

International Estate and Income Tax Planning

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I. Introduction.

A. *International Estate Planning.* Even practitioners who do not practice international estate planning encounter (and are increasingly likely to encounter) international issues (foreign relatives, assets in more than one jurisdiction, or even residence changes through employment or otherwise). Failure to recognize and address these issues poses substantial risks to the clients and practitioners alike. The purpose of this outline is not to provide a complete or exhaustive discussion of all issues that a practitioner might face in an international estate planning practice but rather to generally address those issues we believe are most likely to be encountered by an estate planning practitioner who does not have an international practice so that they can be recognized and addressed through additional research and analysis and, when appropriate, through the association of competent U.S. and foreign international tax and estate planning counsel.

B. *Due Diligence.* To competently assist clients, estate planners must have all of the information that might be relevant to the representation. If the estate planner is not sufficiently familiar with potential international issues the client may be facing, he or she may not gather all such relevant information. One of the purposes of this outline is to help practitioners identify a number of international estate planning issues and the information that might be relevant to those issues. When a practitioner fails to identify an issue or gives incorrect advice, the source of the problem is often that he or she did not have sufficient information or made an incorrect factual assumption. Examples of the assumptions that can get practitioners into trouble include, (i) that a person who is a citizen or resident of one country is not also a citizen or resident of another, (ii) that the children of a client who is a U.S. citizen and resident are all U.S. citizens and residents or are married to only U.S. citizens and residents, (iii) that the parents or relatives of a client who is a U.S. citizen and resident and from whom a gift or inheritance may be expected are all U.S. citizens and residents, (iv) that a client who fails to disclose foreign assets does not have them, (v) that a client's relative or friend who is named as successor trustee of a trust the client established is a U.S. citizen and resident and that such trust is and will always be a domestic trust. The problem with each of these potential factual inaccuracies is illustrated in the sections that follow.

C. *Risk Minimization.* Estate planning practitioners should in all cases consider (i) having an engagement letter with a clearly defined scope of engagement, (ii) accompanying legal advice with a summary of the facts on which the practitioner relied to reach his or her conclusions, (iii) associating competent counsel to assist with any area the practitioner is not competent to handle. When associating local counsel in another jurisdiction, a practitioner should verify that such counsel is not only knowledgeable and experienced in the relevant local law issues but has sufficient experience in cross border matters. Two or more competent local practitioners from different jurisdictions often do not make a competent and effective international estate planning team.

D. *Important Terms.* To understand and correctly apply international tax and trust rules, the terms that are used must be clearly understood and their meaning should never be assumed. Some terms have different meanings for different purposes. For example, the term "residence" has different meanings for immigration law purposes, for income tax purposes and for estate tax purposes. For example, a person who is a resident for tax purposes may not be a resident for immigration purposes and vice versa and a resident for income tax purposes may not be a resident for estate and gift tax ("transfer tax") purposes. In addition, as the international estate planning area has evolved, certain terms have been redefined. See, for example, the discussion below concerning foreign and domestic trusts. In many cases, the same term has a different meaning in different jurisdictions. When performing research and

analysis in any new or unfamiliar area, practitioners should first satisfy themselves that they clearly understand and can properly apply all relevant terms.

II. Taxation of Non-U.S. Citizens. When dealing with a non-U.S. citizen, the individual's residence must be carefully determined in the different contexts in which the term is relevant because different tax rules (filing requirements, tax consequences, planning opportunities and pitfalls) apply to residents and non-residents of the United States. Advising a non-resident under the incorrect assumption that he or she is a resident or vice versa could have disastrous consequences both to the taxpayer and the advisor. The determination of residence in the various contexts should not be left up to the client or someone else. A client's determination of his or her own residence may be based upon (a) immigration concepts, (b) the person's home country concept of residence, (c) income tax concepts, (d) rules applicable where the person currently lives, or (e) a distorted understanding of any of the above concepts.

A. Residence for Income Tax Purposes. For income tax purposes, an individual is treated as an income tax resident of the U.S. for a given calendar year if: (i) he or she is a lawful permanent resident of the United States at any time during the calendar year (the "green card test"); (ii) he or she meets the "substantial presence" test of § 7701(b)(3)¹; or (iii) he or she makes a "first year" election under § 7701(b)(4) to be treated as a resident. All other persons are not U.S. persons for income tax purposes. If a person is determined to be a resident of the U.S. and another country in the same year, applicable provisions of relevant treaties can be applied to insure that such person is only taxed as a resident of one country.

1. Green card test. A lawful permanent resident of the United States is someone who, for immigration purposes, has been admitted to the United States as a permanent resident, which means the person has received an alien registration card or "green card." This prong of the income tax residence test is commonly known as the "green card test." For income tax purposes, a green card holder will continue to be a resident of the United States even if he or she has left the United States and, for immigration purposes, has forfeited his or her right to be treated as a resident. Many people leave the United States with their green cards in their back pockets and incorrectly assume that they are no longer U.S. residents for income tax purposes. To effectively abandon his or her residence for income tax purposes, a taxpayer must actually relinquish his or her green card.

2. Substantial presence test. An individual satisfies the "substantial presence test" if the individual is physically "present" in the U.S. for 183 days or more in the calendar year. The 183 day presence calculation is made by adding the following three numbers: (a) all the days present in the U.S. in the current year, (b) one third of the days present in the U.S. in the first preceding year, and (c) one sixth of the days present in the U.S. in the second preceding year. If certain requirements are met, individuals who are present in the United States while validly holding certain types of visas, such as student visas, trainee visas, etc., are considered "exempt individuals" and their days of presence in the United States under such visas are excluded for purposes of the substantial presence test calculation. Even if a person meets the substantial presence test, certain exceptions may apply to cause the person not to be treated as a resident of the United States for income tax purposes. If, for example, a person meets the substantial presence test but has a tax home and closer connections with another country, the person may meet the closer connection exception to the substantial presence test and successfully establish non-residence for income tax purposes. It is important to note that the closer connection exception is only available if the person who otherwise meets the substantial presence test actually claims it, which means that the person must make a filing admitting that the substantial presence test is otherwise met.

¹ All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

B. Taxation of U.S. and Non-U.S. Residents for Income Tax Purposes. U.S. residents for income tax purposes are generally subject to income tax on their worldwide income. Non-U.S. residents for income tax purposes are subject to income tax only with respect to “U.S. source income” and income that is “effectively connected” with a U.S. trade or business.

1. U.S. source income. Complex rules govern the determination of whether an item of income is from a U.S. source. Generally, U.S. source income includes: (a) interest income, if it is payable by the U.S. government or a state or local government; or by a non-corporate U.S. resident or a domestic corporation, (b) dividend income paid (i) by a domestic corporation; or (ii) by a foreign corporation, if at least 25 percent of its income in the prior three years was effectively connected with the conduct of a U.S. trade or business, (c) income from personal services performed in the U.S., (d) rents and royalties from property located in the U.S. (in the case of tangible or real property) or used in the U.S. (in the case of intangible property), (e) gain from the sale of U.S. real property interests which include either direct ownership in real property located in the U.S. or an ownership interest in an entity that directly or indirectly owns significant amounts of U.S. real property.

