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U.S. Tax Planning for Non-U.S. Persons, Assets and Trusts

An Introductory Outline

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Estate planning for non-U.S. persons differs from domestic planning, not only in the specific rules that apply but also in the outlook that the planner must bring to the process. Put simply, in planning for a U.S. person, we begin with the assumption that all income and assets are subject to U.S. income, estate and gift taxes, and we then hunt for exceptions (e.g., municipal bond interest, charitable deductions, the estate tax marital deduction) that will shelter some income and assets from these taxes. On the other hand, in planning for a non-U.S. person, our starting point is that income, and assets generally will not be subject to U.S. tax without some kind of link or nexus to the U.S. (e.g., U.S. source income, U.S. situs assets). The planner's job in that case is to keep an eye out for pitfalls that may create exposure to such taxes – for example, a client inadvertently becoming a U.S. tax resident or directly holding U.S. situs assets.

The following is an introductory outline of the rules that apply in estate and tax planning for non-U.S. persons and trusts. It is not intended to be the exhaustive word on the subject –volumes are required for that task – but it is meant to serve as a general guide.

I. BASIC RULES

The following are the basic rules of international estate planning:

- U.S. persons are subject to U.S. income taxation on their worldwide income. (Internal Revenue Code [IRC] §§ 1, 61)
- Individuals who are U.S. persons are also subject to estate, gift and generation-skipping transfer taxes on their worldwide assets. (IRC §§ 2001, 2031-2046, 2601)
- Non-U.S. persons are subject to U.S. income tax only on their U.S. source income, including income that is effectively connected with a U.S. trade or business. (IRC §§ 871-875)
- Individuals who are non-U.S. persons are subject to estate, gift and generation-skipping transfer taxes only on U.S. situs assets. (IRC §§ 2001-2106, 2501, 2652)

We elaborate on these rules in the following sections.

II. WHO IS A U.S. PERSON?

A. Individuals, Corporations and Trusts. The term "U.S. person" includes U.S. individuals as well as domestic corporations, partnerships, trusts and estates. (IRC § 7701(a)(30))

B. When Is an Individual a U.S. Person? An individual is a U.S. person if he or she is either:

- a U.S. citizen, regardless of residence, including a dual citizen of the United States and one or more other countries; or

- a U.S. resident, regardless of citizenship.

C. Who Is a U.S. Resident?

1. ***Income Tax Resident:*** A resident for income tax purposes is:

(a) A green card holder (or other lawful permanent resident). (IRC § 7701(b)(1)(A)) There are special rules for the first and last years of lawful permanent residence. For the first year, if the individual was not a resident in the prior calendar year, the individual is treated as a resident only for the portion of the year starting when the residence began, i.e., when he or she was first physically present in the United States with a green card or if he or she was not present in the U.S. that year, then in the first day of the next calendar year. (IRC § 7701(B)(2)(A)) For the last year of residence, if an individual turns in his or her green card and leaves the United States, is not a U.S. resident in the following year, and has a closer connection to another tax jurisdiction, he or she will be a U.S. income tax resident for only the portion of the year that he or she was a cardholder. (IRC § 7701(b)(2)(B)) (There are special rules for "longterm residents" who give up their green cards, discussed infra.)

(b) Under the "substantial presence" test, a person is a U.S. resident for a given calendar year if (i) he or she is present in the United States for at least 31 days of that year, and (ii) the total of the days he or she is present in the United States during the current tax year, plus one-third of the days present in the previous year, plus one-sixth of the days present in the second previous year, equals 183 days or more on a weighted basis. (A person who is never in the United States for more than 121 days per year will not exceed this figure.) (IRC § 7701(b)(3)(A))

Exceptions:

(a) The following are not considered U.S. residents, regardless of the number of days spent in the United States: full-time students, teachers and trainees (for a limited time), individuals holding diplomatic visas, and employees of international organizations. (IRC § 7701 (b)(5)(A))

(b) A person who is present in the United States for fewer than 183 days in the calendar year, but whose three-year weighted total is greater than 183 days, can avoid U.S. resident status by timely filing an IRS Form 8840 with the Internal Revenue Service (IRS) and demonstrating that he or she has a tax home in and a "closer connection" to a foreign country. (IRC § 7701(b)(3)(B))

(c) Treaties with some countries contain "tiebreaker" provisions to resolve the issue of residence for a person who would otherwise be treated as a resident of both of the treaty countries. A taxpayer generally would file an IRS Form 1040NR nonresident return along with a Form 8833 to claim the applicable treaty exemption.

2. ***Estate and Gift Tax Resident:*** A U.S. resident for estate and gift tax purposes is a person whose primary residence, or domicile, is in the United States. This means that the person lives in the United States and has no definite present intent to leave, as shown by the surrounding facts and circumstances. (Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-(1)(b))

   Because a "bright line" test applies for income tax purposes and a "facts and circumstances" test applies for estate and gift tax purposes, it is possible for an individual to be a U.S. resident for purposes of one tax and not the other.

D. What Constitutes a Domestic Corporation? A corporation that is organized or created in the United States. (IRC § 7701(a)(4)) It does not matter where the directors reside or meet or where the corporation's assets are located.

E. What Constitutes a Domestic Partnership? A partnership that is organized or created in the United States, unless the Treasury provides otherwise by regulations. (IRC § 7701(a)(4)) As with a corporation, it does not matter where the directors reside or meet or where the corporation's assets are located. However, because the income of a partnership is generally taxable to its partners on a pass-through basis, the residence of a partnership generally will not be determinative of how its income is taxed. Further, the location of its assets and activities may be relevant to the determination of situs for estate tax purposes.

F. What Constitutes a Domestic Trust? Under IRC §§ 7701(a)(30)(E) and (31)(B), *every* trust is a foreign trust unless both of the following requirements are satisfied:

1. A U.S. court can exercise *primary* supervision over the administration of the trust.

2. One or more U.S. persons have the power to control *all* substantial decisions of the trust.

Under Treas. Reg. § 301.7701-7, the "United States" refers only to the 50 states and the District of Columbia.

If a person other than a trustee (such as a protector) has the power to control substantial decisions, that person's powers will be counted for purposes of the control test. Powers exercisable by a grantor or a beneficiary, such as a power to revoke or a power of appointment, also will be considered in determining substantial control.

The Treasury regulations provide a nonexclusive list of "substantial decisions," which include:

- Whether and when to distribute income or corpus.

- The amount of any distribution.

- The selection of a beneficiary.

- The power to make investment decisions; however, if a U.S. person (trustee, protector, etc.) appoints a foreign investment advisor and can remove that advisor, the appointment of the foreign advisor will not make the trust foreign.

- Whether a receipt is allocable to income or principal.

- Whether to terminate the trust.

- Whether to compromise, arbitrate or abandon claims of the trust.

- Whether to sue on behalf of the trust or to defend suits against the trust.

- Whether to remove, add or name a successor to a trustee, provided, however, that the power solely to name a successor will not be considered a substantial decision if it is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic or vice versa.

This definition is heavily tilted toward a conclusion that a trust is foreign. For instance, if a New York resident creates a testamentary trust for his or her New York resident children by his or her will probated in New York, with a New York bank and, say, an Irish cousin as trustees, and if principal distributions to the children can be made only by majority vote of the trustees, the trust is a foreign trust, since substantial decisions

are not controlled by the U.S. fiduciary. Even if the New York bank is the sole trustee, the trust still would be a foreign trust if the Irish cousin had control over one or more substantial decisions of the trust, such as the power, as protector, to remove and replace the trustee.

There are a few safe harbors and relief provisions for retaining U.S. trust status:

- A trust is automatically considered a domestic trust if it is administered exclusively in the United States, has no provision directing administration outside the United States and has no automatic change-of-situs clause (except in case of foreign invasion or widespread confiscation of assets in the United States).

- Relief is available for situations where an inadvertent change of control would otherwise result in the trust becoming a foreign trust. If a vacancy occurs through the death or sudden resignation of a trustee that would shift control of a substantial decision out of the hands of U.S. trustees, the trust has 12 months to reassert U.S. control by either a change of fiduciaries or a change of residence of a fiduciary. If such a change is made within 12 months, the trust will be treated as having remained a U.S. trust; if no such change is made, the trust will have become a foreign trust on the date the vacancy occurred.

G. **What Constitutes a Domestic Estate?** The residence of an estate is determined based on all facts and circumstances, including the situs of domiciliary administration, the primary location of the major assets held in the decedent's estate, the nationality and residence of the fiduciaries administering the estate, and the extent of their activities in the United States and other countries. There is no bright-line test for determining the residence of an estate. For example, it is possible for the estate of a U.S. citizen or domiciliary to be considered a foreign estate for federal income tax purposes, and it is possible for the estate of a non-U.S. decedent to be considered a U.S. estate. (Rev. Rul. 81-112)

III. TAXATION OF NON-U.S. PERSONS

Persons who are neither U.S. citizens nor U.S. residents (nonresident aliens, or NRAs) are subject to U.S. taxes as follows:

A. **Income Tax:** NRAs are subject to U.S. income tax only on (1) U.S. source "fixed, determinable, annual, or periodical income," which generally is subject to withholding at a 30 percent rate on a gross basis (with no offsetting deductions), and (2) income that is effectively connected with a U.S. trade or business ("effectively connected income"), which is taxed on a net basis at graduated rates.

