some level of throwback tax initially, can increase the default distribution threshold in future years. In other words, gradually increasing year-over-year distributions from a FNGT can have the practical effect of continually raising the ceiling under which tax favored distributions can be made.

This type of distribution planning could perhaps be combined with investment strategies intended to ensure high levels of gain recognition, and thus high levels of DNI, each year, thereby further increasing the base upon which distributions may be calculated. However, the benefits provided by the default method from the perspective of a trust's UNI account must be balanced with the acknowledgment that all distributions received by U.S. beneficiaries will be treated as ordinary income, even if consisting of otherwise tax-favored items.

Gain Recognition on Contribution to a FNGT

Although a U.S. person is generally able to contribute property to a domestic trust on an income tax neutral basis, a special rule can trigger gain recognition when a U.S. person contributes appreciated property to a foreign trust, or in some cases when a U.S. non-grantor trust becomes a FNGT.[116] In essence, this rule treats the U.S. person as though he or she had sold the contributed property to the trust in exchange for an amount equal to the property's fair market value.[117] Note that although this provision can result in gain recognition, it will not allow for recognition of loss.

Because of an exception to the application of this special rule for transfers to grantor trusts, a practitioner's sensitivity to gain recognition upon funding of a foreign trust should be most acute in the relatively rare circumstance of a FNGT funded by a U.S. person that does not include U.S. beneficiaries.[118] These rules could also be triggered by the change in status of a domestic trust. For example, if a domestic non-grantor trust were to become a FNGT, perhaps by change in status of a fiduciary or decanting, gain recognition could potentially be triggered.[119] Lastly, gain could also potentially be triggered by virtue of a domestic grantor trust becoming a FNGT upon the death of the grantor. However, this situation would not generally arise with respect to a trust eligible for a

[112] §665(b) (''If the amounts properly paid, credited or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year'').

[113] Reg. §1.665(b)-1A(c)(1).

[114] Beneficiaries are required to apply the default method if the trustee does not provide a foreign non-grantor trust beneficiary statement. Once the default method has been applied in a year, it is required to be applied in all subsequent years.

[115] Note that if the trust has been a FNGT for less than three years, total distributions are instead divided by the number of years in which the trust has been a FNGT.

[116] This rule is not applicable to transfers to grantor trusts, regardless of whether the transferor is the deemed owner of the trust for income tax purposes.

[117] §684(a).

[118] Reg. §1.684-3(a). This is particularly the case because of the broad sweep of §679, discussed above.

[119] Reg. §1.684-4(a). Note that inadvertent migrations within the meaning of Reg. §1.7701-7(d)(2) may avoid the application of these rules by complying with the relevant remedial procedures.

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step-up in basis under §1014(a) (e.g., a decedent's revocable trust).[120]

Reporting Distributions from Foreign Trusts

A U.S. beneficiary receiving a distribution from a foreign trust (whether from a FGT or FNGT) must report certain information regarding the distribution to the IRS on Form 3520. U.S. tax law contemplates that the trustee of a foreign trust will provide certain statements to trust beneficiaries to inform them of the amount and character of trust income distributed. If a beneficiary does not receive such a statement, the beneficiary is automatically subject to U.S. taxation based on the default calculation specified on Schedule A to Form 3520. Failure to report distributions to the IRS carries a penalty equal to 35% of the amount distributed.

PLANNING STRATEGIES FOR FOREIGN NON-GRANTOR TRUSTS

Domestication

Where a foreign non-grantor trust has primarily U.S. beneficiaries and has not yet accumulated a substantial pool of UNI, it may be worthwhile to consider ''domesticating'' the trust to a U.S. jurisdiction so as to preclude the further accumulation of UNI and, thus, limit the extent of future application of the throwback tax. In so doing, however, a planner must be mindful that a distribution in further trust could, in some instances, itself be considered an accumulation distribution and subject to immediate throwback tax.[121]

As an alternative to decanting a FNGT, for example where a substantial pool of UNI makes the possible risk of an accumulation distribution too substantial, the FNGT could instead migrate to the United States by changing its situs, governing law, and fiduciaries such that it satisfies both the court test and control test.[122] However, planners should be aware that the domestication of a FNGT in this manner will not altogether avoid the future imposition of the throwback tax; rather, the domesticated trust will maintain its existing pool of UNI, potentially triggering a throwback tax upon future distribution. Nonetheless, the domestication of the trust will prevent further build-up of the UNI pool thus containing the issue.

Prior to domesticating a FNGT, planners should undertake a balancing of the relative merits of such a strategy. In so doing, planners should take into account not only the benefits of domestication as it relates to a trust's UNI pool, but also the fact that the domesticated trust will be subject to U.S. income taxation on its worldwide assets on a going forward basis. Although a reduction in the potential for accumulation distributions can be advantageous, the throwback tax is relevant only to the extent a FNGT will benefit U.S. persons — to the extent a FNGT might primarily benefit non-U.S. persons, FNGT status may perhaps be manageable.

Segregating Trust Income

For a FNGT with no existing UNI pool and U.S. beneficiaries, one idea might be for the trustees to make annual distributions either directly to the U.S. beneficiaries or to a domestic trust for their benefit. This will have the practical effect of carving off the trust's income, thus leaving a pool of ''clean capital'' in the original FNGT. If substantial distributions into the U.S. are not desirable, different income tax efficient investment applications, including insurance products, might be available to reduce or eliminate the realization of income for a period of time.

