WHAT YOU SHOULD KNOW REGARDING INTERNATIONAL ESTATE PLANNING

Estate Planning Council of Greater Miami
1st Annual Estate Planning Symposium

Charles (Chuck) Rubin,
Attorney at Law
Gutter Chaves Josepher Rubin Forman Fleisher, PA
February 2013

2101 NW Corporate Blvd., Ste 107
Boca Raton, FL 33431
561-998-7847
crubin@floridatax.com
www.floridatax.com
www.rubinontax.blogspot.com

BIOGRAPHY

Charles (Chuck) Rubin
561-998-7847
www.floridatax.com
www.rubinontax.blogspot.com
crubin@floridatax.com

Charles (Chuck) Rubin, a board certified tax attorney, is managing partner of Gutter Chaves Josepher Rubin Forman Fleisher PA, a tax, trusts and estates boutique law firm situated in Boca Raton, Florida. He is a former adjunct professor at the University of Miami School of Law. Mr. Rubin has published numerous treatises, manuals, and articles, including two BNA Tax Management portfolios, and articles in Journal of Taxation, Estate Planning, Tax Management Estates, Gifts and Trusts Journal, and Tax Notes. He is a regular contributor to Leimberg Information Services. He also authorizes a popular tax blog at www.RubinonTax.blogspot.com, speaks regularly at professional meetings and conferences, and is frequently quoted in national publications such as the Wall Street Journal.
Mr. Rubin has received favorable peer ratings and recognition by various publications and rating services, including Best Lawyers, Chambers USA, Martindale-Hubble, Who's Who in America Law, Top Lawyers in the South Florida Legal Guide, SuperLawyers and Florida Trend's Florida Legal Elite, and his firm has a Tier 1 ranking in the U.S. News & World Report Best Law Firm rankings.

PRESERVING AND ENAHNCING INDIVIDUAL, FAMILY AND BUSINESS WEALTH THROUGH:

- Planning to Minimize Taxes (U.S. & International)
- Estate Planning, Charitable, Marital and Succession Planning
- Business Structuring and Transactions
- Trusts & Estates Administration
- Creditor Protection
- Trust, Estate & Tax Litigation and Disputes

WHAT YOU SHOULD KNOW REGARDING INTERNATIONAL ESTATE PLANNING

1 U.S. Transfer Taxes 4
2 Situs Rules. 9
3 Unified Credit - The Rules Are Different Here 14
4 Marital Deduction - The Rules Are Different Here 14
5 QDT Things To Know 15
6 Treaties 15
7 U.S. Income Tax Traps And Special Rules Relating To Foreign Trusts 16
8 Special Grantor Trust Rules 25
9 General Planning - Varies By Inbound Or Outbound And Where Donors And Recipients Reside 29
10 Unlimited GST Planning Opportunities 31
11 U.S. Real Estate Holding Structures 31
12 Misc. Planning Traps 34
13 Expatriation Rules - Continuing Gift And Estate Tax Regime For Future Transfers To U.S. Persons 35
14 Not All Countries Recognize Trusts 37
15 Or If They Do, They May Have Significant Legal Differences. 38
16 Foreign Taxes 38
17 Forced Heirship Rules 38
18 Life Insurance - Need For Trust? 39
19 Will Drafting Particulars 39
20 Interests In Foreign Corporations Can Give Rise To Issues Under CFC And PFIC Rules 41
21 Reporting 42

1) **<u>U.S. TRANSFER TAXES</u>**

a) General U.S. Estate, Gift and GST Tax Rules

i) Conflicting Policies

(1) Attracting foreign investment.

(2) Taxing nonresidents.

(3) Gives rise to hodge-podge of favorable and unfavorable provisions.

ii) History

(1) Wealth transfer taxes were levied in Egypt as early as the 7th century B.C.

(2) Emperor Augustus established a Roman inheritance tax called the vicesima hereditatum in the year 6 A.D.

(3) There were feudal death duties during the Middle Ages in Europe and, by the 18th century, all the leading nation-states of Europe had wealth transfer taxes in various forms.

(4) The first American wealth transfer tax dates to 1797, when Congress imposed a stamp duty on the receipt of legacies and on probating wills. This tax was repealed in 1802.

(5) Congress then imposed an inheritance tax in 1862 to help fund the Civil War and, thereafter, the tax was repealed in 1870.

(6) In 1894, an income tax on property acquired by gift or inheritance was promulgated but later found unconstitutional.

(7) In 1898, Congress imposed the first estate tax to help fund the Spanish-American War, and this tax was repealed in 1902.

(8) A new estate tax was established in 1916 and exists to this day.

(9) The first gift tax came about in 1924 but was repealed in 1926 and then reintroduced in 1932. In 1976, Congress crafted the new "unified" rate structure.

iii) Almost a voluntary tax, given the broad exemptions.

iv) Community property law ownership concepts will apply to determine ownership, including interests of property in the U.S. titled in one name if the applicable state recognizes community property interests in property acquired with community funds. Vandenhoeck Est. v. Comr., 4 T.C. 125 (1944), *acq.*, 1944 C.B. 29; Simon Est. v. Comr., 40 B.T.A. 651 (1939), *acq.*, 1942-1 C.B. 15.; Rev.Rul. 72-443.

v) Estate Taxes

(1) The same gift tax rates and estate tax rates apply for nonresidents, residents, and citizens. Code §2101(b)(1).

(2) Estate tax retained interest and power provisions of Code §2033-2046 apply. Code §§2103, 2104(b).

(a) DANGER: With respect to property that would be includible under §§2035 through 2038, the property is "deemed to be situated" in the United States if it was situated here either at the time of gift or at the time of the donor/decedent's death. Code §2104(b).

(3) No reduced valuation provisions apply for farm and business property for nonresident decedents for estate tax purposes. Code §§2032A(a)(1)(A) and 2057(b)(1).

(4) TBE and JTWROS Property with Spouse

(a) 50% inclusion if surviving spouse is a U.S. citizen. Code §2040(b).

(b) Apply Code §2040(a) rule if noncitizen surviving spouse (100% inclusion, less share purchased by surviving spouse for consideration).

(5) Deductions

(a) Must allocate between property inside and outside of the U.S. - therefore if want deductions, need to disclose worldwide property.

(i) Otherwise, is no obligation to report non-U.S. situs assets on Form 706NR.

(b) Code §§2053 and 2054 deductions (expenses, losses, indebtedness & taxes) are allowed on a pro rata basis, regardless of where expended or incurred. Code §2106.

(c) Charitable deductions available in any event for certain transfers of property to the U.S. or political subdivision or for the use of a qualified U.S. charity. Code §2106(a)(2).

(i) But not if the bequested assets are not included in the gross estate, such as portfolio debt obligations and life insurance proceeds.

(d) However, nonrecourse debt is not prorated and is a direct reduction against the value of the encumbered property.

(i) •§ 20.2053-7 Deduction For Unpaid Mortgages. A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate;

the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth. See § 20.2043-1. Only interest accrued to the date of the decedent's death is allowable even though the alternate valuation method under section 2032 is selected. In any case where real property situated outside the United States no deduction may be taken of any mortgage thereon or any other indebtedness does not form a part of the gross estate, in respect thereof.

(ii) See also Johnstone Est. v. Comr., 19 T.C. 44 (1952), *acq.*, 1953-1 C.B. 5.

(6) Code §2014 does allow for a foreign tax credit for foreign taxes based on the proportion of that country's taxable assets to the entire gross estate.

vi) Gift Taxes

(1) $14,000 annual exclusion gifts are available to nonresidents.

(2) Gift tax charitable deduction allowed to nonresidents.

(3) Gift splitting is not available if one of the spouses is a nonresident. Code §2513(a)(1).

(4) Outside of treaties, the Code does not afford a foreign tax credit to U.S. persons for gift taxes paid in another country.

(a) Unlike for estate taxes.

(5) The same gift tax rates and estate tax rates apply for nonresidents, residents, and citizens. Code §2101(b)(1).

vii) GST Rules

(1) Applies to nonresidents.

(2) But only as to U.S. situs assets. *See situs discussion below.*

(3) Directs gifts from nonresidents are taxable only to the extent the transfer is subject to federal estate or gift tax. Treas. Regs. § 26.2663-2(b)(1).

(a) Thus, a lifetime direct skip by a nonresident is subject to GST tax only if the gift is of U.S. situs assets, as determined under the gift tax situs rules. The same rules apply for direct skips at death (applying the estate tax situs rules).

(4) Taxable distributions or taxable terminations are taxable to the extent that the initial transfer of property to the trust by a nonresident transferor, whether during life or at death, was subject to federal estate or gift tax. Treas. Regs. §26.2663-2(b)(2).

(a) In determining the portion of a trust that is exempt from GST tax, exemption applies (a) under normal U.S. rules as to application of GST exemption, and (b) as to the portion of the trust funded with assets that were not subject to tax on transfer (by reason of not being taxed under the gift or estate tax rules at the time of funding, as applicable).

(i) Thus, transfers of non-U.S. situs assets have the same effect as generation-skipping tax exemption.

(ii) More technically:

1. A taxable termination or taxable distribution occurs with respect to a pro rata portion of a foreign trust to which a foreign transferor has given both U.S. and foreign assets. Treas. Regs. §26.2663-2(c)(1).