U.S. Source Income for Income Tax Purposes (IRC § 871(a))

- Dividends from U.S. corporations, including U.S. mutual funds, but not the proceeds of the sale of most U.S. securities.

- Passive rent from U.S. real property.

- Interest on debts of U.S. obligors. However, interest on most publicly traded bonds issued after July 18, 1984 (and private debts in registered form), constitutes "portfolio interest" and therefore qualifies for the portfolio exemption and is not taxed as U.S. source income. (IRC § 871(h)) A similar exception applies to interest on U.S. bank accounts, including time deposits and certificates of deposit, which is not U.S. source income. (IRC § 871(i))

- U.S. royalties.

- Certain limited service payments.

Income Effectively Connected With a U.S. Trade or Business (IRC § 871(b))

NRAs are subject to income tax at the same graduated rates as U.S. persons on their income earned in connection with the conduct of a trade or business in the United States. (IRC § 871(b)) In most cases, this will include wages and other compensation paid for services performed in the United States. This also includes rental income from actively managed properties and passive rental income if the taxpayer makes an election to treat the passive rent as effectively connected income. (IRC § 871(d))

Gains from the sale of interests in U.S. real property, including stock of U.S. real property holding corporations and certain partnerships that hold U.S. real property, are taxed as effectively connected income under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). (IRC § 897) Subject to certain exceptions, buyers of U.S. real property interests are required to withhold 15 percent of the consideration paid to a non-U.S. seller. (IRC § 1445)

A foreign partner of a U.S. or foreign partnership that itself is engaged in a U.S. trade or business will be deemed so engaged through the partnership and will be subject to federal and possibly state return filing obligations. The partnership may be subject to withholding obligations with respect to U.S. source earnings allocated to its foreign partners. (IRC § 1446) Further, the disposition of an interest in a partnership by a non-U.S. person may be taxable under IRC § 864(c)(8) and subject to withholding under IRC § 1446(f) if the partnership is engaged in a U.S. trade or business.

Treaties

Income tax treaties between the United States and other countries can alter these rules, including by reducing withholding rates and making outright exemptions on certain types of income.

B. Estate Tax: Estates of NRAs are subject to U.S. estate tax only on U.S. situs assets. The tax is assessed at the same rates as for U.S. citizens, up to 40 percent, but with only a $60,000 exemption (as opposed to the 2024 exemption of $13.61 million for a U.S. person). (IRC § 2106 (b))

Worldwide debts and administration expenses may only be deducted if the worldwide estate is disclosed and only in the proportion that the U.S. assets bear to the decedent's worldwide assets. (Nonrecourse debts are allocated to the properties they secure, but

most commercial lenders prefer a choice of remedies in the event of default, including imposition of personal liability against the borrower, so most third-party loans will be considered recourse debts for this purpose.)

The unlimited marital deduction is only available if the surviving spouse is a U.S. citizen; otherwise, the assets must be left to a qualified domestic trust in order to obtain the deduction (see Section VIII (B) below). The charitable deduction is available only for bequests to U.S. charities, with the exception of trusts that are required to use the funds within the United States.

U.S. Situs Assets (and Exceptions) for Estate Tax Purposes (a Partial List)

- Real property situated in the United States, including houses and condominiums. (Treas. Reg. §§ 20.2104-1(a)(2); 20.2105-1(a)(2))

- Tangible personal property, such as jewelry, antiques, artworks and cars, situated in the United States, unless the items are in transit or on loan for an exhibition at a museum. (Treas. Reg. §§ 20.2104-1(a)(2); 20.2105-1(a)(2))

- Shares of stock of U.S. corporations, including shares of a U.S. cooperative corporation representing a co-op apartment. (IRC § 2104(a)) The location of the certificate and the custody account and the situs of the underlying assets are immaterial. Conversely, shares of non-U.S. corporations are not U.S. situs property even if such corporations hold U.S. situs assets.

- Mutual funds, including money market funds, organized in corporate form are U.S. situs property if incorporated in the United States, regardless of the situs of the underlying assets. (IRC § 2104(a)) If the fund is structured as a grantor trust, the situs of the fund depends on the situs of the underlying assets of the fund.

- The situs rules are less clear for partnerships, which are not addressed in the Internal Revenue Code or the Treasury regulations. Some older authorities suggest one would look to the underlying assets or where the partnership conducts its business, if any, while other authorities suggest one might look to where the partnership is organized. One may generally assume that interests in limited or general partnerships organized in the United States are likely U.S. situs assets, but the law is not settled regarding the situs of interests in foreign partnerships that either do business in the United States or own assets in the United States.

- Cash deposits with U.S. brokers, money market accounts with U.S. mutual funds and cash in U.S. safe deposit boxes are U.S. situs property. (IRC § 2104(c))

- Debts of U.S. obligors. Once again, however, publicly traded bonds and registered private debt issued after July 18, 1984, qualify as "portfolio debt" and therefore are not subject to U.S. estate taxation if owned by an NRA

decedent, provided the decedent was also an NRA for income tax purposes. (IRC § 2105(b)(3))

Life insurance proceeds paid by a U.S. insurer on the life of a non-U.S. person are not U.S. situs property. However, the cash surrender value of life insurance owned by a non-U.S. person on the life of another person is U.S. situs property if issued by a U.S. insurer. (Treas. Reg. § 20.2105-1(g))

- Bank accounts maintained with U.S. banks are not U.S. situs property; this includes checking and savings accounts, time deposits, and certificates of deposit. (IRC § 2104(c))

Again, treaties with various countries can alter these rules, particularly as to whether U.S. stocks owned by a citizen and resident of another country will be taxed by the United States.

Basis Step-Up at Death (IRC § 1014)

Under IRC § 1014(a), the basis of property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent is stepped up or down to fair market value at the time of death.

- Non-U.S. situs property held by an NRA at death is eligible for a basis step-up (or step-down) under this provision even though it is not subject to estate tax. (Rev. Rul. 84-139)

- Property that is otherwise includable in the decedent's taxable estate (for example, U.S. situs assets held in a trust settled by an NRA with certain "retained strings") is eligible for a basis adjustment at death even if such property does not pass by bequest, devise or inheritance. (IRC § 1014(b)(9))

- Property transferred in trust that is not otherwise includable in the decedent's taxable estate (for example, non-U.S. situs assets held in a trust settled by an NRA) is eligible for a basis adjustment at death only if certain delineated powers are retained by the decedent during his or her lifetime. (IRC § 1014(b)(2)-(3))

C. Gift Tax: NRAs are subject to gift tax only on gifts of U.S. situs real property and tangible personal property. The annual exclusion of $18,000 for gifts of a present interest may apply; however, the $60,000 credit afforded to NRAs for estate tax purposes may not be applied to gifts. Gifts of shares of stock of U.S. corporations are not subject to U.S. gift tax even though they have a U.S. situs for estate tax purposes, because the gift tax does not reach gifts of intangible property by NRAs. However, gifts of cash that take place within the United States, possibly including checks drawn from a U.S. account, may be subject to gift tax; therefore, any gifts of cash by a non-U.S. person to a U.S. person should be made outside the United States. (IRC §§ 2501(a)(3); 2511(b))

D. Reporting of Gifts by NRAs to U.S. Persons: Any U.S. person who receives "large gifts" (more than $100,000) from a non-U.S. individual during any calendar year must file a report describing these gifts with his or her income tax return the following April 15. (IRC § 6039F; IRS Form 3520) No tax is owed by the donor or the donee unless the gifts are of real or tangible property situated in the United States or the donor is a "covered expatriate," discussed infra.

The term "gifts" includes bequests from estates of non-U.S. individuals. (IRC § 6039F(b)) Qualified medical or educational payments under IRC § 2503(e) are not considered gifts and are not subject to reporting.

In determining whether a U.S. person has received gifts in excess of $100,000 during the taxable year from a particular foreign donor, the U.S. donee must aggregate gifts from foreign persons that he or she knows or has reason to know are related, within the meaning of IRC § 643(i)(2)(B). For instance, if an NRA mother and father each give their U.S. son $60,000, the gifts are aggregated, the $100,000 reporting threshold is exceeded and the son must report both gifts. Once the $100,000 threshold has been crossed, the donee must separately identify each gift in excess of $5,000.

A U.S. person is required to report the receipt of purported gifts from foreign corporations and foreign partnerships if the aggregate amount of purported gifts from all such entities exceeds $10,000 in any year. This threshold is indexed for inflation and is presently $19,570. The use of the word "purported" gives an indication that the IRS may recharacterize those gifts from entities as taxable income to the U.S. recipient. (IRC § 672(f)(4))

The form used to report gifts from foreign persons (Form 3520) asks for a brief description of the property received as a gift; whether the foreign donor is an individual, corporation, partnership or estate; and whether the foreign donor was acting as a nominee or intermediary for another person. The form does not ask for the identity of a foreign individual donor, although the IRS could request this information.

