United States

International Estate Planning Guide

Individual Tax and Private Client Committee

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A. Will Formalities and Enforceability of Foreign Wills

A Last Will and Testament ("Will") is a legal instrument that directs the disposition of property upon the death of an individual ("decedent'). A Will may also be used to name guardians for minor children, direct how debts should be paid, and achieve certain United States tax savings. A Will does not, however, affect the disposition of "nonprobate" property, which generally includes life insurance policies, retirement plans, survivorship accounts, and certain tenancies (discussed below in Section II.D.). If a decedent dies without a Will, his property is distributed under the applicable laws of intestacy, as discussed in Section II.B below.

There are generally three types of Wills recognized in the United States. The most common type of Will is a non-holographic, or formal, attested Will, which is recognized in all states. The second type of Will is a holographic Will, or a Will made in the decedent's handwriting and not in the presence of witnesses, which is only recognized by certain states. Finally, a small number of states recognize nuncupative, or oral, Wills, but to be valid, an oral Will must meet strict requirements. For example, the applicable state law of such states generally holds that valid oral Wills can only be made by (i) terminally ill individuals or (ii) active military personnel in the presence of witnesses.

Any person over the age of majority[1] and of sound mind (having the requisite mental capacity) can execute a valid Will. To qualify as a valid non-holographic Will, the operative document must meet certain statutory requirements specific to each state. Additional requirements vary depending on the state, but commonly include the following:

- The creator of the Will, the "testator," must clearly identify himself as such, and state his intention to affirmatively make a Will;

- The testator must date the Will and sign at the end of the written document, usually in the presence of at least two disinterested witnesses (persons who are not beneficiaries under the Will);[2] and

- Generally, the Will should be notarized by a notary public.

In most instances, a Will is signed at an execution ceremony conducted by the drafting attorney. It is important that the Will is executed with the requisite formalities of the state in which it is being executed, as meeting these formalities ensures that the Will will be accepted as valid and duly executed by the respective court. In order to more easily permit a court to find that the Will is valid, some attorneys have the testator initial a corner of each page of the Will. Further, some states permit the submission of a "self-proving" affidavit to prove that a Will is valid and duly executed. For these purposes, a self-proving affidavit is merely an affidavit signed by the testator and/or the witnesses under penalties of perjury, which eliminates the need for the witnesses to testify in probate court that the Will was validly executed.

A Will should name an "Executor," sometimes called a "Personal Representative," to manage the administration of the decedent's estate (see Section II below for a more detailed discussion of the probate process). An Executor is generally given broad powers under the Will, which vary by state, but generally include the power to retain or hold property, invest funds, and hire attorneys, accountants, and other professionals to assist in the administration of the decedent's estate.

A Will that is valid wherever executed should be valid in any US state for probate purposes. This includes non-US Wills. However, to ensure that a non-US Will is accepted by a US probate court, it is strongly

[1] Usually age 18, but can vary by state.
[2] Many states provide that if there are not two disinterested witnesses, the interested witnesses may not take under the Will unless the interested witness would have received property under the laws of intestacy (*i.e*., the laws governing the devolution of the decedent's assets if he had not executed a Will).

recommended that the execution of the Will be supervised by an attorney or notary in the country in which the Will is executed. Further, if a testator has made a Will in the United States and in another country, there is a risk that one of the Wills will revoke the other. Therefore, it is important that the attorneys drafting the Wills coordinate their efforts to ensure that both Wills are valid and do not inadvertently revoke one another.

B. Will Substitutes (Revocable Trusts or Entities)

There are many reasons why an individual might want to transfer property other than by his Will, including to avoid the cost of probate, to maintain privacy (a Will admitted to probate becomes public record), or to protect assets from creditors. Set forth below are some of the primary methods of transferring property at death outside of a Will.

1. Trusts

A trust is a legal relationship whereby an individual (the "settlor") transfers property to a trust and one or more individuals or entities (the "trustee(s)") take legal title to such property in order to manage it for the benefit of one or more persons named in the trust (the "beneficiaries"). If a trust is revocable, the settlor may revoke the trust at any time, and title to the property then reverts to him. An "inter-vivos" trust is effective during the settlor's lifetime, while a "testamentary" trust is a trust created under the settlor's Will, and, therefore, only becomes effective upon his death. Since a testamentary trust is created under the settlor's Will, the trust must meet all of the formalities required for a valid Will. Examples of some common planning techniques used with inter-vivos trusts are discussed in Section III.A below.

In the United States, many people create revocable, inter-vivos trusts and name themselves as the sole beneficiary of the trust during their lifetime and name other beneficiaries of the trust after their death. This type of trust allows a settlor to retain control over the property transferred to the trust while maintaining privacy upon death and avoiding probate.

2. Life Insurance

Generally, an individual who owns a life insurance policy on his own life will name a beneficiary to receive the life insurance proceeds upon his death. An individual's life insurance policy is not affected by his Will and is therefore not subject to probate. However, if the beneficiary of the life insurance policy is the insured's estate, the life insurance proceeds will be administered as part of the insured's estate in accordance with his Will or under the laws of intestacy, if the insured died without a Will.

3. Retirement Plans

An individual with certain types of retirement plans will designate a beneficiary or beneficiaries to receive retirement plan benefits upon their death. An individual's retirement benefits are generally not affected by his Will and are not subject to probate. However, as with life insurance proceeds above, if the beneficiary of the retirement plan is the individual's estate, the retirement benefits will be administered as part of the individual's estate in accordance with his Will or under the laws of intestacy, if the insured died without a Will.

4. Other "Will Substitutes"

Other Will substitutes include certain tenancies, survivorship accounts and "payable on death" accounts, as further discussed in Section II.D below.

C. Powers of Attorney, Health Care Directives, and Similar Disability Documents

1. Powers of Attorney

A Power of Attorney is an instrument whereby an individual (the "Principal") grants another person (the "Agent") certain delineated powers over the Principal's person and property. A Power of Attorney may be effective upon execution or upon the Principal's incapacity. A "durable" Power of Attorney is one that remains in effect upon the Principal's incapacity.

2. Living Wills

A "Living Will," or advance directive, is a document whereby an individual sets forth his wishes concerning the medical care he would like to receive in the event he is deemed terminally ill or permanently unconscious <u>and</u> is unable to communicate his own health care decisions. The specific provisions permitted in a Living Will vary depending upon applicable state law.