2. The portion of the trust that is subject to previous GST taxes is based on the applicable fraction at the date of death of the trust attributable to U.S. previous situs assets.

a. The numerator of this fraction is the sum of the amount of previous GST exemption allocated to the trust (if any) plus the value of the nontax portion of the trust at the date of death.

b. The denominator of the applicable fraction is the value of the property transferred to the trust, reduced to reflect prior distributions. Treas. Regs. §26.2663-2(c)(1).

c. The nontax portion of the trust, for this purpose, is a fractional share of the trust, the numerator of which is the value of the property transferred to the trust in a transaction that was not subject to U.S. estate or gift taxes, determined on the date the transfer was completed. The denominator of this nontax portion fraction is the value of the entire trust. Treas. Regs. §26.2663-2(c)(2).

(5) Same GST exemption as available to U.S. persons.

b) <u>Resident vs. Nonresident - The Rules are Different Here</u>

i) <u>Who is a nonresident for U.S. transfer tax purposes?</u>

(1) U.S. citizens - always U.S.

(a) Based on U.S. Constitution, the Immigration and Nationality Act, and the cases and regulations thereunder.

(b) Exception for persons born in the U.S. who are children of accredited diplomats and other persons not subject to u.s. jurisdiction under international law.

(c) Non-u.s. citizenship of dual citizens is disregarded for u.s. tax purposes. Estate of Vriniotis v. Comm, 79 TC 298 (1982).

(2) Test is domicile for non-U.S. citizens. Treas. Regs. § 20.0-1(b)

(a) There is no Code definition of "resident." Instead, it is defined in Regulations.

(b) "A 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(b)(1).

(c) Domicile shifts when two things happen at the same time and place:

(i) Taxpayer residence in a place, and

(ii) Taxpayer intends to reside there indefinitely

(d) Factors:

(i) The duration of stay in the U.S. and in other countries.

(ii) The relative size, cost and nature of houses or other dwelling places, and whether those places are owned or rented.

(iii) The area in which the houses and dwelling places are located. Houses in resort areas are less indicative of permanence than those in more stable and less pleasure-oriented areas.

(iv) The location of family and close friends.

(v) Motivation, especially health, pleasure, business, and avoidance of the miseries of war or political repression.

(vi) The frequency of travel between the U.S. and other countries.

(vii) J. Location of bank accounts, voter registration, car registration, drivers licenses

(viii) The location of church and club memberships.

(ix) The location of business interests.

(x) Declarations of residence or intent made in visa applications for re-entry permits, wills, deeds of gift, trust instruments, letters, and oral statements.

(xi) Visas, work permits and similar documents.

(xii) Testimony and statements.

(xiii) Duration of stays.

(e) Danger - state definitions of domicile may be different than federal, so may have different consequences for state tax purposes.

(f) Same domicile test applies for estate, gift and GST tax purposes.

(g) A domicile once acquired is presumed to continue until it is shown to have changed. Vlandis v. Kline, 412 U.S. 441, 454 (1973)

(h) If there is doubt, the presumption is that the domicile has not been changed. Vlandis v. Kline, 412 U.S. 441, 454 (1973)

(3) Income tax residency is not determinative.

(a) Substantial presence test.

(i) Section 7701(b) test is not applicable

(b) Green card holders.

(i) Not determinative, unlike Section 7701(b).

(ii) But highly indicative since at time of application, the holder was declaring his or her intent to permanently reside in the U.S.

(iii) The Estate of Barkat A. Khan, T.C. Memo 1998-22, where the IRS argued that green card status did not "automatically" result in domiciliary status (the court considered the green card as a factor in finding U.S. domicile, but it was not conclusive).

(4) The term "United States" includes only the 50 states and the District of Columbia

ii) A person who was born in the U.S. may have grounds for administrative relief where the person was either not aware of his status or reasonably motives that he had been deprived of U.S. system and never exercised any of the privileges of citizenship after the date of deprivation. *See* Rev.Rul 75-357.

2) SITUS RULES.

a) Estate Tax

i) General Rule

(1) Nonresidents

(a) Taxed only on U.S. situs assets

(b) Real, tangible and intangible

(2) U.S. Citizens and Residents

(a) Taxation on worldwide assets

ii) U.S. Situs Assets, In General

(1) See Code §2104.

(2) Real Property.

(a) U.S. real property is not described in Code §2104, but is treated as a U.S. situs asset under Treas. Regs. § §20.2104-1(a)(1).

(b) While not explicit in the regulation, buildings, improvements, and fixtures on land should be likewise treated.

(c) Cooperative apartments should be treated as intangible personal property. Stockton v. Lucas, 482 F.2d 979 (Temp. Emer. Ct. App. 1973); In re Miller's Estate, 130 N.Y.S.2d 295 (Sur. Ct. 1954).

(i) Because such an interest is stock in a domestic corporation, gross estate inclusion would result under the domestic stock inclusion rule of Code §2104(a).

(d) Mortgages.

(i) Likely treated as intangible assets and not real property unless treated as real property under local law. However, this law is not settled. Tarafa y Armas Est. v. Comr. , 37 BTA 19 (1938) and Fair v. Comr., 91 F2d 218 (3d Cir. 1937).

(e) Leases.

(i) Likely treated as intangible and not real property, but the law is not well developed. Very long-term leases more likely to be characterized as real property.

(3) Tangible Personal Property Located in the United States.

(a) U.S. situs, except for certain works of art alone for exhibition. Treas. Regs. §20.2104-1(a)(2).

(b) Currency likely treated as tangible personal property, and thus is sitused where physically located. Rev. Rul. 55-143, 1955-1 C.B. 465.

(4) Intangible Personal Property.

(a) Shares of stock are US situs only if issued by a domestic corporation. Code §2104(a).

(i) It does not matter whether certificates are physically located.

(ii) But watch treaty variations.

(iii) DANGER: Thus, domestic corporate holding companies are not advisable.

(b) Debt obligations of a United States person, or of the United States, a State, or any political subdivision thereof, or the District of Columbia, are U.S. situs. Code §2104(c).

(i) Regardless of where the debt instrument is physically held.

(ii) And multiple debtors, the debt should be apportioned among them. Treas. Regs. § 20.2104-1(a)(7).

(iii) Deposits with the domestic branch of a foreign commercial bank are US situs, except as provided under Code § 2105(b)(2) Code §2104(c).

(c) Other intangible property is sitused in the US if:

(i) (1) it is intangible personal property;

(ii) (2) the written evidence of the property is not treated as being the property itself; and

(iii) (3) it is issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit. Treas. Regs. §20-2104-1(a)(4).

iii) Special Exceptions to US Situs Rules

(1) Tangible personal property in transit through the US. Delaney v. Murchie, 177 F2d 444 (1st Cir. 1949).

(2) Some personal property of diplomatic personnel.

(3) Bank deposits with domestic institutions or in foreign branches of domestic banks. Code §§2105(b)(1) and 871(i)(3).

(a) Unless effectively connected with a trade or business in the US operated by the decedent, although this limitation does not apply to deposits in foreign branches of domestic banks.

(b) Includes deposits with persons carrying on the business of banking and insurance (under an agreement to pay interest thereon), including deposits with federal or state chartered savings institutions where the interest is deductible under Code §591.

(c) Deposits include money in a checking, savings, and agency accounts, and certificates of deposit. Deposits also include accrued and unpaid interest on deposits.

(d) In limited circumstances, annuities are equivalent to deposits being held by the insurers and are excluded from the decedent's gross estate for estate tax purposes under Code §2103. See PLR 200842013.

(e) The exclusion will not apply to cash held by a brokerage firm, cash in a bank's safety deposit box, or funds held by an institution in a fiduciary capacity. Ogarrio Est. v. Comr., 337 F.2d 108 (D.C. Cir. 1964); Rosenblum v. Anglim, 135 F.2d 512 (9th Cir. 1943). See also Rev. Rul. 65-245, 1965-2 C.B. 379; Rev. Rul. 56-421, 1956-2 C.B. 602; Rev. Rul. 55-143, 1955-1 C.B. 465; Rev. Rul. 69-596, 1969-2 C.B. 179; GCM 22419 (11/7/40).

(f) Uncertainty if the decedent is a nondomiciliary, but was a resident for income tax purposes.

(i) Because tied to income tax exclusion for nonresidents on interest from such accounts.

(4) Life insurance proceeds on the life of the nonresident (whether payable by a domestic or foreign life insurance company). Code §2105(a).

(a) DANGER: Exception does not apply to policies owned by the decedent on lives of others, if the issuer is domestic.

(5) Portfolio interest debt obligations. Code §§2105(b)(3) and 871(h).

(a) Also applies to OID obligations per their being a subcategory of portfolio interest obligations. See Code §871(h)(1).

(i) Note that before 1997, the foreign situs rules for OID instruments to not apply to instruments maturing within 183 days of issuance, but these rules no longer apply. Thus, for example, short-term government treasury obligations will be foreign situs.

(b) DANGER: Tax-exempt state and local bonds generating OID are not deemed to have a foreign situs, since the portfolio interest rules do not apply to them.

(c) DANGER: may not apply if the decedent is a green card holder since the portfolio interest exemption only applies to obligations held by nonresident aliens for income tax purposes.

iv) Partnership Interests?

(1) Aggregate vs. entity theory is unsettled and hotly debated.