2. Taxation of U.S. source income. Under § 871, non-U.S. persons are generally taxed at a flat 30 percent rate (though tax treaties often reduce this rate) on the following types of U.S. source income: interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations and other “fixed or determinable annual or periodic gains, profits, and income” (This is commonly called “FDAP income.”) Under a major exception to this rule, U.S. source “portfolio interest” – which generally includes most interest received from unrelated borrowers and interest earned on bank deposits – is not subject to U.S. tax. A non-U.S. person’s U.S. source capital gains are generally exempt from U.S. tax, unless the non-U.S. person is physically present in the U.S. for 183 days or more during the year in which such gains are realized. U.S. real property interests are subject to special rules. In general, a non-U.S. resident can elect to treat rents and other income from a U.S. real property interest as income effectively connected with a U.S. trade or business and to have such income taxed accordingly. Gain from the sale or exchange of a U.S. real property interest is treated as income from a U.S. trade or business, and taxed accordingly.

3. Income effectively connected with a trade or business. There is no clear definition of what constitutes a U.S. trade or business. Rather, to determine whether a trade or business exists, courts and the IRS have generally looked to whether a person’s activities (whether personally or through employees or agents) are “regular, continuous, and substantial” or “incidental and sporadic”. It is clear, however, (i) that the performance of personal services in the U.S. for compensation exceeding \$3,000 constitutes a U.S. trade or business; and (ii) that the U.S. activities of a partnership, trust or estate are attributed to its partners or beneficiaries to determine if such individuals are engaged in a U.S. trade or business. If a non-U.S. resident is engaged in a U.S. trade or business, an analysis must be made to determine the income and deductions “effectively connected” with such trade or business U.S. source FDAP income (including portfolio interest), is effectively connected with a U.S. trade or business if either (i) the income is derived from assets used in or held for the trade or business; or (ii) the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income is deemed to be effectively connected with the trade or business. Non-U.S. source income is generally not effectively connected with a U.S. trade or business, unless the foreign person has a fixed place of business in the U.S. to which such foreign income is attributable, and such income consists of (i) rents or royalties from intangible property derived in the active conduct of the trade or business; (ii) dividends or interest derived from the active conduct of a banking or financing business in the U.S.; or (iii) gains from certain inventory sold outside the U.S.

4. Taxation of income effectively connected with a U.S. trade or business. Non-U.S. residents (other than foreign corporations) who realize income that is effectively connected with a trade or business in the U.S. are taxed at the graduated income tax rates (and preferential tax rates for long-term capital gains) that apply to U.S. persons rather than at the flat 30 percent rate applicable to other types of U.S. source income as described above.

C. Residence for Transfer Tax (Gift, Estate, Generation-Skipping Transfer Tax) Purposes.

Different transfer tax rules apply to non-U.S. citizen individuals who are resident or non-resident of the United States for transfer tax purposes. The definition of resident for transfer tax purposes is different from the definition of resident for income tax purposes (discussed above) and is not affected by whether the person in question is or is not a resident for income tax purposes. A person will be treated as a U.S. resident or U.S. person for transfer tax purposes if, at the time of the relevant testamentary or inter vivos transfer, such person is domiciled in the United States. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of leaving. 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. The definition of domicile can be broken down into a three prong test: (i) an individual must have an intent to make the United States the place of his or her permanent home; (ii) the individual must be physically present in the United States at a time when he or she intends to remain permanently in the United States; and (iii) the individual must have the ability to make an informed and intelligent decision as to his or her domicile. Although the intent element of the test is subjective, the objective and outward expressions of intent are carefully reviewed to determine a person's intent. Among the facts and circumstances the IRS considers are: (i) the duration of stay in the United States and other countries, and the frequency of travel between the United States and other countries; (ii) the size, cost, and nature of the individual's homes and whether such homes are owned or rented; (iii) the area in which the homes are located; (iv) the location of expensive and cherished personal possessions; (v) the location of the individual's family and friends, (vi) the age of any children, the location of their schools, and the location of the spouse's business; (vii) the places where the individual maintains church and club memberships; (viii) the location of the individual's business; (ix) declarations of residence or intent made in visa applications or re-entry permits, wills, deeds of gifts, trust instruments, letters and oral statements; and (x) motivation for being in the United States.

D. Taxation of U.S. and Non-U.S. Persons for Transfer Tax Purposes.

In general, U.S. citizens, no matter where they reside or are domiciled, and non-U.S. citizens who are domiciled in the U.S., are subject to U.S. transfer tax with respect to all of their assets or interests in assets whether within or outside of the U.S. In contrast, non-U.S. persons for transfer tax purposes are only subject to transfer tax with respect to those of their assets or interests in assets which are situated or deemed situated within the U.S. (see discussion regarding U.S. situs assets set forth below). An important exception to this rule is that, in the case of non-U.S. persons, the gift tax does not apply to the transfer of intangible assets even if those assets are situated in the U.S. Although non-U.S. persons can take advantage of gift tax exclusions (such as the annual exclusion or the exclusion for medical and educational expenses), they can only make \$60,000 worth of taxable transfers for estate tax purposes without incurring an estate tax and they can make no taxable transfers for gift tax purposes without incurring a gift tax. Although the transfer tax base for U.S. and non-U.S. persons is different as described herein, U.S. and non-U.S. persons are subject to the same transfer tax rates with respect to taxable transfers. Generation-skipping transfer tax applies to non-U.S. persons only if gift or estate tax would otherwise apply to the transfer.

1. U.S. situs assets. Although many gray areas exist and some of the situs rules may be modified by an applicable treaty, in general, the following are considered U.S. assets: (a) real property (including improvements, fixtures, crops, timber, and mineral and royalty interests) located in the U.S., (b) shares of stock in U.S. corporations (including mutual funds organized as U.S. corporations), (c) debt obligations if the primary obligor is a U.S. person or a governmental entity, (d) other intangible assets the written evidence of which is not the property itself if issued by or enforceable against a U.S. resident or domestic corporation, (e) life insurance proceeds from a life insurance policy insuring the life of a U.S. person, and (f) tangible personal property located in the U.S. (unless the items accompanied the non-U.S. person on a temporary visit to the U.S.).

2. Special exemptions. Some assets that are clearly situated in the U.S. may nonetheless not be subject to transfer tax in the hands of a non-U.S. resident as a result of a specific exemption. Examples of these assets are: (a) U.S. bank deposits the interest of which is not effectively connected with the conduct of a U.S. trade or business, and (b) debt obligations issued after July 18, 1984, the interest from which qualifies as "portfolio interest" and is therefore not subject to U.S. income tax.