While there is no tax on non-U.S. situs gifts from foreign persons, the penalty for failure to report the gifts is severe. If a gift is not reported on Form 3520, the tax consequences of the receipt of the gift shall be determined by the IRS. (IRC § 6039F(c)(1)(A)) In addition, the recipient is subject to a penalty equal to the greater of $10,000 and 5 percent of the value of the gift for each month in which the gift is not reported, but the penalty is not to exceed 25 percent. (IRC § 6039F(c)(1)(B)) The penalties can be waived if the failure to file was due to reasonable cause and not willful neglect. Ignorance of the law is not reasonable cause.

E. Generation-Skipping Transfer Taxes: A transfer by an NRA will be subject to generation-skipping transfer (GST) tax only if it is also subject to U.S. estate or gift tax, which will be the case only if it consists of U.S. situs property held by the NRA at death or of tangible property situated in the United States transferred during the NRA's lifetime. (Treas. Reg. § 26.2663-2)

F. Treaties: Income and estate tax treaties with individual countries may alter some of these rules, particularly as to determination of residence, source of income, situs of assets and income tax withholding rates. Some treaties give foreign residents an estate tax credit

amount greater than $60,000, such as a portion of the full U.S. unified credit based on the proportion of the decedent's assets located in the United States. Some treaties also give a marital deduction for bequests to a noncitizen spouse (up to a limit), and some exempt from estate tax shares of U.S. corporations held by residents of other countries. The United States generally enters into treaties with countries that have significant taxes of their own to help avoid double taxation. Therefore, if a treaty allows an NRA to reduce his or her U.S. tax liability, there usually will be an offsetting tax in the NRA's country of residence.

The United States never enters into a treaty that exempts U.S. citizens from worldwide income, estate, gift or GST taxation.

At present, the United States has estate tax treaties with the following countries:

Australia
Austria
Canada (Third Protocol to Income Tax Convention)
Denmark
Finland
France
Germany
Greece
Ireland
Italy
Japan
Norway
South Africa
Sweden*
Switzerland
The Netherlands
The United Kingdom

The estate tax treaties with the United Kingdom, France, Germany, Austria, Denmark and Sweden* are based on the unified system concept and, in consequence, cover taxes on gifts and GSTs as well as estate taxes.

The United States also has gift tax treaties with Australia, Austria, Denmark, France, Germany, Japan and the United Kingdom.

*The estate tax treaty with Sweden was terminated effective January 1, 2008, following the repeal of Sweden's inheritance tax in 2004.

IV. FOREIGN TRUSTS CREATED BY NRAs

A. Foreign Grantor Trusts: A foreign trust, like an NRA, generally is subject to U.S. income tax only with respect to U.S. source income (typically withheld at the source) and income effectively connected with a U.S. trade or business. However, distributions from the foreign trust to a U.S. person will carry out taxable income to that person, with adverse tax treatment of accumulated income, unless the trust qualifies as a "grantor trust" under U.S.

tax law. (IRC §§ 671-677) With a grantor trust, the person who funded the trust (the grantor) is treated as the owner of the income, even if distributions are made to someone else, and the beneficiaries are generally considered to receive tax-free gifts for income tax purposes. Therefore, a U.S. beneficiary of a foreign trust will greatly prefer that the trust be a grantor trust with an NRA individual as grantor.

Under the law in effect as of August 20, 1996, trusts settled by NRAs generally will not qualify as grantor trusts except under limited circumstances. (IRC § 672(f)(1)) If an NRA sets up a trust for the benefit of a U.S. person, the U.S. person will be taxed on the income received from the trust unless a grantor trust exception applies.

There are three relevant *exceptions* to the law, which permit the NRA to be the income tax grantor:

1. The grantor has the full power to revoke the trust without the consent of any person, or with the consent of a related or subordinate person who is subservient to the grantor. (IRC § 672(f)(2)(A)(i)) Upon the grantor's incapacity, his or her guardian or another person previously designated by him for this purpose must possess the power to revoke on his behalf in order for the trust to continue to qualify as a grantor trust.

2. The grantor and/or the grantor's spouse are the sole distributees of income or principal from the trust during the life of the grantor. (IRC § 672(f)(2)(A)(ii))

3. The trust was created on or before September 19, 1995, but only as to funds already in the trust as of that date, which must be separately accounted for, and only if the trust was a grantor trust pursuant to either IRC § 676 (concerning the grantor's power to revoke) or IRC § 677 (concerning the grantor's retained possibility of receiving income), but excluding IRC § 677(a)(3); income may be used to pay premiums on insurance policies on the grantor's life.

Once the NRA grantor dies, a foreign trust that previously qualified as a grantor trust under one of the exceptions no longer will be a grantor trust, and all income accrued after the grantor's death and distributed to the U.S. beneficiary will be taxed to him or her.

B. Foreign Nongrantor Trusts: Accumulations: One of the greatest disadvantages of a foreign nongrantor trust is the treatment of income that is accumulated in the trust and then distributed to a U.S. person in a subsequent year.

If a foreign trust falls into one of the above exceptions and so is a grantor trust, there is no accumulated income issue; any income accumulated in the trust may be added to the principal and distributed later without U.S. tax consequences.

If a foreign trust with U.S. beneficiaries does not fall within one of the exceptions and so is not a grantor trust, and if it distributes the current year's income, including capital gains, to a U.S. beneficiary in the same calendar year, the income is taxed to the beneficiary and retains its character as ordinary income or capital gains. For foreign trusts, realized capital gains are included in distributable net income (DNI).

Any distribution from a discretionary nongrantor trust to a beneficiary carries out with it DNI to the extent that the trust has income. It makes no difference that the trustee characterizes the distribution as one of corpus or of capital gains. (U.S. tax law differs from the tax law of the United Kingdom and many other countries in this respect.) If two beneficiaries receive distributions from the trust in the same calendar year, each is treated as receiving a proportionate share of the trust's DNI for that year. After all current income of the trust has been carried out to the beneficiaries, accumulated income will be carried out before further distributions are treated as distributions of corpus which are not taxed.

If a foreign trust accumulates income, the trust pays no U.S. income tax on that income other than withholding tax on U.S. source income paid to the trust or tax imposed on income effectively connected with a U.S. trade or business, and there is no U.S. income tax *currently* payable by any potential beneficiary on that income. However, the trust is building up undistributed net income (UNI), which will have negative tax consequences if it is distributed to a U.S. beneficiary in a future year.

When a foreign trust has UNI from prior years and it distributes an amount not exceeding the greater of the current year's DNI or fiduciary accounting income to the beneficiaries, including U.S. beneficiaries, the U.S. beneficiaries are taxed only on their share of the DNI. As previously noted, for foreign trusts (unlike domestic trusts), DNI includes realized capital gains, and the capital gains retain their character and are taxed at the lower capital gains rate, currently 20 percent.

When a foreign trust with UNI pays out to the beneficiaries in a calendar year an amount in excess of both the current year's DNI and the current year's fiduciary accounting income, UNI is carried out to the beneficiaries. Any amount distributed in excess of DNI in such case will carry out UNI. UNI paid to U.S. beneficiaries is fully subject to U.S. income tax and has the following additional negative consequences:

1. All capital gains realized by the trust in prior years that constituted part of the trust's DNI are now ordinary income, taxed at rates up to 37 percent.

2. An interest charge is imposed on the tax due by the beneficiary on the UNI from the date the income was originally earned by the trust. From 1996 forward, the interest charge is pegged to the rate applicable to underpayment of tax and is compounded daily.

3. Finally, the "throwback" rules apply, so the income may be taxed at the beneficiary's tax bracket for the years in which income was accumulated.

C. Use of Intermediaries: Because it is difficult for a foreign trust to qualify as a grantor trust, and because distributions of UNI from a foreign nongrantor trust to a U.S. beneficiary have such negative tax consequences, trustees will look for ways to "cleanse" accumulated income in a trust. One idea that has occurred to some is to distribute the accumulated income to a foreign intermediary (either an individual, a corporation or another trust), which can then later pay it to the U.S. beneficiary in the guise of current income, principal distribution or a gift.

To address this, Treas. Reg. § 1.643(h)-1 sets out the treatment of structures that employ intermediaries and the circumstances under which such intermediaries will be

disregarded. Essentially, when property is transferred to a U.S. person by another person (the intermediary) who has received property from a foreign trust, the U.S. person will be treated as having received the property directly from the foreign trust if the intermediary received the property from the foreign trust pursuant to a plan in which one of the principal purposes was the avoidance of U.S. tax. Such a principal plan of avoidance will be deemed to exist if:

1. the intermediary is "related" to the grantor of the foreign trust or has a relationship to the grantor that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer to the U.S. person;

2. the U.S. person receives from the intermediary, within the period beginning 24 months before and ending 24 months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property or property in substitution for such property; or

3. the U.S. person cannot establish that the intermediary acted independently, had a reason for making gratuitous transfers to the U.S. person, and was not the agent of the U.S. person, even if the U.S. person properly reported the gift.