(2) Probably only certainty as to a foreign partnership interest is that it will be foreign situs if the partnership is a separate entity under the local law, it is not engaged in a U.S. trade or business, and the partnership does not terminate on the death of the decedent. See Sanchez v. Bowers, 70 F.2d 715 (2d Cir. 1934); Rev. Rul. 55-701, 1955-2 C.B. 836.

v) Beneficial Interests in Estates and Trusts.

(1) Generally, apply and look through rule, although the rules in this area are somewhat uncertain.

vi) If a transfer described in Code §§2035-2038 involves a US situs asset either at the time of the transfer, or at the time of death, then it will be a US situs asset, even if it was not one at both such times. Code §2104(b).

b) Gift Tax

i) General Rule

(1) Nonresidents

(a) Taxed only on U.S. situs assets

(2) U.S. citizens and residents

(a) Taxation on worldwide assets

ii) U.S. Situs Assets, In General

(1) Includes only:

(a) U.S. real estate.

(i) Apply the same rules as for estate tax.

(b) Tangible personal property located within the United States. Treas. Regs. §25.2511-3(a)(1).

(i) Apply the same rules as for estate tax.

(2) Intangibles are not U.S. situs

(a) Major planning opportunity.

(b) Transformation of property from US situs to non-US situs before the gift, or a gift of non-US situs property with the intent that it be converted by the dummy to US situs property can be problematic.

(i) Davies v. Comr., 40 T.C. 525 (1963), acq. in result, 1966-1 C.B. 3. (gift of foreign bank account funds to fund the purchase of US real estate from donor treated as US situs gift); De Goldschmidt-Rothschild v. Comr., 168 F.2d 975 (2d Cir. 1948).

iii) Cash

(1) If in the U.S., IRS considers it tangible personal property.

(a) Rev.Rul 55-143; PLR 7737063;Regs. §25.2511-3(b)(iv)

(2) In Regs. §25.2511-3(b)(4)(i), a bank deposit is considered a "debt obligation" which supports an argument for intangible treatment.

(3) Conservative course is to transfer cash in banks via checks drawn on foreign accounts, or to retitle foreign accounts at foreign institutions from donor to donee.

(a) Still some uncertainty as to checks drawn on domestic accounts.

(b) PLR 8210055; GCM 36860.

c) GST Tax.

i) Apply gift tax rules for lifetime skips, and estate tax situs rules for testamentary skips. Treas. Regs. §26.2663-2.

ii) In regard to taxable distributions or terminations, the situs at the time of the initial transfer to the trust is determinative. Treas. Regs. § 26.2663-2(b)(2).

d) Misc.

i) In the case of an interest in an estate owned by a nonresident, generally the nonresident heir will not be regarded as owner of U.S.-situs property held by the executor but will be held to have only a claim against the executor. However, local law seems to control on this point. See de Eissengarthen Est. v. Comr., 10 T.C. 1277 (1948), *nonacq.*, 1948-2 C.B. 5.

3) **UNIFIED CREDIT - THE RULES ARE DIFFERENT HERE**

a) If nonresident alien:

i) $60,000 unified credit equivalent for estate tax.

ii) NO unified credit for gift taxes.

b) Citizens and residents receive full unified credit amounts for estate and gift taxes, regardless of nationality of recipient.

4) **MARITAL DEDUCTION - THE RULES ARE DIFFERENT HERE**

a) Estate Tax

i) Both U.S. and non-U.S. decedents can use the marital deduction.

ii) But only if the recipient is a U.S. citizen spouse, or a qualified domestic trust (QDT). Code §§2056(d)(1)(A) and (d)(2)(A).

(1) Deduction available for transfer to surviving spouse if surviving spouse becomes a U.S. citizen prior to the day on which the decedent's federal estate tax return is made, and the surviving spouse is a U.S. resident (for estate tax purposes) at all times after the decedent's death and until becoming a U.S. citizen. Code §2056(d)(4).

(a) A mere application for citizenship is not enough. PLR 9021037.

(b) If cannot obtain citizenship in time, can use a QDT, and then later terminate it.

(c) For purposes of these rules, an estate tax return filed prior to the due date is considered filed on the last date that the return is required to be filed. Treas. Regs. § 20.2056A-1(b).

(d) An extension of time to file the estate tax return also extends the time for the surviving spouse to obtain citizenship.

iii) Foreign death taxes should be paid out of non-marital deduction property, or else reduce the U.S. marital deduction (unless getting a credit for those taxes).

b) Gift Tax

i) Both U.S. and non-U.S. donors can use the marital deduction.

ii) Unlimited if recipient spouse is a U.S. citizen.

iii) $ limited (on an annual basis) if recipient is not a citizen spouse.

iv) Technically, not getting a marital deduction (*see* Code §2523(i)), but instead getting an enhanced Code §2503(b) gift tax exclusion amount.

(1) So make sure it is a present interest gift!

(2) Still must also meet the terminable interest rules of Code §2523(b).

5) **QDT THINGS TO KNOW**

a) Watch use of foreign co-trustee since it may result in the trust being a foreign trust.

i) Code §684 funding issues on IRD.

ii) Throwback rules and interest charges on throwback.

iii) Capital gains in DNI and converted to ordinary income.

iv) But note there is no limitation on having foreign trustees, other than the requirement for at least one qualified domestic trustee.

b) Better to do the transfer in the decedent's documents rather than rely on survivor to fund their own QDT.

i) U.S. transfer and income tax consequences apply to a post-death funding by the surviving spouse. This is because, unlike a QDT funded by the decedent, a surviving spouse is treated as the transferor of any funding undertaken by the surviving spouse of property received outright from the decedent.

(1) If doing a post-death funding, include power of appointments and/or revocability provisions so as to avoid current gift to remaindermen issues (including application of Section 2702).

ii) Also becomes a self-settled trust for creditor protection purposes.

c) The unified credit of the surviving spouse is not available to offset estate tax relating to the QDT.

i) But the credit for prior transfers is available to help avoid double tax.

d) Lifetime distributions are subject to estate tax, unless a hardship distribution.

i) Payments of mortgage on property owned by trust likely to trigger this tax.

e) General marital deduction trust requirements.

i) Must be met for fundings at death directly to a QDT by the decedent.

ii) Need not be met in a QDT that is funded with property by the surviving spouse that the surviving spouse received outright from the decedent.

f) Not only the decedent or the surviving spouse can create the QDT - the executor can, too.

6) **TREATIES**

a) General purpose is to avoid or ameliorate double taxation.

b) U.S. has 15 bilateral death tax treaties (2012).

   i) A number also address gift and GST transfers.

c) Some treaties are situs-based, and set forth rules on situs to determine which country has taxing jurisdiction.

   i) These treaties, other than the one with Japan, generally do not apply to gift taxes.

   ii) These treaties do not apply to GST tax.

      (1) Since all were ratified before the tax was first enacted in 1976.

   iii) Generally do not apply state, provincial and local taxes, so is a risk of double taxation.

d) Others are domicile focused, that seek to address which country has taxing jurisdiction based on the relative ties of the taxpayer to the two countries.

   i) That country gets exclusive taxing jurisdiction, in lieu of assigning situs to various types of assets.

   ii) However, some situs rules remain, *e.g.*, for real property, permanent establishment business property, and tangible personalty.

   iii) Typically covers gift and GST taxes, in addition to estate taxes. However, there are terminology issues as to GST for those that date prior to the newer version of the GST in 1986.

   iv) Does not generally provide a unified credit to nonresidents.

   v) Generally do not apply state, provincial and local taxes, so is a risk of double taxation.

e) Canada has a special type of treaty that seeks to coordinate the U.S. estate tax with Canada's income tax on death provisions.

f) Treaties may, but will not always:

   i) Set a taxable situs for certain classes of assets;

   ii) Allow certain types of deductions;

   iii) Allow for credits.

g) Generally include exchange of information provisions.

h) Treaty-based return position disclosures may be needed on Form 8833.

   i) See Treas. Regs. § 301.6114-1.

   ii) However, since the rules are principally written with income taxes in mind, their precise operation can be difficult to determine.

7) U.S. INCOME TAX TRAPS AND SPECIAL RULES RELATING TO FOREIGN TRUSTS

a) Having a foreign trustee can create a foreign trust for tax purposes.

i) Why do we Care?

(1) Different tax and reporting rules apply.

(2) An inadvertent or intentional conversion of a trust from domestic to foreign can trigger Code §684 gain recognition on appreciation.

ii) APPLICABLE RULE: All trusts are deemed to be FOREIGN unless both:

(1) A court in the U.S is able to exercise primary supervision over the trust administration (the "Court Test"), and

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

(a) EFFECT: If a foreign person has control over only one "substantial decision," foreign trust status results.

(i) Thus, have to watch for powers not just of trustees, but of protectors, beneficiaries, and other persons granted power or authority over the trust.

(ii) Regulation examples allow for foreign person to serve, if can be "outvoted" by U.S. persons.

1. Also, can give powers to foreign persons, so long as a U.S. fiduciary can veto it (and the U.S. fiduciaries are not foreclosed from making those decisions themselves - see Treas. Regs. §301.7701-7(d)(1)(iii) and (v) ex. 2, 3 and 4).

a. "(iii) The term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries."

b. Example 1 provides the foreign trustee(s) cannot have veto power, and there cannot be a requirement for unanimity if there is a foreign trustee.

c. Example 2 importantly blesses a straight majority vote, where one of 3 trustees is foreign.