3. Transfers with retained interests. An often overlooked and/or misunderstood rule dealing with retained interests provides that property transferred, by trust or otherwise, within the meaning of §§2035-2038, is deemed situated in the U.S. if so situated at the time of transfer or death. Accordingly, if a non-U.S. person makes a transfer (with a retained interest) of a U.S. situs asset to a trust and such person later dies, the asset subject to the retained interest will be includible in the non-U.S. person's estate as a U.S. situs asset even if such asset had been exchanged for a non-U.S. situs asset between the date of transfer to the trust and the date of the decedent's death.

III. U.S. Citizens with Multiple Nationalities or Residing Abroad. The U.S. is one of the very few countries that taxes on the basis of citizenship rather than residence. Accordingly, in most cases it will make no difference that the client has a citizenship other than his or her U.S. citizenship. If a U.S. citizen is a resident of a country other than the U.S., he or she will face tax and other issues in the country of residence. As discussed above, the client will generally still have the same reporting obligations and exposure to U.S. income and transfer tax as if he or she were residing in the U.S. Foreign tax credits allowable in the U.S. and/or the country of residence and tax treaties between the U.S. and the country of residence may at least in part address potential double tax issues which may exist. In addition, there are limited tax benefits available to U.S. citizens living abroad. (See, e.g. § 911). Given the onerous tax and reporting obligations U.S. citizens face even while living and paying tax abroad, an issue that must be considered for such taxpayers is whether expatriation is appropriate. Many tax and non-tax factors must be taken into account when an individual is considering whether to expatriate. Given the current enforcement climate, if the individual decides not to expatriate, it is important that he or she understand and fully comply with his or her tax and reporting obligations both in the U.S. and the country of his or her residence.

IV. Transfers to Non-U.S. Citizen Spouses. A good understanding of §§2056(d) and 2056A is essential to minimizing the transfer tax burden attributable to transfers to or for the benefit of non-U.S. citizen spouses. For purposes of this section, the term "Almost Qualified Transfer" is a transfer that would have qualified for the marital deduction if the recipient spouse had been a U.S. citizen at the time of the transfer.

A. *Inter Vivos Transfers*

1. Annual exclusion. If the donee spouse is not a U.S. citizen, the gift tax marital deduction is not allowable for transfers made to such spouse; however, the annual exclusion for a Qualified Transfer to a non-U.S. citizen spouse was increased to \$100,000 (indexed for inflation) rather than the \$10,000 (indexed for inflation) annual exclusion allowable in the case of transfers to non-spouse donees. The higher annual exclusion for gifts to non-U.S. citizen spouses can be a significant planning tool because the transfers to the donee spouse will not be subject to transfer tax and, in cases where the donee spouse is not a U.S. resident for transfer tax purposes, the transferred assets may not be subject to U.S. transfer tax at all. Estate planners who advise clients to transfer assets for tax purposes should also advise such clients of the non-tax consequences of making such gifts to ensure that such clients are fully informed.

2. Inadvertent transfers. After years of enjoying the unlimited marital deduction and the care-free transferability of assets between spouses, estate planners need to advise clients who are married to non-U.S. citizen spouses that direct and indirect, intentional and inadvertent, transfers to their spouse could have unintended transfer tax consequences. Unlike a transfer by death which can be qualified for the marital deduction after the fact (see discussion below), transfers by gift which do not qualify for the marital deduction at the time of the transfer cannot be so qualified.

B. *Testamentary Transfers*

1. Transfers to non-U.S. citizen spouses. Transfers to non-U.S. citizen spouses do not qualify for the marital deduction unless special requirements, discussed below, are met. If those requirements are not met, a transfer to a non-U.S. citizen spouse will be like any other taxable transfer. It is important to remember that the more onerous marital deduction requirements will only need to be met

in the case of estates relying on the marital deduction to defer the payment of estate tax with respect to assets not otherwise covered by the decedent's lifetime exemption. When the rules were first enacted, many couples whose estates did not exceed their lifetime exemptions became unnecessarily worried about the application of the rules.

2. Marital deduction requirements if the surviving spouse is not a U.S. citizen. If the decedent's surviving spouse is not a U.S. citizen (irrespective of the citizenship or residence of the decedent spouse), the marital deduction, otherwise allowed under § 2056(a) for property passing to or for the benefit of the decedent's surviving spouse, is generally disallowed under § 2056(d)(1)(A) unless (a) the transfer would have qualified for the marital deduction if the surviving spouse had been a U.S. citizen (it is an "Almost Qualified Transfer"), and (b) one of the following conditions is met: (i) the surviving spouse becomes a citizen before the date on which the federal estate tax return is made; (ii) an appropriate election is made with respect to property that passes to (or pursuant to) a trust which meets the requirements of a Qualified Domestic Trust ("QDOT"); (iii) an appropriate election is made with respect to property that passes to (or pursuant to) a trust which does not meet the requirements of a QDOT but is reformed after the decedent's date of death to meet those requirements; (iv) an appropriate election is made with respect to property that passes to the decedent's surviving spouse by outright bequest or devise, by operation of law or pursuant to the terms of an annuity or other similar plan or arrangement, and which the surviving spouse then transfers or irrevocably assigns to a QDOT before the decedent's federal estate tax return is filed and during the time the QDOT election may be made; or (v) the requirements contained in Reg. §20.2056A-4(c) are satisfied with respect to a plan, annuity or other arrangement (whether qualified or not) the payments of which are not assignable or transferable to a QDOT under federal, state or foreign law or the terms of the plan or arrangement itself.

3. Qualifying "Almost Qualified Transfers." Almost Qualified Transfers can be qualified after the transferor's death but corrective action must be timely. Unlike other sections of the Code, the rules are quite benign and, so long as the end result is a QDOT or other arrangement that secures the ultimate payment of transfer tax, the marital deduction will be available. The sections below discuss the various ways in which an Almost Qualified Transfer can be qualified for the marital deduction.

4. Surviving spouse becomes a United States citizen. If the decedent's surviving spouse was not a U.S. citizen on the date of the decedent's death, the marital deduction will nonetheless be available with respect to an Almost Qualified Transfer if (a) the surviving spouse becomes a U.S. citizen before the decedent's federal estate tax return is filed, and (b) the surviving spouse was a resident of the U.S. for transfer tax purposes (i.e. a domiciliary) at all times after the death of the decedent and prior to becoming a U.S. citizen. As a practical matter, this alternative is most likely to apply if the surviving spouse had already applied for U.S. citizenship at the time of the deceased spouse's death or the surviving spouse lives in a jurisdiction in which the naturalization process can be completed within a few months. If the naturalization process is not completed by the due date of the return, a QDOT can be established using any of the alternatives described below. Distributions made from the QDOT after the surviving spouse becomes a U.S. citizen will not be subject to the QDOT tax. It is important to keep the QDOT as flexible as possible so that when the surviving spouse becomes a U.S. citizen, any restrictions included solely to qualify the trust as a QDOT can be removed. If the surviving spouse becomes a U.S. citizen after the filing of the deceased spouse's federal estate tax return, notice that the surviving spouse has become a U.S. citizen and the elections described above, if applicable, must be filed by April 15 of the year following the year in which the surviving spouse becomes a U.S. citizen. If the notice or elections are not filed in time, it is possible to seek relief under § 301.9100. The IRS has been quite liberal about granting relief.