3. Other Health Care Directives

Some states permit an Agent acting under a Durable Power of Attorney to make health care decisions if the Principal is incapacitated. Other states provide for a separate Health Care Power of Attorney, which expressly authorizes an Agent to make health care decisions for the Principal. Finally, a limited number of states provide for a separate document appointing a "Health Care Representative" who is specifically authorized to make health care decisions if the Principal is unable to make them on his own.

II. Estate Administration

A. Overview of Administration Procedures

When a person who owns property in the United States dies, a specialized court, generally referred to as a "probate court" (sometimes referred to as a surrogate court), oversees the division of property among those persons legally entitled to such property. If the decedent made a Will, the division of his property will be carried out according to his wishes as set forth in his Will. If the decedent did not execute a valid Will, his property will be divided according to the applicable laws of intestacy.

If the decedent was a United States citizen, his worldwide assets will be included in the probate of his estate. If the decedent was not a United States citizen but was domiciled[3] in the United States, then his estate must be probated in his state of domicile. If the decedent was not domiciled in the United States, then probate should be filed in the decedent's state of primary residence, or if none, in the state where real property owned by the decedent at the time of his death is located as well as the country in which he was domiciled. If there is no connection to any specific state, certain states[4] permit the non-domiciliary probate of property of a non-resident decedent in their courts.

In addition to the decedent's original state of probate, each state in the United States has jurisdiction over any property physically located in such state (such as real estate and tangible property) for probate purposes. Therefore, after the initial probate proceeding is commenced, ancillary probate proceedings should be filed in each additional state where there is property physically located. Intangible property (such as bank accounts, bonds and stocks) is considered sited in the state of the decedent's domicile and is consequently probated there.

The most important purpose of the probate process is to establish a Will's validity in order to permit the executor(s) and their agents to carry out the decedent's wishes. Importantly, a Will has no legal effect

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[3] Domicile is the place which an individual has freely chosen, with no present intention of leaving, as the center of his domestic and legal relations. A domicile, once acquired, is presumed to continue until it is shown to have been changed.
[4] For example, Illinois: Ill. Comp. Stat. Ch. 755. § 5/7-6; and New York: N.Y. Est., Pow. & Trusts L. § 3-5.1 (h).

until it is validated by the requisite probate court. Again, to qualify as a valid Will, the document must comply with statutory requirements specific to the state in which it is executed (as discussed in Section I.A. above). Finally, a Will that is valid wherever executed should be valid in any state for probate purposes.

B. Intestate Succession and Forced Heirship

When a person dies without a Will, his property passes to his legal heirs pursuant to the laws of intestate succession. While each state has its own set of rules for determining legal heirs and intestate succession, property typically passes first (or a significant part of the property passes first) to the surviving spouse, then to children and their descendants; or if there are no children or descendants, to the decedent's parents, or if none, to the decedent's siblings, or if none, to the siblings' descendants, or if none, to the decedent's grandparents, or if none, to the descendants of the decedent's grandparents.

There are also forced heirship rules in certain instances. While a decedent may generally make a Will and bequeath his property to any person or entity, some states have "homestead" laws, or "elective share" requirements, which are rules governing a minimum amount that must be left to a surviving spouse or minor children, or both. In many states, the elective share for a spouse is approximately one-third of the property in the decedent's estate. This amount can change, however, if there are minor children, and it can also vary depending on the length of the decedent's marriage. Additionally, if the decedent lived in a state with "community property" rules,[5] then one-half of any of the decedent's property that is deemed "community property" will pass automatically to the decedent's surviving spouse.

C. Marital Property

There are two types of property ownership regimes solely applicable to married couples, community property and tenancy by the entirety. The availability of community property and tenancies by the entirety vary among the states. Although only married persons may have community property or tenancy by entirety property, even in states without these forms of ownership spouses may also own property solely, jointly with rights of survivorship, or as tenants in common.

D. Tenancies, Survivorship Accounts, and Payable on Death Accounts

Property may be jointly owned in any one of the following ways: (i) jointly with rights of survivorship, (ii) tenancy-in-common, (iii) tenancy by the entirety, (iv) community property, or (v) payable on death accounts (sometimes called Totten Trust accounts). Only property owned as tenants-in-common or community property will need to be probated. In all other types of joint ownership, the right to the property vests in the remaining or successor owner by operation of law immediately upon the death of the decedent.

III. Trusts, Foundations and Other Planning Structures

A. Common Techniques

The following discussion sets forth some relatively common wealth transfer planning techniques that offer benefits such as creditor protection, the removal of assets from an individual's estate for US estate tax purposes, and the tax-efficient transfer of assets (and future appreciation on such assets) to an individual's family or to a structure for their benefit.

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[5] There are presently nine community property states in the United States: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Additionally, Alaska allows couples to elect to treat property as community property.

1. Grantor Retained Annuity Trusts (“GRAT”)

A GRAT is a trust arrangement whereby the settlor transfers property to the GRAT in exchange for a fixed-term annuity. The difference in value between the transferred property and the annuity is a gift subject to US gift tax. If the amount of the gift equals the value of the annuity payments then a tax-free gift results. At the end of the GRAT term, the GRAT terminates and its property is then transferred outright or into a separate trust for the benefit of the grantor’s spouse, children, or others. One benefit of the GRAT arrangement is that assets held by the GRAT (and any appreciation on those assets) are excluded from the grantor’s estate for US estate tax purposes. However, if the grantor does not survive the GRAT term, some or all of the GRAT’s assets will be included in the grantor’s estate.

2. Gift and Sale to a “Grantor” Trust

With this type of planning, a settlor creates a grantor trust for the benefit of his spouse, children or others. The settlor transfers property to the trust, generally with 10% of the transfer made by gift and up to 90% of the transfer made by a sale of property to the trust. The trust pays for the 90% portion of the property with a promissory note made payable to the settlor. Since grantor trusts are disregarded for US federal income tax purposes, there is no taxable gain on the sale of the property to the trust, and interest payments by the trust are not taxable as income to the settlor. However, since grantor trusts are recognized for US estate and gift tax purposes, trust assets (and future appreciation) are protected from the settlor’s creditors and are excluded from the settlor’s estate. Note, however, that if a portion of the promissory note remains unpaid at the settlor’s death, that portion is included in his estate.