(b) 12 month safe harbor if there is an inadvertent change.

(i) An inadvertent change means the death, incapacity, resignation, change in residency, or other change that would change the residency of the trust but was not intended to do so.

1. What other "changes" might come within this rule?

a. Perhaps the removal of a trustee for malfeasance or nonfeasance, or the bankruptcy of a corporate fiduciary.

(ii) Thus, for example, if a sole U.S. trustee dies and the trust designates a foreign person to serve as successor, if that foreign person is replaced with a U.S. person within 12 months, then the trust will not have been converted to a foreign trust.

(iii) An extension of the 12 month period can be requested from the IRS.

b) Having a foreign protector with power to terminate a trust can create a foreign trust for tax purposes.

c) Having a foreign beneficiary with power to appoint trust assets can create a foreign trust.

d) Having a foreign beneficiary with power to remove a trustee can create a foreign trust.

i) Even though the trust requires a U.S. successor trustee.

e) Having a foreign investment advisor can create a foreign trust.

i) If contract is for a year or more.

f) Capital gains are included in DNI.

i) Which can thus unexpectedly increase taxes on beneficiaries receiving distributions.

g) Special rules will create constructive distributions to beneficiaries.

i) Code § 643(i).

ii) Loans to beneficiaries, unless "qualified obligations."

iii) Free use by beneficiaries of trust property.

iv) Which can create phantom income for beneficiaries.

h) The throwback rules apply to foreign trusts.

i) Throwback Rules.

(1) Which trusts do the rules apply to?

(a) The only trusts remaining subject to throwback are foreign trusts and domestic trusts that either (a) were at any time foreign trusts, or (b) were created before March 1, 1984, and would have been subject to the aggregation requirement of §643(f) if that provision had then applied.

(b) Not applicable to grantor trusts.

(2) What is happening here?

(a) Undistributed DNI (reduced by applicable taxes) carries out in later years to beneficiaries.

(3) Statutory Mechanics:

(a) Calculate UNI (undistributed net income) for years after 1969 on a year by year basis.

(i) UNI = excess of DNI over (a) distributions to beneficiaries in that year under Code §661(a)(1) and (2), and (b) taxes imposed on trust allocable to the undistributed DNI. Code §665(a).

1. Essentially, undistributed DNI, less taxes on that undistributed DNI.

2. ALERT: Watch for unexpected sources of DNI (e.g., depreciation recapture, imputed income under Code §§ 482, 446, 551, 951, 7872).

3. If no records are available, assume UNI arose in earliest taxable years of trust. Code §666(d).

4. Foreign taxes can be included for this purpose. Code §665(d)(2).

(ii) But credit against UNI accumulation distributions previously made for that year. Code §665(a)(1) and Code §666(a).

(b) Calculate accumulation distribution for the current tax year. Code §666(a).

(i) This is essentially the excess of Code §661(a) distributions over DNI for the current tax year. Code §665(b).

(c) Allocate the accumulation distribution amount to prior tax years with UNI. Code §666(a).

(i) Apply to oldest tax year with UNI first, and then second oldest, etc.

(ii) Gross up the distribution amount for each such year with UNI by taxes previously imposed on the trust in that year. Code §666(b) & (c).

(d) The accumulation distribution is deemed to occur in each prior year and is included in the income of the recipient beneficiary when paid, credited, or required to be distributed as if it was a current year Code §662(a)(2) distribution. Code §667(a).

(i) Thus, U.S. beneficiaries will include the distribution in income. Code §667(a)(2).

(ii) However, the rate of tax is determined by averaging formula applied over the 5 years preceding the current tax year. Code §667(b).

1. For the 5 preceding tax years, throw out the years with the highest and lowest taxable income amounts of the beneficiary.

a. Augmented by accumulation distributions that increased prior years' taxable income.

2. Then divide the accumulation distribution by the number of prior tax years to which the accumulation distribution is allocated.

   a. However, this number of prior tax years may be reduced for years with low amounts of UNI allocated to them. Code §667(b)(3). Amounts accumulated in that year are still part of the total accumulation distribution.

3. Add that fractional amount of the total accumulation distribution to the taxable income of the remaining 3 preceding tax years and determine the resulting tax increases for those years, and then determine the average tax increase for those three years.

4. Multiply the average tax increase by the number of prior tax years to which the accumulation distribution is allocated.

5. Reduce that figure by the amount of taxes deemed distributed to the beneficiary under Code §§665(b) and (c).

   a. The beneficiary may not obtain a refund where the credit for taxes paid by the trust exceeds the partial tax obligation. Code §666(e).

6. The remaining amount is the net tax imposed on the accumulation distribution.

   a. Subject to adjustment for estate and GST taxes attributable to the partial tax. Code §667(b)(6).

      I. FOR EXAMPLE, ASSUME THE TRUST SOLD PROPERTY DURING THE BENEFICIARY'S LIFETIME, BUT THE BENEFICIARY DIED BEFORE THE GAIN WAS DISTRIBUTED SO THAT THE GAIN WAS INCLUDED IN THE BENEFICIARY'S ESTATE AS INCOME IN RESPECT OF A DECEDENT. THE ULTIMATE RECIPIENTS OF THE GAIN WOULD BE ABLE TO REDUCE THEIR TAX ON THE DISTRIBUTION BY A RATABLE PORTION OF THE ESTATE OR GENERATION-SKIPPING TAXES PAID ON THE UNI OF THE TRUST.

(iii) Are special rules for multiple trusts and foreign taxes. Code §§667(c) & (d).

(iv) U.S. beneficiaries will thus be taxed on the accumulation distribution at ordinary income rates, since there is no provision for the pass-through of character.

1. Foreign beneficiaries will get the benefit of a character pass-through. Code §667(e).

2. <u>Implications</u>:

   a. No preferential capital gains rates.

b. Distribution will lose any applicable foreign income character and thus may reduce otherwise available foreign tax credits.

c. Distribution will lose passive activity income character and thus may not allow for offset by passive losses.

3. However, tax-exempt municipal bond interest should keep its tax-free character. Code §643(a)(5).

(4) Observations.

(a) There can be no accumulation distribution in any year in which total distributions do not exceed trust accounting income. A "simple" trust generally avoids the problem.

(b) Nonresident alien beneficiaries are subject, on items of income that are otherwise taxable to an NRA.

(c) Since foreign trusts include capital gains in DNI, undistributed capital gains are included in undstributed income.

(d) There is no minority exception for younger beneficiaries. Therefore, accumulation of income during minority is a problem.

(5) Traps!

(a) Beneficiary of foreign trust is a 5 year old U.S. person. The trustee accumulates the income of the trust until the beneficiary reaches age 18, and then distributes it.

(i) Throwback rules apply - there is no exception for accumulations while there is a minor beneficiary.

(b) Foreign trust sells a condominium for a $500,000 gain on 11/1/2010. On 6/30/2011, it distributes the proceeds of the sale to a U.S. beneficiary.

(i) Capital gain goes into DNI. In 2010 this DNI was not distributed, so there was an accumulation. In 2011, there is an accumulation distribution. As an accumulation distribution, the accumulated capital gain loses its character and is taxed as ordinary income to the U.S. beneficiary.

ii) Observations.

(1) There can be no accumulation distribution in any year in which total distributions do not exceed trust accounting income. A "simple" trust generally avoids the problem (except as to capital gains included in DNI).

(2) Nonresident alien beneficiaries are subject, on items of income that are otherwise taxable to an NRA.

(3) Since foreign trusts include capital gains in DNI, undistributed capital gains are included in undstributed income.

(4) There is no minority exception for younger beneficiaries. Therefore, accumulation of income during minority is a problem.

i) Interest Charge on Accumulation Distributions.

i) Interest is charged on accumulation distributions.

ii) Rate of Interest.

(1) Use rates and method of interest under Code §6621 applicable to underpayments of tax.

(2) For portion of period which occurs before 1/1/96, use 6% (with no compounding).

iii) Mechanics.

(1) Identify the tax years that have undistributed net income.

(2) For each such year, multiply the UNI for that year by the number of years away that year is from the current year of distribution.

(a) But exclude years in which the beneficiary was a nonresident alien. Code §668(a)(4).

(3) Add up all those products.

(4) Divide that sum by the aggregate UNI of all years.

(5) Multiply the result by the partial tax under Code §667(b) (after tax credits) and the applicable Code §6621 interest rate.

(6) The result is the applicable interest charge.

(7) Effect: Creates a weighted number of years for which interest should be charged, based on the years with UNI and the relative amounts of UNI in each years.

iv) Misc.

(1) Interest is not deductible.

(2) Maximum interest charge is limited so that interest and tax does not exceed 100% of the accumulation distribution.

v) Traps!

(1) Foreign trust accumulates foreign source for 15 years. It then distributes the income to a U.S. beneficiary.

(a) The interest charge is so high that between tax on the accumulation distribution and interest, almost all of the distribution is taxed away.

j) The transfer of property to a foreign trust can be treated as a sale or exchange.

i) History.

(1) In 1997 new Code § 684 replaces former Code §1491 excise tax.

(2) New Code §684 applies to transfers after August 4, 1997.

ii) Elements.

(1) Transfer of property,

(a) Direct, indirect, or constructive transfer. Treas. Regs. §1.684-2(a).

