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## **Inbound Essentials: Estate And Income Tax Planning For Nonresident Aliens**

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### **INTRODUCTION**

The U.S. tax laws are sufficiently complicated when advising U.S. citizens and residents on their estate and income tax planning. We have overlapping tax regimes (income, gift, estate, and generation-skipping transfer) that can apply simultaneously — and work in opposition to one another — in a single transaction.

When we expand U.S. estate and income tax planning beyond U.S. borders, either for a U.S. person with foreign connections (“outbound planning”) or for a foreign person with U.S. connections (“inbound planning”), the complications rise to another level.

This article will focus on the unique U.S. tax rules that apply to individuals who are not citizens or residents of the United States, referred to as “nonresident aliens,” or “NRAs.”

### **DETERMINING U.S. TAX RESIDENCY**

Before we delve into the U.S. taxation of NRAs, we should first review the rules for determining

whether a non-citizen individual is indeed an NRA for U.S. tax purposes, or whether the individual is actually a U.S. resident. As shown below, a person may be a resident for income tax purposes and not be a resident for transfer tax purposes, and vice versa.

### **Income Tax Residency**

A non-citizen is considered a U.S. resident for income tax purposes (and therefore taxed on worldwide income) if the individual meets any one of three tests: (1) the green card test; (2) the substantial presence test; or (3) the first-year election.<sup>1</sup>

#### **The Green Card Test**

Under the green card test, a person who holds a permanent-residence visa, also known as a green card, will be considered a U.S. resident for income tax purposes.<sup>2</sup> If an individual’s green card merely expires and is not proactively relinquished, revoked, or administratively determined to have been abandoned, the individual will continue to be taxed as a U.S. resident until one of these events occurs.<sup>3</sup>

#### **The Substantial Presence Test**

Under the “substantial presence” test, an individual who is physically present in the United States for a certain number of days over a three-year period will

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<sup>1</sup> §7701(b)(1)(A). All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

<sup>2</sup> §7701(b)(1)(A)(i).

<sup>3</sup> §7701(b)(6).

be considered a U.S. resident for income tax purposes.<sup>4</sup>

An individual is substantially present in the United States if he or she is present for at least 31 days during the current year and at least 183 days for the three-year period ending on the last day of the current year using a weighted-average calculation, with days present in the current year weighted more heavily than days present in the prior two years.

This weighted average is calculated as follows (with 2014 as the “current year”):

- 2014: Multiply # of days present by 1
- 2013: Multiply # of days present by 1/3
- 2012: Multiply # of days present by 1/6

For example, assume an individual is present in the United States for 120 days in the current year (2014) and 120 days for each of the two preceding years:

- 2014: 120 days present  $\times$  1 = 120
  - 2013: 120 days present  $\times$  1/3 = 40
  - 2012: 120 days present  $\times$  1/6 = 20
- Weighted Average Total: 180

In this example, the foreign individual does not meet the substantial presence test, and is therefore an NRA for 2014 under this test, because he or she was not present for a weighted average of at least 183 days.

There are a couple of exceptions to the substantial presence test. First, if an individual is physically present in the current year for 31 days, but fewer than 183 days, and he or she otherwise meets the substantial presence test, that individual will nonetheless be considered an NRA if he or she proves on an IRS Form 8840 (attached to an IRS Form 1040NR) that he or she has a “tax home” in a foreign country and a “closer connection” to that foreign country than to the United States.<sup>5</sup> The location of a person’s “tax home” (defined as a person’s home for purposes of determining deductible business travel expenses while

away from home)<sup>6</sup> and whether he or she has a “closer connection” to a foreign country are subjective inquiries and are based on criteria similar to those used to determine domicile (which is discussed under “Transfer Tax Residency,” below). Second, if the individual is not present for at least 31 days in the current year, the substantial presence test does not apply at all, even if the three-year weighted average equals 183 days (i.e., he or she will be an NRA automatically without the requirement to prove a closer connection to a foreign country).

Finally, it is important to highlight the fact that if an individual is present in the United States for 183 days in the current year, he or she cannot take advantage of the “closer connection” exception to the substantial presence test.

### The First-Year Election

A special “first-year election” is available for an individual seeking to be treated as a U.S. resident if the individual: (i) is present in the U.S. for 31 consecutive days during the current year; (ii) is present in the United States for a total number of days equal to or exceeding 75% of the days in the “testing period” of the current year (which is the period starting on the first day of the consecutive 31 days and ending on December 31 of the year of the election); and (iii) meets the substantial presence test for the succeeding year.<sup>7</sup>

Because the first-year election cannot be made unless an individual also meets the substantial presence test for the succeeding year, it is not truly a third stand-alone residency test. Rather, it is a way to achieve U.S. residency for the year prior to the first year of substantial presence. The election is effective starting with the portion of the year beginning with the first consecutive 31-day period, which will not necessarily be on January 1.

The first-year election is best described with the following example, which assumes that 2014 is the first year that the individual meets the substantial presence test, and the individual wishes to elect to be treated as a U.S. resident for 2013:

<sup>4</sup> §7701(b)(3).

<sup>5</sup> §7701(b)(3)(B).

<sup>6</sup> §911(d)(3).

<sup>7</sup> §7701(b)(4).

Arrives in U.S.	March 11, 2013	= 5 days	Period less than 31 days is disregarded
Departs U.S.	March 15, 2013		
Arrives in U.S.	June 1, 2013	= 92 days	Testing Period = 214 days
Departs U.S.	August 31, 2013		
Arrives in U.S.	October 11, 2013	= 82 days	Present for 174 days of Testing Period
Departs U.S.	December 31, 2013		

In the above example, the individual’s testing period begins on the first day of his or her first consecutive 31-day presence in the United States (June 1) and

ends on the last day of that same calendar year (December 31). There are 214 days in the testing period, of which he or she was present for 174 days, which is

81% of the days in the testing period. Because he or she was present for 31 consecutive days and also present for more than 75% of the days in the testing period, he or she can elect to be treated as a U.S. resident beginning on June 1, 2013.

## Transfer Tax Residency

As shown above, determining residency for income tax purposes generally involves objective criteria (except for the “closer connection” exception to the substantial presence test). In contrast, residency for U.S. transfer tax purposes (i.e., estate and gift taxes) involves a subjective inquiry regarding the individual’s domicile.

“Domicile” is a common-law term meaning a person’s fixed and permanent place of abode in which the person intends to remain indefinitely or to which the person intends to return.<sup>8</sup> A person can have multiple residences, but a person can have only one domicile. A person may be considered a resident of the country in which he or she currently lives but still be considered domiciled in another country if he or she intends to return to that country. Once domicile is established in a particular country, it can be difficult to lose because original domicile remains until the taxpayer demonstrates the requisite intent to establish a new domicile. The regulations provide the following general definition of domicile:<sup>9</sup>

A person acquires a domicile in a place by *living there*, for even a brief period of time, with no definite present *intention* of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

Thus, for U.S. tax purposes, to be characterized as a U.S. domiciliary, a person must: (i) live in the United States; and (ii) have no fixed intention of leaving.<sup>10</sup> Because of the subjective intent factor, there are no hard and fast rules as to the required length of physical presence to establish transfer tax domicile like there are for income tax residency.<sup>11</sup> This subjective inquiry looks to many factors, including:

- the length of time spent in the United States and abroad, and the amount of travel to and from the United States and between other countries;

<sup>8</sup> See *Black’s Law Dictionary* 558–59 (9th ed. 2009); see also Rev. Rul. 80-209, 1980-2 C.B. 248.

<sup>9</sup> Reg. §20.0-1(b)(1), §20.0-1(b)(2) (for estate tax), §25.2501-1(b) (for gift tax) (emphasis added).

<sup>10</sup> Reg. §20.0-1(b)(1), §25.2501-1(b).

<sup>11</sup> *Restatement (Second) of Conflicts of Law* §16, cmt. b (1971).

- the value, size, and locations of the person’s homes, and whether he or she owned or rented them;
- whether the person spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.;
- the situs of valuable or meaningful tangible personal property;
- where the person’s close friends and family are situated;
- the locales in which the person has religious and social affiliations or in which he or she partakes in civic affairs;
- the locales in which the person’s business interests are situated;
- the person’s visa status;
- the places where the person states that he or she resides in legal documents;
- the jurisdiction where the person is registered to vote;
- the jurisdiction that issued the person’s driver’s license; and
- the person’s income tax filing status.<sup>12</sup>

Generally, no one factor is determinative. Rather, the courts look to the totality of the circumstances to determine a person’s domicile. Facts supporting the conclusion that the taxpayer has not abandoned his or her prior domicile may also lead to a conclusion that the taxpayer has not established a new one elsewhere. Also, claiming privileges based on residency (e.g., by filing an IRS Form 1040NR instead of an IRS Form 1040) may be considered evidence that the taxpayer has not abandoned his or her domicile in his or her home country.

Also, because domicile requires a permanent and fixed place of abode, a person can continue to be domiciled in a country he or she left long ago if he or she has not yet established a new permanent residence elsewhere. A person who sells his or her home in one country to move abroad but does not become a permanent resident of the new country may still be a domiciliary of the country that he or she left. In any case, the burden of proof is generally on the taxpayer to establish that his or her domicile has, or has not, changed.

In the face of conflicting evidence as to an individual’s domicile, U.S. choice-of-law rules favor the

<sup>12</sup> See 837 T.M., *Non-Citizens — Estate, Gift, and Generation-Skipping Taxation*.

retention of the original domicile.<sup>13</sup> The Supreme Court has held that domicile is a question of state law, rather than federal law, such that an individual could demonstrate the requisite intent to establish domicile in a U.S. state under that state's rules regardless of the individual's federal immigration status.<sup>14</sup>

## EXPATRIATES

Before we discuss the U.S. taxation of "regular" NRAs, one special category of NRA must be reviewed: NRAs who were previously U.S. citizens or long-term green card holders (i.e., those who held their green card for eight of the 15 years prior to expatriating)<sup>15</sup> and whose expatriation is deemed to be tax motivated.<sup>16</sup> Such expatriates will be considered NRAs for U.S. tax purposes, but they may be subject to an alternative tax regime.

