United States

International Estate Planning Guide

Private Client Tax Committee

Contact:

Eric Dorsch

Kozusko Harris Duncan, New York

EDorsch@kozlaw.com

Alexander Lewis

Kozusko Harris Duncan, Washington, DC

alewis@kozlaw.com

I. Wills and disability planning documents

A. Will formalities and enforceability of foreign wills

A Last Will and Testament (a 'will') is the historical keystone document for estate planning. Modern estate planning has evolved to include a number of other documents (eg, revocable and irrevocable trusts, and powers of attorney). However, the will is the most common and well-known estate planning device. A will is a legal instrument that, among other things, directs the disposition of an individual's probate property on his or her death. Non-probate property generally passes pursuant to a will substitute (discussed below). A will may be used to do things that cannot be accomplished through other means. For example, a will may be used to disinherit children in favour of a spouse (or otherwise deviate from local intestate succession law), appoint guardians for minor children, marshal assets in testamentary trusts and exercise testamentary powers of appointment (among many other uses).

A 'formal will' or a 'formally witnessed will' is a written will, duly signed and witnessed as required by state statute. In some jurisdictions, this is the only type of will recognised; other jurisdictions also may allow oral or holographic wills or a document intended as a testator's will. A holographic will is a will handwritten by the testator that is not executed with the formalities generally required for wills, such as attestation by witnesses. The acceptance of such wills varies among states and is generally subject to differing requirements (eg, whether some or all of the will must be in the testator's handwriting).

Generally, for a formal will to be valid: (1) the testator must be of sound mind; (2) the testator must be at least 18 years of age; (3) the will must be in writing; (4) the will must signed by the testator (or in the testator's name by some other individual in the testator's conscious presence and by the testator's direction); and (4) the will must be signed by at least two disinterested witnesses. Generally, wills should be signed before a notary public. Usually, the attorney responsible for preparing the will oversees the signing. The attorney generally prefers to oversee the signing to ensure that the execution formalities necessary for the will to be valid are followed.

Foreign wills are recognised in the United States. Each state has different requirements for admitting a foreign will for probate. Generally, probate courts will require a copy of the foreign will, a certified translation of the foreign will by a qualified translator and an affidavit from the qualified translator. Wills executed outside the US will be considered valid as long as they are valid wherever executed. However, to ensure a will is valid in a specific state, it is best to execute the will with the formalities required in that jurisdiction. As noted above, this will generally be satisfied as long as the will is executed before two disinterested witnesses and before a notary.

B. Will substitutes (non-probate property)

Property that passes outside a person's probate estate (ie, non-probate property) is generally referred to as such because such property passes pursuant to a will substitute. These instruments facilitate faster transfers of property after death, keep assets private (ie, out of probate) and may provide creditor protection. Additionally, property may pass pursuant to the operation of law (eg, property owned as joint tenants with the right of survivorship).

1. TRUSTS

Trusts are recognised and widely used in the US. When a trust is created, a settler separates the legal title from the equitable title to property. The settler conveys the legal title to a trustee, and the equitable title to a beneficiary or beneficiaries. The settler may also be a trustee, beneficiary, or one of several trustees or beneficiaries. The trustee takes title to property only for the purpose of protecting or conserving it for the beneficiaries of the trust. The beneficiaries, however, are usually not the creators of the trust, and as such, do no more than accept the benefits of the trust. The trustee, while holding title, is obligated to deal with trust property solely in the beneficiaries' best interest. The beneficiaries, on the other hand, while being the beneficial owners of the property, do not have title to the property itself and are not able to transfer or otherwise deal with trust property. Trusts governed by the laws of other jurisdictions are recognised in the US. Revocable trusts may be revoked by the settler at any time and irrevocable trusts cannot be revoked. Trusts established during an individual's lifetime are *'inter-vivos'* trusts and trusts established at death are 'testamentary' trusts.

Typically, in the US, individuals use both a will and revocable trust to manage their property during life and dispose of their property at death. The individual will typically transfer property to the revocable trust during their life and direct in their will that any remaining property in their probate estate at their death be transferred to the revocable trust to be disposed of pursuant to the terms of the trust. The will in this scenario is referred to as a 'pour-over' will, because the will 'pours over into' the revocable trust. The revocable trust will typically contain all the dispositive provisions of the settler's estate plan.

2. LIFE INSURANCE

Individuals own and use life insurance for a variety of reasons. Generally, individuals that own life insurance policies on their own life name individual beneficiaries to receive the proceeds on the purchaser's death. Life insurance proceeds pass outside an individual's probate estate (but not necessary outside his or her taxable estate for US estate tax purposes). Frequently, individuals in the US establish irrevocable life insurance trusts (ILIT) to purchase life insurance on their life so that the proceeds pass outside their probate *and* taxable estate. This is discussed in further detail below.

3. RETIREMENT PLANS

Retirement plans (eg, pension plans and 401(k) plans) generally pass pursuant to a beneficiary designation and are not affected by the terms of an individual's will. The taxation of retirement plans can be extremely complicated, and typically, plan owners name individuals as the beneficiaries after their death to avoid the complications associated with the ownership of a retirement plan through a trust, for example.

4. TENANCIES, SURVIVORSHIP ACCOUNTS AND PAYABLE ON DEATH ACCOUNTS

Property may also pass pursuant to survivorship accounts or pursuant to various types of property ownership. Property that passes pursuant to one of these accounts or pursuant to joint ownership (except as noted below) passes outside an individual's probate estate. Property may be jointly owned in any one of the following ways: (1) jointly with rights of survivorship; (2) tenancy-in-common; (3) tenancy by the entirety; (4) community property; or (5) payable on death accounts (sometimes called Totten trust accounts). Only property owned as tenants-in-common or community property will need to be probated.