If the intermediary can be viewed as an agent *of the foreign trust*, a distribution will be deemed to take place from the foreign trust to the U.S. beneficiary at the time the intermediary makes the distribution to the U.S. beneficiary. If the intermediary can be viewed as an agent *of the U.S. beneficiary*, a distribution will be deemed to have been made to the U.S. beneficiary when the foreign trust makes the distribution to the intermediary.

A foreign trust with a large pool of UNI may be able to clear out the UNI in advance of a distribution to the U.S. beneficiary. If the foreign trust distributes all of its UNI to a non-U.S. person or a distinguishable foreign trust, the original trust becomes cleansed and can make a large principal distribution to a U.S. beneficiary in the next calendar year without carrying out accumulated income. The question remains of what to do with the "tainted" funds if they are added to a new trust; they can remain with the foreign beneficiaries or trusts or can go to charities, but it will be difficult for those funds to find their way to the U.S. beneficiaries without running afoul of the intermediary rules.

D. Loans From Foreign Trusts: Under IRC § 643(i), if a non-U.S. settlor creates a foreign nongrantor trust that then loans cash or marketable securities to a U.S. beneficiary (including certain related U.S. persons even if they are not named in the trust instrument), the loan will be treated as a distribution to the U.S. person receiving it and will be taxed accordingly, even if the loan is later repaid.

In Notice 97-34, the Treasury carved out an exception to this rule. This exception permits a foreign trust to lend money to a U.S. beneficiary without having it treated as a distribution if it is a "qualified obligation." An obligation is a qualified obligation only if it meets the following requirements:

1. The obligation is set forth in a written agreement.

2. The term of the obligation does not exceed five years.

3. All payments on the obligation are denominated in U.S. dollars.

4. The yield to maturity of the obligation is not less than 100 percent and not greater than 130 percent of the applicable federal rate (IRC § 1274(d)) for the day on which the obligation is issued.

5. The U.S. borrower extends the period for assessment by the IRS of any income tax attributable to the loan and any consequential income tax changes for each year that the obligation is outstanding to a date not earlier than three years after the maturity date of the obligation.

6. The U.S. borrower reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.

A loan cannot be rolled over at the end of five years, and a new loan from the trust to the same U.S. beneficiary raises the issue of whether it constitutes a rollover.

The IRS is particularly focused on this area of the law. In fact, on May 8, 2024, Proposed Regulations were issued under Section 643(i) relating to loans from a foreign trust and below market use of property of a foreign trust by a US beneficiary, addressed in the following section. The Proposed Regulations largely track the current guidance of Notice 97-34. With respect to loans, the Regulations go beyond current law and would subject a nonresident who becomes a U.S. person within two years of receiving a non-qualified obligation as having received a distribution on his or her residency start date.

E. **Uncompensated Use of Trust Property:** Under Section 643(i), uncompensated use of trust property by a U.S. beneficiary of a foreign nongrantor trust is treated as a constructive distribution to the beneficiary to the extent of the fair rental value of the beneficiary's use of the property. If there is DNI or UNI in the trust, the deemed distribution can carry out taxable income. However, if the trust's only asset is residential property used by the beneficiary and the property is not rented out, there may not be any income to carry out, in which case the constructive distribution would be reportable by the U.S. beneficiary but not taxable. It is not a foregone conclusion, however, that having a U.S. trust is preferable instead. While U.S. trusts are not subject to this deemed distribution rule, gains on the sale of property owned by a U.S. trust are subject to an additional 3.8% net investment income tax that does not apply to foreign trusts.

It is notable that the Proposed Regulations under Section 643(i) mentioned previously also cover uncompensated use of trust property by a U.S. beneficiary. While there is a proposed “de minimis” rule whereby below market use of trust property for 14 days or less is disregarded, this is unlikely to provide significant relief in most cases. Interestingly, a deemed distribution of marketable securities under this rule could create significant tax consequences for the beneficiary. In those cases, built-in gain will be triggered (under Section 643(e)) and thus carried out to the beneficiary. There is also a 60 day cure period for paying fair market value rent for use of trust property and avoiding the deemed distribution.

F. **Reporting Distributions From Foreign Trusts:** Any U.S. person who receives a distribution from a foreign trust, including a constructive distribution as noted above, after August 20, 1996, must report that distribution to the IRS on Form 3520.

The U.S. person must report the name of the trust and the amount of the distribution received from the trust during the taxable year, and must indicate how such distribution is characterized, even if it is claimed that the distribution is not taxable because it came from a grantor trust or from a trust that had no income or for some other reason. Reporting is

required under IRC § 6048(c) only if the U.S. person knows or has reason to know that the trust is a foreign trust.

If the distribution is not reported, the U.S. recipient may be subject to a penalty of the greater of $10,000 or 35 percent of the gross amount of the distribution. (IRC § 6677(a)) Any distribution from a foreign trust whether from income or corpus, to a U.S. beneficiary may be treated as an accumulation distribution includable in the gross income of the U.S. beneficiary if adequate records are not provided to determine the proper treatment of the distribution, even if the trust would have qualified for grantor trust treatment. (IRC § 6048(c)(2))

The U.S. beneficiary will not be required to treat the entire distribution as an accumulation distribution if the beneficiary obtains from the foreign trustee either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement with respect to the distribution, which will provide full information about the trust. If a U.S. beneficiary cannot obtain such a beneficiary statement from the trustee, the U.S. beneficiary still may avoid treating the entire amount as an accumulation distribution if the U.S. beneficiary provides information regarding actual distributions from the trust for the prior three years. Under this "default treatment," the U.S. beneficiary will be allowed to treat a portion of the distribution as a distribution of ordinary income based on the average of distributions from the prior three years, with only the excess amount of the distribution treated as an accumulation distribution and therefore subject to the interest charge of IRC § 668. (See generally IRS Notice 97-34, Form 3520.)

It is notable that the Proposed Regulations under Section 643(i) mentioned previously also cover uncompensated use of trust property by a U.S. beneficiary. While there is a proposed "de minimis" rule whereby below market use of trust property for 14 days or less is disregarded, this is unlikely to provide significant relief in most cases. Interestingly, a deemed distribution of marketable securities under this rule could create significant tax consequences for the beneficiary. In those cases, built-in gain will be triggered (under Section 643(e)) and thus carried out to the beneficiary. There is also a 60 day cure period for paying fair market value rent for use of trust property and avoiding the deemed distribution.

V. PLANNING FOR NON-U.S. PERSONS

A. NRAs Generally: Reducing U.S. Taxes: Three general guidelines for NRAs who wish to minimize U.S. taxes are as follows:

1. Monitor day count and contacts with the United States to avoid becoming U.S. residents for income or estate tax purposes.
2. Minimize direct ownership of U.S. situs assets to avoid estate taxation. Typically, this means holding U.S. real estate, tangibles located in the United States and shares of stock of U.S. corporations through non-U.S. corporations (or through entities that can elect to be treated as non-U.S. corporations) or completed gift, irrevocable trusts. This step does not reduce income taxes on U.S. source income; the income is still payable to a non-U.S. entity and thus subject to income tax withholding. Also, transferring U.S. real estate to a non-U.S. corporation can trigger gain recognition and withholding or reporting obligations under FIRPTA. In some cases, an irrevocable trust may be structured to serve as an effective estate tax blocker. (This may be more tax-efficient than a foreign corporation for certain asset classes, such as U.S. real estate.)
3. Minimize taxable U.S. source income to avoid U.S. income taxation. Increase bond interest income, and decrease stock dividend and rental income.

The creation of a revocable trust by an NRA to hold assets will not in itself reduce U.S. taxes payable by the NRA. U.S. source income paid to the trust still will be subject to U.S. withholding tax. Also, if the grantor has a retained interest in the trust, such as the power to revoke, it will not shield U.S. assets from U.S. estate tax. A trust can own the shares of a foreign corporation that in turn holds financial assets, in which case the corporation, provided it is appropriately administered, will shield U.S. stocks from U.S. estate tax.

However, the trust may offer other benefits: the retention of the wealth for future generations, with discretionary income and principal payments, which is not available in most civil law jurisdictions; mitigation of exposure to foreign taxes, depending on the terms of the trust and the tax rules in the grantor's country of residence; protection from various risks such as creditors and home country considerations such as nationalization and political risks; and protection from forced heirship and marital claims. The trust may also save estate and GST taxes for future generations.

A properly structured and administered irrevocable trust in an appropriate jurisdiction can also protect the U.S. assets from U.S. estate tax.

It is important, however, to confirm with foreign counsel that holding assets through a trust and/or corporation will not create tax or other complications in the NRA's home jurisdiction. More and more jurisdictions are imposing new taxes and reporting requirements on assets abroad.