5. Outright transfers.

a) Property otherwise qualifying for the marital deduction and passing from a decedent to his or her non-U.S. citizen surviving spouse, either outright (by testamentary bequest or devise or by operation of law) or pursuant to an annuity or other similar plan or arrangement, is treated as passing to the surviving spouse in a QDOT (solely for purposes of § 2056(d)(2)(A)) if such property is

either actually transferred or irrevocably assigned to a QDOT before the decedent's federal estate tax return is filed and during the time that the QDOT election may be made.

b) The transferee QDOT may be a QDOT previously established by the decedent for the transfer of other assets or may be established by the decedent's executor or the surviving spouse. Since the decedent placed no restrictions on the transfer to the surviving spouse, the establishment of the QDOT should not have the effect of depriving the surviving spouse of flexibility or control. The surviving spouse may establish a very flexible trust and retain the power to invade the trust and withdraw trust assets so that the surviving spouse can determine when distributions will be made and thereby choose the timing of the payment of transfer tax or permit tax-free distributions if the surviving spouse has become a U.S. citizen. If no property other than the property passing to the surviving spouse from the decedent is transferred to the QDOT, the transferee QDOT need not be in a form that would have otherwise qualified for the marital deduction under § 2056(a), and the QDOT can certainly be revocable by the surviving spouse. Note that in the context of non-judicial reformations, discussed below, QDOTs that are revocable by the surviving spouse or are subject the spouse's general power of appointment must provide that no person (including the spouse) has the power to amend the trust such that it would no longer qualify as a QDOT. Although this requirement only appears in the portion of the regulations dealing with reformation, it may be wise to include such language in any revocable QDOT.

c) The transfer or assignment of property to the recipient QDOT may be made by the surviving spouse or the surviving spouse's legal or personal representative. The transferred assets are deemed to pass from the decedent to the surviving spouse solely for marital deduction purposes. For all other purposes, the surviving spouse is the transferor unless the transfer is a qualified disclaimer. If the surviving spouse retains sufficient interests in the recipient QDOT (including the power to revoke the trust as discussed above) to cause the transfer to be an incomplete gift, there will be no adverse gift tax consequences to the transfers.

d) If a transfer or assignment is of a specific asset or group of assets, only assets passing from the decedent and included in the decedent's gross estate (or proceeds from the sale, exchange or conversion of such assets) may be transferred or assigned to the QDOT. The surviving spouse may not fund the QDOT with property owned by the surviving spouse at the time of the decedent's death. Note that with respect to joint tenancy property, the § 2040(a) (contribution tracing rule) rather than the § 2040(b) rule applies to determine the portion of the assets includible in the decedent's gross estate if the surviving spouse is not a U.S. citizen. If, as a result of the application of this rule, only a portion of the property interest is includible in the decedent's estate, only the portion so includible may be transferred to the recipient QDOT. Since the assets of the QDOT will be subject to the QDOT tax, it is very important to accurately determine which assets are includible in the decedent's gross estate and which assets should be transferred to the QDOT. In the event of uncertainty, a protective assignment may be made in some circumstances.

6. Transfers in Trust – Revocable Trusts.

a) If the trust is revocable or subject to the surviving spouse's general power of appointment or power of amendment, the trust can be amended by the surviving spouse in accordance with the reformation provisions of the statute and the regulations. If the trust consists of both assets passing from the decedent to the surviving spouse and the surviving spouse's own assets, the trust should be divided into two separate trusts so that the surviving spouse's assets are not subject to the more restrictive provisions applicable to QDOTs. Alternatively, the surviving spouse can exercise his or her power to withdraw trust assets and treat the transfer from the decedent as an outright transfer. See discussion above. If the transfer is treated as an outright transfer and specific assets are transferred to a QDOT, keep in mind the rule that prevents the surviving spouse from transferring to the QDOT assets that the surviving spouse owned at the time of the decedent's death (i.e. community property interest or other co-ownership interest).

b) It is important not to give up flexibility unnecessarily. The regulations provide that the reformed trust may be revocable by the spouse, or otherwise be subject to the spouse's general

power of appointment, provided that no person (including the spouse) has the power to amend the trust such that it would no longer qualify as a QDOT. As set forth above, this provision should probably be included in every QDOT that is revocable by the surviving spouse. The restriction is innocuous in light of the spouse's power of revocation.

c) A non-judicial reformation must be completed by the time prescribed (including extensions) for filing the decedent's estate tax return. To minimize problems on audit, a thorough return with a copy of the amended trust and all other relevant documents and information should be filed.

7. Transfers in Trust – Irrevocable Trusts.

a) If the trust is irrevocable (i.e. a QTIP trust), and no person has the power to amend the trust to include the provisions to qualify the trust as a QDOT, the trust may be reformed by judicial reformation. Such a reformation is permitted if it is commenced on or before the due date (including extensions actually granted) for filing the decedent's estate tax return, regardless of the date the return is actually filed. Prior to the time the judicial reformation is completed, the trust must be treated as a QDOT. If, for any reason, the judicial reformation proceeding is terminated prior to being completed, the decedent's estate is required to pay any estate tax, interest and penalties attributable to the trust's failure to qualify as a QDOT and a claim for refund may be filed to recover any QDOT tax paid prior to termination of the reformation proceeding.

b) If judicial reformation proceedings are commenced, the period for assessing a deficiency attributable to the failure of the trust to qualify as a QDOT shall not expire before one year after the date on which the IRS is notified that the trust has been changed pursuant to such final proceeding or that such proceeding has been terminated. This post-filing requirement is often overlooked and must be met in order for the period for assessing a deficiency to expire.

8. Non-assignable annuities. A non-assignable plan, annuity or other arrangement which would otherwise qualify for the marital deduction, is treated as meeting all marital deduction requirements if either (a) the surviving spouse agrees to pay annually the deferred tax due on the corpus portion of each payment received, or (b) the surviving spouse agrees to roll over the corpus portion of each payment received, within 60 days of receipt, to a QDOT (whether created by the decedent's will, the decedent's executor or the surviving spouse). The regulations contain detailed requirements that must be met to qualify these annuities for the marital deduction, including specific information statements and agreements to be entered into by the surviving spouse.

9. Deadline to Make QDOT Elections. Note the statutory (not regulatory) deadline that no QDOT election may be made on a return that is filed more than one year after the due date (including extensions actually granted) for filing the decedent's estate tax return.