### Overview and Covered Expatriates

Congress has amended the expatriation statutes in a variety of ways over the past half-century, with the most notable changes occurring in the last decade. As a result, different rules apply depending on whether the expatriation falls within one of the following date ranges:

- on or before June 3, 2004;
- after June 3, 2004 and before June 17, 2008; or
- on or after June 17, 2008.

Between 1966 and 2004, an individual who wished to relinquish his or her passport or green card could avoid the special expatriation tax rules by obtaining a private letter ruling ("PLR") from the IRS that his or her expatriation was not for the principal purpose of avoiding U.S. tax.

In 2004, the American Jobs Creation Act ("AJCA")<sup>17</sup> eliminated the subjective PLR inquiry of tax motivation; created an objective set of criteria to deem individuals to have expatriated for tax-avoidance purposes; imposed an onerous annual reporting requirement on those expatriates for the 10-year period following expatriation; and treated a tax-motivated expatriate as a U.S. resident (i.e., taxed on worldwide income) for the entire year if they were

physically present in the United States for 30 days at any point during the taxable year (other than for legitimate business reasons).<sup>18</sup>

Then, in 2008, the Heroes Earnings Assistance and Relief Tax Act (the "HEART Act")<sup>19</sup> was passed, which retained the objective tax-motivation criteria of the AJCA but otherwise changed the expatriation tax regime completely.

Expatriates who were deemed to have expatriated for tax-avoidance purposes under the pre- and post-AJCA rules (i.e., those who expatriated before June 17, 2008) are taxed on certain types of U.S.-source income for 10 years after expatriation as though they were still citizens or green card holders. Although this 10-year alternative income tax regime does not apply to individuals expatriating under the HEART Act rules, the AJCA rules are still in effect for expatriates who left prior to June 17, 2008 and who have not yet completed their 10-year period (meaning this regime will still be effective for those expatriates through June 16, 2018). However, we will focus the remainder of this discussion on the U.S. taxation of expatriates under the HEART Act.

The AJCA's objective criteria that deem an individual's expatriation to be tax motivated continue to apply under the HEART Act. These criteria are listed below:

- the individual's average annual net income tax for the five years ending before the date of expatriation is more than \$124,000, adjusted for inflation (\$157,000 for 2014);<sup>20</sup>
- the individual's net worth is \$2 million or more (not adjusted for inflation) on the date of expatriation; or
- the individual fails to certify on IRS Form 8854 that he or she has complied with all U.S. federal tax obligations for the five years preceding the date of expatriation.<sup>21</sup>

If any one of these factors apply, the individual is considered a "covered expatriate" to which the special expatriation tax regime, described below, applies.<sup>22</sup>

### Exit Tax

The HEART Act drastically amended the prior versions of the expatriation tax regime. For those expa-

<sup>13</sup> *E.g., Margani v. Sanders*, 453 A.2d 501 (Me. 1982).

<sup>14</sup> *Elkins v. Moreno*, 435 U.S. 647 (1978) (holding that federal law did not bar an individual present in the United States under a G-4 diplomatic visa from establishing a domicile in Maryland for the purposes of qualifying for in-state tuition rates at the state university).

<sup>15</sup> §877(e)(2).

<sup>16</sup> §877(a), §877(e).

<sup>17</sup> Pub. L. No. 108-357.

<sup>18</sup> §877(g), §6039G.

<sup>19</sup> Pub. L. No. 110-245.

<sup>20</sup> Rev. Proc. 2013-35, 2013-47 I.R.B. 537, §3.29.

<sup>21</sup> §877(a)(2).

<sup>22</sup> There are minor exceptions for certain individuals who have held dual citizenship since birth or who relinquish their U.S. citizenship prior to age 18½ if they have not been a U.S. resident for more than 10 years prior to their relinquishment. §877A(g)(1)(B).

trating on or after June 17, 2008, the cumbersome 10-year taxation rules no longer apply. Instead, a covered expatriate will be subjected to a one-time mark-to-market tax (or “exit tax”), meaning that all property of the covered expatriate is deemed to be sold at its fair market value on the date immediately preceding the expatriation date.<sup>23</sup>

Property subject to the exit tax is any property that would be taxable as part of the expatriate’s gross estate for federal estate tax purposes.<sup>24</sup> The exit tax essentially treats the expatriate as if he or she sold all of his or her property at fair market value on the day before the expatriation date, and any built-in gain that would arise under the deemed sale is subject to tax. The gain is taxable to the extent that it exceeds a \$600,000 exclusion amount, indexed for inflation (\$680,000 for 2014).<sup>25</sup> The \$600,000 exclusion amount is allocated pro rata among all built-in gain property.<sup>26</sup> The covered expatriate may make an irrevocable election to defer payment of the exit tax.

The mark-to-market regime does not apply to: (i) deferred compensation (such as a qualified retirement plan); (ii) any specified tax-deferred account (such as an IRA); or (iii) any interest in a nongrantor trust.<sup>27</sup> These types of property will be subject to special rules that capture tax when income is distributed to the covered expatriate after expatriation. A detailed discussion of the applicability of the exit tax to certain types of property is beyond the scope of this article.<sup>28</sup>

## Covered Gifts and Bequests

In addition to the exit tax, the HEART Act also implemented a new regime that imposes gift and estate tax when a covered expatriate’s property is repatriated to a U.S. citizen or resident in the form of a gift or bequest (called a “covered gift” or a “covered bequest”).<sup>29</sup> Under the normal U.S. transfer tax regime, gift and estate tax is imposed upon the donor or decedent. However, with respect to gift or estate tax imposed on a covered gift or bequest, the tax is instead imposed on the U.S. recipient because the covered expatriate is no longer subject to U.S. jurisdiction for collecting the tax.<sup>30</sup>

The transfer tax rate applicable to covered gifts and bequests is the higher of the highest estate tax rate in

effect on the date of receipt, or the highest gift tax rate in effect on that date.<sup>31</sup> The tax can be reduced by any gift tax or estate tax paid to a foreign country in connection with the transfer. The following will not be subject to the tax on covered gifts and bequests: (i) gifts valued below the annual gift tax exclusion; (ii) gifts or bequests that qualify for a marital or charitable deduction; (iii) taxable gifts that are reported on a U.S. gift tax return; and (iv) property that is included in the gross estate of a covered expatriate and reported on a U.S. estate tax return.<sup>32</sup>

In 2009, the IRS announced that it would issue a new IRS Form 708 on which to report receipt of covered gifts and bequests,<sup>33</sup> but as of the date of this article, there has been no indication that a draft IRS Form 708 is in progress. Also, in Notice 2009-85, the IRS stated that separate guidance will be released regarding covered gifts and bequests, but no such guidance has been issued to date.

## TREATY CONSIDERATIONS

If an NRA is considered a tax resident of a country with a highly developed tax regime (e.g., the United Kingdom, France, Canada), it is paramount to obtain tax advice in that other country to ensure that any U.S. planning does not have negative tax consequences in the other country. If the other country is a treaty partner with the United States, then U.S. taxation of the individual may be reduced or eliminated by treaty.

Currently, the United States has income tax treaties with over 60 countries and estate and gift tax treaties with only 17 countries. Further information can be found on the IRS website at the following URLs:

- <http://www.irs.gov/Individuals/International-Taxpayers/Tax-Treaties;and>
- <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estate-&-Gift-Tax-Treaties-International>.

## U.S. INCOME TAXATION OF NRAs

In general, an NRA is taxable only on U.S.-source income. A great deal of case law and volumes of treatises deal with navigating the source rules for determining whether income is derived from U.S. sources or foreign sources, especially where activities are conducted by an NRA or foreign corporation in the

<sup>23</sup> §877A.

<sup>24</sup> Notice 2009-85, 2009-45 I.R.B. 598.

<sup>25</sup> §877A(a); Rev. Proc. 2013-35, 2013-47 I.R.B. 537, §3.30.

<sup>26</sup> Notice 2009-85.

<sup>27</sup> §877A(c).

<sup>28</sup> Detailed guidance on the exit tax is available in Notice 2009-85.

<sup>29</sup> §2801.

<sup>30</sup> §2801(b).

<sup>31</sup> §2801(a).

<sup>32</sup> §2801(c), §2801(e).

<sup>33</sup> Announcement 2009-57, 2009-29 I.R.B. 58.

United States through an agent.<sup>34</sup> For our purposes, we will not delve into determining the source of income, but will focus on the taxability of different types of U.S.-source income in the hands of NRAs.

## Effectively Connected Income (“ECI”)

Foreign taxpayers’ income that is “effectively connected with a U.S. trade or business” (referred to as “effectively connected income” or “ECI”) is taxed at graduated rates on a net income basis (rather than at a flat rate on a gross basis, as with FDAP income, discussed below).<sup>35</sup>

An NRA will be considered engaged in a U.S. trade or business if his or her activities (or those of his or her agents) in the United States are “considerable . . . as well as continuous and regular.”<sup>36</sup> For example, owning rental real property may qualify as a trade or business if it is managed regularly, systematically, and continuously.<sup>37</sup> It can qualify as a trade or business even if the foreign person hires a U.S. manager to handle the rental activities. On the other hand, if the foreign person rents out the U.S. real property but is not in the “business of renting,” the property will be considered an investment, rather than a rental business, and any rental income will thus be considered FDAP income (described below).

## FDAP Income

An NRA’s U.S.-source income that is “fixed, determinable, annual, or periodic” (“FDAP” income) is subject to a flat 30% tax on gross income, or a lower rate if an income tax treaty applies (which will typically reduce the rate, ranging from 15% to as little as 5%). The 30% tax is collected through withholding at the source of the income (e.g., the bank paying the interest; the U.S. corporation paying a dividend). In general, FDAP income consists of interest, dividends, rents, and royalties that are not effectively connected with a U.S. trade or business (i.e., passive investment income).<sup>38</sup> That being said, there are two broad categories of investment income that fall outside of the FDAP withholding regime: interest and capital gains, discussed below.

<sup>34</sup> *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953); see §861–§865.

<sup>35</sup> §871(b) (for individuals), §882 (for corporations).

<sup>36</sup> §864; Reg. §1.864-2; *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940); Rev. Rul. 70-424, 1970-2 C.B. 150.