B. Estate, Gift and GST Taxes: As previously noted, transfers by an NRA to a U.S. beneficiary (including a U.S. trust) may be subject to reporting, but they are not subject to U.S. estate, gift or GST taxes except on assets that have U.S. situs. This is a significant benefit that should always be taken full advantage of when planning for NRAs.

C. Foreign Trust Planning: As noted, there are still great advantages to having an NRA create a multigenerational trust for the benefit of U.S. persons, because the trust assets will not be subject to estate, gift or GST taxes under current law. Moreover, there are strong reasons (if feasible in the NRA's jurisdiction) for the NRA to create a foreign grantor trust for the U.S. beneficiary in order to avoid U.S. income taxes during the life of the NRA. This also can be helpful in situations where the NRA grantor is going to remain taxable on the trust's income in his or her own country, as this can align the U.S. and foreign income tax treatment of the trust and reduce the risk of double taxation.

An NRA can create a long-term trust for U.S. beneficiaries, which can established in a foreign or U.S. trust jurisdiction (and still be foreign for tax purposes), and escape all transfer taxes for the life of the trust on assets that remain in the trust. Because a longer term results in a longer avoidance of transfer taxes, the trust should be created in a jurisdiction that has a long perpetuities period. Delaware, South Dakota, Wyoming and Nevada are among the popular trust jurisdictions in the U.S. For estate and gift tax purposes, it does not matter whether the trust is a U.S. trust or a foreign trust.

Further, even if the trust is established in a state within the United States, it will not be subject to U.S. income taxes while it is treated as a grantor trust with an NRA grantor, in which case the NRA grantor will be subject only to U.S. tax on U.S. source income. On the death of the grantor, the status of the trust if established in a U.S. state will depend on whether foreign persons hold powers over the trust. So, this flexibility can allow for separate trusts for U.S. and foreign beneficiaries to be established under one document. The foreign nongrantor trust for non-U.S. beneficiaries will only be subject to U.S. tax on U.S. source income and the domestic nongrantor trust for U.S. beneficiaries will be taxed similar to a U.S. taxpayer in its own right. However, the throwback rules noted before do not apply to domestic trusts. This may be a reason to establish the trust in the U.S. from the start as any trust established offshore will necessarily be a foreign nongrantor trust on the NRA grantor's death.

In light of the foregoing, and subject to input from foreign counsel, a good strategy for an NRA grantor who wants to benefit a U.S. beneficiary through a trust would be the following:

1. Make the trust revocable by the grantor or, if it is irrevocable, restrict distributions to the grantor and/or the grantor's spouse during the grantor's lifetime.

   If the trust is fully revocable by the grantor, making it a grantor trust means distributions could be made directly to a U.S. beneficiary without being subject to U.S. income tax during the grantor's life. In this case, however, the beneficiary would be required to report the receipt of any trust distributions, identify the trust, and appoint a U.S. agent or else have the foreign trustee represent to the IRS that it will allow access the trust's books and records to prove that it is in fact a grantor trust. For this reason, partial revocations followed by gifts may be preferable because of more streamlined reporting.

2. After the death of the grantor, the trust should continue for the U.S. beneficiary and descendants for the longest term permissible, possibly with a limited power of appointment granted to the beneficiaries at each generational level.

3. Know that on the death of the foreign grantor other planning will be required such as:

   (a) Pay all current income, including capital gains, to the U.S. beneficiary, who then pays U.S. income tax on the income, thus avoiding any accumulations problem. This, however, increases the assets that are distributed to the U.S. beneficiary and will ultimately be subject to estate tax on the beneficiary's death, particularly if there are large realized capital gains that must be distributed. Paying all income annually to a U.S. trust avoids this.

   (b) Move the trust situs to the United States. If this is done, all income will be taxed currently, but income can be accumulated without resulting in an interest charge, and realized gains can be accumulated without being converted to ordinary income when later distributed.

   Whether leaving the trust offshore or domesticating it to the U.S., further planning will need to be undertaken with respect to the underlying entities as described below to avoid running afoul of the foreign anti-deferral rules.

D. Underlying Entities: During the grantor's lifetime, the trust may hold assets through one or more underlying offshore corporations to avoid U.S. estate tax. The use of offshore corporations as "blockers" against the estate tax has been a widely accepted practice, but it is important to recognize the non-tax attributes for housing assets in an offshore corporation as well. These include anonymity, limited liability, consolidation of assets, and avoidance of multi-jurisdictional probate, among other things. Therefore, an underlying corporation may be advisable even if the assets are not U.S. situs assets.

After the death of the NRA grantor, if the trust has U.S. beneficiaries, the underlying corporation may become a controlled foreign corporation (CFC) or a passive foreign investment company (PFIC), which may have negative tax consequences for the U.S. beneficiaries. To mitigate this problem, after the grantor's death, the corporation ordinarily should elect to be disregarded for U.S. tax purposes and possibly liquidated outright. Under the U.S. "check the box" regulations (Treas. Reg. §§ 301.7701-1, 301.7701-2 and

301.7701-3), it is possible to simply elect for most foreign corporations to be treated as a pass-through for U.S. tax purposes. However, not all foreign corporations are eligible to make this election, so it is important when setting up the structure to choose an entity type that has not been designated as a "per se" corporation by the IRS. (Treas. Reg. § 301.7701-2(b)(8)) Additionally, this election must not be made during the grantor's lifetime if the corporation holds U.S. situs assets, since the pass-through treatment will apply for estate tax purposes as well and could eliminate the estate tax shelter for U.S. assets that the foreign corporation is intended to provide.

The timing of any postmortem election will need to be carefully considered, particularly when there is a mix of U.S. and non-U.S. situs investments in the same foreign holding company, as such an election may result in some phantom income inclusions for the U.S. beneficiaries on a fractional basis under the CFC rules, based on when the NRA grantor dies. However, the phantom income inclusion often can be minimized with proper planning and, in most cases, will result in a much lower overall tax liability than the estate tax inclusion that could result from a pre-mortem election.

E. **Non-U.S. Person Who Is Moving to the United States:** If a non-U.S. person (the pre-immigrant) is planning to become a U.S. resident in the near future, he or she might consider taking the following steps (in coordination with a tax advisor in his or her current country of residence) before becoming a U.S. resident for income or estate tax purposes.

1. **Make Gifts to Non-U.S. Persons:** The pre-immigrant could make irrevocable gifts, particularly of non-U.S. situs assets, to non-U.S. persons so as to keep such assets out of the U.S. tax net. This simple strategy only makes sense with respect to assets the individual no longer needs and with respect to assets that are intended to benefit foreign family members back home (assuming a trust is not an ideal structure for them).

2. **Create Irrevocable Discretionary Trusts:** The pre-immigrant could consider transferring a portion of his or her assets to an irrevocable discretionary trust of which his or her family members are permissible discretionary beneficiaries. If the transfer is properly structured and administered in a U.S. jurisdiction that protects such a trust from the claims of creditors, then the pre-immigrant could be one of the discretionary beneficiaries without causing the assets to be includable in his or her estate. However, a pattern of distributions to the pre-immigrant could undermine this position. It is overwhelmingly preferable to structure the trust as a U.S. trust for tax purposes, in which case it will have to be administered in the United States. The reason for this is that when a foreign grantor trust with a U.S. grantor becomes a foreign nongrantor trust – for example, upon the grantor's death – gain, but not loss, may be recognized if there are appreciated assets in the trust. (IRC § 684) This outcome may be avoided by setting up the trust in the United States or later domesticating the trust if it is already a foreign trust.

   If either the pre-immigrant or the pre-immigrant's spouse is a beneficiary, the trust will become a grantor trust for U.S. income tax purposes, and its income will be subject to U.S. income tax once the grantor becomes a U.S. taxpayer, regardless of whether the trust is a U.S. or a foreign trust. However, subject to the above considerations, the trust assets should be shielded from U.S. gift, estate and GST taxes in the future.

3. **Review Appreciated Assets:** If the pre-immigrant owns appreciated assets when he or she becomes a U.S. resident or citizen, the United States will tax the entire capital gain on the later sale of the asset, regardless of when it was bought or acquired, even if most of the appreciation occurred before the pre-immigration became a U.S. person. If it is possible to do so without triggering taxable gain at a higher rate in another country, the pre-immigrant should sell appreciated marketable securities before entering the United States and reinvest the proceeds. The pre-immigrant also should review his or her less-liquid assets, including appreciated residences and closely held securities in other countries, with a tax advisor to determine whether there might be opportunities to step up basis, transfer assets or restructure ownership into a form that will be tax-efficient for U.S. tax purposes.