(i) Example of "indirect:" transferring property first to an intermediary, and the intermediary makes the transfer to the trust. Treas. Regs. §1.684-2(b)(2), Ex. 1.

(ii) Example of "constructive:" Termination of grantor trust status of a foreign trust when there was a U.S. grantor. Treas. Regs. §1.684-2(e)(2), Ex. 2.

(2) By a U.S. person,

(a) Use regular Code §7701(a)(30) definition.

(b) Including Code §6013(g) election by NRA to be treated as a resident alien. Treas. Regs. §1.684-1(b)(1).

(3) To a foreign estate or trust, and

(4) Treated as a sale or exchange, and gain recognized.

iii) Exceptions.

(1) Transfer to a grantor trust to the extent a U.S. person is treated as the owner under Code §671 (including §679).

(2) Code §501(c)(3) foreign trust.

(3) Transfers at death that result in a basis step-up under Code §1014(a).

(a) Thus, while 2010 was a problematic year, with the restoration of estate taxes and basis step-up (absent an election out of estate tax), most transfers at death will not trigger gain recognition.

(b) Since IRD items do not get a basis step-up, they can be triggered at death.

(4) Transfers for fair market value to unrelated trusts.

(5) Distributions to a trust by an entity other than a trust and certain other special forms of entities.

iv) Nonobvious Applications.

(1) Transfer by a U.S. estate.

(2) Conversion of a domestic trust to a foreign trust.

(a) Deemed to occur on same day, but immediately before, conversion to a foreign trust. Treas. Regs. §1.684-4(b).

(b) Exception for "inadvertent migrations." Treas. Regs. §1.684-4(c).

(3) Foreign grantor trust with U.S. grantor ceases to be a grantor trust (including death).

(4) Transfers of property to entities owned by a foreign trust.

v) Observations.

(1) Loss is not recognized.

(a) Gain recognized on an asset by asset basis - no offset for losses. Treas. Regs. §1.684-1(a)(2).

(2) Irrelevant whether the foreign trust has U.S. beneficiaries.

(a) Except to the extent that it may create a grantor trust under Code §679.

(3) Receipt of partial consideration will not usually change the result, nor the amount of gain.

(a) A transfers property that has a fair market value of $1000X to foreign trust in exchange for $400X of cash. A's adjusted basis in the property is $200X. A recognizes gain at the time of the transfer equal to $800X. Treas. Regs. §1.684-1(d), Ex. 3.

(4) Such deemed transfers are subject to reporting requirements under Code §6038.

vi) Traps!

(1) Joe, a U.S. person, sets up a revocable trust in Nevis for credit protection purposes. The trustee is a Nevis bank. Joe dies.

(a) Gain triggered.

(b) But subject to reduction for basis step-up at death.

(2) U.S. domestic trust. U.S. trustee dies, and Uncle Jose, a resident of Panama, takes over as successor trustee.

(a) Conversion of trust from a domestic trust to a foreign trust triggers gain recognition.

(3) Foreign trust has a U.S. grantor and a U.S. mandatory income beneficiary, and is thus treated as a grantor trust under Section 679. U.S. beneficiary dies, and Mexican daughter of beneficiary succeeds as a beneficiary.

(a) Conversion out of grantor trust status triggers gain recognition.

(4) U.S. grantor gifts a portfolio of securities with $1 million in accrued gains and $1 million in accrued losses to a nongrantor foreign trust.

(a) $1 million in gains recognized. No offset permitted - losses not recognized under Section 684.

(5) U.S. person sells a Bahamas condominium to a foreign trust. The property is worth $1 million, and the U.S. person has a $500,000 basis in it. The sales price is $900,000.

(a) All $500,000 in gain is recognized.

8) **SPECIAL GRANTOR TRUST RULES**

a) Foreign trusts with U.S. grantors have their own special grantor trust rule. A foreign trust funded by a U.S. person with a U.S. beneficiary is a grantor trust. Code §679.

i) Thus, trust need not otherwise meet the traditional grantor trust rules of Subchapter J.

ii) When will a trust be considered to have a U.S. beneficiary?

(1) The test is made annually. Treas. Regs. §1.679-2(a)(1).

(2) It is defined in the negative. A U.S. beneficiary will be deemed to exist unless:

(a) Under the trust terms, no part of income or corpus may be paid or accumulated to or for the benefit of a U.S. person, and

(i) Income will be treated as being accumulated for a U.S. person even if that person's interest is contingent on a future event. Code §679(c)(1).

1. Thus, merely contingent U.S. person beneficiaries will be enough (at least if income is being accumulated).

(ii) It does not matter if no income or corpus is actually distributed to a U.S. person. Treas. Regs. §1.679-2(a)(2)(i).

(iii) Exception for negligible interests.

1. A person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest in the trust is so remote as to be negligible. Treas. Regs. §1.679-2(a)(2)(ii).

2. However, this exception is not applicable to such a person if they are also a discretionary beneficiary. Id.

(iv) The Regulations provide 13 examples of situations that provide guidance on when there is a potential beneficiary and the exception for negligible interests. Treas. Regs. §1.679-2(a)(2)(iii).

(b) If the trust were terminated at any time in the taxable year, no part of the income or corpus could be paid to or benefit a U.S. person. Code §679(c)(1); Treas. Regs. §1.679-2(a)(1).

(3) Attribution of ownership can occur through foreign corporations, foreign partnerships, foreign trusts, and foreign estates. Code §679(c)(2). A U.S.

person beneficiary will be deemed to exist as to amounts paid to or accumulated for:

(a) A controlled foreign corporation,

(b) A foreign partnership with a U.S. person partner, or

(c) A foreign trust or foreign estate with a U.S. beneficiary.

(4) When a trustee or other person has discretion to determine beneficiaries (e.g., under a power of appointment), a U.S. beneficiary will be deemed to exist, unless:

(a) The trust terms specifically identify the class of persons, and none of those persons are U.S. persons in the taxable year. Code §679(c)(4).

(b) Thus, powers of appointment are a danger.

(c) Powers to amend the foreign trust to benefit a U.S. person, either under the instrument or applicable local law, may also trigger the existence of a U.S. beneficiary. Treas. Regs. §1.679-2(a)(4)(ii).

(5) Oral or written agreements or understandings that effectively result in a U.S. person beneficiary will be treated as trust terms. Code §679(c)(5).

(a) Such as letters of wishes, or actual distributions that are made. Treas. Regs. §1.679-2(a)(4)(i).

(6) Loans of cash or property to U.S. persons will result in such person being treated as a U.S. beneficiary. Code §679(c)(6).

(a) Except for loans repaid at a market rate of interest within a reasonable period of time or fair market value rent being paid.

(7) If a U.S. person transfers property to a foreign trust, the IRS may presume there is a U.S. beneficiary absent the submission of satisfactory information or evidence to the contrary. Code §679(d).

(8) Can also extend to U.S. persons who are indirect beneficiaries via agent or nominee relationships. Treas. Regs. §679-2(b)(2).

iii) Extended "transfers."

(1) "Transfers" include indirect transfers if there is a principal purpose of tax avoidance. Treas. Regs. §1.679-3(c).

(2) They will also include an assumption or satisfaction by a person of a foreign trust's obligation to third party. Treas. Regs. §1.679-3(d)(1).

(3) Guarantees of trust obligations by a related U.S. person can constitute a transfer. Treas. Regs. §1.679-3(e)(1).

(4) Transfers by a related U.S. person to an entity owned by the foreign trust may constitute a transfer. Treas. Regs. §1.679-3(f).

iv) <u>Exceptions</u>.

(1) Excluding deferred compensation and charitable trusts. Code §§6048(a0)3)(B)(ii).

(2) Transfers by reason of death of transferor. Code §679(a)(2).

(3) Transfers by sale/exchange for fair market value. Code §679(a)(2)(B).; Treas. Regs. §1.679-4(b).

(a) In testing consideration, obligations of, and obligations guaranteed by, the trust, any grantor, owner, or beneficiary, or certain related persons, will not be counted unless they are "qualified obligations." Code §679(a)(3); §1.679-4(c).

(4) Not applicable to any transfer of property by reason of a beneficiary becoming a U.S. person more than 5 years after the transfer. Code §679(c)(3); Treas. Regs. §1.679-2(a)(3)(i).

v) Late entries to grantor trust status.

(1) Foreign grantor later becomes a U.S. person.

(a) If residency starting date is within 5 years of the date the grantor transferred property to the trust, such transfer will be deemed to have occurred on the residency starting date (and thus may trigger grantor trust status). Code §679(a)(4); §1.679-5(a).

(b) Determine residency start date using Code §7701(b)(2)(A) rules. Code §679(a)(4)(C).

(c) Property deemed transferred includes undistributed income. §1.679-5(b)(2).

(2) U.S. trust becomes a foreign trust.

(a) If there is a U.S. grantor and a U.S. beneficiary, the grantor will be treated as having made the transfer as of the day the trust becomes foreign, thus triggering grantor trust status. Code §679(a)(5).

(i) Property transferred includes undistributed net income. §1.679-6(b).

(3) Foreign trust with U.S. grantor acquires a U.S. beneficiary.

(a) This will trigger the operation of the grantor trust rules in the year it acquires a U.S. beneficiary, including by reason of a beneficiary becoming a U.S. person. Code §679(a)(1); Treas. Regs. §1.679-2(a)(3).