<sup>37</sup> *Alvary v. United States*, 302 F.2d 790 (2d Cir. 1962).

<sup>38</sup> §871(a), §881(a). *But see* §871(d), §882(d) (which allow an NRA to elect to treat real property income as ECI even if it would not otherwise be ECI). This “net election” permits net taxation at graduated rates instead of 30% FDAP withholding on gross income.

## Portfolio Interest and Bank Deposit Interest

Two forms of U.S.-source investment income received by an NRA that are not subject to U.S. tax are portfolio interest and interest on U.S. bank deposits.<sup>39</sup> The portfolio interest exemption is aimed at helping U.S. borrowers compete with foreign borrowers for loans from foreign lenders, who, without the portfolio interest exemption, would be subject to 30% withholding on all interest paid by the U.S. borrower. Similarly, the bank deposit interest exemption helps U.S. banks compete with foreign banks for non-U.S. customers.

Bank deposit interest is self-explanatory, but portfolio interest requires a bit more explanation. Foreign lenders can take advantage of the portfolio interest exemption only if: (i) the obligation is in registered form (i.e., it cannot be in “bearer” form); and (ii) the U.S. borrower obtains a statement that the beneficial owner of the obligation is not a U.S. person.<sup>40</sup> The registration requirement can be met with a “book entry” system, whereby the issuer maintains a record of ownership of the obligation.<sup>41</sup> The interest payable on the obligation cannot be contingent (e.g., based on the value of the debtor’s property or cash flow),<sup>42</sup> and in the case of a corporate or partnership borrower, the lender cannot own 10% or more of the borrower’s stock, capital, or voting power.<sup>43</sup>

## Capital Gains (Non-Real Estate)

Capital gains received by an NRA from the sale of U.S.-situs property are not subject to U.S. tax, as long as such gains are not attributable to property that is effectively connected with a U.S. trade or business (ECI, as discussed above) or gains from the disposition of U.S. real property interests (discussed below).<sup>44</sup>

## Capital Gains (Real Estate)

The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)<sup>45</sup> created an exception to the general rule that NRAs are not subject to tax on U.S.-source capital gains. FIRPTA treats an NRA’s gain (or

<sup>39</sup> §871(h), §871(i), §881(c), §881(d).

<sup>40</sup> §871(h)(2)(B).

<sup>41</sup> Staff of J. Comm. on Tax’n, “Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act, Under Consideration by the Senate (JCX-4-10)” 52–53 (Feb. 23, 2010).

<sup>42</sup> §871(h)(4).

<sup>43</sup> §871(h)(3).

<sup>44</sup> §871(a)(1).

<sup>45</sup> Pub. L. No. 96-499.

loss) from the sale or exchange of a U.S. real property interest (“USRPI”) as if the NRA was engaged in the conduct of a U.S. trade or business and the gain (or loss) was effectively connected with such trade or business.<sup>46</sup> In other words, FIRPTA treats U.S. real estate gains as ECI.

A USRPI is defined as:<sup>47</sup>

- an interest in U.S. real property, which includes:
  - land and buildings or other improvements on the land;
  - growing crops and timber; mines, wells, and other natural deposits that have not been severed or extracted from the land;
  - “shared appreciation loans” (i.e., loans with direct or indirect rights to share in appreciation in value, gross or net proceeds, or profits from real property); and
- an interest in a U.S. corporation that was a “U.S. real property holding corporation” (“USRPHC”) at any time during the shorter of:
  - the five-year period preceding the sale; or
  - the taxpayer’s holding period.

A USRPHC is any corporation in which the fair market value of its USRPIs equals or exceeds 50% of the fair market value of such corporation’s: (i) USRPIs; (ii) its interests in real property located outside of the United States; and (iii) any of its other assets which are used or held for use in a trade or business.<sup>48</sup>

A USRPI does NOT include:

- an interest in real property held solely as a creditor;<sup>49</sup>
- a mortgage loan at a fixed or variable rate of interest (such as prime, LIBOR, etc.) that is not principally tied to the fluctuation of the value of real property;<sup>50</sup> or
- an interest in a real estate investment trust (“REIT”), provided that the REIT is: (i) “domestically controlled”; (ii) not a USRPHC; or (iii) publicly traded and the foreign shareholder owned less than 5% in the last five years.<sup>51</sup>

FIRPTA applies a look-through rule for partnerships and trusts holding a USRPI. An interest in a partnership is a USRPI if 50% or more of the value of the partnership’s gross assets are USRPIs and 90% or more of the value of the gross assets of the partnership consists of USRPIs plus cash or cash equivalents

where gain on the disposition is attributable to USRPIs.<sup>52</sup> Gains from the sale or exchange of foreign taxpayers’ interests in partnerships, trusts, or estates that hold USRPIs are treated as received from the sale or exchange of USRPIs to the extent attributable to such USRPIs.

In order to collect the taxes imposed on foreign investors, FIRPTA imposes a withholding scheme in which 10% of the *amount realized* on the disposition of a USRPI must be withheld by the transferee, regardless of the amount of the foreign person’s gain.<sup>53</sup> If, at the end of the year, the amount withheld would not actually be owed, the foreign person can then file a U.S. income tax return (using IRS Form 1040NR, IRS Form 1041, or IRS Form 1120F, as appropriate) to calculate any tax due, and may receive a credit or a refund for amounts withheld.<sup>54</sup> Excess withholding can be avoided based on the maximum tax.<sup>55</sup> Some states also require withholding on a sale of real estate by a nonresident.

FIRPTA withholding does not apply to the following:<sup>56</sup>

- sales of property for less than \$300,000 if such property will be the transferee’s residence (this amount has not been increased to adjust for inflation in the past 30+ years);<sup>57</sup>
- sales of publicly traded stock where the seller owns no more than 5% of the total stock;
- sales for which the seller provides a non-foreign affidavit;
- sales for which the seller provides a non-U.S. real property holding company affidavit; or
- situations in which withholding is required under the partnership withholding rules of §1446 (i.e., the partnership withholding rules trump the FIRPTA withholding rules).

As stated above, under FIRPTA, an NRA’s gain on the sale of a USRPI or certain gains from interests in a USRPHC are treated as income effectively connected with a U.S. trade or business.<sup>58</sup> This ECI is taxed at regular U.S. income tax rates on a net basis. If the USRPI is a capital asset in the hands of a for-

<sup>46</sup> §897.

<sup>47</sup> §897(c).

<sup>48</sup> §897(c)(2).

<sup>49</sup> Reg. §1.897-1(c), §1.897-1(d).

<sup>50</sup> Reg. §1.897-1(d)(2)(ii)(D).

<sup>51</sup> §897(h).

<sup>52</sup> Reg. §1.897-7T(a); Notice 88-72, 1988-2 C.B. 383.

<sup>53</sup> §1445(a).

<sup>54</sup> Reg. §1.1445-1(f)(1).

<sup>55</sup> See IRS Form 8288-B; Rev. Proc. 2000-35, 2000-35 I.R.B. 211.

<sup>56</sup> See §1445(b).

<sup>57</sup> The seller may still be subject to U.S. tax on the sale, but FIRPTA withholding does not apply (e.g., a vacation home that was a rental property for the NRA seller but will be used as a personal residence by the buyer).

<sup>58</sup> §897(a)(1).

ein individual, the gain will be eligible for the lower capital gains rates if the asset is held for over a year. If the USRPI is held by a foreign corporation, it will be subject to regular corporate income tax rates (as corporations do not get the benefit of lower capital gains rates). In addition, foreign corporations are also subject to the branch profits tax on ECI, discussed in more detail below.

## Branch Profits Tax on Foreign Corporations' ECI

Foreign corporations that receive U.S.-source income that is, or is deemed to be, effectively connected with a U.S. trade or business will be subject to regular income tax, plus an additional "branch profits tax."

The branch profits tax was enacted to subject the income earned by foreign corporations operating in the United States to the same two levels of taxation to which domestic corporations are subjected (once at the corporate level and again on dividends). Without the branch profits tax, dividends from a foreign corporation to a foreign shareholder could potentially escape the dividend-level tax as a foreign-sourced dividend.

The way that the branch profits tax mimics U.S. corporate double taxation can be seen by putting the essence of U.S. corporate taxation and foreign corporate branch-profits taxation side by side. For domestic corporations, the maximum corporate rate on the corporation's earnings is 35%, and dividend payments to foreign shareholders are subject to a 30% FDAP withholding rate. Foreign corporations are taxed at the same maximum 35% corporate rate on ECI earned by the corporation, and an additional 30% branch profits tax is imposed on the foreign corporation for income that is distributed from the U.S. branch to the foreign shareholder, or deemed to be distributed because it is not reinvested in U.S. assets (referred to as the "dividend equivalent amount").<sup>59</sup> That being said, a treaty, if applicable, may reduce or eliminate the branch profits tax altogether.

## U.S. TRANSFER TAXATION OF NRAs

### Gift Taxation of NRAs

#### Property Transfers Subject to Gift Tax

The U.S. gift tax generally applies to gratuitous transfers of property made during the donor's lifetime.

<sup>59</sup> §884(e)(3).

For U.S. citizens and residents,<sup>60</sup> the gift tax applies to gratuitous transfers of any property, wherever situated.<sup>61</sup> But for NRAs, the gift tax applies only to gratuitous transfers of U.S.-situs real and tangible personal property.

Gifts of intangible U.S.-situs property by NRAs are not subject to U.S. gift tax.<sup>62</sup> Unfortunately, "intangible property" is not exhaustively defined in the Internal Revenue Code (Code) or the regulations, and this has led to a great deal of uncertainty for NRAs and their U.S. tax and estate planning counsel. However, it is clear that the following types of property are intangible property, and therefore not subject to gift tax:

- stock in a domestic corporation;<sup>63</sup> and
- debt obligations, including bank deposits, issued by a U.S. borrower.<sup>64</sup>

Physical currency (bank notes and coins, i.e., "cash") is considered tangible personal property for gift tax purposes.<sup>65</sup> Therefore, advisors should caution their NRA clients with regard to transfers that could be construed as cash gifts, including the transfer of a U.S. safe deposit box holding cash<sup>66</sup> and writing a check from a U.S. bank account.<sup>67</sup>

The guidelines for wire transfers from a U.S. bank remain muddied. Though some commentators believe that wire transfers are intangible property because it is an obligation of the bank to electronically shift the deposit from one bank to another, with no physical transfer from the donor to the donee; it would be less risky to use another method to transfer ownership of a bank's obligations, for instance, by transferring an actual certificate of deposit in-kind to the donee.<sup>68</sup>

It is also unclear whether transferring ownership of a bank deposit account, which is definitively intangible property, will be characterized as a taxable transfer. This is because the bank, rather than simply changing the name on the account, might instead

<sup>60</sup> Although the test for transfer-tax purposes is one of "domicile," rather than "residence," as described above, we refer to "residence" here for ease of discussion. And the term "NRA" here means a non-U.S. domiciliary.