C. QDOTs. In general, to qualify as a QDOT, a trust must satisfy the following requirements: (1) The trust must be an ordinary trust as defined in Reg. §20.2056A-2(b); (2) The trust must be maintained under the laws of a state of the United States or the District of Columbia, and the administration of the trust must be governed by the laws of a particular state of the United States or the District of Columbia; (3) The trust instrument must require that at least one trustee (United States trustee) be an individual United States citizen or a domestic corporation, subject to regulatory exceptions when foreign countries prohibit trusts from having United States trustees; (4) The trust instrument must provide that no distribution, other than a distribution of income, may be made from the trust unless the United States trustee has the right to withhold the QDOT tax imposed on that distribution; (5) Detailed additional requirements to ensure collection of the deferred estate tax are satisfied. These requirements include governing instrument requirements for using a United States bank trustee, bond, or letter of credit if the QDOT has assets in excess of \$2 million (excluding \$600,000 for a personal residence and related furnishings) and reporting requirements for QDOTs owning foreign real property if these security requirements do not apply.

D. Taxation of QDOTs.

1. **Deferred Estate Tax.** A deferred estate tax is imposed under IRC §2056A(b)(1) on the occurrence of a taxable event as defined in Reg §20.2056A-5(b). The deferred estate tax generally will be equal to the estate tax that would have been imposed if the amount involved in the taxable event had been included in the decedent's taxable estate and had not been deductible under IRC §2056. IRC §2056A(b)(2); Reg §20.2056A-5(a).

2. **Taxable Events.**

a) With limited exceptions, the deferred estate tax is imposed on any distribution from the QDOT before the surviving spouse's death. IRC §2056A(b)(1)(A). The amount subject to tax is the amount of the distribution (amount of money and fair market value of property distributed in kind), including any amount withheld by the United States trustee to pay the deferred estate tax. If the tax is not withheld but is paid by the United States trustee out of other assets of the QDOT, the tax so paid is treated as an additional distribution to the spouse in the year that the tax is paid. Reg §20.2056A-5(b)(1).

b) The deferred estate tax is imposed on the value of the property remaining in a QDOT on the date of the surviving spouse's death (or alternate valuation if applicable). IRC §2056A(b)(1)(B). Any corpus portion amounts remaining in a QDOT on the surviving spouse's death and any residual payments resulting from a non-assignable plan or arrangement that, on the surviving spouse's death, are payable to the spouse's estate or to successor beneficiaries are subject to the QDOT tax. Reg §20.2056A-5(b)(2).

c) The deferred estate tax is imposed if a QDOT ceases to meet statutory and regulatory requirements imposed on QDOTs. IRC §2056A(b)(4). The amount subject to the deferred tax is the fair market value of the trust assets on the date of disqualification. Reg §20.2056A-5(b)(3).

d) Although a detailed discussion of the taxation of QDOT distributions is beyond the scope of this outline, it is important to note that, notwithstanding the repeal of the estate tax in 2010, the deferred estate tax will continue to be imposed on any principal distribution (other than on account of hardship) from a QDOT before January 1, 2021. IRC §2210(b)(1). The deferred estate tax will not apply on the death of a surviving spouse after December 31, 2009. IRC §2210(b)(2).

3. **Distributions not subject to tax.**

a) Distributions of income to the surviving spouse. IRC §2056A(b)(3)(A). For this purpose, "income" is defined by reference to IRC §643(b) and Reg §1.643(b)-1; however, income does not include capital gains or other items allocable to principal under applicable local law even if the trust instrument contains provisions to the contrary. The word "income" includes principal allocated to income as a result of a trustee's exercise of a statutory power to make such an adjustment. Under Prob C §16336, such adjustments are permitted in specified circumstances. The word "income" also may include a unitrust amount in the range of 3-5 percent if state law so provides, but California law does not provide such a definition. Reg §20.2056A-5(c)(2).

b) Distributions of principal to the surviving spouse on account of hardship. IRC §2056A(b)(3)(B). These are distributions of principal to the surviving spouse in response to an immediate and substantial financial need relating to the spouse's health, maintenance, or support, or the health, maintenance, or support of any person the surviving spouse is legally obligated to support, unless the amount distributed may be obtained from other reasonably available sources. Reg §20.2056A-5(c)(1).

c) Miscellaneous distributions and dispositions specified in Reg §20.2056A-5(c)(3).

E. *Practical Issues.*

1. Consider relevant tax and non-tax issues. As illustrated by the discussion above, QDOTs can be more cumbersome to establish and administer than the average marital trust. In addition, unlike U.S. citizen surviving spouses who receive assets qualifying for the marital deduction, non-U.S. citizen surviving spouses who benefit from a QDOT may not withdraw and consume principal from the trust without transfer tax consequences. A QDOT is, therefore, only a transfer tax deferral technique. Before advising a client to establish a QDOT and transfer foreign or domestic assets to the trust, consider whether or not the surviving spouse is and will continue to be a U.S. person for transfer tax purposes, the types of assets includible in the decedent's estate, which assets or portions of assets are eligible for transfer to the QDOT, the cost of establishing and maintaining the QDOT, the appreciation potential of the assets, the overall transfer tax projected to be paid in both the decedent's estate and the surviving spouse's estate, the probability that tax-free distributions can be made (under the hardship exemption or otherwise), the loss of control attributable to the requirement that a QDOT have a U.S. trustee and whether the tax deferral alone is worth the trouble and additional expense. In the case of foreign assets, it is important to verify whether those assets can be transferred to a U.S. trust or be sold or exchanged readily so that the proceeds can be transferred to the QDOT. It is also important not to lose sight of the fact that, given that the marital deduction (especially in the case of a non-U.S. citizen surviving spouse) is nothing more than a mechanism to defer tax, in many cases a cost-benefit analysis will lead one to conclude that payment of all or portion of the transfer tax on the death of the deceased spouse is a better alternative. It is important to keep an open mind and to thoroughly review the tax and non-tax costs and benefits of each alternative.

2. The devil is in the details. If the decision is made to establish a QDOT, to ensure qualification of the transfer for the marital deduction, special attention must be given to drafting requirements, the procedural rules set forth in the statute and the regulations concerning the deadline to make the assignment and/or transfer of assets to the QDOT, the form of the transfer or assignment and the special rules applicable to pecuniary and protective assignments. Particular attention should be paid to those requirements that need to be met after the decedent's estate tax return is filed because they are the most likely to be overlooked once the pressure of the filing deadline has passed. The fact that the rules are benign and designed to help taxpayers and their advisors get it right (if not before then after the decedent's death), means that the failure to get it right creates even greater risks for the advisor. The fact is that there are many rules to follow, requirements to be met and places to go wrong.

V. **Gifts/Bequests From Foreign Sources**

A. *Tax Consequences.* Unlike the inheritance tax that is imposed in other jurisdictions, the U.S. transfer tax and reporting obligations attributable to a donative transfer are imposed on the transferor. The transferee is not subject to U.S. income or transfer tax as a result of the transfer regardless of the value of the transferred property and, until relatively recently, U.S. taxpayers were not even required to report any gifts or bequests received. Accordingly, a properly structured gift or bequest, no matter how large, can be made by a non-U.S. resident for transfer tax purposes to a U.S. person without any U.S. tax consequences directly attributable to the transfer. This does not mean, however, that the transfer could not have adverse U.S. tax consequences if made without further planning. For example, assume a U.S. person for transfer tax purposes, who otherwise does not have an estate that would be subject to U.S. estate tax, receives a non-taxable gift of \$10 million dollars from a non-U.S. donor. While the transfer has no immediate tax consequences, the donee now has a \$10 million dollar estate that is potentially subject to U.S. transfer tax. If, on the other hand, the transfer was made through a properly structured generation-skipping trust, the donee and the donee's descendants could benefit from the \$10 million dollars without being subject to U.S. transfer tax.