3. Qualified Personal Residence Trusts (“QPRT”)

This type of trust is used to transfer an individual’s personal residence into a trust established for the benefit of the settlor’s spouse and/or descendants, with the settlor retaining exclusive use of the residence for a fixed term of years. The transfer of the residence into the QPRT is a gift; however, the value of the gift is reduced by the value of the settlor’s retained interest in his use of the residence. Accordingly, the longer the QPRT term, the greater the value of the settlor’s retained interest and the lower the value of the resulting gift. If the settlor survives the QPRT term, the residence (and any appreciation) is excluded from his estate for US estate tax purposes, and passes to the beneficiaries of the QPRT without any additional gift or estate tax. Note, however, that if the settlor does not survive the QPRT term, the value of the residence is included in the settlor’s estate for US estate tax purposes.

4. Charitable Remainder Trust (“CRT”)

An individual’s philanthropic goals can also be met through the use of trusts. For example, through the use of a CRT, trust distributions are made to named beneficiaries either during the beneficiaries’ lifetime or for a fixed term, and charity receives all remaining trust assets at the termination of the trust term. The annual payment to the named beneficiaries may be determined either as a percentage of the CRT’s assets as revalued each year (a unitrust) or as a fixed payment each year (an annuity trust). The settlor of the CRT receives an immediate US income tax deduction for the present value of the remainder interest, regardless of whether the actual value that ultimately passes to charity is the amount computed at inception of the trust.

5. Family Limited Partnership (“FLP”)

A properly structured FLP can permit an individual to transfer assets out of his estate and to his family in a tax-efficient manner, while allowing him to retain a limited amount of control over the assets held by the transferee FLP. For example, an individual can transfer assets into a FLP in exchange for a 99% limited partner (“LP”) interest. The individual’s spouse or a trust for the spouse’s benefit, a third party, or another entity can then transfer assets into the FLP in exchange for a 1% general partner (“GP”) interest, and as GP, the general partner will have sole control over the FLP. The LP interests may then be transferred to the individual’s children and other family members, but as LP interest holders, they have little say in most partnership decisions. Since the owners of the LP interests are not able to participate in the management of the FLP, the LP interests may be accorded a substantial discount for lack of control and lack of marketability. Accordingly, an individual is able to transfer assets (and any future appreciation) directly and/or indirectly to his family at a reduced amount of gift tax. Provided certain requirements are met, the assets transferred into the FLP are not includable in the individual's estate for US estate tax purposes. However, any LP or GP interests held by a decedent at death will be includable in his gross estate.

B. Fiduciary Duties

1. Trustee

As discussed in section I.B above, a trust is a legal relationship whereby the settlor transfers property to a trust and one or more trustees take legal title to such property for the purpose of managing it for the benefit of the beneficiaries. The trustee of a trust, in fulfilling his duties, must act in accordance with both statutory law and the specific provisions of the trust instrument.

The settlor of a trust will often appoint family members, friends or personal advisors as trustee of his trust. While these individual trustees are usually familiar with family dynamics and may be motivated to act in accordance with the wishes of the settlor, individual trustees can also be inexperienced and may need to hire professionals such as accountants and lawyers to assist them in carrying out their duties as trustee. Accordingly, a settlor may instead wish to appoint a corporate trustee rather than an individual trustee. A corporate trustee is an entity such as a trust company or a bank that is entrusted with managing the trust and its assets. Corporate trustees can provide the benefit of experience, objectivity, and combined investment management and accounting, but they can sometimes be perceived as expensive, formal and impersonal, at least as compared to individual trustees. That being said, the authors are strong proponents of corporate rather than individual trustees.

The trustee has many duties, including duties to prudently invest trust assets, to make distributions to beneficiaries, and to perform various other administrative services, as more fully discussed below. Notably, the trustee may be permitted to delegate some of these duties to others where permitted under the trust instrument and local law.

a. Investment of Trust Assets

The Uniform Prudent Investor Act ("UPIA") provides trustees with broad discretion with regard to trust investments. Under the UPIA, trustees are permitted to use the "modern portfolio theory" of investment, whereby a custom investment strategy is created for a particular trust. Under this approach, the trustee must consider (i) the role each investment plays within the overall trust portfolio and (ii) the expected total return from trust income and capital gain. If the settlor would like to provide the trustee with even broader latitude than is provided under the UPIA, the trust instrument may explicitly waive the UPIA in lieu of some other stated investment standards.

b. Distribution Decisions

Many trusts give the trustees absolute discretion to make distribution decisions, including when distributions are made and how much, if any, will be distributed to each beneficiary. These so-called absolute discretion trusts provide significant asset protection vis-a-vis their beneficiaries as such beneficiaries do not have a right to receive or compel distributions. As such, trust assets should remain out of reach of the beneficiaries' creditors so long as they are not distributed.

Other types of trusts may limit a trustee's ability to make distributions. For example, such trusts may provide that distributions can only be made by the trustees for a beneficiary's "health, education, maintenance and support." Trusts may also be drafted that provide for mandatory distributions of income, principal, or both. In any case, every trust instrument should provide the trustee(s) with a distribution standard, including whether the trustees may/must consider a beneficiary's other resources in making distribution decisions.

c. Other Administrative Services

Other administrative services provided by trustees include accounting, recordkeeping, determination of the fair market value of trust assets, the preparation of trust and fiduciary tax returns, the collection of interest and dividends, and the voting of shares with respect to any stock held by the trust, among other things.

d. Trustees' Standard of Care

Most state statutes set forth specific standards of care for trustees, which vary greatly by state, and which are outside the scope of this guide. Nevertheless, we note that a settlor is generally free to expand or restrict the trustee's standard of care within the limits of applicable state law. Thus, the duties, powers and applicable standard of care are generally as specified in the terms of the trust.

Set forth below is a brief summary of certain statutory rules applicable to trustees that have been adopted by a majority of states.

(i) As discussed above, the UPIA governs the investment responsibilities of trustees. The UPIA requires that trustees invest and manage trust assets as a "prudent investor" by considering all of the facts specific to the trust, including the trust's purposes, terms, and distribution requirements. In satisfying this "prudent investor" standard, trustees must exercise reasonable care, skill and caution.