C. Powers of attorney, healthcare 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 remains in effect upon the Principal's incapacity. Typically, as part of basic estate planning, individuals will execute a durable power of attorney with respect to property so that their Agent can transact on their behalf. Most commonly, this is useful so that an agent can handle day-to-day financial activities on behalf of the principal.

2. Living wills

A living will is a type of advance directive that deals with an individual's wishes concerning medical care. Generally, the scope of a living will is limited to an individual's wishes concerning life-sustaining measures, the use of which may be recommended or considered when the individual is terminally ill or lacks the capacity to make decisions concerning life-sustaining measures.

Some states provide statutory forms for the appointment of a 'Healthcare Representative' or other agent that may act on behalf of the Principal. Such forms must typically be executed with the requisite formalities to be valid.

II. Estate administration

A. Overview of administration procedures

When an individual dies in a US state, or owns property situated in that state, the disposition of the individual's property is overseen by a 'probate court'. The person named in the decedent's will as the estate's executor (alternatively called the administrator or the personal representative) administers the estate. If there is no one named in a will or the named individual is unable to serve, state law will dictate who serves as the executor. The probate court will issue letters testamentary (or similar such documents) empowering the executor to act on behalf of the estate. The executor acts in a fiduciary capacity and has broad powers to administer and distribute the estate.

The probate estates of US citizens and persons domiciled in the US will generally include their worldwide assets. Depending on the jurisdiction in which non-US assets are located, such assets may be subject to probate in both jurisdictions. Non-US individuals domiciled in the US with assets outside the US will have their estates probated in the state in which they reside. Individuals domiciled outside the US with assets in the US will generally need to open an ancillary probate proceeding in the state in which assets are located in order to obtain the probate court's permission to transfer title to the assets. Generally, tangible or real property located in a state will be subject to probate in the state in which it is located. Intangible property is typically subject to probate in the decedent's state of residence.

With respect to assets included in the probate estate, upon distribution from the estate, the executor transfers title of the assets to the heirs. Title to certain assets that are not included in the probate estate (eg, joint tenancy property, community property or pay on death accounts) transfer as a matter of law. Finally, title to assets held in trust is transferred by the trustee of the trust.

Individuals with foreign (non-US) assets will frequently execute wills in each jurisdiction that stipulate that the disposition of the assets in each jurisdiction will be governed by provisions of the applicable will.

B. Intestate succession and forced heirship

If an individual dies without a valid will, the individual's estate will be disposed of pursuant to the intestate succession rules of the jurisdiction of the individual's domicile at death. Each US state has different intestate succession laws, but the rules generally provide that the individual's estate will go to his or her closest relatives. For instance, in New York, the intestate succession rules provide that a surviving spouse will receive $50,000 plus one-half of the remaining probate assets and that the decedent's descendants (children, grandchildren, etc) will receive one-half of the remaining probate assets. Note that certain assets are not included in the individual's estate for intestate succession purposes (eg, life insurance proceeds, certain retirement assets and assets held in trust).

> *Example*: Bob is married to Lauren and they have one grown-up child. Bob and Lauren own a bank account in joint tenancy and Bob took out a life insurance policy naming Lauren as the beneficiary. On Bob's death, Lauren inherits the bank account outright and receives the life insurance policy proceeds. Those items are not intestate property subject to probate. If Bob also owned $450,000 of Apple stock, Lauren would inherit $250,000 of Apple stock ($50,000 + one-half of the remaining property - $200,000) and the grown-up child would inherit the remaining $200,000 of Apple stock.

Forced heirship rules in the US typically dictate a minimum share that must be left to a surviving spouse or minor children. Some states have 'homestead' laws, or 'elective share' requirements, which are rules that set minimum amounts that must be left to a surviving spouse or minor children. A surviving spouse's elective share can range from one-third to one-half of a decedent's estate, depending on the length of the marriage and the presence of minor children.

States generally have marital property regimes that are only applicable to married couples, specifically community property and tenancy by the entirety. Under the community property regime, one-half of the decedent's property passes automatically to the surviving spouse. Tenancy by the entirety is similar to joint tenants with the right of survivorship, but provides greater creditor protection as transfers or mortgages of the property typically require both spouses' consent.

III. Trusts, foundations and other planning structures

A. Common techniques

The items below represent common estate planning techniques that individuals regularly use to pass wealth to future generations in a tax-efficient manner. Each has benefits and drawbacks that are important to consider based on a client's facts, wishes for his or her wealth and timeline.

1. GRANTOR RETAINED ANNUITY TRUSTS (GRAT)

A powerful tool for increasing after-tax returns is a special type of trust called a GRAT. A GRAT is a trust arrangement whereby the grantor transfers property to a trust, but keeps the right to receive scheduled payments (the 'annuity') from the trust for a stated time after the transfer, for example, two years. The difference between the value of the property transferred to the GRAT and the annuity amount is subject to gift tax. Any property remaining in the trust after the annuity term will escape the grantor's estate tax, just like any other gift. The gift will succeed if two conditions are met: (1) the grantor survives the stated term of two years; and (2) the total investment return (including capital appreciation) exceeds a certain threshold rate. This hurdle rate is specified by the tax law based on the 'normal' annual rate of return expected on certain kinds of assets when the trust is funded, for example, five per cent per year for certain months in 2024. Any remaining property at the end of the annuity term is generally paid into a separate trust for the benefit of the grantor's spouse and children. If the grantor dies during the annuity term, the GRAT's assets will generally be included in his or her estate.