B. *Reporting.* The Small Business Job Protection Act of 1996 ("SBJPA 1996") enacted new § 6039F which requires United States persons to report large gifts or bequests from foreign sources.

1. Foreign gifts. The receipt by a U.S. person of non-taxable gifts from foreign sources must, in some cases, be reported, and the failure to report such gifts has serious tax consequences. For

purposes of these rules, the term “foreign gift” means any amount actually or constructively received from a person, other than a U.S. person, which the recipient treats as a gift or bequest but does not include (a) amounts paid on behalf of the donee as tuition to a qualified educational organization for the education or training of the donee, (b) amounts paid to any person who provides medical care with respect to the donee as payment for such medical care, (c) distributions to United States persons from foreign trusts (such distributions are subject to a different set of reporting rules discussed in greater detail below), or (d) contributions of property by foreign persons to domestic or foreign trusts that have U.S. beneficiaries, unless the U.S. beneficiaries are treated as receiving the contribution in the year of the transfer. Reporting is only required if the U.S. donee knows or has reason to know that the donor is not a U.S. person (i.e. is an individual who is neither a resident nor a citizen of the U.S., or a foreign estate, a foreign partnership, or a foreign corporation).

2. Reporting thresholds

a) Although the statute provides that if the value of the aggregate foreign gifts received by a United States person (other than a qualified charitable organization) during any taxable year exceeds \$10,000, reporting is required, the IRS recognized that the rule would result in the filing of far too many returns and that different reporting thresholds were warranted for gifts received from different types of foreign taxpayers. Accordingly, the IRS published Notice 97-34 giving taxpayers additional guidance with respect to the transfers that would be subject to the reporting requirements.

b) In the case of gifts from individuals who are not U.S. persons or from foreign estates, a United States person is only required to report aggregate gifts from a single donor or estate that exceed \$100,000 during the taxable year. Once the \$100,000 threshold is met, the donee is required to separately identify each gift in excess of \$5,000, but is not required to identify the donor.

c) In the case of gifts from foreign corporations or foreign partnerships, a U.S. person is required to report all gifts from all such entities if the aggregate of the gifts from all such entities exceeds \$10,000 (as modified by cost of living adjustments) in the taxable year. Once the \$10,000 threshold is met, the recipient must separately identify each gift and disclose the identity of the donor (including the name, address, and tax identification number).

d) To determine whether a particular reporting threshold has been met, the U.S. donee must aggregate gifts from foreign persons or entities that he or she knows or has reason to know are related, whether or not each gift independently exceeds the threshold. For example, a gift of \$8,000 (below the \$10,000 reporting threshold) from a foreign corporation and a gift of \$6,000 (below the \$100,000 reporting threshold) from a foreign individual who is related to the foreign corporation must both be reported because when the gifts are aggregated as a result of the relationship between the donors, the total of \$14,000 exceeds the \$10,000 reporting threshold. Similarly, two gifts of \$60,000 from foreign individuals who are related must be aggregated and reported even though neither gift alone reaches the reporting threshold.

3. Procedural requirements. U.S. persons who receive reportable foreign gifts in any given year must report such gifts (including the date of the gift or bequest, a description of the property received, and the fair market value of the property received) on Part IV of Form 3520. Form 3520 needs to be filed as an attachment to the taxpayer’s income tax return. In addition, the taxpayer must file a copy of Form 3520 with the Philadelphia Service Center by the applicable due date.

4. Penalties for failure to report. If a U.S. person fails to furnish the required information with respect to any foreign gift within the time prescribed (including extensions), the U.S. person will be subject to severe civil penalties. First, the Internal Revenue Service will determine the tax consequences of the receipt of the gift, i.e. the Internal Revenue Service may determine that the amount received is taxable to the recipient rather than a non-taxable gift. Second, the U.S. person will be required to pay, on demand by the Internal Revenue Service, an amount equal to 5 percent of the amount of the foreign gift for each month for which the failure continues (not to exceed, in the aggregate, 25 percent of the amount of the gift). In other words, a taxpayer’s failure to properly report a \$200,000 foreign non-taxable gift,

could “cost” the U.S. recipient a maximum of \$50,000 in penalties and the recharacterization of the transfer from an otherwise non-taxable gift into a taxable receipt.

C. Practical Issues. Since, under prior law, the receipt of a gift had no tax or reporting consequences, advisors may not discuss received or expected gifts with their clients. Given the significant tax and non-tax advantages of planning and properly structuring the receipt of a foreign gift and the reporting requirements associated with such receipt, it is now critical that advisors discuss with their clients whether they expect to receive a gift or bequest and whether that gift or bequest is likely to be from foreign sources. In many cases, a person who does expect a bequest or gift may not be in a position to discuss such expectancy with the prospective donor. Understanding the planning possibilities and reporting requirements will, however, enable the client to comply with the reporting requirements and to discuss the planning opportunities with the prospective donor if the opportunity arises in the future.

VI. Non-U.S. Beneficiaries. In our mobile and global society, it is more and more likely that a U.S. client may have children who do not reside in the U.S. A plan that fails to take into account planning opportunities and pitfalls associated with transfers to the children who reside in other countries is potentially inappropriate for such client and exposes the advisor to a potential claim for malpractice. Many countries, including the U.S. and Canada, permit inbound transfers to be structured in such a way as to confer substantial tax and non-tax benefits to its beneficiaries. Although a U.S. estate planner would certainly not be expected to know or understand the rules applicable in other jurisdictions, he or she would certainly be expected to associate competent counsel or to advise the client to retain such counsel.

VII. Foreign Trusts. Since the mid-1990s, the U.S. has enacted significant legislation and we now have significant guidance and authority dealing with the taxation of and reporting of information with respect to foreign trusts. As shown below, the rules are far reaching and even practitioners whose practices can be characterized as purely domestic must have a good enough understanding of the new rules to be able to identify clients and/or trusts that may be affected by them.

A. Foreign/Domestic Trusts Defined. To be able to comply with the extensive tax and reporting rules dealing with foreign trusts, (discussed more thoroughly below), taxpayers and their advisors must first be able to determine whether a particular trust is foreign or domestic. SBJPA 1996 amended §§7701(a)(30) and (31) to provide new more objective rules for determining whether a trust is domestic or foreign. The new rules replace the previously subjective test which required the consideration and weighing of various factors such as (i) the location of the assets, (ii) the nationality and residence of the fiduciary, the settlor and the beneficiaries, (iii) the applicable law, and (iv) the place of administration of the trust. Under the subjective test, practitioners were often left with uncertainty about the residency of a trust and the risk that the taxpayer’s determination might be challenged years later.