4. **Consider Any Interests in Foreign Corporations:** If the pre-immigrant holds a 10 percent or greater interest in a foreign corporation and that corporation will be owned more than 50 percent by U.S. persons, each owning at least 10 percent, after the pre-immigrant becomes a U.S. citizen or resident, then the foreign corporation will become a CFC. As discussed in more detail in Section V of this outline, the now-U.S. shareholder may be subject to phantom income inclusions, meaning that he or she may be taxed on a pro rata share of both active and passive income earned by the CFC without regard to whether it pays a dividend. Certain elections could mitigate some of these adverse tax consequences:

   - It may be possible to file an entity classification election to convert the foreign corporation into a foreign partnership or disregarded entity for U.S. tax purposes before the pre-immigrant becomes a U.S. person. He or would be taxed as a partner on the company's income, but there would be only one level of U.S. tax. Foreign tax credits could offset the federal income tax liability. This could also step up the basis of the underlying assets.

   - If it is not feasible to change the entity classification of the corporation (e.g., because the entity is of a type that is not eligible to make the election or the election would adversely impact other shareholders), there are other elections that could be made after the pre-immigrant becomes a U.S. person in order to claim foreign tax credits to offset the phantom income or possibly exclude it altogether, depending on how the CFC is taxed on its income overseas.

   If the pre-immigrant owns shares of a foreign mutual fund or other foreign investment vehicle that is not closely held by U.S. persons, then the PFIC rules likely will come into play. Broadly stated, gains would not be eligible for long-term capital gain treatment, and an interest charge could apply to both dispositions and certain distributions. Although it is sometimes possible to mitigate some of these tax consequences with certain PFIC elections, these elections are not always available. If feasible, the pre-immigrant will want to dispose of any PFICs and rotate his or her portfolio into more U.S.-friendly investments. He or she will also want to discuss any foreign life insurance products with a tax advisor, as these could also present potential PFIC exposure.

5. **Consider Any Interests in Foreign Trusts:** If the pre-immigrant is a beneficiary of a foreign nongrantor trust and is expecting to receive distributions in the coming years, the trustees should consider making a large distribution to the pre-immigrant before he or she becomes a U.S. person so that the distribution will not be taxed in the United States. If the pre-immigrant is not likely to receive anything else from the trust, then it may be better to remove him or her in some cases so as to cut off potential phantom income exposure from PFICs owned by the trust. Additionally, a beneficiary's powers over the trust should be reviewed so that he or she does not have U.S. estate tax exposure with respect to the trust after moving to the U.S. Roles such as protector can create the exposure which is difficult to mitigate once the person is a U.S. transfer tax resident.

6. **Make Gifts Between Married Couples:** If a married pre-immigrant couple become U.S. residents but not U.S. citizens, any gifts made between them in excess of $185,000 per year (2024 figure) will be subject to gift tax. Therefore, any gifts that will be made between the spouses should be made before they enter the United States with non-U.S. assets or intangible property. The planner should be aware that joint accounts, joint tenancy property is common for married couples and can create unwitting U.S. gift tax exposure.

7. **Invest in an Annuity or Life Insurance Policy:** The pre-immigrant can purchase a U.S.-compliant commercial annuity or life insurance policy issued by a non-U.S. carrier without being subject to U.S. income tax on the earnings. If the pre-immigrant stays in the United States for a number of years without withdrawing any funds from the annuity and then leaves the United States, the funds invested in the annuity never will be subject to U.S. income tax. Further, once he or she leaves the United States permanently, as a nondomiciliary, he or she will not be subject to U.S. estate tax at death on the value of those assets. Even if the life insurance product is issued by a U.S. carrier, such a policy will not be considered a U.S. situs asset subject to estate tax if it is only on the (now non-U.S.) holder's life, though the U.S. income tax benefits of such a U.S.-issued product may not be the same in that case. Overall, a foreign-issued U.S.-compliant life insurance policy that is not a modified endowment contract can provide funds while the pre-immigrant is a U.S. resident without triggering a U.S. income tax liability, and it is a worthwhile tool to be considered in certain cases. However, many non-U.S. carriers offer products that can be classified as investment accounts for U.S. purposes so it is critical to find a product that was built with U.S. persons in mind.

VI. INTERNATIONAL ESTATE PLANNING FOR U.S. PERSONS

A. Basic Rule: As previously noted, the general rule is that U.S. persons are subject to income taxation on their worldwide income, and individuals who are U.S. persons are also subject to gift and estate taxation on their worldwide assets. The fact that the assets are located offshore or the income is paid offshore does not make a difference. When U.S.

persons invest abroad, they may have specific foreign informational filing obligations associated with those investments that can lead to steep penalties if missed.

1. **FBARs and 8938**. A U.S. citizen or resident is permitted to own assets and maintain bank and securities accounts abroad. However, all such accounts are subject to U.S. income, gift and estate taxes in the same way as are U.S. assets. In addition, for foreign financial accounts that exceed $10,000 in the aggregate, the U.S. person who has a financial interest or signature power over the account must check the appropriate box on Schedule B of Form 1040 (interest in or signature power over a foreign account) and must file electronically with the Treasury FinCEN Form 114, often referred to as the "FBAR," or Foreign Bank Account Report, disclosing the offshore accounts. Failure to comply with all filing requirements may result in significant penalties, even if all taxes have been paid. Entities that are created or organized in the United States, such as trusts (even if treated as foreign trusts for tax purposes under the control test), corporations, partnerships and limited liability companies (including single-member limited liability companies that are otherwise disregarded for most federal tax purposes) also must file an FBAR if they maintain foreign accounts. In addition, Form 8938, which is filed with the taxpayer's U.S. income tax return, also requires reporting of a wide range of foreign assets. Foreign real estate owned directly (not through a corporation or trust) is not required to be reported, although all income on foreign real estate and the gift or ownership of foreign real estate at death must be reported.

B. U.S. Citizen Who Resides Abroad: U.S. citizens who are not U.S. residents are taxed on their worldwide income and assets for income and estate tax purposes in the same way as if they resided in the United States. The only significant advantage is that U.S. citizens residing abroad may exclude the first $126,500 (for 2024) of foreign earned income from U.S. income taxation. (IRC § 911(b))

In addition, treaties with various countries often provide relief from double taxation, as do foreign tax credits that are generally available for both foreign source income and estate taxes paid to other countries, subject to certain limitations. (IRC §§ 901, 2104)

The United States generally does not allow a credit to U.S. persons for gift taxes paid to foreign jurisdictions. However, at least three treaties – with France, Germany and the United Kingdom – do provide for such a credit.

C. U.S. Person Who Creates Foreign Trusts: There are no tax advantages for a U.S. person in creating a foreign trust for the benefit of him or herself, his or her spouse or any other U.S. persons. That said, it may make sense for non-tax reasons or due to the fact that all of the intended beneficiaries are not U.S. persons.

1. **Income tax:** As a general rule, a foreign trust, like any other non-U.S. person, pays no U.S. income tax except for withholding tax on U.S. source income. However, the broad grantor trust rules prevent this result in most cases where the economic settlor of a trust is a U.S. person. (IRC §§ 671-679) In those cases, the trust will be a grantor trust for income tax purposes, and all trust income will be taxed to the U.S. settlor, regardless of whether the income is accumulated in the trust or distributed to another beneficiary. Among the provisions that will cause the trust to be a grantor trust is if

either the grantor or the grantor's spouse is a permissible beneficiary of the trust (IRC § 677) or if the trust permits any U.S. person to be a beneficiary (IRC § 679). Therefore, unless a U.S. settlor is willing to eliminate him- or herself, his or her spouse, and all other U.S. persons as permissible beneficiaries of the trust, as well as give up any power to control or direct the trust asset, the trust will be a grantor trust, and all income will be taxed to the U.S. settlor.

Further, when the settlor dies, the trust will become a foreign nongrantor trust. If the trust has been drafted so that the trust assets are not includable in the settlor's estate, then any appreciated assets held in the trust will be deemed to have been sold immediately prior to the settlor's death, causing the settlor to recognize gain but not loss on the deemed sale. (IRC § 684)

2. **Estate, Gift and GST Taxes:** U.S. persons are fully subject to gift and estate taxes on their worldwide gifts and assets, including completed gifts to foreign trusts. A foreign trust created by a U.S. settlor is fully subject to GST tax except to the extent that the U.S. settlor applies his or her lifetime exemption to the trust.

   In making a transfer to a trust, whether foreign or domestic, the settlor must choose one of the following options:

   (a) Make a completed gift to the trust. This will result in gift tax or the application of the settlor's unified credit and annual exclusion for gift taxes. However, the trust assets, including future appreciation and income, will not be includable in the settlor's estate at death. To make the gift complete, the trust may not be revocable, alone or with the consent of another person; the settlor cannot have power as trustee or otherwise to control beneficial enjoyment; and the settlor may not have a reversionary interest or retain a testamentary power of appointment (including a limited power) over the trust. As previously noted, the cost of making a completed gift with a foreign trust is potential gain recognition at the settlor's death, or sooner if the trust becomes a foreign nongrantor trust during the grantor's lifetime.