(i) But note above exception as to transfers that occurred more than 5 years before a foreign person becomes a U.S. person.

(b) Interestingly, if there was no U.S. beneficiary in the prior year, any undistributed income at the end of the year will be income to the U.S. grantor in the next year when there is a U.S. beneficiary. Code §679(b); Treas. Regs. §1.679-2(c)(1).

(i) This will trigger an accumulation distribution interest charge on the undistributed net income. Treas. Regs. §1.679-2(c)(1).

b) Code §672(f) imposes limits on when a foreign person can be treated as owner under the grantor trust rules. Thus, a trust may appear to be a grantor trust under other Subchapter J rules, but will not be treated as such unless it meets the requirements for grantor trust status that apply when the grantor is foreign.

i) The situations where grantor trust will be allowed to operate with a nonresident alien grantor are:

(1) Revocable trust, or

(a) Power to revest absolutely in grantor; and

(i) Power to revest must be held for at least 183 days. Treas. Regs. §1.672(f)-3(a)(2).

(b) Revocation power exercisable solely by grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) (a) without approval or consent of any person, or (b) with consent of related or subordinate party who is subservient to grantor. Treas. Regs. §1.672(f)-3(a)(1).

(i) "Related or subordinate party" is defined under Treas. Regs. §1.672(c)-1. Treas. Regs. §1.672(f)-3(a)(1).

(ii) A related or subordinate party is subservient to the grantor unless the presumption in the last sentence of §1.672(c)-1 is rebutted by a preponderance of the evidence. Treas. Regs. §1.672(f)-3(a)(1).

(iii) See Treas. Regs. §1.672(f)-3(a)(4) examples for IRS interpretations of these general rules.

(2) Benefit trust, or

(a) Distributions (income or corpus) during lifetime of grantor can only be made to grantor or the grantor's spouse.

(i) A distribution in satisfaction of a legal obligation of the grantor or the grantor's spouse is considered a distribution to the grantor/grantor's spouse, but subject to some restriction for related party obligations. Treas. Regs. §1.672(f)-3(b)(2).

(3) Compensatory trust.

(a) A trust whose distributions are taxable as compensation for services rendered. See Treas. Regs. §1.672(f)-3(c).

ii) Trusts that are not treated as a grantor trust by reason of Code §672(f) are taxed as regular trusts, subject to accumulation distribution and

interest charge rules for accumulation distributions to U.S. beneficiaries. Treas. Regs. §1.672(f)-1(a)(1).

iii) Code §672(f) applies to trusts for which the grantor is not a U.S. citizen or resident or a domestic corporation.

iv) Code §672(f) applies to both domestic and foreign trusts.

v) Special Rules:

(1) A CFC is treated as a domestic corporation for this purpose. Code §672(f)(3)(A).

(2) A PFIC is treated as a domestic corporation for this purpose. Treas. Regs. §1.672(f)-2(a).

(3) These rules do not apply for purposes of Code §1297 PFIC rules in determining whether a corporation is a PFIC. Code §672(f)(3)(B). Treas. Regs. §1.672(f)-2(c)(1).

(4) Once a trust fails to be treated as a grantor trust under these rules, later qualification under these rules will not then allow grantor trust status. Treas. Regs. §1.672(f)-3(a)(3).

vi) Grandfathered trusts.

(1) These limits on grantor trust status do not apply to any portion of a trust that was treated as owned by the grantor under Code §§676 and 677 on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995. Treas. Regs. §§ 1.672(f)-3(a)(3) and -3(b)(3).

9) GENERAL PLANNING - VARIES BY INBOUND OR OUTBOUND AND WHERE DONORS AND RECIPIENTS RESIDE

a) Owning assets through a foreign corporation to insulate against estate tax for nonresidents.

i) Stock of a non-U.S. corporation is a foreign situs asset, so the stock, and any property owned by the corporation (even if that property is U.S. situs property), is not subject to estate tax.

ii) Nonetheless, this is not a blanket solution. There can be negative U.S. income tax consequences to the arrangement.

(1) Watch income tax consequences on formation or transfer of U.S. assets to the foreign corporation.

(a) This is especially so if the property is appreciated U.S. real property.

(b) U.S., state and local corporate income taxes and branch profits tax may applicable for U.S. effectively connected income.

(c) Limitations on deductibility of expenses may apply.

(2) The transfer of a U.S. corporation to become a subsidiary of a foreign corporation can constitute an "inversion." Stock of a foreign corporation after an inversion may be treated as domestic corporation stock post-inversion. Code §7874.

(3) Foreign corporation reporting requirements may apply.

(4) CFC/PFIC considerations apply if the heirs are U.S.

iii) The IRS may also challenge the effectiveness of the arrangement.

(1) See Estate of Swan, 24 T.C. 829 (1955*), aff'd in part, rev'd in part*, 247 F2d 144 (2d Cir. 1957) (ownership in Liechtenstein and Swiss Stiftungen not deemed to be corporate ownership); Fillman, USTC Para. 12,374, 355 F2d 632 (Ct. Cl. 1966) (corporate property deemed owned by shareholder based on holding out of such property as owned by the shareholder); Rev.Rul. 72-552; PLR 7844041.

(2) Transfer of real property to a foreign corporation, followed by continued personal use of that property can be a Code §2036 problem. A fair market leaseback of the property should remove this issue, but will result in rental real estate income tax consequences. *See* DuPont, 63 TC 746, where a lease did not avoid Code §2036 when the rent charged was not based on the highest and best use of the land.

(3) If corporate ownership to be respected, corporate formalities of corporation and its ownership need to be observed.

b) Gifts of intangible property.

i) Including death bed transfers - e.g., having assignments in your wallet.

ii) Allows easy transfer of assets that may be subject to estate tax if held until death, since U.S. issuer intangible property is not U.S. situs asset for gift tax purposes, but is for estate taxes.

c) Maximize lifetime transfers to noncitizen spouse through maximum annual exclusion gifts.

i) Don't wait until death to use QDT, due to deferred tax becoming applicable if principal applied during second spouse's lifetime.

(1) Also, surviving spouse cannot use his or her own unified credit at death against QDT assets, so if a domiciliary, want that spouse to have own assets to be able to use unified credit at second death.

ii) True whether recipient spouse is U.S. domiciliary or not, but as to U.S. situs assets this is more important for nondomiciliary recipient spouses. This is because assets transferred inter vivos to a nonresident spouse will not be subject to estate tax at the death of the nonresident spouse if they are subsequently converted to non-U.S. situs assets before death.

iii) Consider sale of U.S. situs to U.S. resident spouse from nonresident spouse.

(1) If nonresident spouse holds those assets until death, there will be estate tax or the need for a QDT.

(2) A sale allows more assets to be transferred than the maximum annual exclusion gift, and Code §1041 avoids gain.

d) Reducing value of U.S. situs property.

i) Nonrecourse mortgages will accomplish such reduction, if bona fide. This is to be compared to recourse mortgages which will be deductible only a pro rata basis against worldwide assets, and will require a disclosure of worldwide assets on the estate tax return.

ii) Another method of accomplishing this is to isolate the property in an entity that has liabilities.

e) Becoming a U.S. citizen or resident to obtain larger exemptions.

i) But exposing worldwide assets to transfer taxes and income taxes, and worldwide income to income taxes.

f) Establishment of dynasty trusts during lifetime with intangible property.

i) Effectively unlimited GST exemption will act to exempt the trust assets from future transfer taxes. See further discussion below.

10) UNLIMITED GST PLANNING OPPORTUNITIES

a) There are tremendous opportunities for GST transfers to U.S. persons that are not available to U.S. transferors.

b) Simple Level.

i) Transfers of non-U.S. situs property are not subject to GST taxes. Therefore, generation skips can be freely made, either at lifetime or at death.

(1) Inter vivos gifts use the gift tax rules to determine situs.

(a) Thus, transfers of intangibles can be freely made.

(2) Testamentary transfers use the estate tax rules to determine situs.

c) Dynasty Trusts.

i) If transfers of non-U.S. situs assets are made to a dynasty trust, that trust will be forever exempt from future GST taxes (if no other taxable assets are transferred to it).

ii) Effectively, this is an unlimited GST exemption if non-U.S. situs assets are used.

11) U.S. REAL ESTATE HOLDING STRUCTURES

a) Alternative - Ownership in Individual Name.

i) Advantages

(1) Simple.

(2) Only one level of income tax.

(3) Estate tax basis step-up at death.

(4) Lower maximum capital gain rates on sale of property (as compared to corporation).

(a) Where ordinary income is not an issue.

(5) Allows use of U.S. taxes against foreign taxes.

ii) Disadvantages.

(1) U.S. estate taxes at death.

(a) Subject to marital deduction relief.

(b) Can cover through life insurance.

(2) Unlimited liability.

(3) Lack of confidentiality.

(4) Becomes a U.S. taxpayer for income tax purposes.

iii) Helpful Variations.

(1) Life insurance coverage to pay taxes.

(2) Nonrecourse mortgaging to reduce value.

(3) Use an LLC or partnership to own, with a gift of ownership being made prior to death.

(a) Treating as a gift of an intangible which is not subject to gift tax.

(i) If respected.

(b) But watch Code §1446 withholding issues.

b) Alternative - Foreign Corporation Structures.

i) With or without a subsidiary U.S. corporation.

ii) Advantages.

(1) U.S. estate tax avoided.