1. Domestic Trusts. § 7701(a)(30)(E) provides that the term “United States person” means any trust if (a) a court within the U.S. is able to exercise primary supervision over the administration of the trust (the “Court Test”), and (b) one or more U.S. persons have the authority to control all substantial decisions of the trust (the “Control Test”). A trust will be treated as a U.S. person on any day that the trust meets both the Court Test and the Control Test. For purposes of the regulations, the term “domestic trust” means a trust that is a U.S. person as described herein. The terms of the trust instrument and applicable law must be applied to determine whether the Court Test and the Control Test are met.

2. Foreign Trusts. § 7701(a)(31)(B) provides that the term “foreign trust” means any trust other than a trust described in § 7701(a)(30)(E). For purposes of the regulations, the term “foreign trust” means any trust other than a domestic trust.

3. The Court Test. A trust will meet the Court Test if a court within the U.S. is able to exercise primary supervision over the administration of the trust.

a) For purposes of this test, (i) “Court” means any federal, state or local court; (ii) “United States” includes only the States of the U.S. and the District of Columbia (for purposes of the

Court Test, a court within a territory or possession of the U.S. or within a foreign country is not a court within the U.S.); (iii) "Is Able to Exercise" means that court has or would have authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust; (iv) "Primary Supervision" means that a court has or would have authority to determine substantially all issues regarding the administration of the entire trust (irrespective of whether another court has jurisdiction over a trustee, beneficiary, or trust property); and (v) "Administration of the Trust" means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.

b) The final regulations provide a non-exclusive list of trusts that meet the Court Test. A trust meets the Court Test if the trust is registered by an authorized fiduciary in a court within the U.S. under a state statute substantially similar to Article VII, Trust Administration, of the Uniform Probate Code. A trust created pursuant to the terms of a will probated within the U.S. (other than in an ancillary probate) will meet the court test if all fiduciaries of the trust have been qualified as trustees by a court within the U.S. Trusts, other than testamentary trusts, will meet the Court Test if the fiduciaries and/or beneficiaries take steps with a court in the U.S. that cause the administration of the trust to be subject to the primary supervision of the court.

c) If both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust meets the Court Test.

d) Notwithstanding any other provision of the regulations, a trust will not meet the Court Test if the trust instrument provides that a U.S. court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the U.S. In response to comments, the final regulations added a very limited exception to this rule which provides that a trust will not fail to meet the Court Test solely because the trust instrument provides that the trust will migrate from the U.S. only in the case of foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S.

e) Recognizing that it may be difficult to determine whether a court of a particular state would assert primary supervision over the administration of particular trust, the final regulations provide a safe harbor for the Court Test. Under the safe harbor, a trust will satisfy the Court Test if (i) the trust instrument does not direct that the trust be administered outside of the U.S., (ii) the trust in fact is administered exclusively in the U.S. and, (iii) the trust is not subject to an automatic migration provision.

4. The Control Test. A trust will meet the Control Test if one or more U.S. persons have the authority to control all substantial decisions of the trust.

a) "United States person" means a U.S. person within the meaning of § 7701(a)(30);

b) "Substantial decisions" means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial (substantial decisions include, but are not limited to, decisions concerning (i) whether and when to distribute income or corpus, (ii) the amount of any distributions, (iii) the selection of a beneficiary, (iv) whether a receipt is allocable to income or principal, (v) whether to terminate the trust, (vi) whether to compromise, arbitrate, or abandon claims of the trust, (vii) whether to sue on behalf of the trust or to defend suits against the trust, (viii) whether to remove, add, or replace a trustee, (ix) whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa, and (x) investment decisions - however, if a U.S. person hires an investment advisor for the trust, investment decisions made

by the investment advisor will be considered substantial decisions controlled by the U.S. person if the U.S. person can terminate the investment advisor's power to make investment decisions at will);

c) "Ministerial decisions" include decisions regarding details such as bookkeeping, the collection of rents, and the execution of investment decisions made by the fiduciaries; and

d) "Control" means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto the substantial decisions. To determine whether U.S. persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries. It is important to note the breadth of what is considered a "substantial decision" because almost any power or authority in the hands of a non-U.S. person will cause an otherwise domestic trust to become a foreign trust with all the consequences such characterization entails.

e) Notwithstanding any other provision of the regulations, U.S. persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by U.S. persons.

f) Provided that U.S. fiduciaries control all of the substantial decisions made by the trustees or fiduciaries, the following types of trusts are deemed to satisfy the Control Test: (i) a qualified trust described in § 401(a); (ii) a trust described in § 457(g); (iii) a trust that is an individual retirement account described in § 408(a); (iv) a trust that is an individual retirement account described in § 408(k) or § 408(p); (v) a trust that is a Roth IRA described in § 408A; (vi) a trust that is an education individual retirement account described in § 530; (vii) a trust that is a voluntary employees' beneficiary association described in § 501(c)(9); (viii) such additional categories of trusts as the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin.

g) In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed 12 months from the date of the change to make necessary changes either with respect to the persons who control the substantial decisions or with respect to the residence of such persons to avoid a change in the trust's residency. For purposes of this section, an inadvertent change means the death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust that would cause a change to the residency of the trust but that was not intended to change the residency of the trust. If the necessary change is made within 12 months, the trust is treated as retaining its pre-change residency during the 12-month period. If the necessary change is not made within 12 months, the trust's residency changes as of the date of the inadvertent change. If reasonable actions have been taken to make the necessary change to prevent a change in trust residency but, due to circumstances beyond the trust's control, the trust is unable to make the modification within 12 months, the trust may provide a written statement to the district director having jurisdiction over the trust's return setting forth the reasons for failing to make the necessary change within the required time period. If the district director determines that the failure was due to reasonable cause, the district director may grant the trust an extension of time to make the necessary change. Whether an extension of time is granted is in the sole discretion of the district director and, if granted, may contain such terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the district director does not grant an extension, the trust's residency changes as of the date of the inadvertent change. Given the potential tax and reporting consequences associated with the change in a trust's residence (some of which are discussed below), inadvertent changes in trust residence must be avoided or promptly cured.

B. Establishment of or Transfers to a Foreign Trust. The establishment and/or transfer of assets to a foreign trust by a U.S. person has both tax and reporting implications. From a tax point of view, (a) § 679, which generally determines when the transferor will be treated as the owner of the transferred assets, has been significantly expanded, and (b) new § 648, governing the recognition of gain

with respect to certain transfers to certain foreign trusts and estates, was enacted. From a reporting point of view, expanded reporting obligations exist both with respect to the establishment and/or transfer of assets to a foreign trust and with respect to the ongoing reporting obligations of the person treated as the grantor of the trust.