(ii) The Uniform Principal and Income Act (the "Act") provides procedures for the allocation of receipts and payments to principal and income. The Act also ensures that the settlor's intentions are carried out and that distributions of assets are properly made.

2. Directed Trustees

Certain states now permit the settlor of a trust to appoint one or more third parties to direct the trustee in performing certain trustee duties. This type of arrangement provides flexibility as to the administration of a trust, as the settlor may designate various individuals with different skills to perform the duties of administering the trust (*e.g.*, one party may make distribution decisions and another party may make investment decisions).

3. Protector

A protector provides a "check and balance" on the trustee with respect to the trustee's administration of the trust, and some practitioners consider this role to be the most important in any trust arrangement. Protectors may be granted a wide range of powers, including the power to remove and replace trustees, approve the addition or removal of trust beneficiaries, approve trust distributions, approve investment decisions, and direct the termination of the trust. However, it is important to note that in the authors' experience the majority of US trusts (as defined in section C.1. below) do not grant protectors the broad powers listed above, but instead give protectors solely the power to remove and replace trustees and/or approve the addition or removal of trust beneficiaries.

4. Private Trust Companies ("PTC")

A PTC is a structure that provides fiduciary services similar to an institutional or corporate trustee and is created solely by one family and for their trusts. A PTC may provide for a long-term trustee arrangement without the formal requirements of an institutional trustee. In these types of arrangements, family members may have a certain amount of involvement in trust management decisions. That being said, it is critical that family members limit their involvement in the governance decisions of a PTC in order to ensure that the assets overseen by the PTC are not included in the settlor's (or some other family member's) estate for US estate tax purposes.

A PTC is officially managed by directors and officers (much like a corporation) who are responsible for day-to-day business decisions, including the delegation of administrative tasks to committees. Depending on the PTC's bylaws or articles (or other analogous agreements), at least one of the directors must be independent (*i.e*., not related or subordinate to the settlor or to trust beneficiaries[6]).

Usually a distribution committee is responsible for all decisions regarding the distribution of trust income or assets. Importantly, only half of the distribution committee members may be related or subordinate to the settlor or the trust beneficiaries. Finally, an investment committee is typically responsible for making decisions regarding the investment of trust assets.

C. Treatment of Foreign Trusts and Foundations

1. Foreign Trusts

A trust formed after August 19, 1996[7] is considered a US trust only if both (i) a court within the United States is able to exercise primary supervision over the administration of the trust (the "Court Test"), and (ii) one or more United States persons have the authority to control all substantial decisions of the trust (the "Control Test").[8] Any other trust formed after August 19, 1996 is deemed a "foreign trust" for US federal tax purposes.[9]

The <u>Control Test</u> is satisfied only if United States persons control *all* substantial trust decisions. In other words, no foreign person may control a substantial trust decision. Thus, one must evaluate the roles of all persons who have authority to make substantial decisions regarding the trust, not only the trust fiduciaries.[10] For these purposes, the term "substantial decision" means a decision that is not ministerial in nature and that a person is either authorized or required to make under the trust instrument and applicable law. Substantial decisions include, but are not limited to, decisions regarding: (i) the distribution of trust income or principal (*i.e*., when, how much, and to whom); (ii) the allocation of trust receipts to income or principal; (iii) the termination of the trust; (iv) the addition, removal or replacement of a trustee; (v) the appointment of a successor trustee to succeed a trustee who has died, resigned or ceased to act (unless the decision could not be exercised in a manner that would change the trust's residency from domestic to foreign, or vice versa); and (vi) investment decisions (those made by an investment advisor who is hired by a United States person and is removable for any reason by the United States person will be treated as if the United States person is making the investment decisions).[11]

The <u>Court Test</u> is satisfied if a court (federal, state or local) located in the United States is able to exercise primary supervision over the trust's administration. The term "primary supervision" means that a court has the authority to determine substantially all issues regarding the administration of the trust. If a United States court has such authority, then a court outside of the United States may have jurisdiction over a trustee, beneficiary or asset of the trust without causing the trust to fail the Court Test and, thus, be treated as a non-US trust.[12]

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[6] Pursuant to I.R.C. § 672(c).

[7] A trust that in existence on August 19, 1996 that was treated as a domestic trust on such date may make an election to continue treatment as a domestic trust notwithstanding the court and control tests.

[8] I.R.C. § 7701(a)(30)(E).

[9] I.R.C. § 7701(a)(31)(B).

[10] Treas. Reg. §301.7701-7(d)(1)(iii).

[11] Treas. Reg. §301.7701-7(d)(1)(ii).

[12] Treas. Reg. §301.7701-7(c)(3)(iv).

Whether a trust satisfies the Court Test depends on the facts and circumstances specific to such trust. However, there are certain situations that have been recognized as causing a trust to clearly satisfy or fail the Court Test.[13] For example, if the trustee or the beneficiaries of a trust register the trust with a United States court under applicable state law, the trust will satisfy the Court Test.[14] A trust will also satisfy the Court Test if (i) the trust instrument does not provide for administration of the trust outside of the United States; (ii) the trust is actually administered exclusively in the United States; and (iii) the trust instrument does not contain an automatic migration provision (*i.e*., a "flee" clause).[15]

2. Foreign Grantor Trusts

A "grantor" trust is a trust created by a settlor who makes a gratuitous transfer of property to the trust during his lifetime and retains certain powers and rights over the property transferred to the trust such that the trust is ignored for US federal income tax purposes. In other words, the fact that the settlor retained certain powers over trust property causes that person to be treated as the owner of the trust assets for US federal income tax purposes.

Under applicable law, a grantor trust is ignored and the grantor is subject to US income tax on trust income and gains, regardless of whether such income or gains are actually distributed (or otherwise made available) to the grantor. Historically, if a foreign person (*i.e*., a nonresident alien as defined in section IV.A. below) created a grantor trust (a "foreign grantor trust"), the foreign grantor would be subject to US income tax on only limited items of trust income under the general rules on the taxation of nonresident aliens (see discussion in section IV.C. below). In order to avoid this result, the foreign grantor trust rules now limit the ability of a foreign person to be treated as a grantor of a trust.