This strategy could also be adapted to work with a FNGT that has accumulated a substantial pool of UNI. In this application, the trustee of the FNGT would make a substantial distribution, consisting of all current year income and all prior accumulations, to foreign beneficiaries or to an unrelated foreign entity, thereby leaving only a pool of clean capital untainted by UNI. In the following tax year, the trustee could either domesticate the trust, thereby permitting future accumulations of income without fear of the throwback tax, or could implement the annual distribution procedure described in the preceding paragraph to manage future income accumulations. The timing is extremely important in this application, as distributions to U.S. and non-U.S. beneficiaries in a single tax year will carry out proportionate amounts of UNI, which is undesirable from a tax efficiency standpoint.

Managing DNI and FAI Through Entity Planning

As discussed above, §655(b) provides that an accumulation distribution occurs when a trust makes a distribution that exceeds *both* current year DNI and current year FAI. In other words, if a trust distribution is less than either DNI or FAI for the current year, no accumulation distribution will have occurred. Notably, a trust's FAI is determined under the terms of the trust's governing instrument and local law, and will

[120] Reg. §1.684-3(c).

[121] Reg. §1.665(b)-1A(b)(1) (''A distribution from one trust to another trust is generally an accumulation distribution''). Note that a distribution in further trust may also affect the GST-exempt status of the trust assets, although this conclusion is being studied by the IRS. Rev. Proc. 2017-3, 2017-1 I.R.B. 130, §5.01(16).

[122] PLR 7917063, PLR 7917037. Domestication by these means should not generate an accumulation distribution, and should not affect the trust's GST-exempt status.

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often differ in some regards from the determination of the trust's DNI.[123] The laws of many jurisdictions provide that certain non-liquidating distributions from a business entity will be treated as fiduciary accounting income of the trust, rather than as a return of capital.[124] In some circumstances, a situation may arise in which a substantial disparity exists between trust FAI and DNI for a particular year, and attentive and proactive planners can sometimes structure trust distributions for such years to pass significant value to U.S. beneficiaries while mitigating the impact of the throwback tax.

Preferred and Reverse Preferred Partnerships

One interesting technique to consider as a means to address the accumulation of UNI in a FNGT is through the use of a preferred partnership. Preferred partnerships are vehicles with multiple classes of equity, which provide the preferred class a priority annual coupon payment, and the common class access to all asset growth in excess of the preferred coupon. It should be noted that, in most cases involving trusts and family members, it is critical that any preferred partnership planning implemented comply with the sometimes draconian provisions of §2701, a detailed review of which is outside the scope of this article, but which should be familiar to the domestic estate planner.[125]

FNGT Holding Preferred Interest

A preferred interest in a preferred partnership can function as a ceiling under which distributions may be made without triggering the throwback tax. This is because, under the laws of many jurisdictions, non-liquidating distributions received from a partnership are included in FAI. Because an accumulation distribution is only deemed to occur to the extent a trust distribution exceeds both DNI and FAI, a FNGT should be able to make a distribution up to the amount received in respect of the preferred coupon without fear of triggering the throwback tax. Moreover, proactive planners can substantially impact how large or small the required preferred coupon should be by properly structuring the preferred interest, thereby permitting significant flexibility in determining the size of the annual distributions.[126]

FNGT Holding Common Interest

In the so called ''reverse'' preferred partnership, a FNGT would hold the common interest, such that it would only be entitled to distributions of income to the extent that the partnership's income exceeded the amount required to be paid to the preferred partner (perhaps a domestic trust). Particularly in the situation in which the preferred coupon is structured to be higher, the practical result would be less (or no) excess income allocated to the FNGT and, therefore, less (or no) annual realization of DNI by the FNGT, thereby containing the accumulation of income on a going forward basis.

In circumstances in which the required coupon were to exceed the partnership's investment performance, the preferred partnership strategy would also have the effect of eventually depleting the FNGT's asset base simply by virtue of its underperforming investment in the preferred partnership. An ancillary benefit of this technique vis-à-vis making regular trust distributions is the absence of the requirement to file Form 3520, which would otherwise be required upon distribution from a foreign trust to a U.S. person.

CONCLUSION

As noted above, this is the first in a series of articles aimed at providing a primer on international taxation for domestic estate planners and tax practitioners. This installment attempted to set out the general landscape of tax rules relevant to basic international estate planning, both from a transfer tax and income tax perspective. The next installment of this series will discuss a series of specialized tax regimes targeted at cross-border transactions perceived as potentially abusive, including the rules for controlled foreign corporations and passive foreign investment companies, as well the rules applicable to foreign investment in U.S. real estate and operating businesses and certain U.S. individuals who have relinquished their U.S. citizenship.

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[123] Reg. §1.643(b)-1. Note that the terms of a trust's governing instrument will only be respected for purposes of determining FAI to the extent they do not ''depart fundamentally from traditional principles of income and principal.''

[124] *See, e.g.,* Uniform Principal and Income Act §401(c)(3), §401(d)(2) (distributions of less than 20% of an entity's gross assets treated as income).

[125] The authors would like to acknowledge the contribution of James R. Brockway, Esq. and Richard Cassell, Esq. in connection with the idea of the Throwback Preferred Partnership. The discussion included in this section is also derivative of a discussion contained in N. Todd Angkatavanich & Edward A. Vergara, *Preferred Partnership Freezes: They Come in Different ''Flavors'' and Provide a Menu of Creative Planning Solutions*, Tr. & Est. (May 2011).

[126] Rev. Rul. 83-120. Notably, factors such as the strength (or weakness) of the partnership's ''coverage'' of the preferred coupon and liquidation preference can significantly affect the required coupon. In the case of a preferred partnership that is heavily capitalized with preferred interests, and therefore has much less common interest to help support the required coupon payments, the partnership would have weaker coverage and would likely result in a much higher required coupon.

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