(a) However, rental at fair value needed to avoid Code §2036 argument if personal use intended, at least if the property was previously owned in individual form.

(i) With income tax consequences of rentals.

(b) May also want rental to avoid home country taxable "shareholder benefit" if otherwise is personal use.

(i) Sometimes avoided by use of home country partnership or pass-through entity that elects corporation treatment in the U.S.

(2) Assuming no appreciation in the property, no U.S. income tax on funding.

(a) However, filings with IRS needed (withholding certificate) to avoid withholding tax on funding.

(b) If there is appreciation, subject to U.S. capital gains tax on funding, and withholding tax on funding (10% of purchase price, with refund of excess over actual tax when tax returns filed, or reduced withholding pursuant to withholding certificate procedure).

(c) Consider third party appraisal to establish appreciation or lack thereof, or at least a broker's letter.

(3) One level of U.S. income tax on sale of the U.S. real estate, if restrict to one property.

(a) Corporate tax rates - branch profits tax avoided by immediate subsequent liquidation of corporation.

(4) Limited liability protection.

iii) <u>Disadvantages.</u>

(1) Potential documentary stamp taxes on transfer if mortgage.

(2) U.S. tax return requirements for foreign corporation

(3) No capitalization/tax benefit of real property taxes if owned by foreign corporation, unless rented and "net election" made.

(4) No basis step-up at death.

(5) Formation and misc. maintenance costs for corporations.

(a) And home country/country of incorporation income tax issues.

(6) Potential title insurance costs on transfer of title.

(7) Need to respect corporate formalities.

(8) Potential need to register to do business in Florida if renting.

(9) No capital gains rates.

(10) Florida corporate income tax.

(11) Code §2036 issues.

(12) Interest stripping limitations apply to corporations only.

(a) But presumably have allocation issues of interest expense for individuals or partnership owner/borrowers

(13) Home country CFC-type rules.

(14) Gain on funding exposures.

(a) And anti-inversion rules if first fund domestic corporation and then transfer that to foreign corporation

c) <u>Alternative - Foreign Partnership Owning a Domestic Partnership</u>.

i) If effective, provides the benefit of one level of income tax and avoids estate tax.

ii) Uncertain effectiveness.

d) Alternative - Acquisition in Trust.

i) If properly structured, will allow passage at death free of estate and GST tax.

ii) Cannot fund with real estate, since that is a taxable gift.

iii) If fund with cash and then acquire real estate immediately acquired, may be deemed a gift of real estate.

iv) If retain personal use, need to pay rent. If paying rent, watch limits on grantor trust rules.

12) MISC. PLANNING TRAPS

a) Gifts where the source of funds was a partnership or foreign corporation.

i) Code §672(f)(4): Recharacterization of purported gifts. In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection.

(1) Enacted as a backstop to Code §672(f) to prevent taxpayers from avoiding the foreign grantor ownership rule by using a foreign corporation or partnership as a substitute for a trust.

ii) Such a transfer out of a partnership must be included as ordinary income in the hands of the donee. Treas. Regs. § 1.672(f)-4(a)(1).

(1) But see Regulation for exceptions.

iii) Such a transfer out of a foreign corporation is deemed a distribution to the U.S. recipient, who is treated as a shareholder with $0 basis with the holding period of the grantor. Treas. Regs. § 1.672(f)-4(a)(2).

(1) But see Regulation for exceptions.

b) Gratuitous transfers from trusts that received a grantuitous transfer from a partnership or foreign corporation.

i) This will trigger the above Code §672(f)(4) rules. Treas. Regs. §1.672(f)-4(c).

c) Gift tax in home country.

i) Often payable by recipient, or by the home country donor if the donee resides outside of the country (*e.g.*, Germany).

d) *Temporary conversion of assets into non-U.S. situs property to accomplish a tax-free gift.*

i) In Goldschmidt-Rothschild, 168 F2d 975, *aff'g* 9 TC 325, the Second Circuit held that a nonresident's gift of exempt property (Treasury notes) in trust for her children was subject to gift tax where the gift was funded with the proceeds of sale of stocks in domestic corporations (which were not then exempt property).

(1) The court didn't like "temporary" conversion into exempt property only for purposes of transer which conversion was terminated after the transfer.

ii) In Davies, 40 TC 525, nonresident sold U.S. real estate to son in return for down payment funded by gift and then son paid off notes with gifts each year.

(1) The court held the down payment was a gift of an interest in real estate because it was received on the express condition that it be so used, but that subsequent gifts were not agreed to as part of the original transaction and thus not deemed gifts of property.

13) EXPATRIATION RULES - CONTINUING GIFT AND ESTATE TAX REGIME FOR FUTURE TRANSFERS TO U.S. PERSONS

a) A transfer tax is imposed on U.S. citizen or resident who receives any "covered gift or bequest" from a "covered expatriate." Code §2801.

i) Apply Code §877A(g)(1) definitions of "covered expatriate" which have a net worth test, a threshold amount of U.S. income taxes test, and a filing compliance test.

b) Exclusions and Credits.

i) Exclude gifts and bequests that are otherwise taxable gifts or taxable bequests. Code §2801(e)(2).

(1) Thus, gifts of U.S. real property, intangibles, and tangible personalty will already be subject to gift tax and thus not subject to this tax (which is helpful since regular gift tax is tax exclusive if 3 years survival).

(2) And similar exclusion for those items subject to estate tax.

(3) Another way to look at it is that the estate and gift taxes are the primary transfer taxes, and §2801 applies only when assets are transferred that are not subject to those taxes (generally, non-U.S. situs assets).

(4) Interestingly, the Code excludes transfers that are on a TIMELY filed gift or estate tax return. Does this mean that a late filing subjects an asset to both taxes?

ii) Receive an exclusion for an annual exclusion amount in the year of transfer (whether gift or testamentary transfer). Code §2801(c).

(1) But note that the annual exclusion is given to the recipient - thus, recipient can only exclude one annual exclusion amount regardless of number of covered expatriates making gifts.

(2) It is unclear if or how the present interest interest requirement applies. It is also unclear how it applies to transfers to foreign trusts with multiple distributees, and whether each distributee should get the benefit of it in each year a distribution is made (see the rules below as to foreign trust recipients).

iii) Exclude marital and charitable gifts that would qualify for deduction if made by a U.S. person. Code §2801(e)(3).

iv) No unified credit.

v) The regular gift tax exclusions for tuition payments and medical care do not apply here.

vi) The tax is reduced by foreign gift or estate tax. Code §2801(d).

c) <u>Some Mechanics</u>.

i) Tax is imposed at highest bracket rates.

(1) Like GST taxes.

ii) The RECIPIENT is liable for the tax, not the donor. Code §2801(b).

(1) Making it much easier for the IRS to enforce and collect the tax.

iii) Applies to gifts and bequests directly and indirectly received (whatever that means). Code §2801(e)(1).

d) <u>Trusts</u>.

i) Treats a U.S. domestic trust recipient as a U.S. citizen for purposes of this tax. Code §2801(e)(4)(A).

(1) Both as to triggering the tax, and imposing the tax on the trust itself.

ii) Covered gifts and bequests to a foreign trust are covered by the tax, but no immediate tax. Instead, distributions to U.S. persons made from the trust are taxed at the time of distribution as if they were covered gifts or bequests. Code §2801(e)(4)(B)(i).

(1) Recipients get an income tax deduction under Code §164 for the §2801 tax imposed to the extent it is included in gross income of the U.S. distributee. Code §2801(e)(4)(B)(ii).

(2) A foreign trust can make an election to be taxed as a domestic trust for purposes of Code §2801.

(a) Which may be revoked only with IRS consent.

(3) Query whether a distributee gets an annual exclusion in each year a distribution is made to him or her.

e) <u>Unexpected Reach</u>.

i) The tax may applied until the death of expatraite, or even longer as to foreign trust transfers.

ii) The tax applies to post-expatriation wealth.

iii) The gift tax aspect is tax inclusive, unlike normal gift tax rules which are tax exclusive. Thus, need to make a larger overall gift to deliver an after-tax amount to the beneficiary.

f) Reporting obligations and tax obligations are presently deferred, pending issuance of guidance. Notice 2009-85.

g) Planning

i) Making Lifetime Gifts of Property to U.S. Persons that are Subject to U.S. Gift Tax Instead of Testamentary Transfers. Under normal U.S. gift tax rules, gift taxes are tax-exclusive if the donor survives the gift by three years. That is, the taxes themselves are not considered by the gift – there is no tax on the tax. However, §2801 taxes are tax inclusive – thus, they are taxed at higher effective rates. So, similar to the same considerations that apply to U.S. donors, a lifetime gift bears less taxes than a testamentary gift. Since this does not work if the gift is taxed under §2801, the gift must be of property that is otherwise subject to U.S. gift taxes aside from the expatriate status of the donor. This is because §2801 will not apply to a gift of a nonresident that is otherwise subject to U.S. gift taxes. Thus, the donor should use property that is U.S. situs property for gift tax purposes, such as U.S. real property, to make the gift.

ii) Make Use of Double Annual Exclusion Gifts. It is likely that if a donor makes an annual exclusion gift of U.S. situs property and of non-U.S. situs, each gift can benefit from a $14,000 annual exclusion. One exclusion is the regular exclusion that applies to U.S. situs assets under the regular gift tax rules, and the second is the annual exclusion that is granted to the donee under §2801.

iii) Consider Making Generation Skipping Transfers of Non-U.S. Situs Assets. Transfers of non-U.S. situs assets will still be subject to tax under §2801. However, there is no GST tax under §2801 so when appropriate, a generation skip can be included in the transfer to avoid future transfer taxes.

iv) Carefully Allocate U.S. Situs Property and Non-U.S. Situs Property Between U.S. and non-U.S. Recipients. The goal here is to transfer the U.S. situs property to the U.S. people, since it will be taxed under the normal nonresident transfer rules or §2801 – either way. This leaves non-U.S. situs property to go to nonresidents, free of U.S. transfer taxes – if U.S. situs property is instead transferred to them, then U.S. transfer taxes would apply.