   (b) Make an incomplete gift to the trust. In this case, no gift tax will be payable and no credits need to be used up. However, the assets will be fully subject to U.S. estate taxation at the settlor's death. On the other hand, if the assets are includable in the settlor's estate or otherwise eligible for a basis step-up under IRC § 1014(a), then no gain will be recognized on the appreciated assets if the trust becomes a foreign nongrantor trust by reason of the settlor's death. (Treas. Reg. § 1.684-3(c)) To make the gift incomplete, the settlor must retain some power or control over the trust assets, such as making the trust revocable, alone or with the consent of another person. Alternatively the trust may be irrevocable with the settlor retaining a testamentary power of appointment over the trust, coupled with a veto power over distributions as is the case with most asset protection trusts

3. **Reporting:** The creation of a foreign trust and the transfer of assets to a foreign trust by a U.S. person must be reported by the U.S. settlor to the IRS annually on Form 3520. If the trust is a grantor trust, the settlor and foreign trust also have annual

information reporting on Forms 3520 and 3520-A, respectively. The penalties for failure to report are significant: up to the greater of $10,000 or 35 percent of the amount transferred to the trust (IRC §§ 6048; 677(a)) and up to 5 percent of the portion of the trust treated as owned by the U.S. settlor under the grantor trust rules. The settlor of the trust is encouraged (but not required) to appoint a U.S. person as "agent" for the trust, with the responsibility of supplying the IRS with information about the trust. If no agent is appointed, the foreign trustee is required to represent to the IRS that it will provide access to the trust's books and records on request and, if necessary, will allow the IRS to determine the tax consequences of the distribution.

4. **FBAR and Other Filings:** If a U.S. settlor establishes a foreign trust and is treated as the grantor under the foregoing rules, he or she may have other foreign informational filings associated with the structure as noted above. For example, foreign bank accounts held by the trust will be reportable by him on an FBAR and he will have reporting obligations on Form 8938 as well with respect to the foreign financial assets held by the trust.

5. **Creditor Protection Benefits:** If a U.S. person makes an irrevocable gift to a U.S. trust of which the settlor and his or her family are discretionary beneficiaries, with an independent trustee, the trust can still be reached by subsequent creditors of the grantor under the self-settled trust rules of most U.S. states. Because the trust's assets are reachable by the settlor's creditors, the assets are still includable in the settlor's estate. However, Alaska, Delaware, South Dakota, Wyoming, Nevada, New Hampshire and a few other states have enacted legislation overturning this rule as to trusts that are sited in those states, meaning that it is possible for a settlor to be a discretionary beneficiary of such a trust and still keep the assets out of his or her estate. One still would want to avoid a pattern of distributions back to the settlor; i.e., this should be solely for emergency use. Whether a trust created in one of those states will be defeated by a creditor from another state under the "full faith and credit" doctrine of the U.S. Constitution remains to be tested. Similarly, some offshore jurisdictions provide that if the settlor gives up the power to revoke or withdraw funds from such a trust, its assets cannot be reached by creditors whose claims arise after the transfer of assets to the trust. However, the trust would be a foreign grantor trust (with the attendant income and reporting obligations), and upon the settlor's death, there likely would be a tax on the built-in gains.

D. U.S. Person Who Wishes to Benefit Non-U.S. Persons: If a U.S. person makes gifts to a non-U.S. person, either outright or to an offshore trust, the U.S. donor still is subject to U.S. gift tax in the same manner as with gifts to U.S. persons. However, after the transfer is made to a foreign individual, future income and appreciation of the assets are not subject to U.S. income, estate or gift taxation, except as to U.S. source income and U.S. situs assets. A transfer to a foreign trust solely for foreign beneficiaries is also free of future U.S. income, estate and gift taxes, provided the U.S. donor does not retain any strings, such as a power to recover the assets or to control their distribution, that either could make the trust a grantor trust for U.S. income tax purposes or could bring the assets back into the estate of the U.S. person for estate tax purposes. However, such a trust will remain subject to U.S. GST tax except to the extent that the U.S. settlor applies his or her lifetime exemption. Further, any transfer to a foreign trust would be reportable on IRS Form 3520.

As previously noted, if a U.S. person creates or transfers funds to a foreign trust, the trust is a grantor trust during any year that the trust may have a U.S. person as a beneficiary. (IRC § 679) Therefore, if the U.S. grantor does not wish to be taxed on the trust's income, the trust agreement should provide that no U.S. citizen or resident may be a beneficiary. Further, the trust agreement should be carefully vetted to ensure that neither the grantor nor any other party holds a power that could otherwise cause the trust to be considered a grantor trust. The U.S. person also should be careful to avoid transferring appreciated property to the trust so as to avoid forced gain recognition or should harvest losses from other assets in the same year to offset the forced gain. (IRC § 684)

E. **U.S. Person Who Owns Interests in Non-U.S. Corporations:** The general rule is that U.S. shareholders of non-U.S. corporations are taxed only on distributions in the same manner as are shareholders of U.S. C corporations. However, there are several important exceptions that ensnare many U.S. shareholders of foreign corporations in the U.S. tax net, most notably the previously discussed CFC and PFIC rules. It should be noted that in each case, broad attribution rules apply in determining ownership. In the case of CFCs, ownership can be attributed among U.S. family members.

1. **Passive Foreign Investment Company:** Whether a foreign corporation constitutes a PFIC is determined by a passive income and asset test. (IRC § 1297) A foreign corporation is a PFIC if either (i) 75 percent or more of its gross income is passive income or (ii) 50 percent or more of the average value of its assets are held for the production of passive income. Under this definition, most foreign mutual funds would be considered PFICs. The fact that a fund is publicly traded will not prevent it from being treated as a PFIC.

The U.S. shareholder may elect to include in current income the pro rata share of ordinary income and capital gains of a PFIC. (This is a "qualified electing fund," or QEF, election.) If such an election is not timely made, then on the sale of the shares of the PFIC, the U.S. shareholder will recognize ordinary income on the gain, plus an interest charge under IRC § 1291. In order to make and maintain a QEF election, the U.S. shareholder must report certain financial information regarding the PFIC, which the offshore fund managers may not be willing to provide. Thus, in many cases, a QEF election will not be an option.

2. **Controlled Foreign Corporation:** A CFC is generally a foreign corporation owned more than 50 percent (in value or voting control) by "U.S. shareholders," who are defined as U.S. persons who hold at least 10 percent of the corporation's stock by voting control or value. (IRC § 957) Unlike PFICs, CFCs are not limited to companies with primarily passive income.

Subpart F Income and GILTI Inclusions

If a foreign corporation is a CFC during any part of the taxable year, each U.S. person who is a U.S. shareholder on the last day of the CFC's taxable year may be taxed on his or her pro rata share of the CFC's "subpart F" income under IRC § 951(a) and global intangible low-taxed income (GILTI) under IRC § 951A.

Subpart F income includes the following:

- Insurance income as defined under IRC § 953.

- The foreign base company income as determined under IRC § 954, which includes most types of passive investment income as well as certain types of related party sales and services income, with carve-outs for de minimis amounts and "high taxed" income.

- Income derived from illegal international boycotts.

- Illegal bribes, kickbacks or other payments that would be unlawful under the Foreign Corrupt Practices Act of 1977.

- The income of such corporation derived from any foreign country that the United States does not recognize, with which the United States has severed diplomatic relations or which repeatedly provides support for acts of international terrorism.

GILTI picks up most other types of income earned by the CFC. Under the GILTI regime, a U.S. shareholder of one or more CFCs is taxed on his or her share of the excess of (1) the CFCs' modified gross income (excluding certain items) over (2) a benchmark return of 10 percent of the CFCs' adjusted bases in depreciable tangible property placed in service, with certain adjustments for interest income and expense.

- The GILTI regime eliminated a long-standing distinction, under the CFC rules, between passive income (which was and remains taxable as subpart F income) and operating income of a bona fide business overseas (which generally was not taxable prior to the introduction of the GILTI regime).

- Foreign blocker structures that hold mostly marketable securities generally will not be impacted by GILTI, as the income will continue to be taxable to U.S. persons as subpart F income. However, trusts that hold stock in closely held operating companies could be impacted.

VII. U.S. CITIZEN OR RESIDENT WHO EXPATRIATES

The United States imposes an expatriation tax on certain U.S. citizens who renounce their citizenship and long-term residents who give up their green cards. (IRC § 877A) An individual is considered a long-term resident for this purpose if he or she has been a lawful permanent resident (green card holder) for any part of 8 of the past 15 years. (IRC § 877(e)(2)) If an individual is a "covered expatriate," he or she will be deemed, among other things, to have sold all of his or assets at fair market value. Further, any subsequent gifts or bequests from a covered expatriate to a U.S. person are subject to an inheritance tax. (IRC § 2801)

The current expatriation rules apply to expatriations on or after June 17, 2008. The previous rules in place for expatriations prior to that date included a 10-year alternative regime of U.S. income, gift and estate taxation of a broad list of U.S. source income and U.S. situs assets, and the provision that an expatriate who spends 30 or more days in the United States in any of the 10 years following expatriation will be taxed as a U.S. person on his or her worldwide income and

assets for that year. (IRC § 877) The old rules are largely obsolete now that any affected individuals would be past the 10-year window, but many of the key definitions and concepts of the current expatriation regime key off on the old rules.