<sup>61</sup> §2501(a), §2511(a).

<sup>62</sup> §2501(a)(2).

<sup>63</sup> Reg. §25.2511-3(b)(3).

<sup>64</sup> Reg. §25.2511-3(b)(4); see also *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995); *Estate of Gade v. Commissioner*, 10 T.C. 585 (1948); *Estate of Fabbriotti Fara Forni v. Commissioner*, 47 BTA 76 (1942).

<sup>65</sup> *Blodgett v. Silberman*, 277 U.S. 1, 48 S. Ct. 410 (1928).

<sup>66</sup> Rev. Rul. 55-143, 1955-1 C.B. 465.

<sup>67</sup> GCM 34845 (Apr. 4, 1972), GCM 36860 (Sept. 24, 1976).

<sup>68</sup> See Aballi, *Gifts of Certain Intangible Property by Foreign Persons — Principles, Pitfalls, and Planning Opportunities*, 37 Tax Mgmt. Est., Gifts & Tr. J. 160 (Mar./Apr. 2012).

move the funds into a newly created account in the name of the donee, inadvertently converting the “bank deposit” into cash en route. Generally, it would be safest to have the NRA move funds to an offshore account and wire the funds to the donee from there.

With regard to partnership interests, the IRS has stated that it will not ordinarily rule on the issue of whether they should be treated as intangible property for gift tax purposes.<sup>69</sup>

Finally, it should be noted that otherwise nontaxable intangible property gifts will be subject to tax if they are “covered gifts” from a covered expatriate to a U.S. recipient, as discussed under “Expatriates,” above.

## Gift Tax Exclusions, Unified Credit, and Imposition of Tax

NRAs can make tax-free transfers of U.S.-situs real property and tangible personal property up to the applicable annual exclusion amount of \$10,000 per donee per year, indexed for inflation (\$14,000 for 2014).<sup>70</sup> Gifts of U.S. real estate and tangible personal property by an NRA that exceed the annual exclusion amount will be subject to current gift taxation because NRAs do not receive the benefit of the unified estate and gift tax credit that allows U.S. citizens and residents to avoid paying gift tax during life through the “pre-use” of their estate tax exemption via lifetime gifting. However, NRAs can make unlimited charitable gifts and gifts on behalf of donees directly to educational and medical institutions.<sup>71</sup>

If gift tax is imposed during the donor’s lifetime, the tax is calculated at a progressive rate schedule, and gifts are accumulated over the lifetime of the taxpayer.<sup>72</sup> The calculation of the tentative gift tax requires computing the tax on the aggregate sum of the taxable gifts for that year and for each of the preceding calendar periods, and dividing that tentative tax by the tentative tax on the aggregate sum of the taxable gifts for the preceding calendar periods.<sup>73</sup> Taxable transfers by NRAs are subject to gift tax at rates ranging from 18% to a maximum 40%, and the result of the cumulating lifetime gifts means that taxable gifts made in subsequent years will be taxed at increasingly higher rates up to the maximum rate of 40%.

### Gifts to Spouses

In general, there is an unlimited deduction from gift tax for transfers made to spouses. However, this does

not apply to gifts made to a spouse who is not a citizen.<sup>74</sup> Instead, gifts to spouses who are non-citizens are limited to a special “super annual exclusion” amount of \$100,000 per year, indexed for inflation (\$145,000 for 2014).<sup>75</sup> Note that the taxation of gifts of U.S.-situs property between spouses depends entirely on the *citizenship* of the *donee* spouse (not the domicile of the donor). Thus, a non-citizen spouse could make unlimited gifts of U.S.-situs real and tangible personal property to a citizen spouse, but not the other way around.

### Spousal Gift-Splitting

As mentioned above, for gifts to non-spouses, an NRA is limited to the regular annual exclusion amount of \$10,000, indexed for inflation (\$14,000 for 2014).<sup>76</sup> Typically, spouses are allowed to “split” gifts of non-community property made to third parties, which means that both annual exclusions are applied to a single gift, thereby doubling the total annual exclusion available per donee.<sup>77</sup> However, gift-splitting is not available where one of the spouses is an NRA (unless a gift tax treaty provides otherwise).<sup>78</sup> Gift-splitting is available if either (or both) of the spouses is a non-citizen, but both spouses must be U.S. residents for transfer tax purposes.<sup>79</sup>

### Creation of Jointly Owned Property

#### *General Rule: Joint Ownership with Non-Spouse*

The general rule with regard to the creation of a joint tenancy in property where one party provides all or a disproportionate share of the consideration for that property is that the donor will have made a gift to the donee to the extent that the donee did not provide full consideration for his or her interest.<sup>80</sup> Assuming that the laws of the jurisdiction where the property is located allow a joint tenant to unilaterally sever his or her interest, the value of each person’s interest in the property is his or her proportionate share; otherwise value is determined on an actuarial basis (i.e., each joint tenant’s likelihood of surviving the other joint tenant). As with any other gift, the value of the transfer of an undivided interest in property is reduced, for gift tax purposes, by the annual exclusion amount.

For example, assume that a father purchases real property for \$100,000 and titles it in the names of

<sup>69</sup> Rev. Proc. 2014-7, 2014-1 I.R.B. 238, §4.01(28).

<sup>70</sup> See §2503(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537, §3.34(1).

<sup>71</sup> §2503(b), §2503(e), §2522(b).

<sup>72</sup> §2001(c).

<sup>73</sup> §2502(a).

<sup>74</sup> §2523(i)(1).

<sup>75</sup> §2523(i)(2); Reg. §25.2523(i)-1(a), §25.2523(i)-1(c)(2); Rev. Proc. 2013-35, 2013-47 I.R.B. 537, §3.34(2).

<sup>76</sup> §2503(b).

<sup>77</sup> §2513.

<sup>78</sup> §2513(a)(1).

<sup>79</sup> *Id.*

<sup>80</sup> Reg. §25.2511-1(h)(5).

himself and his daughter, as joint tenants. Daughter does not furnish any consideration for the purchase of the property. Daughter has received an undivided one-half interest in the property, valued at \$50,000 at the time of the transfer. Assuming the jurisdiction allows unilateral severance of each tenant's interest, the interests are valued on a pro-rata basis (50%) rather than on an actuarial basis. The father may exclude the annual exclusion amount (\$14,000 for 2014) from the value transferred (\$50,000), so the taxable gift is \$36,000.

### ***Joint Ownership with Non-Citizen Spouse***

The above gift tax treatment for the creation of joint tenancies differs when the joint tenants are spouses. Prior to the enactment of the unlimited gift tax marital deduction by the Economic Recovery Tax Act of 1981,<sup>81</sup> the creation of a spousal joint tenancy with right of survivorship or a tenancy by the entirety had gift tax consequences in accordance with the general rules applicable to non-spousal joint tenancies. But with the enactment of the unlimited gift tax marital deduction, such transactions between citizen spouses have no gift tax consequences, and so the Code sections which provided guidance on spousal joint tenancies were repealed.<sup>82</sup> However, gifts to non-citizen spouses remain subject to gift tax, and so we must look for guidance to the regulations that refer to these repealed statutes.

### ***Real Property***

For joint tenancies in real estate, where the donee spouse is a non-citizen, the creation of the joint tenancy (and additional improvements to the property) is not a taxable gift, regardless of the proportion of the consideration furnished by each spouse.<sup>83</sup> However, if the joint tenancy terminates, other than by reason of the death of a spouse (which may have estate tax consequences, discussed below), a taxable gift occurs to the extent that the non-citizen donee spouse receives proceeds that are not proportionate to the amount of the consideration that such spouse furnished.<sup>84</sup>

Consider the following example: A non-citizen Husband and his non-citizen Wife take title to U.S.-situs real property, creating a joint tenancy with right of survivorship. If Husband paid \$300,000 for the real property and took title in the names of both Husband and Wife as joint tenants, there will be no gift tax upon the purchase. If, however, the couple sells the

property for \$400,000, and the proceeds are distributed equally to both Husband and Wife, Husband is deemed to have made a gift of one-half of the proceeds (\$200,000) to Wife. The annual exclusion amount (\$145,000 for gifts to a non-citizen spouse in 2014) will be excluded from the proceeds for purposes of calculating the gift tax, assuming that the exclusion has not already been used for prior gifts to Wife that year. Thus, \$55,000 of Wife's proceeds will be subject to gift tax, and Husband must report the gift on an IRS Form 709.

As a result, a joint tenancy or tenancy by the entirety cannot be used as a disguise to transfer property to a non-citizen spouse on a tax-free basis because gift tax will arise if the tenancy is terminated before the death of the donor spouse. If the tenancy terminates due to death, there may be estate tax consequences, as described in more detail under "Estate Taxation of NRAs," below.

### ***Personal Property***

Whereas spousal joint tenancies in real property are subject to gift tax on the termination (rather than the creation) of the joint tenancy, the rules differ for the creation of spousal joint tenancies with a non-citizen spouse in personal property.

The regulations state that the creation of a spousal joint tenancy with a non-citizen spouse in personal property results in each spouse retaining a one-half interest in the property.<sup>85</sup> Treating each spouse as retaining a one-half interest in the property avoids the need to calculate the actuarial value of each spouse's interest; instead, where the consideration is entirely furnished by the donor spouse, it's treated as a gift of one-half of the total value of the property, and taxed accordingly after application of the annual exclusion amount (\$145,000 for gifts to a non-citizen spouse in 2014). At termination of the joint tenancy (other than by death), no gift tax is imposed as long as the proceeds are distributed 50/50.