2. GIFT AND SALE TO A 'GRANTOR' TRUST

Planning that involves a gift and sale to a grantor trust takes advantage of the grantor trust rules to move appreciation out of the grantor's estate without income tax consequences during the grantor's life. This planning usually involves establishing an irrevocable grantor trust for the benefit of the grantor's spouse and children (or others), and subsequent gift of approximately ten per cent of the value the grantor intends to transfer to the trust. The trust will then purchase the remaining 90 per cent of the asset in exchange for a promissory note. Because the trust is a grantor trust, the sale to the trust and subsequent interest payments are considered non-events for income tax purposes (ie, the grantor is deemed to be transacting with him or herself and such transactions are disregarded).

Similar to a GRAT, this strategy moves appreciation out of the grantor's estate to the extent that the trust's assets appreciate at a rate greater than the promissory note rate. Additionally, because the trust is recognised for gift and estate tax purposes, trust assets (and future appreciation) are removed from the grantor's estate. The value of the promissory note will be included in the grantor's estate, so successive sales may be required to move additional value out of the grantor's estate.

3. QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRT)

A QPRT is a trust to which an individual makes a gift of all or a portion of a residence while retaining a right under the trust document to occupy the residence for a specified term of years. After the specified term, the QPRT benefits designated remainder beneficiaries (eg, children). The value of the retained interest (ie, the retained right to occupy the residence for a term of years) is quantified using valuation tables and methods prescribed under the Treasury Regulations; the value of the gift for gift tax purposes is the difference between the fair market value of the residence on the date of the transfer to the QPRT and the value of the retained interest. If the grantor survives the QPRT term, the residence (and any appreciation) is excluded from his or her estate for US estate tax purposes. If the grantor dies during the term, the value of the residence will be included in his or her gross estate.

A disadvantage of the QPRT is the loss of a step-up in basis of the property at the grantor's death. If the grantor dies owning the residence, the basis of the residence for capital gains tax purposes will be its fair market value upon the grantor's date of death. On the other hand, if the grantor transfers the property to a QPRT and survives the term of years, the basis of the residence in the hands of the children (or trusts for their benefit) will be the grantor's basis. The basis of the property will be increased somewhat due to the grantor's payment of gift tax on the transfer to the QPRT.

4. Charitable remainder trust (CRT)

A CRT is a trust from which: (1) during the trust term, one or more individuals (typically the donor of property to the trust and his or her spouse), each year, receives either: (i) a fixed amount (a sum certain) of trust property (a charitable remainder annuity trust); or (ii) a fixed percentage of the fair market value of the trust property, determined annually (a charitable remainder unitrust); and (2) at the termination of the trust, one or more charitable organisations receives the then remaining trust property. A CRT is not subject to income taxation. Consequently, the trustee of the CRT may sell the trust's interest in the trust assets without incurring income tax by reason of the sale.

The benefits of the CRT are significant. First, the client is entitled to a US federal income tax charitable deduction for the present value of the assets he or she transfers to the trust. This deduction will reduce the client's taxable income in the year of the donation by sheltering from taxation a portion of the income the client realises on the sale of the assets he or she retains outside the trust. Second, the trustee of the CRT may sell the trust's interest in the asset and reinvest the gross sale proceeds undiminished by the payment of income taxes. Finally, the payment of capital gains tax on the sale of trust assets will be deferred until payments of trust property are made to the client in satisfaction of the annuity or unitrust interest.

5. Family limited partnership (FLP)

Many families use FLPs as a part of their estate planning to transfer the control of privately held assets to lower generations in a tax-efficient manner. Generally, the principal asset owner will transfer assets into a FLP in exchange for a limited partner (LP) interest, while other family members will transfer assets (generally worth much less) in exchange for a general partner (GP) interest in the entity. Importantly, the primary donor will lose some or all control over the assets transferred to the entity. The primary benefit is that gifts of LP interests will receive significant discounts for lack of control, thereby reducing the amount of gift tax incurred on direct or indirect transfers of the LP interests. This strategy is often combined with strategies discussed above (eg, GRATs or sales to grantor trusts) to maximise the value transferred to lower generations in a tax-efficient manner.

B. Treatment of foreign trusts and foundations

US tax rules apply to trusts differently depending on: (1) whether a trust is classified as a 'US trust' or 'foreign trust'; and (2) whether the trust is classified as a 'grantor trust' or 'non-grantor trust'.

1. Foreign trusts

Under US rules, a trust is a foreign trust if it is not a domestic trust. A trust is a domestic trust if: (1) a court within the US is able to exercise primary supervision over the trust's administration (the 'court test'); and (2) one or more US persons have the authority to control all the trust's substantial decisions (the 'control test').[1]

Under the court test, a court is able to exercise primary supervision over a trust if the court has authority to render orders or judgments concerning the trust.[2] For purposes of the control test, US persons include individuals as well as domestic corporations and partnerships (or eligible entities electing as such). The regulations provide several examples of substantial decisions, such as whether and when to distribute income or principal, determining the amount of distributions, selection of beneficiaries and whether to remove, add or replace a trustee.[3]

2. Foreign grantor trusts

A trust that is classified as a 'grantor trust' is not considered a taxpayer for US federal income tax purposes. Instead, the person deemed to be the owner of the trust for tax purposes (the 'grantor') is treated as the tax owner of the trust's underlying assets and the income and gains generated on such assets. If a trust is classified as a grantor trust, its grantor includes all items of trust income, gain, deduction and so on, in computing his or her taxable income as if he or she had received such items directly. Generally, this applies regardless of whether the trust is a US trust or foreign trust and regardless of whether the grantor is a US person or non-US person; however, a trust with a non-US grantor will only qualify as a grantor trust under certain circumstances.