A. Test: To be a covered expatriate subject to the new law, the renouncing person must also meet one of the following three tests in IRC § 877 (a)(2):

(A) His or her average net income tax liability for the prior five years exceeds $201,000 (amount for individuals who expatriate in 2024, indexed each year for inflation);

(B) His or her net worth exceeds $2 million, including interests in trusts; or

(C) He or she fails to certify under penalty of perjury that he or she has complied with all federal tax obligations for the previous five years. (In other words, even if the expatriate does not meet the income tax or net worth tests, he or she must certify compliance with U.S. tax laws for the past five years or else be subject to the new taxes.)

B. Exceptions: There are exceptions for the following persons, provided they can make the certification as to tax compliance for the previous five years:

(i) Persons who were dual citizens of the United States and another country from birth, are tax residents of that country at the date of expatriation, and have not been U.S. income tax residents for more than 10 of the past 15 years.

(ii) Persons who expatriate before age $18^1/_2$ and have not been U.S. income tax residents for more than 10 years.

C. Computation of Tax: To compute the tax, the expatriate determines what would have been the capital gains tax if he or she had sold all his or her worldwide assets for their fair market value the day before he or she expatriated. Losses are taken into account, but the "wash sale" rules (IRC § 1091), which provide that a loss is not recognized in the case of a sale and purchase within 30 days, do not apply.

The first $866,000 of net appreciation (2024 figure, indexed annually for inflation) is exempt from the tax. In addition, the covered expatriate may elect to defer the tax on any asset until that asset is sold or until the death of the covered expatriate, if sooner. A satisfactory security arrangement such as posting a bond must be reached with the IRS in the case of any such deferral.

For a person who moved into the United States and is now leaving and renouncing citizenship or a green card, the cost basis of assets that he or she owned on the date he or she first became a U.S. resident is their fair market value on that date for purposes of the expatriation tax.

Deferred compensation items and tax-deferred retirement accounts are not subject to the immediate expatriation tax but are subject to their own special rules. Any 401(k) plans and other qualified plans generally are not subject to immediate tax, provided that the covered expatriate timely (within 30 days of expatriation) furnishes a Form W-8CE to the plan administrator and waives any treaty benefits on subsequent distributions, which then are

subject to withholding at a flat 30 percent rate. Individual retirement accounts (IRAs), in contrast, are treated as if the entire balance was distributed to the covered expatriate the day immediately prior to his or her expatriation. In the case of a traditional IRA, this results in ordinary income inclusion but no early distribution penalty. In the case of a Roth IRA, there should not be any income inclusion.

D. Beneficial Interests in Trusts: All trusts that are included in the grantor's estate are subject to the mark-to-market tax. For other trusts, both domestic and foreign, of which the covered expatriate was a beneficiary immediately before expatriation, there is a withholding requirement for the trustee of 30 percent on the "taxable portion" of all distributions to the covered expatriate. The taxable portion of a distribution is the portion that would have been includable in gross income if the expatriate were still a U.S. person. In addition, if a nongrantor trust distributes appreciated assets to a covered expatriate beneficiary, the trust is taxed by the United States on the gain.

E. Inheritance Tax: IRC § 2801 imposes a special transfer tax on all covered gifts and bequests from a covered expatriate (made during the rest of his or her life after expatriation and at death) to a U.S. citizen or resident. The U.S. recipient is liable for payment of the tax, at a rate equal to the highest estate tax rate under IRC § 2001 or, if higher, the highest gift tax rate under IRC § 2502(a); currently, both are 40 percent. The amount of the annual gift tax exclusion under IRC § 2503(b), currently $18,000, is exempt, and gifts and bequests that are subject to U.S. estate tax or that pass to a surviving spouse or a charity are not covered gifts. If the spouse is not a U.S. citizen, the bequests must pass to a qualified domestic trust, and gifts will qualify for the exception up to only $185,000 per year (2024 figure, indexed for inflation). The tax is payable by the recipient.

Covered gifts or bequests to U.S. trusts are taxed in the same manner as gifts to U.S. persons. If covered gifts or bequests are made to a foreign trust, then distributions of income or principal from that trust to a U.S. person are taxed as covered gifts to that person.

VIII. NONCITIZEN SPOUSE

A. Qualified Domestic Trust: A U.S. person is entitled to a 100 percent estate tax marital deduction for assets left to his or her surviving spouse if the spouse is a U.S. citizen. This applies also to an NRA who leaves U.S. situs assets to the surviving U.S. citizen spouse. However, in either case, if the surviving spouse is not a U.S. citizen and does not become a U.S. citizen by the time the decedent spouse's estate tax return is due – within nine months of death – the estate tax marital deduction is not available unless the assets pass to a qualified domestic trust (QDT). (IRC § 2056 (d)(2)(A))

Further, assets owned jointly with a noncitizen spouse are fully includable in the estate of the first spouse to die if the survivor is a noncitizen, except to the extent that the surviving spouse can prove contribution to the property.

To qualify, a QDT must meet the following requirements:

1. The trust must be maintained under and governed by the laws of a U.S. state. (Treas. Reg. § 20.2056A-2(a)) This does not mean that the trust must be created in the United

States initially. For example, a trust created under a foreign decedent's will can be a QDT if the trust is subsequently migrated to the United States. Further, the trust can be a foreign trust for U.S. tax purposes – for example, because it has a foreign trustee or protector – so long as it is a U.S. law trust.

2. The trust must pay all income to the surviving spouse for life.

3. The trust may not permit principal distributions to anyone other than the surviving spouse during his or her life. Any principal distributions, except for hardship, to the surviving spouse will be subject to estate tax at the time of distribution at the top bracket of the deceased spouse's estate. The remaining principal in the trust upon the death of the second spouse also will be subject to estate tax on the estate of the first spouse.

4. The trust must have at least one U.S. trustee who is either a U.S. citizen with a "tax home" in the United States or a U.S. corporation, and the U.S. trustee or trustees must have the power to withhold estate tax on any such distribution.

5. Security arrangements:

    - For trusts of more than $2 million, there must be either a U.S. institutional trustee (a U.S. bank or a U.S. branch of a foreign bank) or the posting of a bond or letter of credit in an amount equal to 65 percent of the initial value of the trust assets. In determining whether the trust has more than $2 million in assets, and also in determining the amount of the bond or letter of credit, there is an exclusion for up to $600,000 of real property – but apparently not cooperative apartments – constituting one or two residences and their contents used by the surviving spouse. (Treas. Reg. § 20.2056A-2(d)(1)(iv))

    - For trusts of $2 million or less, if more than 65 percent of the trust assets constitute offshore real property, there must be either a U.S. institutional trustee or the posting of a bond or letter of credit in an amount equal to 65 percent of the initial value of the trust assets. (Proposed Treas. Reg. § 1.0155(d))

6. Finally, the executor of the decedent spouse's estate must make the QDT election on the decedent's estate tax return. Once made, the election is irrevocable. No partial marital deduction election may be made over a QDT.

In addition to the particular QDT requirements, the trust also must qualify under one of the other marital deduction provisions that apply for U.S. estate tax purposes generally. (Treas. Reg. § 20.2056A-2(b))

Most often, the QDT is established by the decedent spouse in his or her will or a stand-by trust created by him or her during life. However, it is possible for the surviving spouse to establish the QDT within nine months of the decedent’s death if one was not included in the decedent spouse’s estate planning documents.

It is important to note that the assets remaining in the QDT at the time of the surviving spouse's death also may be included in his or her taxable U.S. estate, with some offsetting credit for the QDT tax paid. Proper planning is needed in these cases, particularly because

the surviving spouse does not enjoy full "portability" with respect to the decedent spouse's unused U.S. estate tax exemption, if any.

Outright bequests to a noncitizen spouse also will qualify for the marital deduction without the need for a QDT if the surviving spouse becomes a U.S. citizen before the decedent's estate tax return is filed. If the surviving spouse becomes a U.S. citizen at any time after the return is filed, the QDT can be terminated and all assets will be paid outright to the surviving spouse, but any principal distributions that were made to the spouse prior to becoming a citizen will be taxed.

B. Gifts to Noncitizen Spouse: A U.S. person or an NRA may make unlimited gifts to his or her U.S. citizen spouse without gift tax consequences. However, if the donee spouse is a non-U.S. citizen, regardless of whether or not the donor spouse is a U.S. citizen or resident, the donor spouse may give up to only $185,000 (2024 figure) per year to the donee spouse without gift tax consequences. These annual gifts must be either outright or in a trust that qualifies them as gifts of a present interest. They also must be in a form that would qualify for the marital deduction if the spouse were a U.S. person. Any gifts in excess of this amount will be subject to gift tax, although the unified credit is available if the donor spouse is a U.S. citizen or resident. (IRC § 2523(i)(2))

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