Generally, a trust will only be treated as a foreign grantor trust as to a nonresident alien settlor in one of the following circumstances:

- The non-US settlor has the power to revoke the trust and such power is exercisable by (i) the settlor alone or (ii) the settlor with the consent of a party who is related or subordinate to the settlor. Additionally, the non-US settlor must hold the revocation power for 183 days or more during the trust's tax year in order for the trust to be treated as owned by the settlor; or

- Distributions from the trust may only be made to the non-US settlor or his spouse during the settlor's lifetime.

3. Foreign Non-Grantor Trusts

Generally, a foreign trust that is not treated as a foreign grantor trust in accordance with the rules above will be treated as a foreign non-grantor trust ("FNGT"). A FNGT is taxed as a nonresident alien, with certain modifications. Accordingly, a FNGT is generally subject to US federal income tax on the following: (i) income that is effectively connected with a US trade or business; (ii) income from the disposition of US real property interests (also considered "effectively connected" income); and (iii) fixed or determinable annual or periodic ("FDAP") income, which generally includes dividends, interest, rents and royalties (see detailed discussion of the foregoing types of income in section IV.C. below).

United States person beneficiaries of a FNGT are subject to US income tax on (i) trust income required to be distributed to them (whether or not the income was actually distributed), to the extent of the trust's

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[13] Treas. Reg. §301.7701-7(c)(4).

[14] Treas. Reg. §301.7701-7(c)(4)(A) or (C).

[15] Treas. Reg. §301.7701-7(c)(1).

distributable net income ("DNI"); and (ii) trust income actually distributed to them,[16] again to the extent of the FNGT'S DNI. The DNI of a FNGT includes its taxable income plus any tax-exempt income (for US tax purposes), less any deductions taken for (i) distributions to beneficiaries and (ii) the personal exemption. Notably, the DNI of a FNGT also includes capital gains, which are not included in the DNI of a US nongrantor trust. If a FNGT's DNI is accumulated and not distributed to its beneficiaries, the accumulated DNI is deemed to be undistributed net income ("UNI"). This is important because when a FNGT distributes UNI to a US beneficiary[17], the distribution is subject to harsh "throwback" rules. Under these rules, a portion of the UNI distribution is "thrown back" and is treated as having been made in prior years, which results in (i) a higher rate of tax being imposed on capital gains as they are taxed as ordinary income under these rules, and (ii) a potentially steep interest charge on the income tax attributable to those prior years. As a result, the total tax and interest imposed on a distribution of UNI can be up to 100% of the distribution.

4. United States Reporting Requirements for Foreign Trusts

Foreign trusts that receive "effectively connected" income[18] must file a US federal income tax return. The instructions to Form 1041, *US Income Tax Return for Estates and Trusts,* state that all foreign trusts receiving effectively connected income should file Form 1040NR, *US Non-Resident Alien Income Tax Return*, in lieu of Form 1041. In practice, however, some tax professionals feel that it is more appropriate for certain foreign grantor trusts to file Form 1041. Regardless of whether a foreign grantor trust files a Form 1040NR or Form 1041, it should attach a schedule of the amounts taxable directly to the grantor of the trust.[19] The penalty for failure to file either return equals 5% of the tax due for each month the return is late, up to a maximum of 25%. However, if the failure to file the form is fraudulent, the penalty is much steeper and can equal 75% of the tax due.

A US beneficiary of a foreign trust is required to file Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, if such beneficiary transfers assets to a foreign trust or receives a distribution of assets from the trust. If the distribution received is from UNI and is therefore an "accumulation distribution", it is subject to the throwback rules and the beneficiary must file Form 4970, *Tax on Accumulation Distribution of Trusts*, which calculates the "throwback tax" on the distribution and which should be attached to the Form 3520. Additionally, US persons who are treated as the owner of assets held in a foreign trust are required to file Form 3520. Form 3520 is due on the date that the individual's US personal income tax return is due (including extensions), and the failure to file Form 3520 may result in a penalty equal to the greater of $10,000 or 35% of the amount distributed.

If a foreign trust is treated as having a US person owner, the trust itself must file Form 3520-A, *Annual Information Return of Foreign Trust with a US Owner*, which provides identifying information of the foreign trust. Form 3520-A is due on the 15th day of the 3rd month after the end of the foreign trust's tax year, and failure to file the form may result in penalties equal to the greater of $10,000 or 5% of the value of the foreign trust's assets that are treated as owned by the US person.

The US trustee of a foreign trust must file FinCEN Form 114 (formerly Form TD F 90-22.1), *Report of Foreign Bank and Financial Accounts* ("FBAR"), to report any foreign financial accounts held by the foreign trust, including bank accounts, securities accounts, brokerage accounts, foreign-issued life insurance with a cash value, shares in certain mutual funds, and annuity policies with a cash value. Additionally, a US person who is treated as the owner of the foreign trust under the grantor tax rules discussed above must file an FBAR to report any foreign financial accounts held by the foreign trust. Finally, a US person beneficiary of a foreign trust whose interest in such trust exceeds 50% of the trust's

[16] It should be noted that loans made from a FNGT to its US person beneficiaries or to persons related to such beneficiaries may be treated as a distribution from the FNGT.
[17] Distributions to beneficiaries other than natural persons are beyond the scope of this guide.
[18] A foreign trust must report FDAP income on a US tax return only if the required US tax was not properly withheld by the payor of the income.
[19] Two alternative filing options are available to US grantor trusts, but these options are not available to foreign grantor trusts.

assets or income must file an FBAR to report the foreign financial accounts held by the foreign trust. However, the beneficiaries of a foreign non-grantor trust are not required to file an FBAR if the US trustee of the foreign non-grantor trust files an FBAR on behalf of the trust. The FBAR is due on June 30th of the year following the year in which the US person had the interest in the foreign account, and the penalties for failure to file an FBAR are severe. For the non-willful failure to file an FBAR, civil penalties can equal $10,000 per violation, and for a willful failure to file, civil penalties equal the greater of $100,000 or 50% of the balance in the foreign account. Criminal penalties may also be imposed, including imprisonment and extensive monetary penalties.

IV. Taxation

A. Domicile and Residency

As more fully discussed below, different standards apply for determining whether an individual will be subject to US federal income tax as compared to whether such individual will be subject to US gift, estate and generation-skipping transfer tax. The applicable standard that governs the extent to which US federal income tax will be imposed is an individual's *residency*. However, for US gift, estate and generation-skipping transfer tax purposes, the determining factor is an individual's *domicile*. In fact, it is not uncommon for an individual to be a resident of the United States for federal income tax purposes but not a domiciliary of the United States for gift, estate and generation-skipping transfer tax purposes.