## **Estate Taxation of NRAs**

### **Imposition of Estate Tax**

U.S. citizens and residents enjoy a \$5 million estate tax exemption, indexed for inflation (\$5,340,000 for 2014), in addition to an unlimited estate tax marital deduction that allows spouses, with proper planning, to avoid estate tax on \$10 million of assets (indexed

<sup>81</sup> Pub. L. No. 97-34.

<sup>82</sup> Reg. §25.2523(i)-2, promulgated under former §2515, §2515A (repealed) (the current §2515 is a generation-skipping transfer tax provision).

<sup>83</sup> Reg. §25.2523(i)-2(b)(1).

<sup>84</sup> Reg. §25.2523(i)-2(b)(2)(i). The rules differ for pre-July 1988 transfers. See Reg. §25.2523(i)-2(b)(2)(ii).

<sup>85</sup> Reg. §25.2523(i)-2(c) (note the exception for property in which the fair market value cannot be determined without reference to the life expectancy of one or both spouses).

to \$10,680,000 for 2014).<sup>86</sup> NRAs are allowed a mere \$60,000 exemption, which is not indexed for inflation and has not been increased in decades.<sup>87</sup> For this reason, NRAs must plan carefully around the U.S. estate tax for U.S.-situs property held at death.

### Property Taxed

While NRAs are subject to gift tax only on transfers of U.S.-situs real property and tangible personal property, all property situated in the United States and owned at the death of the NRA is included in the NRA's U.S. taxable estate.<sup>88</sup> For estate tax purposes, U.S.-situs property includes the following, subject to a few exceptions where indicated.

#### *U.S. Tangible Personal Property*

Any tangible personal property (automobiles, furnishings, jewelry, etc.) physically located in the United States will be subject to estate tax.<sup>89</sup> Cash and currency are considered tangible personal property and will thus be taxable if located in the United States at the decedent's death.

#### *U.S. Intangible Property*

While U.S. intangible property transferred by an NRA during lifetime is not subject to gift tax, U.S. intangible property owned by an NRA at death is generally subject to U.S. estate tax.<sup>90</sup>

The following U.S. intangible assets are included in an NRA's U.S. estate:

- funds in bank or other brokerage accounts that are used in a U.S. trade or business;
- qualified retirement plans held in the United States;
- stock in domestic corporations;
- life insurance policies held by the decedent on the life of another person, issued by a U.S. insurance company; or
- annuities on the life of another, issued by a U.S. insurance company.

However, the following U.S. intangible assets are not included in an NRA's U.S. estate:<sup>91</sup>

- savings accounts, checking accounts, or certificates of deposit with a U.S. bank (if not used in a U.S. trade or business);

- funds held in a U.S. bank custody account;
- funds deposited in a foreign branch of a U.S. bank;
- proceeds of a life insurance policy on the life of the decedent, owned by the decedent, and issued by a U.S. insurance company; or
- debt obligations and certain short-term OID obligations of a U.S. person that qualify for the portfolio interest exemption under §871(h).

#### *U.S. Real Property*

U.S. real property held directly by the NRA is included in the NRA's U.S. estate and includes land, buildings, fixtures, and improvements on the property.<sup>92</sup>

#### *Certain Retained Interests*<sup>93</sup>

U.S.-situs property that is gratuitously transferred by an NRA decedent while he or she is alive, by trust or otherwise, is includible in the decedent's estate if:

- the decedent retained for his or her life (or for a period that cannot be ascertained without reference to his or her death) some type of possession, control, or enjoyment of the property or its income, or the right to designate who will possess or enjoy the property;<sup>94</sup>
- possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest in the property that exceeds 5% of the value of the property at the time of the decedent's death;<sup>95</sup>
- the property was, on the date of the decedent's death, subject to his or her right to alter or revoke the transfer (or if such a power was relinquished by the decedent within three years of the date of his or her death);<sup>96</sup> or
- the decedent transferred within the three-year period prior to his or her death an interest in property that would have been included in his or her estate under any of the foregoing rules, *and if the property so transferred was situated in the United States at the time of the transfer or at the time of the decedent's death.* For this reason, it's best to transfer only non-U.S. assets to a trust structure

<sup>86</sup> See §2010(c), §2056; Rev. Proc. 2013-35, 2013-47 I.R.B. 537, §3.32.

<sup>87</sup> §2102.

<sup>88</sup> §2103; Reg. §20.2103-1.

<sup>89</sup> Reg. §20.2104-1(a)(2).

<sup>90</sup> Reg. §20.2104-1(a)(4).

<sup>91</sup> Reg. §20.2105-1.

<sup>92</sup> Reg. §20.2104-1(a)(1).

<sup>93</sup> §2104(b).

<sup>94</sup> See §2036.

<sup>95</sup> See §2037.

<sup>96</sup> See §2038.

and to ensure that the structure never acquires U.S. assets.<sup>97</sup>

### ***Partnerships and Limited Liability Companies***

Much debate exists concerning the determination of the situs of a partnership or LLC interest for U.S. estate tax purposes. This debate is rooted in the history of partnership law. Partnerships originated in ancient Roman law, and when they emerged in English statutory law over a century ago, partnerships were viewed as aggregate-ownership vehicles (where each partner owns a pro-rata interest in the partnership's operations and assets). This is referred to as the "aggregate theory" of partnerships. But as limited partnerships and limited liability companies emerged as more evolved versions of general partnerships over the past century, partnership statutes also evolved to treat these entities as separate from their owners, and interests in the entity were treated as personal property (known as the "entity theory" of partnerships).

Thus, the U.S. estate taxation of an NRA's interest in a partnership or LLC can be summarized under each of these theories as follows.<sup>98</sup>

- **Aggregate Theory.** Because this approach views a partnership interest as pro-rata ownership of the partnership's underlying assets, the place of organization of the partnership is irrelevant, and we must look to the situs of the partnership's property to determine the situs of a partner's interest.
- **Entity Theory.** Because this approach treats the partnership as an entity separate from its partners, we must look to: (i) the location where the partnership conducts its business; or (ii) the residency of the partnership for income tax purposes (i.e., its place of organization) to determine the situs of a partner's interest in the entity.

Generally, a partnership interest is deemed to be a U.S.-situs asset if: (i) the partnership does not qualify as a separate legal entity under the law of the jurisdiction where it was established, or is dissolved on the death of one partner, and the underlying assets of the partnership are situated in the United States; or (ii) the partnership is a separate legal entity under the laws of the jurisdiction where it was established, it survives the death of a partner, and the partnership carries out its business in the United States.<sup>99</sup>

In the past, the IRS has not suggested that the aggregate theory should be applied to the question of the situs of a partnership interest for purposes of applying

transfer taxes to a gift or to the estate of an NRA. However, very little guidance is available to instruct advisors on how the interests will be characterized, and therefore caution must be taken when planning. Some very outdated pronouncements indicate that the IRS seems to favor the use of the entity theory to determine the situs of the partnership interest based on where the entity itself is engaged in business.<sup>100</sup> However, the location of a partnership's business is a facts-and-circumstances determination. And still other authorities seem to prefer a look-through theory to determine the situs of the partnership interest based on the location of the assets.<sup>101</sup>

Because uncertainty exists with regard to partnership interests (and interests in LLCs that are taxed as partnerships), an NRA should plan conservatively by assuming that any U.S. connection will cause the partnership or LLC interest to be considered a U.S.-situs asset.

### **Bequests to Non-Citizen Spouses Using a QDOT**

An important estate planning mechanism for married U.S. citizens and residents is the unlimited estate tax marital deduction for bequests to a surviving spouse. In other words, the value of property transferred to a surviving spouse is deducted from the deceased spouse's gross estate to arrive at the deceased spouse's taxable estate.

However, the marital deduction is available only for transfers to surviving spouses who are U.S. citizens. If the surviving spouse is not a U.S. citizen, it is available only for transfers to a "qualified domestic trust" for the spouse's benefit (commonly referred to as a "QDOT"). A U.S. citizen or resident who uses a QDOT to leave property to a non-citizen spouse is permitted an estate tax marital deduction for the value of the property transferred to the trust. A QDOT defers estate tax in the deceased spouse's estate by imposing estate tax on: (i) distributions of capital from the trust to the surviving spouse during his or her lifetime; and (ii) the value of the property remaining in the trust on the date of the surviving spouse's death.

QDOTs are available only for testamentary transfers, not for lifetime gifts. A QDOT can be established via the deceased spouse's will or revocable management trust, but if the non-citizen spouse received a spousal bequest outright, he or she can transfer the

<sup>97</sup> See §2035.

<sup>98</sup> For more information on these theories, see 710 T.M., *Partnerships — Conceptual Overview* (U.S. Income Series).

<sup>99</sup> See *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934); Rev. Rul. 55-701, 1955-2 C.B. 836.

<sup>100</sup> Rev. Rul. 55-701, 1955-2 C.B. 836; see also GCM 16164 (1936), *rev'd*, GCM 18718 (1937) (later declared obsolete by Rev. Rul. 70-59, 1970-1 C.B. 280, which applied the entity theory to partnership interests).

<sup>101</sup> *Sanchez*, 70 F.2d at 718. See Cassell, Karlin, McCaffrey & Streng, *U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests*, Tax Notes Int'l 563 (Aug. 11, 2003).

property to a QDOT prior to the filing of the decedent's estate tax return.<sup>102</sup>

In general, to qualify as a QDOT, a trust must: (i) have at least one trustee who is a U.S. citizen or domestic corporation; and (ii) provide that no distribution (other than a distribution of income) may be made from the trust, unless the trustee who is a U.S. citizen or domestic corporation has the right to withhold from such distribution the estate tax described in the paragraph above. The deceased spouse's executor must also make an election on the estate tax return to treat the trust as a QDOT.

A "large QDOT" (one funded with assets having a value of more than \$2 million on the U.S. spouse's date of death) carries with it more cumbersome administrative requirements than a "small QDOT."<sup>103</sup> This is because the Code requires additional assurance that the IRS will be able to collect the tax from a large QDOT than a small QDOT. These collection assurances are provided by requiring a large QDOT to satisfy one of the following three so-called "Security Requirements": (i) a U.S. bank must serve as a trustee; (ii) the trustee must furnish a bond in favor of the IRS equal to 65% of the fair market value of the trust assets; or (iii) the trustee must provide the IRS with a letter of credit in an amount equal to 65% of the fair market value of the trust assets. By contrast, a small QDOT can satisfy the Security Requirements by merely containing provisions that prohibit the trust from holding foreign real estate.