Under the general rule, a non-US person will not be considered the owner of a foreign trust for US federal income tax purposes unless certain exceptions are met. Instead, the default treatment of such trusts is as foreign non-grantor trusts. There are two primary exceptions[4] to this rule:

- generally, a trust will be treated as a grantor trust where the trust is revocable by the grantor. More specifically, the general rule will not apply to any portion of a trust for a taxable year of the trust if the power to revest is: (1) exercisable solely by the grantor[5] without the approval or consent of any other person; or (2) by the grantor with the approval of a 'related or subordinate party' who is subservient to the grantor;[6] and

- distributions from the trust may only be made to the non-US grantor or the individual's spouse during the grantor's lifetime.[7]

During the grantor's lifetime, the trust's income will be included in the grantor's income.

3. Foreign non-grantor trusts

If a trust (or any portion thereof) does not qualify as a grantor trust, it will be classified as a non-grantor trust for US federal income tax purposes, and consequently, treated as a separate taxpayer. A non-grantor trust generally calculates its taxable income in the same manner as an individual, subject to several modifications set out in the code, which allocate the trust's income, gains, deductions and credits between the trust and its beneficiaries.

A distribution to a US beneficiary will be taxable to the beneficiary to the extent the trust has distributable net income (DNI) or undistributed net income (UNI). Distributions to US beneficiaries that carry out UNI (ie, accumulated income or gains) are subject to a 'throwback' tax.[8]

Note, a foreign trust's DNI includes the trust's realised capital gains. As a non-resident, a foreign non-grantor trust is not subject to US income tax on its capital gains from the sale of US assets, other than certain partnership interests and US real property interests. The inclusion of the trust's realised capital gains in its DNI, however, effectively makes capital gains subject to US income tax to the extent that the trustee makes a distribution to a US beneficiary.

If a distribution from a foreign trust exceeds the trust's DNI or accounting income for the year of distribution, the distribution is an 'accumulation distribution' for US income tax purposes, which triggers the 'throwback tax'. An accumulation distribution is based on a trust's UNI for prior years. A foreign trust's UNI for a given year is its undistributed DNI for that year. As noted above, a foreign trust's DNI includes its realised gains. As a result, a foreign trust that buys and sells investments could have substantial amounts of UNI for prior years, which means the accumulation distribution could be quite large.

The purpose of the throwback tax is to capture the US tax that would have been paid had the trust distributed the accumulated income to the US beneficiary on a current basis. Under the accumulation distribution rules, the receipt of an accumulation distribution in effect triggers income tax, with an accompanying interest charge, for previous years, even though the beneficiary may never have received anything from the trust in those prior years.

4. US reporting requirements for foreign trusts

Foreign trusts that receive effectively connected income (ECI) are required to file a US federal income tax return. As noted above, where the trust is a foreign grantor trust, the foreign grantor will include in income all income received by the trust; accordingly, the non-US grantor may be required to file a US federal income tax return, Form 1040NR, US Non-Resident Alien Income Tax Return.

If a US beneficiary receives a distribution from a foreign trust, whether a grantor or non-grantor trust, the beneficiary must report the receipt of the distribution on Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Form 3520 is due on the due date of the individual's US income tax return (generally 15 April, with a six-month extension available), but is filed separately from Form 1040. If the distribution was from a foreign non-grantor trust and included a distribution of UNI, the beneficiary must also file Form 4970, Tax on Accumulation Distribution of Trusts, which calculates the throwback tax.

A foreign trust with a US owner must also file Form 3520-A, Annual Information Return of Foreign Trust with a US Owner. A foreign trust with a US owner must provide the grantor with a Foreign Grantor Trust Owner Statement and provide any US beneficiaries who receive a distribution a Foreign Grantor Trust Beneficiary Statement to be filed with their personal income tax returns.

A US trustee, US grantor or US beneficiary with a greater than 50 per cent interest in a foreign trust may be required to file FinCEN Report Form 114 (Report of Foreign Bank and Financial Accounts) ('FBAR') to report any financial accounts held by the foreign trust. A beneficiary of the foreign trust will not be required to file FBAR if the trustee files on the trust's behalf. FBAR requires the taxpayer to report the name of the financial institution, account number and maximum value of each account during the year. The due date for FBAR is also 15 April, with a six-month extension available for filing. FBAR is filed electronically with the Financial Crimes Enforcement Network, through its BSA E-Filing System. There are significant penalties for failure to file an FBAR or failure to report accounts on the FBAR that range from $10,000 per violation to the greater of $100,000 or 50 per cent of the balance in the foreign account.[9]

IV. Taxation

A. Domicile and residency

The US applies different standards to determine the applicability of its income tax and estate, gift and generation-skipping transfer (GST) tax regimes. The applicability of the US income tax regime is based on an individual’s residency, whereas the applicability of the transfer tax regimes is based on an individual's domicile. An individual may be subject to the income tax regime but not the transfer tax regime due to his or her remaining domiciled in another jurisdiction.