1. Residency for US Income Tax Purposes

United States citizens are subject to federal income tax on their worldwide income. Individuals who are not United States citizens are either (i) "resident aliens" who are subject to federal income tax on their worldwide income, or (ii) "nonresident aliens" who are subject to federal income tax only on certain types of US-source income and gains.

a. Resident Aliens

i. Lawful Permanent Resident (Green Card Holder)

A Green Card holder (or "lawful permanent resident" for US immigration purposes) is deemed a resident alien of the United States for federal income tax purposes. As such, the individual is subject to US federal income tax on his worldwide income.

ii. Substantial Presence (183-Day Count Test)

An individual may also be deemed a resident of the United States for federal income tax purposes if they meet the "substantial presence" test in any calendar year. The substantial presence test focuses on the number of days that an individual is physically present in the United States.

(a) During any year in which an individual is physically present in the United States for fewer than 31 days, the individual will be treated as a nonresident alien.

(b) During any year in which an individual is physically present in the United States for 183 or more days, the individual will be treated as a resident alien (unless an income tax treaty with another country provides relief).

(c) If an individual is physically present in the United States for 31 days or more but fewer than 183 days, then it is necessary to add (i) the number of days physically present in the United States during the current year; (ii) one-third of the number of days physically present in the United States during the immediately preceding year; and (iii) one-sixth of the number of days physically present in the United States during the second preceding year. If the total is less than 183, the individual will be deemed a nonresident alien (for these purposes, an individual may spend up to 121 days in the United

States per year for any three-year period without becoming a tax resident). If the total equals or exceeds 183, the individual will be deemed a resident alien (unless the "closer connection" exception discussed below applies or an income tax treaty provides relief).

(d) Closer Connection Exception. Even if he meets the rolling day count test, an individual will *not* be deemed a US resident for a given year if he (i) is physically present in the United States for less than 183 days in the current year, (ii) is not a green card holder, and (iii) has a tax home in a foreign country to which he has a "closer connection" than the United States. Importantly, to avoid being treated as a US resident, he must file Form 8840, *Closer Connection Exception Statement for Aliens*, to claim the closer connection exception. Finally, Form 8840 must be filed by the due date (including extensions) of Form 1040NR to which it must be attached, where applicable.

(e) For purposes of the substantial presence test, a person is generally considered as being physically present on a day if he is physically present in the United States *at any time* during that day. Accordingly, days arriving in and departing from the United States are counted under the physical presence test. However, if an individual is in transit between two points outside of the United States and enters the United States during his travel from one point to the other, that day is generally not counted as a day of presence in the United States.

b. Nonresident Aliens

If an individual is not a United States citizen or Green Card holder and does not meet the "substantial presence" test discussed above, the individual is deemed a nonresident alien for United States federal income tax purposes. As such, the individual is subject to US federal income tax only on certain types of US-source income and gains, as further discussed below.

2. Domicile for Transfer Tax Purposes

US citizens and individuals domiciled in the United States are potentially subject to US transfer taxes on certain gratuitous transfers of their worldwide assets during life and at death, as more fully discussed in Section IV.B below. Individuals who are not domiciled in the United States are potentially subject to US transfer taxes on certain gratuitous transfers of US-situs assets. An individual is considered to be domiciled in the United States for transfer tax purposes if he is physically present in the United States, even if for only a brief period of time, and he has the *intention* to permanently remain there. An individual's domicile will generally continue in a particular country until it is affirmatively established in another country.

Domicile, unlike income tax residency discussed above, is determined on a case-by-case basis by examining the particular facts and circumstances at hand. The IRS considers numerous factors in making a determination of domicile, including the location, size, cost and nature of homes, where cherished possessions are located, location of business contacts, location of family and friends, location of church and club memberships, place of driver's license and automobile registration, location of voter registration, location of bank and securities accounts, amount of time spent in the United States and other countries, and declarations of residence made in visa applications, Wills, trust deeds, tax returns, and other written and oral statements.

B. Gift, Estate and Inheritance Taxes

1. Overview

There are three types of US transfer taxes that may be imposed on transfers of property by gift or bequest: estate tax, gift tax, and generation-skipping transfer ("GST") tax (collectively referred to as "transfer taxes"). Gift tax applies to lifetime transfers, estate tax applies to transfers at death, and GST tax applies when there is a transfer of property to an individual who is in a generational level two or more generations below that of the transferor (*e.g.*, a grandchild). It should be noted that many states impose their own transfer taxes in addition to the US federal transfer taxes.

2. Gift Tax

a. US Citizens and Domiciliaries

For US citizens and domiciliaries, the gift tax applies to gratuitous transfers of property during life, including transfers of real estate, tangible property and intangible property made to individuals and entities located anywhere in the world. However, there are certain lifetime gratuitous transfers to which the gift tax does not apply. For example, US citizens and domiciliaries are permitted to make "annual exclusion" gifts of up to $14,000 (for the 2014 tax year) per donee, free from US gift tax. A married US citizen or domiciliary may make annual exclusion gifts of up to $28,000 per donee if the donor "splits" the gift with a US citizen or domiciliary spouse. Additionally, gifts to a US citizen spouse and qualified charities are entitled to a tax deduction. Finally, payments of educational and medical expenses made directly to an educational institution or medical provider on behalf of a donee also are not subject to US gift tax.

b. Non-US Domiciliaries

For individuals not domiciled in the United States, US gift tax generally applies only to real property or tangible personal property located in the United States at the time of the gift. Intangible property, including corporate stock, bonds, notes, bank deposits, and potentially, certain partnership interests, even if located in the United States, is not subject to gift tax. Non-US domiciliaries are entitled to some of the same gift tax exemptions discussed above, including the annual exclusion and the direct payment of educational and medical expenses on behalf of a donee. However, non-US domiciliaries are not permitted to "split" their annual exclusion gifts with their spouse. Nevertheless, non-US domiciliaries are entitled to an unlimited marital deduction for gifts to US citizen spouses, but gifts to spouses who are not US citizens are subject to gift tax if they exceed $145,000 (for the 2014 tax year) a year.

c. Mechanics

The individual making the gift ("donor") is responsible for paying the gift tax, which is imposed on the fair market value of the gift. US gift tax is imposed at graduated rates ranging from 18% to a maximum of 40%. In addition to the annual exclusion gifts discussed above, US citizens and domiciliaries are entitled to a lifetime exemption of $5,340,000 (for the 2014 tax year) for cumulative transfers subject to US gift tax <u>and</u> estate tax. In other words, the portion of an individual's lifetime exclusion amount that is not used against lifetime gifts subject to US gift tax may be used against US estate tax at his death.