Because of the more stringent Security Requirements on large QDOTs, it is preferable to maintain small-QDOT status if possible. For example, if the deceased spouse's estate consists of both U.S. and non-U.S. assets, and the surviving non-citizen spouse is not domiciled in the United States, it might be desirable to leave only U.S.-situs assets to the QDOT and leave the foreign-situs assets to the surviving spouse outright or in a regular testamentary trust to keep the QDOT below the \$2 million limit.

## Jointly Owned Property

### *Joint Ownership with a Non-Spouse*

For U.S. citizens who hold property in a non-spousal joint tenancy with right of survivorship, the general "consideration furnished rule" applies a presumption that the value of the entire jointly owned asset is included in the gross estate of the first joint tenant to die unless the surviving tenant or tenants can prove that they provided adequate and full consider-

ation for their share of the joint tenancy.<sup>104</sup> In that case, the value of the joint tenancy that is proportionate to the consideration furnished by the surviving joint tenants will be excluded from the decedent-joint tenant's estate. There is an exception where the entire property was acquired by all of the joint tenants at the same time in the form of a gift, bequest, devise, or inheritance; in that case, the value included in a decedent-joint tenant's estate is his fractional share of the property.<sup>105</sup>

The consideration-furnished rule applies to all non-spousal joint tenancies regardless of citizenship, and if the property is U.S.-situs property, it will be subject to estate tax in the hands of an NRA decedent up to the amount of consideration that the NRA furnished.

### *Joint Ownership with a Non-Citizen Spouse*

For tenancies in which the only two tenants are spouses and U.S. citizens, only one-half of the value of the joint tenancy or tenancy by the entirety is included in the decedent's estate, and the passage of the deceased spouse's interest to the surviving spouse by right of survivorship will be covered by the estate tax marital deduction.<sup>106</sup> This is known as the "50-50 rule." However, if the surviving spouse is not a U.S. citizen, the 50-50 rule does not apply, and the consideration-furnished rule will apply instead.<sup>107</sup>

Consider how to plan with regard to the marital assets of Wife who is not a U.S. citizen and Husband who is a U.S. citizen. If the non-citizen spouse, Wife, were to die first, the 50-50 rule would apply, and one-half of the value of assets held jointly with Husband would be included in Wife's estate, regardless of who provided the funds for such assets. However, if Husband is the first to die, leaving a non-citizen surviving spouse, the default consideration-furnished rule applies, meaning that Wife would have to prove the source of funds for any jointly held assets to determine the portion of those assets to be included in Husband's gross estate. Furthermore, Husband's share of the joint property passing to Wife will not be eligible for the marital deduction.

With regard to how these rules will apply to U.S. assets versus non-U.S.-situs assets, the answer again differs depending on who dies first, and whether the non-citizen spouse is also a nonresident for estate tax purposes. If the U.S. citizen, Husband, dies first, both U.S.- and non-U.S.-situs assets will be implicated because his gross estate includes worldwide assets. If the non-citizen Wife dies first and if she is also a nonresident, the only joint tenancy assets that will be included in her U.S. gross estate are U.S.-situs assets.

<sup>104</sup> §2040(a).

<sup>105</sup> *Id.*

<sup>106</sup> §2040(b), §2056(a).

<sup>107</sup> §2056(d)(1)(B), §2040(b)(2)(B).

<sup>102</sup> Reg. §20.2056A-2(b)(2).

<sup>103</sup> Reg. §20.2056A-2(d).

Due to the wide variance in the tax treatment depending on which spouse will die first, where the couple's property is located, and whether the non-citizen spouse is a resident or a nonresident for transfer tax purposes, it is not recommended to create joint-tenancy property with a non-citizen spouse.<sup>108</sup>

## Generation-Skipping Transfer Taxation of NRAs

Generation-skipping transfer ("GST") tax generally applies to certain transfers to "skip persons." In very general terms, skip persons are those who are assigned to a generation that is two or more generations below the donor, or, if the donor and donee are not closely related, a skip person is a donee who is more than 37½ years younger than the donor.<sup>109</sup> However, GST tax will not apply to gifts or bequests made by NRAs to skip persons if the gift or bequest is not subject to U.S. gift or estate tax.<sup>110</sup> Therefore, transfers of non-U.S. property from an NRA to a U.S. person will not incur GST tax.

To the extent that GST tax applies, NRAs are allowed a \$1,000,000 GST tax exemption on GST taxable transfers.<sup>111</sup> The regulations set the GST tax exemption at \$1,000,000 for both U.S. residents and NRAs in 1995; since then, the exemption amount was increased for U.S. residents, but the regulations for NRAs have not been amended. Commentators have noted that the IRS presumably intended for the GST tax exemption for NRAs to track the exemption for U.S. residents. Therefore, it's likely that the IRS would recognize for NRAs a \$5,000,000 GST tax exemption, indexed for inflation (\$5,340,000 for 2014).<sup>112</sup>

## U.S. TAX PLANNING FOR NRAs

Because of the minimal \$60,000 estate tax exemption that is available to NRAs, if an NRA owns U.S.-situs property, it can trigger a devastating amount of estate tax. Therefore, the transfer tax considerations tend to drive U.S. planning for NRAs, with the income tax issues taking the passenger seat. Unfortunately, what is good for transfer tax purposes is not always the best income tax situation, and vice versa. Additional complications arise when a non-citizen is

a resident for income tax purposes and a nonresident for transfer tax purposes, but an analysis of these complications is outside the scope of this article. Therefore, for purposes of this discussion, we will assume that an individual is an NRA for both income and transfer tax purposes.

As will be discussed below, the most widely used solution for an NRA to avoid U.S. estate tax is to place U.S.-situs property in a foreign corporation, because stock in a foreign corporation is not subject to U.S. estate tax in the hands of an NRA. However, this structure does have some disadvantages that must be weighed on a case-by-case basis and compared with the pros and cons of other ownership structures. We will review the various ownership options and their benefits and drawbacks below.

## Basis Considerations

As a threshold matter to planning for NRAs, we must first discuss the future income tax consequences to the NRA's U.S. beneficiaries upon a later sale of assets received from the NRA by gift or inheritance.

Gifted property takes a carryover basis, meaning that the basis of the property in the hands of the donee will equal the donor's basis in the property.<sup>113</sup> In contrast, property transferred at death receives an adjustment in basis equal to the fair market value at the decedent's date of death.<sup>114</sup> Typically, the fair market value of property at death is higher than the property's basis, and so this adjustment is usually referred to as a "step-up" in basis. Therefore, property received by devise or bequest will normally have less taxable gain upon subsequent disposition than property received by gift.

However, if an NRA decedent leaves stock in a foreign holding company to a U.S. beneficiary, the stock itself will receive a basis step-up, but the underlying assets will not. Accordingly, if it's anticipated that U.S. persons may inherit or otherwise receive the stock of a foreign holding company, the NRA should consider periodically selling and repurchasing appreciated assets held by the company to increase the basis of the underlying assets, thereby reducing the built-in gain to future U.S. recipients.

If, instead of holding the shares of the foreign corporation until death, the NRA gifts the shares of a foreign corporation to a trust that has U.S. beneficiaries and will not be included in the NRA's estate, the shares of the corporation will not receive a step-up in basis at the NRA's death, and there could therefore be two levels of built-in gain, one at the corporate level and one at the share level.

<sup>108</sup> For further explanation of these complicated rules as they relate to the estate tax consequences of joint tenancies, see PLR 9551014.

<sup>109</sup> §2613, §2651(d).

<sup>110</sup> Reg. §26.2663-2(b)(1).

<sup>111</sup> Reg. §26.2663-2(a).

<sup>112</sup> See 850 T.M., *Generation-Skipping Transfer Tax* (EGT Series).

<sup>113</sup> §1015(a).

<sup>114</sup> §1014(a).

There are ways to plan around these issues, but it is important to keep these basis considerations in mind when planning for NRAs who have U.S. beneficiaries.

## Direct or Pass-Through Ownership by Foreign Individuals

The simplest way for an NRA to invest in the United States is directly in his own name or via a disregarded entity or other pass-through entity. The major advantages of direct or pass-through ownership are: (i) it's simple; (ii) it avoids the double income taxation of corporate ownership; (iii) individual investors have the benefit of lower capital gains tax rates (where corporate investors do not); (iv) the NRA's U.S. beneficiaries will receive a step-up in basis in the assets at the NRA's death (i.e., the basis won't be trapped in a corporation as described above); and (v) if the NRA owns multiple U.S. properties, losses from unprofitable properties can offset income from profitable properties.

If the NRA is not concerned about losing the lower capital gains rates through corporate ownership, and if the NRA's assets generate ECI, then one disadvantage of direct ownership versus corporate ownership is that a higher maximum income tax rate applies to individuals (39.6%) as opposed to the maximum rate for corporations (35%). In addition, if a foreign individual dies while owning property that is considered "situated in the United States" for estate tax purposes, and that property exceeds \$60,000 in value, estate tax will be incurred. This factor would also weigh in favor of corporate ownership.

As mentioned under "Partnerships and Limited Liability Companies," above, the situs of an interest in a partnership or LLC for estate and gift tax purposes is a gray area. Although it should be possible under the entity theory of partnerships for an NRA to avoid estate tax on U.S. assets held in a foreign partnership, caution would dictate that a foreign corporation be used instead.

There are certain situations in which an NRA need not own U.S. assets through a corporate vehicle to avoid estate taxation. Assets that are excluded from the NRA's U.S. estate under the Code (e.g., bank deposits and life insurance) can be held outright or in a pass-through entity. There may also be scenarios in which a treaty provides sufficient relief. For example, the U.S.-Canada tax treaty allows a Canadian decedent to receive a marital "credit" for U.S. property left to a Canadian-resident NRA surviving spouse, as

long as the bequest would otherwise qualify for the U.S. marital deduction.<sup>115</sup>

## Ownership Through a Foreign Corporation

As mentioned above, owning U.S. assets through a foreign corporation is the most common way for an NRA to block U.S. estate taxation. This is because the NRA's estate will consist of shares in a foreign corporation (which are not includible in the NRA's estate for estate tax purposes), rather than the underlying U.S. assets. Furthermore, during the NRA's lifetime, he or she can gift shares of the foreign corporation free of gift tax, and sell shares of the foreign corporation free of U.S. income tax. Finally, dividends from the foreign corporation are not subject to U.S. income tax in the hands of an NRA.