1. Residency for US income tax purposes

i. Resident aliens

An individual non-citizen of the US is a US resident for federal income tax purposes if he or she is a lawful permanent resident (ie, a ‘green card’ holder) or meets the substantial presence test, defined below. If a taxpayer meets either test, he or she will generally be considered a US tax resident, unless one of the exceptions detailed below is met.

a. ‘Green card’ test: lawful permanent resident

An individual that has received a green card or has become a lawful permanent resident for US immigration purposes, is deemed to be a US resident for federal income tax purposes. Similarly, the termination of a green card is viewed as an expatriation event and can result in adverse tax consequences if certain conditions apply.

b. Substantial presence test: 183-day count test

Under US tax rules, an alien individual will be a US resident with respect to any calendar year if the individual meets the substantial presence test. Under the substantial presence test, an individual will be considered a US resident if the individual is physically present in the US on at least:

1. 183 days or more during the current calendar year; or
2. 31 days during the current year; and
   183 days during the three-year period that includes the current year and the two years immediately before that, counting:
   (i) all the days the individual was present in the current year;
   (ii) one-third of the days the individual was present in the first year before the current year; and
   (iii) one-sixth of the days the individual was present in the second year before the current year.

Given the above test, a good ‘rule of thumb’ is that an alien individual will not become a US resident as long as he or she does not spend more than 120 days in the US during every calendar year.

There are certain exemptions to the substantial presence test that may be applicable even if an individual stays in the US beyond the threshold amount of time.

1. Exempt visa: A foreign national in the US on an exempt visa (a foreign government-related individual, teacher or trainee, student or professional athlete temporarily in the US to compete in certain charitable sports events) will not have his or her days counted for the purpose of the substantial presence test while such an entry visa is active.

2. Medical exception: Days that a foreign national intended to but was unable to leave the US due to medical reasons are not counted for the Substantial Presence test. Such medical reasons must have arisen while in the US (or the foreign national must not have had knowledge if the condition was pre-existing upon entry into the US) and the foreign national must not stay in the US beyond a reasonable time for making arrangements to leave once treatment is completed.

3. Closer connection: If a foreign national can demonstrate a closer connection to a country other than the US (ie, (1) in the US for fewer than 183 days in the current year; and (2) demonstrates a tax home outside the US and a closer connection to that country), then he or she may not be a US resident alien despite meeting the substantial presence test. This exception is inherently subjective and based on a totality of the facts, which examines a non-exclusive list of factors, such as the location of personal belongings, primary residence, and family, social, political, economic, cultural and religious affiliations. An individual claiming the closer connection exception must file Form 8840, Closer Connection Exception Statement for Aliens. Form 8840 must be filed by the due date (with extensions) of Form 1040NR and attached thereto, where applicable.

4. Treaty override: Even if an individual would be a US income tax resident under the substantial presence and does not qualify for the closer connection or medical exceptions, it is still possible that the individual may take the position that he or she is a non-resident under a relevant income tax treaty. US income tax treaties generally apply a set of tie-breaker rules to determine residency status for an individual who meets the residency requirements of both the US and a foreign jurisdiction. For example, under the US–UK Income Tax Treaty:[10]

    - the individual must be considered a tax resident of both countries. If the individual has a permanent home in both the US and the treaty country, he or she will be deemed a resident of the country where his or her personal and economic relations are closer (his or her 'centre of vital interests'). Generally, an individual's personal and economic relations are based on the location of the individual's family and social relations, cultural and political activities, and the place of occupation, business and administration of property. If the location of the individual's centre of vital interests cannot be determined, an individual will be considered to be a resident of the country in which he or she has a habitual abode (ie, spends the majority of his or her time). If the individual has a habitual abode in both countries or in neither of them, he or she shall be deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or neither of them, the competent authorities of the two countries will settle the question by mutual agreement.

    To be considered a non-resident of the US under a treaty, the individual must timely file Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b). An individual that is a dual-resident may take a position under the treaty to be treated as a US resident for part of the year and non-resident for the remainder. It is possible for a US green card holder that is living outside the US to make a treaty election to be considered a non-resident for income tax purposes; however, it is important to consider the ramifications of such an election for immigration purposes.

2. Domicile for transfer tax purposes

US citizens and US non-citizen residents (as determined for transfer tax purposes) are subject to US transfer tax rules on their entire estates, even if they also reside in another jurisdiction. The test for determining whether a non-US citizen is considered a resident of the US for transfer tax purposes is a subjective test that takes into account various facts and circumstances. The US Treasury Regulations provide that a resident for estate tax purposes is someone who was domiciled in the US at the time of his or her death. Specifically, the Treasury Regulations state that '[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' and that '[r]esidence 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'.[11]

As a result, the Internal Revenue Service considers the following factors in determining domicile:

- duration of the person's stay in the US compared to other countries;
- size and value of the person's houses and whether those houses are owned or rented;
- area in which the person's houses are located;
- location of the person's expensive and important personal belongings;
- location of the person's family and close friends;
- places where the person maintained church and club memberships and participated in the community;
- location of the person's business interests;
- declarations of residence/intent by the person on visa applications, wills and so on, and the person's visa status;
- where the person is registered to vote, maintains a driver's licence and so on; and
- motivation of the person in selecting a place to live.[12]

Further, the US has entered into estate tax treaties with certain countries that govern the determination of a decedent's domicile if he or she resided in both the US and the treaty county, and which, in some cases, serve to reduce double taxation on death.