3. Estate Tax

a. US Citizens and Domiciliaries

United States estate tax is imposed upon transfers occurring at an individual's death. US citizens and domiciliaries are subject to US estate tax on their "gross taxable estate", which means they are taxable on their worldwide assets. Certain transfers that were made prior to death may also be included in an individual's taxable estate for estate tax purposes, including certain property transferred within three years of death and other transfers in which the individual retained certain rights. Similar to US gift tax, bequests to US citizen spouses and qualified charities qualify for an estate tax deduction. Finally, individuals are entitled to a tax deduction for estate administration costs such as attorneys' fees.

b. Non-US Domiciliaries

Non-US domiciliaries are subject to US estate tax only on their US-situs property. However, the type of property that is taxable for US estate tax purposes is much broader than for gift tax purposes. In addition to US real estate and tangible property located in the US, securities or obligations issued by US persons or US entities are also subject to estate tax. However, non-US domiciliaries may be able to avoid US estate tax by investing in United States property through an offshore holding company.[20] A non-US domiciliary's charitable gifts will qualify for an estate tax deduction only if made to a United States charity. Transfers to US citizen spouses will qualify for an unlimited marital deduction. However, in order for transfers to non-US citizen spouses to qualify for a marital deduction, the property must pass to a qualified domestic trust (a "QDOT"), which must meet the following requirements:

- Income from the QDOT must be paid to the surviving spouse;
- The QDOT must have one US trustee; if assets of the QDOT exceed $2,000,000, that trustee must be a bank or must furnish a bond or letter of credit; and
- Distributions of principal during the non-US citizen spouse's life and the principal of the QDOT remaining at the surviving spouse's death are subject to US estate tax, calculated as if the principal were included in the predeceasing spouse's taxable estate (*i.e.,* the benefit of the surviving spouse's estate tax exemption is lost).

c. Mechanics

As with US gift tax, federal estate tax is imposed at graduated rates ranging from 18% to 40%. As discussed above, US citizens and domiciliaries are entitled to a lifetime exemption of $5,340,000 (for the 2014 tax year) for both gift tax <u>and</u> estate tax, so that the portion of an individual's lifetime exemption not used against their lifetime gifts is available to be used against their estate tax liability. An individual's unused lifetime exemption amount at the date of his death is "portable," which means that it may be used by the surviving spouse. Non-US domiciliaries do not have the benefit of a lifetime exemption; they are generally allowed a reduced estate tax exemption of $60,000 or, where provided under treaty, a portion of the lifetime exemption amount provided to US citizens and domiciliaries.

4. Generation-Skipping Transfer Tax

In addition to gift and estate tax, the United States imposes a GST tax upon certain transfers that "skip" a generation. In other words, GST tax is imposed upon transfers to an individual who is two or more generations below the donor.[21] This type of transfer frequently involves an outright gift or transfer to a trust for the benefit of the donor's grandchildren. The reach of the GST tax generally is aligned with the reach of the gift and estate tax. Thus, a transfer by a non-US domiciliary of non-US situs property is not subject to the GST tax, since it is not subject to US estate or gift tax. The GST tax is imposed at a rate of 40% on generation-skipping transfers that exceed $5,340,000.

5. Special Expatriation Rules

"Covered expatriates," defined as US citizens and long-term green card holders (8 out of the past 15 tax years) who meet one of the following tests, are subject to a special expatriation tax regime:

a. The individual has a net worth of $2,000,000 or more;

b. The individual's average US federal income tax liability for the previous five tax years exceeds $157,000; or

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[20] Notably, adverse income tax consequences can arise with this type of structure. *See, e.g.,* G.D. Parker, Inc. v Commissioner, T.C. Memo 2012-327, in which the court held that a non-US holding company owning a personal residence in the United States and/or the non-US owners of the holding company were potentially subject to US income tax.

[21] Gifts to individuals more than 37½ years younger than the donor will be assumed to be made to a "skip" person and GST tax will be applied. I.R.C. § 2651(d).

c. The individual fails to certify compliance with his US federal tax requirements for the previous five tax years.[22]

The expatriation tax regime consists of a "mark-to-market" tax, whereby the covered expatriate is treated as having sold all of his assets for fair market value on the date prior to the date of expatriation. If a covered expatriate receives a distribution from a trust, the trustee is required to withhold and pay tax on the distribution. Additionally, US persons who receive gifts or bequests from covered expatriates are subject to a 40% tax on the gift or bequest. An exception from the expatriation tax is provided for individuals who are citizens of both the United States and a foreign country at birth. Specifically, these individuals will not be deemed covered expatriates for purposes of the expatriation tax if (i) they have not been a US resident for 10 of the past 15 years and (ii) they continue to be a citizen and tax resident of the foreign country after expatriation. Additionally, an exception exists for those individuals who (i) relinquish their US citizenship before attaining age 18 ½ and (ii) have been a US resident for less than 10 years.

C. Tax on Income and Capital

1. US Citizens and Resident Aliens

US citizens and resident aliens are subject to US federal income tax on their worldwide "taxable income," which generally includes income received for services provided, interests, dividends, rents, royalties, capital gains, business income and certain distributions from trusts, partnerships, corporations and other entities, less certain statutory exclusions and tax deductions.