All of that sounds quite ideal, but the negative implications of this ownership structure must be considered as well. Although the foreign corporation will not be taxed on the sale of any U.S. stock that it owns, the sale of U.S. real estate held by the foreign corporation will not receive the lower capital gains tax rates available to individuals, and the gain will be deemed to be ECI under FIRPTA, thereby subjecting the gain to the additional 30% branch profits tax on top of the regular corporate tax.<sup>116</sup>

Another downside of corporate ownership, as mentioned under "Basis Considerations," above, is that upon the NRA's death the shares in the corporation will receive a step-up in basis, but the assets owned by the entity will not. This means that U.S. beneficiaries who inherit shares of the foreign corporation will also acquire the assets' built-in gain, causing a gain event if the assets are later sold or if the corporation is liquidated. However, the income tax on the built-in gain will typically be less than the estate tax on the gross value of the corporation's U.S.-situs assets, and so using a foreign corporation to avoid estate taxation may be preferable.

## Foreign Investment Through a U.S. Corporation

An NRA may choose to hold U.S.-situs assets through a domestic corporation. Utilizing a domestic corporation will avoid the branch profits tax that arises on a foreign corporation's ECI. In addition, gifts of domestic stock by an NRA are not subject to gift tax. And, as with foreign corporations, the maxi-

<sup>115</sup> Article XXIX.B. of the United States-Canada Income Tax Convention.

<sup>116</sup> §897(a)(1)(B), §884.

imum tax rate on the corporation's income will be 35% as opposed to the highest individual rate of 39.6%.

However, unlike a foreign corporation, the stock of the domestic corporation will be subject to estate tax since it is a U.S.-situs asset. In addition, like the foreign corporate structure, a domestic corporation carries with it the same built-in gain problem for U.S. beneficiaries, as mentioned under "Basis Considerations," above.

## Foreign Corporation (Parent) / U.S. Corporation (Subsidiary) Structure

Utilizing a tiered structure consisting of a U.S. corporation to hold the U.S. assets and a foreign corporation to hold the shares in the U.S. corporation may provide the best of all worlds. The foreign parent/U.S. subsidiary structure results in no U.S. gift or estate tax if stock in the foreign corporation is gifted during the NRA's lifetime or owned at death. And if the domestic corporation is a USRPHC under FIRPTA, the branch profits tax will not apply to gain on the disposition of the foreign corporation's interest in the domestic corporation.<sup>117</sup>

Although the tiered structure provides many income and transfer tax savings, certain disadvantages cannot be avoided. For example, the domestic corporation will be taxed on its worldwide income, so the U.S. corporation's holdings should be limited to only U.S. assets to avoid incurring U.S. tax on foreign income. Also, corporations do not receive the benefit of lower capital gains rates. In addition, double taxation will occur if earnings and profits are distributed to the foreign parent via a dividend; however, the amount of the taxable dividend can be controlled by reducing the corporation's earnings and profits with expenses at the corporate level. It's also possible to reduce the double taxation by paying the NRA a salary, which will be taxed at graduated individual rates and deducted at the corporate level.

Another potential disadvantage of this structure is that a liquidating distribution of a U.S. subsidiary corporation to a foreign parent generally will not qualify for the nonrecognition treatment that would otherwise apply in a wholly domestic structure.<sup>118</sup> However, if the foreign corporation uses the distributed property in a U.S. trade or business for at least 10 years after

the liquidation, no recognition of gain on the appreciated assets of the U.S. subsidiary is required.<sup>119</sup>

Finally, there's also a potential issue with this structure where the nonresident shareholder intends to use the U.S. subsidiary corporation's property for personal use. The IRS has stated that personal use of corporate property is a constructive dividend equal to the amount by which the fair market rental value of the U.S. property exceeds the amount that the shareholder actually pays in rent.<sup>120</sup> The result is that the U.S. subsidiary will be deemed to pay a U.S.-source dividend to the foreign parent (subject to 30% FDAP withholding), which then pays a deemed foreign-sourced dividend (not subject to U.S. tax) to the NRA shareholder. Thus, with this structure, the NRA should pay fair rental value for any personal use of the corporation's property.

All things considered, the foreign parent/U.S. subsidiary structure is usually the recommended way for NRAs to acquire U.S. property, especially if the property generates ECI that would be subject to the branch profits tax if earned by a foreign corporation. The NRA should first form the foreign corporation, which will then form the domestic corporation, which will then be used to acquire the U.S. property. To avoid a deemed disposition under FIRPTA, U.S. real estate that is already owned by the NRA should not be transferred to a corporate structure.<sup>121</sup>

## Ownership Through a Foreign Trust

The final ownership option for an NRA's U.S. assets is through a foreign trust. There are two types of trusts for U.S. income tax purposes: grantor trusts and nongrantor trusts.

Grantor-trust status will retain the positive income tax benefits of direct or pass-through ownership because all of the trust's income is treated as owned by the NRA grantor. However, a grantor trust will usually not accomplish estate tax avoidance on U.S. assets in the trust because in order for it to be classified as a grantor trust, the trust must either be: (i) revocable; or (ii) the grantor or the grantor's spouse must be the sole beneficiaries during the grantor's life.<sup>122</sup> If the trust is revocable or if the grantor is a trust beneficiary, these traits are impermissible retained interests,

<sup>119</sup> Reg. §1.367(e)-2(b)(2).

<sup>120</sup> *G.D. Parker, Inc. v. Commissioner*, T.C. Memo 2012-327; see also Rev. Rul. 58-1, 1958-1 C.B. 173; FSA 199945017 (advising that rent-free use of an S corporation's corporate asset by the majority shareholder was a constructive dividend to the majority shareholder in the amount of the fair rental value of the asset).

<sup>121</sup> §897(e).

<sup>122</sup> §672(f).

<sup>117</sup> §884(d)(2)(C).

<sup>118</sup> §367(e)(2); but see Reg. §1.897-5T(b)(3)(iv) (regarding liquidating distributions of a U.S. subsidiary that is a USRPHC under FIRPTA).

which cause estate taxation on U.S. assets in the trust, as described under “Certain Retained Interests,” above. If, however, the grantor is willing to name only his or her spouse as the trust beneficiary, and if the trust is funded with the grantor’s separate property (rather than the community property of the grantor and his or her spouse), grantor-trust status could be achieved for income tax purposes without causing estate taxation on U.S. assets in the trust.<sup>123</sup>

A nongrantor trust will also avoid corporate double taxation because trusts are taxed like individuals, albeit at compressed rates.<sup>124</sup> In addition, a nongrantor trust will achieve estate tax savings so long as the grantor relinquishes all impermissible retained interests, meaning that the trust must be used for actual gifting and must be truly irrevocable.<sup>125</sup> A foreign nongrantor trust will not be desirable if the current or future beneficiaries are or may become U.S. citizens or residents due to the throwback tax regime applicable to accumulated income of foreign nongrantor trusts. To avoid the throwback tax, all income of the trust, even foreign-source income, must be distributed out of the trust each year.<sup>126</sup> For this reason, if an NRA has U.S. beneficiaries, it is usually best to utilize a U.S. trust for lifetime gifting or for testamentary transfers to those beneficiaries.

## Inheritance of Shares in a Foreign Corporation by U.S. Beneficiaries; CFCs

As mentioned above, when establishing an entity structure to plan around transfer taxes and income taxes, an NRA must consider the long-term tax ramifications upon the ultimate disposition of the structure at the NRA’s death. If a foreign corporation is used as an estate tax blocker to hold U.S.-situs assets, and the shares in the foreign corporation are inherited by U.S. descendants or held in a trust for the benefit of U.S. beneficiaries, then these U.S. shareholders may find themselves subject to special U.S. income tax “anti-deferral” regimes applicable to certain foreign corporations. Although U.S. anti-deferral regimes are not applicable to NRAs, an NRA with U.S. beneficiaries must be aware of them due to the adverse income tax consequences to the U.S. beneficiaries who will ultimately receive shares of the foreign corporation.

The primary anti-deferral regime applicable to closely held foreign corporations is known as the

“Subpart F” regime, which applies to “controlled foreign corporations,” or “CFCs.” In a nutshell, the Subpart F rules provide that certain types of passive income earned by a CFC (“Subpart F income”) will be deemed to be distributed to the company’s U.S. owners and taxed as ordinary income in the U.S. owners’ hands, even if it is not actually distributed to them.<sup>127</sup>

A CFC is defined as any foreign corporation of which more than 50% of the total value of the stock is owned by U.S. shareholders on any day during the corporation’s taxable year.<sup>128</sup> A “U.S. shareholder” is a U.S. person who owns, or is considered to own, 10% or more of the total combined voting power of all classes of the corporation’s stock.<sup>129</sup> For purposes of determining U.S. share ownership, constructive ownership rules apply, meaning that stock of a foreign corporation that is owned by corporations, partnerships, and trusts is treated as owned proportionately by the shareholders, partners, or beneficiaries, and certain family members are treated as owning each other’s stock.<sup>130</sup>

Thus, if a U.S. person receives an interest in a CFC, whether directly or indirectly (e.g., if they are beneficiaries of a trust which holds a CFC),<sup>131</sup> the U.S. beneficiaries must report their ownership of the CFC to the IRS on Form 5471, even though it may be indirectly owned through a trust. And all of the CFC’s passive income (interest, dividends, capital gains, etc.) will flow through to the U.S. shareholders each year and must be reported on their personal income tax returns, even if the income is not actually distributed to them. Furthermore, capital gains generated in a CFC are taxed as ordinary income, and because of the way that Subpart F income is calculated, certain types of credits that would normally offset taxable income will not be fully available to the U.S. owners.