B. Gift, estate and inheritance taxes

1. Gift tax

The US applies gift tax to all gratuitous lifetime transfers from a US citizen or US gift tax resident. A US gift tax resident is an individual domiciled in the US. A US citizen or US gift tax resident is entitled to a unified lifetime estate and gift tax credit currently equal to a $13.61m exemption.[13] In addition, gifts of up to $18,000 per year per donee, and certain gifts for educational and medical expenses are excluded from gift tax.

Gratuitous transfers from individuals who are not US gift tax residents are not subject to US gift tax unless the transferred property is a US situs asset (eg, US real estate and tangible personal property located in the US). Gifts to spouses who are US citizens are exempt from gift tax. Gifts to non-citizen spouses of less than $185,000 per year are excluded from US gift tax.[14] Transfers to charity may also qualify for a deduction from US gift tax.

Gift tax is currently assessed at a maximum rate of 40 per cent and is payable by the individual making the gift. As referenced above, US citizens and US gift tax residents are entitled to a lifetime exemption of $13.61m; specifically, such individuals are entitled to a unified estate and gift tax credit, which results in an exemption amount equal to $13.61m. The lifetime exemption amount applies against an individual's cumulative transfers subject to US gift and estate tax.

2. Estate tax

The US applies estate tax to a US citizen's or US estate tax resident's worldwide assets, which constitute their 'gross taxable estate'. A US estate tax resident is a person who is domiciled in the US. As noted above, the unified estate and gift tax credit applies to a US citizen or estate tax resident's estate: $13.61m as of 2024.[15]

The estate of a non-US estate tax resident is only subject to US estate tax on US situs assets. US situs assets, for estate tax purposes, include US real property, tangible personal property located in the US and intangible property located in the US. Intangible property located in the US includes the stock of US corporations. A non-US estate tax resident is entitled to a US estate tax credit equal to $60,000 exemption (this amount is not indexed for inflation).

Transfers at death to a US citizen spouse are not subject to US estate tax. Transfers to a non-citizen spouse are subject to US estate tax unless the transfer is made to a qualifying domestic trust ('QDOT'). In order for a transfer to a QDOT to qualify for the marital deduction, the QDOT must satisfy the following requirements:

- the laws of a US state or the District of Columbia govern its administration;
- have terms that qualify it as a power of appointment trust, a qualified terminable interest property trust ('QTIP'), qualified CRT or estate trust;
- require at least one trustee to be a US citizen or US corporation; if the assets of the QDOT exceed $2,000,000, that trustee must be a bank or must furnish a bond or letter of credit;
- income from the QDOT must be paid to the surviving spouse; and
- no distributions (except distributions of income) may be made from the trust, unless the trustee has the right to withhold estate tax.

Distributions of principal during the non-US citizen spouse's life (and any remaining principal at his or her death) are subject to US estate tax as though they had been included in the deceased spouse's estate. Thus, a QDOT does not eliminate estate tax; it simply defers its application until the surviving spouse's death.

Transfers to charity, whether US or foreign, may qualify for a charitable deduction. Estate tax is imposed at a maximum rate of 40 per cent. As noted above, US citizens and domiciliaries are entitled to a lifetime exemption of $13.61m (for 2024) against gift and estate taxes. Thus, the portion of an individual's lifetime exemption not used by *inter vivos* gifts is applied against his or her estate tax liability. To the extent that an individual's lifetime gifts and gross estate are less than his or her lifetime exemption at his or her death, the unused portion is 'portable' to a surviving spouse to be used against his or her estate or gift tax liabilities.

3. GST

The US also imposes an additional tax called the GST on lifetime and testamentary transfers to individuals more than one generation removed from the transferor. The rules refer to such a transfer as a 'skip' and GST tax is imposed on transfers to an individual who is two or more generations below the donor. 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 GST tax generally is aligned with the reach of gift and estate tax. Thus, a transfer by a non-US domiciliary of non-US situs property is not subject to GST tax because it is not subject to US gift or estate tax.

US citizens and domiciliaries also have a lifetime exemption against GST tax equal to $13.61m;[16] although, this exemption is separate from the gift and estate exemption amount. GST tax is imposed at a rate of 40 per cent on GST that exceeds $12.92m (or the excess over an individual's remaining GST exemption amount).

Transfers by non-gift and estate tax residents are currently only subject to GST tax if the transfer would have been subject to US gift or estate tax.

4. Special expatriation rules

The US imposes an 'exit tax' on individuals who meet certain tests; specifically, individuals that are US citizens relinquishing US citizenship or who have been long-term permanent residents. Long-term permanent residents are defined as individuals that have held a permanent resident visa (ie, green card) in eight of the past 15 years. Notably, a full year is counted towards this test if an individual is considered a permanent resident for a single day of the year. Such individuals are collectively referred to as 'covered expatriates' if they also meet the requirements described below.

'Covered expatriates,' include US citizens and long-term green card-holding permanent residents (as defined for purposes of the test) who meet one of the following tests, and are subject to a special expatriation tax regime:

- the individual has a net worth of $2,000,000 or more;
- the individual's average US federal income tax liability for the previous five tax years exceeds $201,000 in 2024; or
- the individual fails to certify compliance with his or her US federal tax requirements for the previous five tax years.