14) NOT ALL COUNTRIES RECOGNIZE TRUSTS

a) Noncommon law jurisdictions (including civil law jurisdictions) often have no equivalent concept, or if they do, they may be creatures of statute.

i) Civil law concepts of community property and forced heirship may preclude the use of a trust.

b) Some civil law countries have trust-like devises.

i) Power of attorney.

ii) Usufruct.

(1) Splits life interest from a remainder interest.

(2) But does not split powers of management and enjoyment.

iii) Fideicommissum or fideicommiso (e.g., Mexico).

iv) Treuhand (Germany).

v) Bewind (Netherlands).

vi) Foundation.

(1) Stiftung and anstalt.

c) Titling real estate in such a jurisdiction in a trust may create title, inheritance, or other unknown difficulties.

15) OR IF THEY DO, THEY MAY HAVE SIGNIFICANT LEGAL DIFFERENCES.

a) English common law system also has differences from American system.

i) Under English statutory law the trustee has the power to sell, mortgage or lease the trust assets regardless of any restrictions in the terms of the trust instrument; a trustee is not entitled to compensation unless the instrument so provides; and trustees are given the power to appoint successor trustees.

ii) The beneficiaries of a trust governed by English law have the power at all times to modify or terminate the trust even though one or more trust purposes have not been accomplished.

iii) Spendthrift restraints on alienation of beneficial interests may not be valid.

16) FOREIGN TAXES

a) Don't forget to confirm that any planning will not incur or increase taxes in non-U.S. jurisdictions.

i) Gift, estate, inheritance, and income taxes, including taxes on entities that may be involved.

17) FORCED HEIRSHIP RULES

a) Forced heirship rules apply in many civil law jurisdictions, forcing distributions at death to specific heirs in specific percentages.

i) They may still allow for a freely devisable portion.

b) Therefore, transfer tax planning transfers may not be respected, allowed, or enforced in applicable foreign jurisdictions, and thus can upset desired planning.

c) Other jurisdictions with control over assets may at times still apply the forced heirship rules as the controlling rule of law for owners resident in a forced heirship jurisdiction.

i) Although many jurisdictions, especially under their trust codes, will expressly override the law of the domicile or residence of the donor and apply only their own local law and the dispositive provisions of the applicable instrument.

d) Even if assets are located out of the forced heirship jurisdiction, and thus may be freely transferable, "make-up" allocations for assets remaining in the foreced heirship jurisdicton may be imposed.

18) LIFE INSURANCE - NEED FOR TRUST?

a) If the policy proceeds are exempt from U.S. estate tax because the policy is on the life of a nonresident, should a foreign trust still be used with foreign individuals involved?

i) Advantages of foreign trust include avoidance of exchange controls in home country, forced heirship avoidance, and benefits of asset protection.

ii) However, if U.S. beneficiaries, see the discussion elsewhere in this outline relating to special U.S. taxes and rules.

19) WILL DRAFTING PARTICULARS

a) Determine whether to use single will or several wills.

i) Benefits of multiple wills.

(1) To allow local law compliance with testamentary formalities.

(2) To protect property in one jurisdiction from claims of creditor in other jurisdictions.

(3) To allow for use of local fiduciairies.

(4) To limit disclosure of assets across jurisdictions.

(5) To limit risks of disputes among beneficiaries and/or taxing jurisidctions if conflicting claims of domicile.

ii) Risks.

(1) Possible challenges when secondary jurisdiction will use to avoid forced heirship provisions in home jurisdiction.

b) Determine proper use of trusts as will substitutes.

c) Be careful in regard to use of testamentary trusts to hold property situated in jurisdictions that may not respect or recognize trusts.

d) State what property is covered by the will and what is not.

e) Revoke earlier wills only to the extent that those wills disposed of property covered by the new will.

   i) Do not inadvertently revoke prior wills governing property located in other countries.

f) Authorize fiduciaries to act outside the domiciliary estate.

g) Indicate residence, domicile and citizenship.

h) Specify what jurisdiction's law is to be used.

i) Direct executor to offer will for probate in the chosen jurisdiction.

j) Alert testator to the possibility that making another will in a different jurisdiction could result in revocation of this will.

k) Beef up abandonment flexibility in fiduciary as to foreign situs property.

l) Be cognizant that treaty protections may not exempt state taxation.

m) Consider use of STEP 2011 standard provisions for England documents.

   i) Http://www.step.org/pdf/Standard_Provisions_FINAL.pdf

n) Consider use of 3 witnesses to cover most witness requirements.

o) Confirm applicable countries will accept a will entered into under U.S. state law formalities.

p) Will may be covered by Convention providing a Uniform Law on the Form of an International Will. Also consider compliance if executing a U.S. will where property may be situated in signatories to the Convention.

   i) U.S. is a signatory.

   ii) Provides an additional "international will" which will be respected by states that adopt the law (*i.e.*, specific U.S. states, and non-U.S. jurisdictions).

      (1) In the U.S., some states have adopted it via the Uniform International Wills Act.

      (2) The Act establishes internationally accepted standards for what constitutes a validly created will. While states and countries typically recognize the validity of a will that is executed in accordance with the laws of the jurisdiction in which the will was executed, as a practical matter, it is sometimes difficult to convince a probate court judge or other applicable official that a will that was executed internationally was properly executed. The Act is intended to reduce problems associated with proving that a will executed in another country was properly executed, by establishing clear, internationally accepted standards.

   iii) Currently, 18 states and jurisdictions in the United States have enacted the Uniform International Wills Act, including: Alaska, California, Colorado, Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Michigan, Minnesota, Montana, New Hampshire, New Mexico, North

Dakota, Oklahoma, Oregon, Pennsylvania and Virginia. Several countries in addition to the United States have adopted the Act, including: Belgium, Bosnia, Ecuador, Herzegovina, Canada, Cyprus, France, Italy, Niger, Portugal and Slovenia.

iv) The basic requirements of the Act are as follows: 1.The will must be in writing; 2.The will must be witnessed by two individuals and an authorized person (an attorney licensed to practice in the jurisdiction where the will is signed, or certain members of the diplomatic and consular services); 3.The person creating the will (the "testator") must sign each page of the will; 4.The witnesses and authorized person must attest the will by signing in the presence of the testator; 5.Each page of the will must be numbered; 6.A certificate, the form of which is provided by the Act, must be attached to the will; 7.The testator must be asked if he or she wishes to declare where the will is to be kept, and any preference must be stated on the certificate; and 8.An international will may be revoked by the testator.

(1) Thus, note special provisions that you may not be observing in your typical will executions, such as having an attorney as a witness, full signature on each page, and use of special certificate.

v) Text of Convention is available at http://www.unidroit.org/english/conventions/1973wills/1973wills-e.htm.

q) Be leery of powers of attorney and other testamentary substitutes.

20) <u>INTERESTS IN FOREIGN CORPORATIONS CAN GIVE RISE TO ISSUES UNDER CFC AND PFIC RULES</u>

a) <u>Controlled Foreign Corporations (CFC's)</u>

i) A CFC is a non-U.S. corporation in which more than 50% of the stock (by vote or value) is owned by U.S. shareholders that own at least 10%

(1) Watch attribution rules from family members and related entities.

(2) Ownership often comes into play when shares of a nonresident decedent pass to U.S. beneficiaries, or a trust with U.S. beneficiaries.

ii) <u>Some Negative Aspects of a CFC</u>

(1) Pass-through taxation of certain items of income, including passive income.

(a) Conversion of capital gains to ordinary income.

(b) No net operating losses or capital loss carryforwars at corporate level.

(2) Foreign income taxes effectively not creditable.

b) <u>Passive Foreign Investment Companies (PFICs)</u>

i) A PFIC is a foreign corporation for which (a) 75% or more of the income is passive income, or (b) 50% or more of the assets by value produce passive income.

(1) Once a PFIC, always a PFIC.

(2) If a CFC, may not also be a PFIC.

ii) Some Negative Aspects of a PFIC

(1) A transfer of stock of a PFIC at death can trigger taxation of deferred gain.

(2) Taxes on distributions can arise, even though no earnings.

(3) Overides nonrecognition of gain rules on some dispositions of stock.

(4) Can convert some capital gain to ordinary income.

(5) Deferred income can be subject to an interest charge when income recognized.

c) CFC's and PFIC's give rise to special foreign reporting.

21) REPORTING

a) U.S. persons with foreign assets and accounts, or with direct or indirect interests in non-U.S. entities are subject to a panalopy of reporting requirements.

b) Transfers of assets involving foreign entities, foreign assets, or foreign persons, may also give rise to specific reporting requirements.