Therefore, in order to avoid the Subpart F rules, the U.S. beneficiaries who inherit stock of a foreign corporation will likely want to liquidate the corporation or elect pass-through treatment for the corporation at the NRA shareholder’s death. For U.S. tax purposes, a pass-through election is treated as a deemed liquidation. And in either case, it will potentially be a taxable event to the U.S. owners. The taxation of an actual or deemed liquidation by U.S. shareholders of a foreign corporation is described as follows.

The shareholder of a corporation has a basis in his shares equal to the amount that he or she paid for the

<sup>123</sup> §672(f)(2)(A).

<sup>124</sup> §1(e), §1(f)(1) (for 2014, a nongrantor trust’s taxable income over \$12,500 is taxed at 39.6%).

<sup>125</sup> §2035–§2038, §2104(b).

<sup>126</sup> §668.

<sup>127</sup> §951, *et seq.*

<sup>128</sup> §957(a).

<sup>129</sup> §951(b).

<sup>130</sup> §958.

<sup>131</sup> Reg. §1.958-1(d) Ex. 3; FSA 199952014; *see also* Reg. §1.958-1(c)(2) (regarding whether a trust beneficiary actually can control or influence the voting of the shares within the meaning of §951(a)).

shares and the amounts that he or she contributed to the company over time. The shareholder's basis in the company is called the "outside basis." As mentioned under "Basis Considerations," above, when a shareholder dies, his outside basis is adjusted to the fair market value ("FMV") of the shares on the date of death, which is typically higher than his outside basis, hence the "step-up in basis at death" rule.<sup>132</sup> Assuming that there is a step-up in basis at the NRA shareholder's death, the U.S. beneficiaries' basis in inherited shares of a corporation equals the new stepped-up basis of the deceased shareholder, thereby eliminating any built-in gain at the share level.

The step-up in basis at death rule is usually ideal for beneficiaries because they receive an inheritance free of tax, and then they can sell the inherited asset at no, or little, gain. However, in the context of inheriting shares of a corporation, this is not necessarily the case because the company itself is a separate "person" from the shareholders, and it has its own basis in its assets equal to the value that it paid for those assets. The company's basis in its assets is called the "inside basis." Although the outside basis in the shares is stepped up at the shareholder's date of death, the inside basis in the underlying assets is not. The only way to step up inside basis is to periodically harvest gains in the corporation's assets by selling appreciated investments and purchasing new investments over time.

If the U.S. beneficiaries effect an actual or deemed liquidation of a foreign corporation at the NRA shareholder's death, the corporation will be deemed to realize gain to the extent to which the FMV of the corporation's assets exceeds the corporation's inside basis. This is a deemed gain event at the corporate level, which is passed through to the U.S. shareholders of a CFC as Subpart F income (as ordinary income, not as capital gain).<sup>133</sup> The gain that passes through to the U.S. shareholders will momentarily increase their outside basis in the shares to the extent of the gain, and then the FMV of the assets that they receive, or are deemed to receive, from the corporation will decrease their basis again to the extent of the assets' FMV.<sup>134</sup> If the FMV of the assets that they receive exceeds their outside basis in the shares, there will be another capital gain event to the shareholders; if the FMV of the assets is lower than their outside basis, there is a capital loss event.<sup>135</sup> Capital losses can only offset up to \$3,000 of ordinary income each year and then must be carried forward to subsequent years, so the share-

holders will not get the full benefit of the capital loss (and even if they have other gains for the year of liquidation, there is usually a net cost to the beneficiaries because the corporate-level gain is taxed at higher ordinary income tax rates). This means that the application of Subpart F results in a mismatch because capital losses are partially offsetting ordinary income, rather than offsetting capital gains.

For example, assume that a foreign corporation has a \$60x inside basis in its assets, and that those assets have an FMV of \$100x on the date of the NRA shareholder's death. The stock of the foreign corporation itself also has an FMV of \$100x at death (by reference to the FMV of the underlying assets). The outside basis will be stepped up to \$100x on the date of the NRA shareholder's death. The foreign corporation is inherited by U.S. beneficiaries, and is thus classified as a CFC, so they decide to liquidate the foreign corporation (or elect pass-through treatment). Upon liquidation, the beneficiaries will realize the corporate-level gain (which is Subpart F income) of \$40x (i.e., the FMV of the foreign corporation's assets (\$100x) minus the inside basis (\$60x)), and this will be taxed to them as ordinary income. The beneficiaries' \$100x outside basis is momentarily increased by the amount of the \$40x gain to \$140x. When the beneficiaries receive the underlying assets worth \$100x in the liquidation, they will realize a capital loss of \$40x (the difference between their new \$140x basis and the assets of \$100x). Their basis in the assets that they received from the foreign corporation is now back to \$100x.

That being said, there may be a way to avoid the corporate-level gain being taxed to the U.S. shareholders as Subpart F income. The U.S. tax rules provide that a U.S. shareholder will be taxed on Subpart F income only "if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year."<sup>136</sup> Therefore, if the corporation is either liquidated or is deemed to be liquidated by electing pass-through treatment within 30 days of the NRA's death, the corporate-level gain would not be passed through to the U.S. beneficiaries as Subpart F income because the corporation was not a CFC for 30 days in the relevant "tax year" (which, for U.S. tax purposes, begins on the NRA's date of death).

One concern with implementing the above strategy may be that the PFIC (passive foreign investment company) rules (another anti-deferral regime) will apply in place of the Subpart F rules. But fortunately, the company's classification as a CFC will trump its classification as a PFIC.<sup>137</sup> By liquidating the CFC within 30 days of the NRA's death, we are not removing the

<sup>132</sup> §1014(a); *but see* §1291(e) (regarding a PFIC's basis).

<sup>133</sup> §951(a).

<sup>134</sup> §961(a), §1223(9).

<sup>135</sup> §331.

<sup>136</sup> §951(a)(1).

<sup>137</sup> H.R. Rep. No. 105-148 (1997); Pub. L. No. 105-34.

company's CFC status; we are merely avoiding the application of Subpart F.

## INTERNATIONAL WILLS

Some clients are migratory, or are at a point in their lives at which they need to implement an estate plan, but they may not know where their permanent residence will be in the future. To avoid executing a new will every time they move to a new jurisdiction, these clients may be able to use an "international will" that can cover them in multiple jurisdictions.

The Uniform International Wills Act (hereafter, the "Act") was enacted by the UNIDROIT "Convention Providing a Uniform Law on the Form of an International Will" as part of the Washington Convention in

1973. The United States signed the Washington Convention in 1973, formally adopting the Act, and it was added to the Uniform Probate Code in 1977. However, it is a state-by-state determination whether or not to honor an international will.

The following countries and U.S. states have adopted the Act as signatories to either the Act or to the Washington Convention, or have otherwise consented to be bound.<sup>138</sup>

<sup>138</sup> See <http://www.state.gov/documents/organization/209142.pdf>. Czechoslovakia signed the Convention in 1974 but ceased to exist on December 31, 1992. Neither of its two successor independent states, the Czech Republic or the Slovak Republic, have indicated whether the Act shall apply.

<u>Signatories of the Act</u>	<u>U.S. States and Territories</u> <sup>139</sup>
Belgium* <sup>+</sup>	Alaska
Bosnia-Herzegovina <sup>+</sup>	California
Canada <sup>+</sup>	Colorado
Croatia <sup>+</sup>	Connecticut
Cyprus <sup>+</sup>	Delaware
Ecuador* <sup>+</sup>	District of Columbia
France* <sup>+</sup>	Illinois
Holy See*	Hawaii
Iran*	Maryland
Italy <sup>+</sup>	Michigan
Laos*	Minnesota
Libya <sup>+</sup>	Mississippi
Niger <sup>+</sup>	Montana
Portugal <sup>+</sup>	Nevada
Russian Federation*	New Hampshire
Sierra Leone*	New Mexico
Slovenia <sup>+</sup>	North Dakota
United Kingdom*	Oklahoma
United States*	Oregon
	Pennsylvania
	Virginia
	U.S. Virgin Islands

\* Signature

<sup>+</sup> Consent to be bound

To meet the Act's requirements, a will must be in writing (handwritten or typewritten) and can be in any language. The testator must sign and acknowledge the will in the presence of two witnesses and an "authorized person." For purposes of the Act, an "authorized person" is not simply a notary public; it should be an attorney licensed in the jurisdiction where the will is executed. Both witnesses and the authorized person must sign in the presence of the testator. A certificate (an example is included as *Exhibit A*) signed by the authorized person must be attached to the will. Both the authorized person and the testator must retain copies of the certificate.

<sup>139</sup> See <http://www.uniformlaws.org/Narrative.aspx?title=Why%20States%20Should%20Adopt%20UIWA>.

**EXHIBIT A**

**CERTIFICATE OF AUTHORIZED PERSON  
UNIFORM INTERNATIONAL WILLS ACT §2-1005  
CONVENTION OF OCTOBER 26, 1973**

I, Attorney Name, an attorney licensed in State, practicing with the law firm of Law Firm Name, located at Firm Address, a person authorized to act in connection with international wills, certify that:

1. on this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_, at \_\_\_\_\_  
Firm Address,  
Testator Name, as Testator, (born DOB, in Place of Birth, and presently residing at Testator Address), in my presence and that of the witnesses, Witness 1, (born DOB, in Place of Birth, and presently residing at Witness 1 Address), and Witness 2, (born DOB, in Place of Birth, and presently residing at Witness 2 Address), has declared that the attached document is his/her will and that he/she knows the contents thereof;
2. in my presence and that of the witnesses, the Testator has signed the will or has acknowledged his/her signature previously affixed;
3. the witnesses and I have signed the will;
4. each page of the will has been signed by Testator Name, as Testator, and numbered;
5. I have satisfied myself as to the identity of the Testator and of the witnesses as designated above;
6. the witnesses met the conditions requisite to act as such according to the law under which I am acting; and
7. per Testator's request, I have placed the original Last Will and Testament of Testator Name at Location/Address of Original Will, for safekeeping.

Subscribed and sworn to before me by the said Testator Name, Testator, and by the said Witness 1 and Witness 2, witnesses, this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_.

\_\_\_\_\_  
Attorney Name, Authorized Person  
Firm Address  
U.S.A.