The US imposes a mark-to-market (MTM) exit tax regime on covered expatriates, which generally provides that a covered expatriate is deemed to have sold his or her worldwide assets for a fair market value the day before their expatriation. Any gain arising from the deemed sale would then be taxable income payable to the US to the extent that the gain exceeds $866,000.[17] Additionally, gifts or bequests to US persons from covered expatriates are subject to 40 per cent tax.

C. Taxes on income and capital

1. US citizens and resident aliens

US citizens and residents are subject to US federal income tax on their worldwide income, which includes compensation for services (including fees, commissions, fringe benefits and similar items), capital gains, interest, rents, royalties, dividends, annuities, certain business income and distributions from trusts, partnerships, corporations and other entities. The US tax code provides a number of statutory exclusions, credits and deductions against income.

The US also imposes two primary anti-deferral regimes on US citizens and residents. Specifically, those are the controlled foreign corporation (CFC) and passive foreign investment company (PFIC) regimes. In general, shareholders are not taxed on a corporation's earnings until such earnings are distributed. However, the anti-deferral rules contained in the CFC and PFIC regimes can override this rule, and cause US owners of foreign corporations, including US beneficiaries of foreign trusts that own foreign corporations, to be taxed on corporate earnings, even if they are not distributed (or at more punitive rates).

i. CFC rules

A foreign corporation is treated as a CFC if more than 50 per cent, by vote or value, of its stock is owned by US shareholders. For the purpose of the CFC rules, a US shareholder is a US person (or tax resident) who owns at least ten per cent of the total combined value or voting power of all classes of stock in the CFC.

If the corporation is a CFC during any part of the taxable year, each US person who is a US shareholder (greater than ten per cent owner) on the last day of the CFC's taxable year will have to include in his or her income his or her pro rata share of the CFC's 'Subpart F' income and global intangible low-taxed income (GILTI), each discussed briefly below.

a. Subpart F

Generally, Subpart F income includes most types of passive investment income and certain types of related party sales and services income, with carve-outs for certain *de minimis* amounts and 'high-taxed' income. Passive income caught by the Subpart F regime is generally part of what is called foreign personal holding company income (FPHCI). FPHCI includes, among other things, dividends, interest, royalties, rents, annuities, gains from the sale or exchange of certain types of property, gains from commodities, foreign currency gains, profits from the certain purchases and sales of certain types of personal property, and income from the performance of certain services for or on behalf of a related person outside the CFC's country of incorporation.

b. GILTI

GILTI, a new regime introduced as part of US tax reform in 2017, generally forces a taxpayer to pick up that income not already considered to be Subpart F, providing for certain deductions and reduced tax credits. Under the GILTI regime, a US shareholder of one or more CFCs is taxed on the excess of: (1) the CFCs' modified gross income (excluding certain items, eg, Subpart F Income); over (2) a benchmark return of ten per cent of the CFCs' adjusted bases in depreciable tangible property placed in service (with certain adjustments for interest income and expense).

ii. PFIC rules

The second anti-deferral regime applicable to foreign companies owned by US citizens and residents is the PFIC regime. The PFIC rules were enacted to eliminate beneficial treatment for certain offshore investments. Prior to enactment of these rules, individuals could defer income from their offshore investments, recognising gain at long-term capital gains rates upon sale.

A PFIC is a foreign-based corporation that satisfies one of two tests: (1) at least 75 per cent of the company's income is derived from passive sources instead of the company's regular business (ie, interest, dividends, royalties, etc); or (2) at least 50 per cent of the company's assets are investments that produce passive income, such as interest, dividends and capital gains, which could also include cash and other working capital accounts. Unless certain elections (outlined below) are made, gains from the disposition of a PFIC are taxed as ordinary income and potentially subject to an interest charge.

Annual distributions from PFICs that exceed 125 per cent of a three-year trailing average (referred to as 'excess distributions') are subject to an interest charge, and dividends received from a PFIC are not eligible for qualified dividend rates. This means that, unless one of the below elections is made, dividends from PFICs are not eligible for reduced capital gains rates. Where a distribution is deemed to be an excess distribution, it is subject to a punitive tax and interest regime similar to the throwback tax regime applicable to distributions to US beneficiaries of foreign non-grantor trusts (as discussed above).

The available elections that may minimise the adverse impact of the PFIC rules are as follows.

a. Qualified electing fund (QEF) election

Taxpayers can generally avoid the application of the PFIC rules by making a QEF election. If a timely QEF election is made, the electing US shareholder must take into account, in each taxable year, his or her pro rata share of the PFIC's ordinary income and net capital gains for the year, regardless of whether such income and gains are distributed to the shareholder. Where a taxpayer immigrates to the US while owning a PFIC, the taxpayer will generally maintain his or her existing basis in the shares of the PFIC, unless he or she takes some action to step-up the basis in his or her shares prior to arrival. A timely made QEF election allows the taxpayer to avoid the interest charge and excess distribution rules, recognise capital gains on the subsequent sale of PFIC stock, and take advantage of capital gains recognised by the PFIC. However, a taxpayer that makes the QEF election will face current taxation on income generated by the PFIC, whether it is distributed or not.

Note, often the QEF election is not available because the PFIC may be unwilling or unable to provide the necessary record keeping information to the shareholder. A QEF election requires the taxpayer to obtain enough information annually from the PFIC (financial statements, etc) to calculate the impact of the election.

b. MTM election

The MTM election allows the PFIC shareholder to pay tax on the gains of the PFIC's underlying assets each year to avoid paying tax and interest on a deemed excess distribution. The MTM election is generally made to avoid having future distributions from the PFIC deemed excess distributions.