US citizens and residents are also subject to the below anti-deferral rules:

a. Controlled Foreign Corporation ("CFC") Rules

A foreign corporation is a CFC if more than 50% of its stock is owned (by vote or value) by "United States Shareholders," which is defined as a US citizen or resident alien shareholder who owns at least 10% of the corporation's voting stock. Under these rules, a United States Shareholder is taxed on a pro-rata portion of the CFC's passive income, even if the CFC does not actually distribute its passive income. Generally, US tax on the active business income of a CFC is deferred until such income is actually distributed to the United States Shareholders.

b. Passive Foreign Investment Company ("PFIC") Rules

A foreign corporation is a PFIC if (i) at least 75% of its income consists of interest, dividends and other passive income, or (ii) at least 50% of its assets generate such income. A US citizen or resident alien shareholder of a PFIC is subject to an onerous tax and interest regime based on distributions deemed to be from prior years and on the transfer of the shareholder's stock in the PFIC (the PFIC rules are similar to the throwback rules applicable to US person beneficiaries of foreign non-grantor trusts, as discussed above). The harshness of the PFIC tax can be minimized through the following available elections:

i. Qualified Electing Fund ("QEF") election, whereby the PFIC shareholder timely elects to be taxed annually on his pro-rata share of PFIC earnings;[23]

ii. Check-the-box election, whereby the PFIC is treated as a pass-through entity for US federal income tax purposes; and

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[22] I.R.C. § 877A(g)(1).
[23] The QEF election is available only if the PFIC agrees to provide the information required by the Code and applicable regulations.

iii. Mark-to-Market election, whereby the PFIC shareholder elects to report as income each year the amount by which the year-end fair market value of the shareholder's stock exceeds the shareholder's basis in the stock.

2. Non-Resident Aliens

Non-resident aliens are generally subject to US federal income tax only on certain types of US-source income, including:

a. US-source "fixed, determinable, annual or periodic" income ("FDAP" income)

FDAP income includes dividends, interest, rents and royalties, but generally does not include capital gains. FDAP income is subject to a flat 30% tax (unless reduced by an income tax treaty with another country), usually satisfied through withholding at the source.

b. Income effectively connected with a United States trade or business

Effectively connected income is taxed at the individual and corporate graduated tax rates, subject to offset by certain deductions and credits.

c. Income deemed "effectively connected" under the Foreign Investment in Real Property Tax Act ("FIRPTA")

Under FIRPTA, gains on a non-US person's disposition of US real property are treated as effectively connected income. Importantly, if a foreign person has any interest in US property or in a US corporation that holds real property, such interest is considered real property under the FIRPTA rules.

3. Mechanics

US federal income tax is imposed on individuals at graduated rates based on the taxpayer's level of income. For individuals earning more than $400,000 and married couples earning more than $450,000 – so-called "High Income Taxpayers" – income over those threshold amounts is taxed at a rate of 39.6%.

US citizens and resident aliens are eligible for a foreign tax credit for certain foreign taxes paid on their income. The foreign tax credit alleviates the double taxation that occurs when foreign income is taxed by both the United States and a foreign country. To qualify for the foreign tax credit, foreign taxes paid must be (i) a compulsory levy and (ii) not a payment for receipt of specific benefits by the taxpayer.

Most states and a number of municipalities impose their own income tax, which is beyond the scope of this discussion.

In addition to US federal income tax imposed on individuals, US income tax is also imposed on corporations and other entities treated as corporations for US tax purposes. US federal corporate tax is imposed at graduated rates ranging up to 35%, based on the corporation's level of income. In addition to the tax at the corporate level, shareholders of "C-corporations" are subject to tax on dividends received from the corporation. However, shareholders of "S-corporations" do not pay tax on dividends received from the corporation, but instead pay US corporate income tax directly on the corporation's earnings. Like the individual income tax, most states and many municipalities impose their own corporate income tax, which is beyond the scope of this discussion.

Finally, it is important to note that US citizens, resident aliens, and entities organized under the laws of the United States must file an FBAR (as previously discussed in section III.C.) to report a financial interest in or signature authority over any non-US financial accounts, including but not limited to bank accounts, securities accounts, brokerage accounts, foreign-issued life insurance policies with a cash value, shares in certain mutual funds, and annuity policies with a cash value. The FBAR is due on June 30th of the year following the calendar year being reported, and the penalties for failure to file an FBAR are severe. Civil penalties can equal $10,000 per violation for the non-willful failure to file an FBAR, while civil penalties for the willful failure to file can equal the greater of $100,000 or 50% of the balance in the foreign account. Criminal penalties, including imprisonment and extensive monetary penalties, may also be imposed.

D. Tax Treaties

The United States has entered into a number of income tax, estate tax and gift tax treaties with other countries in order to prevent double taxation. While these treaties are outside the scope of this discussion, it is important to note that they may modify the rules discussed above.

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<u>Overview</u>
Von provides U.S. tax advice to affluent families as well as their family offices. He counsels clients on structuring their inbound and outbound investments to minimize their overall U.S. tax burden. Von advises individual and corporate fiduciaries on the U.S. tax consequences of trust investments and on issues arising from trust administration and management. He also provides guidance on U.S. estate and gift tax planning techniques for both U.S. and non-U.S. families. Finally, Von advises beneficiaries and fiduciaries of non-U.S. trusts on the U.S. tax consequences associated with foreign structures. Von is admitted to practice in the United States Tax Court.

<u>Publications and speaking engagements</u>
- Presenter "Family Matters: Family Governance," Estate Planning Council of New York City's Estate Planners Day, May 2013.
- Co-Author of “Global Mobility: U.S. tax considerations associated with obtaining a green card,” *Trusts & Estates*, August 2012.
- Panelist at the ABA Section of Taxation and Section of Real Property, Probate and Trust Law, Fall CLE Meeting, "Foreign Reporting for Estate Planners," Denver, October 2011.
- Moderator, "Current Trends in US and English Family Law-Opportunities and Pitfalls," STEP New York, New York, May 2011.
- Panelist at the International Bar Association annual conference, "Nuts and bolts of trust mechanics," Vancouver, October 2010.
- Author of "Tax Planning for a Nonresident Noncitizen Buying a U.S. Condo or Co-op," *Journal of International Taxation*, July 2005.
- Panelist at the Eighth Annual Advanced ALI-ABA Course of Study for the Estate Planner, Litigator, and Corporate Fiduciary Counsel, *Representing Estate and Trust Beneficiaries and Fiduciaries*, "When is a Trust not a Trust," San Francisco, July 2005.

<u>Memberships</u>
- New York State Bar Association • International Bar Association, Section of Taxation • American Bar Association - Section of Taxation; Section of Real Property, Probate and Trust Law; Member, Fiduciary Income Tax Committee and International Tax Planning Committee; Chair, Foreign Trusts Sub-committee • Society of Trust and Estate Practitioners