Where a taxpayer immigrates to the US while owning an asset (typically a foreign investment fund) that is considered a PFIC, and the taxpayer makes an MTM election, he or she would not immediately recognise all the built-in gain. Instead, the taxpayer would begin to separately track his or her initial basis in the stock (necessary for a later sale) and his or her deemed PFIC basis (necessary to compute the annual MTM inclusion), which is the value of the shares at the time US residency begins. In each subsequent year, the taxpayer MTMs the shares, and recognises the gain, if any, of the shares' fair market value over the deemed PFIC basis. Any amounts that are subject to tax are then added to the taxpayer's initial basis so that when the shares are eventually sold, the shareholder is not taxed on the same appreciation twice.

The MTM election is only available for stock that is regularly traded on a qualified exchange (eg, stock that is publicly traded). The regulations stipulate that to make the MTM election, the shares of the PFIC must be traded on an exchange that is essentially equivalent to the New York Stock Exchange. Thus, investment funds only available through private placements may not qualify for the election.

2. NON-RESIDENT ALIENS

An individual that is not a US citizen is either considered a resident alien (due to residency tests outlined above), and therefore subject to US federal income tax on worldwide income on a net basis (ie, after allowing for deductions against gross income) or a non-resident alien, and therefore only subject to income tax from income considered to be 'sourced' in the US. Such income generally includes three types of income: (1) fixed, determinable, annual or periodical ('FDAP') income; (2) income that is effectively connected with a trade or business in the US ('ECI'); and (3) gains from the sale of real property located in the US, which is treated as ECI under the Foreign Investment in Real Property Tax Act of 1980 ('FIRPTA').

FDAP income generally includes US source dividends, interest, rents, royalties and other portfolio income, as well as certain service income. FDAP income is subject to a 30 per cent withholding tax on the gross amount of income (unless reduced by treaty).

ECI is taxed on a net basis at the individual and corporate graduated tax rates. As of 2024, the top marginal tax rate for individuals is 37 per cent.[18]

3. US TAX REPORTING

A general discussion of US tax reporting obligations is beyond the scope of this discussion; however, there are several forms that are relevant to the international client and practitioner that arise frequently and carry substantial penalties as a result of delinquent filings.

The following are international reporting forms that US citizens and residents with assets outside the US (or non-US persons transferring assets to US persons) should be aware of:

- FinCEN Form 114, Report of Foreign Bank and Financial Accounts ('FBAR'): A US person that has a financial interest or signature authority over foreign bank accounts, securities accounts or other financial accounts must file an FBAR with respect to such accounts if the aggregate value of all such accounts exceeds $10,000 at any time during the calendar year;

- Form 8938, Statement of Specified Foreign Financial Assets: Generally, US persons must report their interests in certain specified foreign financial assets, including financial accounts at foreign financial institutions, stock in non-US corporations, ownership of foreign trusts, beneficial interests in non-US estates and interests in non-US business entities (among other financial assets);

- Form 5471, Information Return of US Persons with Respect to Certain Foreign Corporations: There are several categories of US persons required to file Form 5471; generally, US taxpayers with a greater than ten per cent interest in a foreign corporation should evaluate their filing obligation. Indirect attribution rules must also be considered. US beneficiaries of non-US trusts may be required to file this form in certain circumstances, despite the lack of a direct interest in the entity; and

- Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund: Form 8621 is used to report interests in PFICs. Individuals immigrating to the US should be aware that this form is likely to be required if they hold foreign mutual funds (or similar collective investment vehicles) upon beginning their residency in the US.

D. Tax treaties

The US has entered into numerous income tax, estate and gift tax treaties with other countries in order to prevent double taxation. These treaties can significantly modify the way in which the US tax rules apply to a non-resident individual or entity.

The US has also entered into numerous intergovernmental agreements pursuant to the Foreign Account Tax Compliance Act (FATCA), whereby the US collects information about financial accounts held by US persons.

Notes

[1] Code s 7701(a)(30)(E).
[2] Treas Reg s 301.7701-7(c)(3)(iii).
[3] Treas Reg s 301.7701-7(d)(1)(iii).
[4] There are additional exceptions for compensatory trusts and grandfathered trusts. See Code s 672(f)(2)(B) and Treas Reg s 1.672(f)-3(a) and (b).
[5] 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.
[6] See Code s 672(f)(2)(A)(i) and Treas Reg s 1.672(f)-3(a)(1).
[7] Code s 672(f)(2)(A)(ii).
[8] Code s 6048(c)(2).
[9] There is a complicated penalty computation that depends on whether the failure to file an FBAR was wilful or non-wilful.
[10] Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains (as amended to 2002) ('US–UK Income Tax Treaty').
[11] Treas Reg s20.0-1(b)1.
[12] This list of factors is in no particular order and is not exhaustive.
[13] 2024 amount; amount is indexed for inflation.
[14] 2024 amount; amount is indexed for inflation.
[15] This amount is set to revert to pre-2017 levels, approximately $6m, beginning 1 January 2026.
[16] 2024 amount; amount is indexed for inflation.
[17] 2024 amount; amount is indexed for inflation.
[18] Prior to 2017, the top marginal was 39.6 per cent, not including the 3.5 per cent net investment income tax (NIIT). The top rate was reduced to 37 per cent by the Tax Cuts and Jobs Act (the 'TCJA') of 2017. The maximum rate is currently set to go back to 39.6 per cent in 2026.