1. Expanded grantor trust rules of § 679.

a) Unless one of the exceptions described below applies, a U.S. person who directly or indirectly transfers property to a foreign trust (other than deferred compensation and charitable trusts described in § 6048(a)(3)(B)(ii)) will be treated as the owner for his or her taxable year of the portion of the trust attributable to the transferred property if, for that taxable year, there is a U.S. beneficiary of any portion of the trust. This rule applies irrespective of whether the transferor retained any interest in or powers over the trust or the transferred assets that would have caused the grantor trust rules (other than § 679 to apply). The general rule does not apply to any transfer by reason of the death of the transferor or to any transfer of property in exchange for consideration of at least the fair market value of the transferred property.

b) For purposes of § 679(a), a trust is treated as having a U.S. beneficiary for the taxable year unless under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a U.S. person. Amounts paid to or accumulated for a controlled foreign corporation (defined in § 957(a)), a foreign partnership of which a U.S. person is a partner, or a foreign trust or estate with a U.S. beneficiary are defined as payments to a U.S. beneficiaries. When applying § 679 with respect to any transfer of property to a foreign trust, a beneficiary who first became a U.S. person more than 5 years after the date of the transfer will not be treated as a U.S. person.

c) If a non-U.S. person becomes a resident of the U.S. within 5 years after directly or indirectly transferring property to a foreign trust, § 679 and the reporting obligations discussed below will apply as if the individual transferred to the trust, on the residency starting date, an amount equal to the portion of the trust attributable to the transferred property. Undistributed net income for periods before the transferor's residency starting date will be considered property transferred by the transferor to the trust but will not otherwise be taken into account. The term residency starting date is defined by reference to § 7701(b)(2)(A).

d) If an individual who is a citizen or resident of the U.S. transfers property to a domestic trust which becomes a foreign trust while the transferor is alive, § 679 and the reporting obligations discussed below will apply as if the transferor transferred to the trust, on the date the trust becomes a foreign trust, an amount equal to the portion of the trust attributable to the transferred property. Undistributed net income for periods before the trust became a foreign trust will be considered property transferred by the transferor to the trust but will not otherwise be taken into account.

2. Recognition of gain upon transfer of assets to a foreign trust. Section 684 generally provides that any transfer by a U.S. person to a foreign estate or trust (unless the transferor is treated as the grantor of the trust) will be treated as a sale or exchange and result in recognition of any unrecognized gain. Section 684 also provides that a domestic trust that becomes a foreign trust will be treated as having transferred, immediately before becoming a foreign trust, all of its assets to the foreign trust.

3. Reporting required in the case of a foreign trust with a U.S. grantor.

a) A U.S. person who at any time during a taxable year is treated as the owner of any portion of a foreign trust under the grantor trust rules is responsible to ensure that, by the 15th day of the third month after the end of the trust's tax year, the trust (1) files a return (Form 3520-A) for the year setting forth a full and complete accounting of all trust activities and operations for the year, the name of its U.S. agent, and such other information as the IRS may prescribe, and (2) furnishes such information to

each U.S. person (a) who is treated as the owner of any portion of the trust or (b) who receives (directly or indirectly) any distribution from the trust.

b) The determination of amounts required to be taken into account by a U.S. person under the grantor trust rules with respect to a foreign trust of which the U.S. person is an owner will be determined by the IRS, unless the trust agrees to authorize a U.S. person to act as the trust's limited agent solely for purposes of applying §§7602, 7603, and 7604 with respect to (i) any request by the IRS to examine records or produce testimony related to the proper treatment of amounts required to be taken into account under the grantor trust rules, or (ii) any summons by the IRS for such records or testimony. If the agent resigns, liquidates or its responsibility as an agent of the trust is terminated, the U.S. owner of the foreign trust must ensure that the foreign trust notifies the IRS within 90 days by filing an amended Form 3520-A with the Philadelphia Service Center. This notification must contain the name, address and taxpayer identification number of the new U.S. agent, if any. Even if the foreign trust identifies a U.S. agent on Form 3520-A, the foreign trust may be treated as providing incorrect information and, therefore, the U.S. owner may be subject to penalties (see discussion below), if either the U.S. agent or the foreign trust fails to comply with its obligations under the agreement. Rules similar to § 6038A(e)(2) and (4), dealing with enforcement of requests for certain records of foreign owned corporations, are applicable in the event of noncompliance.

c) In addition to being responsible to ensure that the foreign trust files its annual information return, discussed above, the U.S. owner of a foreign trust must (i) include all items of income and deductions attributable to the portion of the trust he or she owns on his or her income tax returns for the taxable year, and (ii) complete and file Form 3520 providing all documents and information requested. If the foreign trust complied with its reporting obligations, discussed above, the U.S. owner must include in his or her own returns and in Form 3520, the documents and information he or she received from the foreign trust. If the foreign trust did not comply with its reporting obligations, the U.S. owner must provide the information requested to the best of his or her ability and must file Form 8082 (Notice of Inconsistent Treatment or Amended Return) to notify the IRS that the U.S. owner did not receive adequate information from the foreign trust. Similarly, if the U.S. owner, on his or her income tax returns, and the foreign trust, in its return, treat certain items differently, the U.S. owner must file Form 8082 to report the inconsistency.

4. Reporting the establishment of and transfers to a foreign trust. Section 6048(a) requires that taxpayers report certain transfers made by a U.S. person to a foreign trust. The types of transfers that are reportable are only "gratuitous transfers," which have been specifically defined as "reportable events."

a) The term "reportable event" includes any of the following events: (1) the creation of any foreign trust by a U.S. person, (2) the transfer of any money or property (directly or indirectly) to a foreign trust by a U.S. person, including a transfer by reason of death, (3) the death of a citizen or resident of the U.S. if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or any portion of a foreign trust was included in the gross estate of the decedent, or (4) the change in residence of a trust from domestic to foreign. The term "reportable event" does not include any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property, or any transfer or other event with respect to a deferred compensation trust or charitable trusts described in § 501(c)(3).

b) A "gratuitous transfer" is a transfer other than (i) a transfer for fair market value, (ii) a corporate distribution described in §§301, 302, 305, 355 or 356, or (iii) a partnership distribution described in § 731. A transfer to a foreign trust may be considered a gratuitous transfer regardless of whether the transfer was treated as a gift for gift tax purposes. A distribution from one trust to another trust that is a beneficiary of the distributing trust is a gratuitous transfer. In addition, a domestic trust that becomes a foreign trust will be deemed to have made a gratuitous transfer of all of its assets immediately before becoming a foreign trust. Finally, a gratuitous transfer will also include any direct or indirect transfer that is structured with a principal purpose of avoiding the application of §§679 and 6048.

c) The term “transfer for fair market value” includes only transfers in consideration for property received from the trust, services rendered by the trust or the right to use property of the trust and only to the extent that the property, services or right to use property received is equal to the fair market value of the property transferred. Any obligations (other than “qualified obligations”) issued by a related foreign trust or any person related to the trust will be disregarded in determining whether fair market value was received by the transferor. A U.S. person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction.

d) An obligation will be treated as a “qualified obligation” only if: (i) the obligation is reduced to writing by an express written agreement; (ii) the term of the obligation does not exceed five years; (iii) all payments on the obligation are denominated in U.S. dollars; (iv) the yield to maturity of the obligation is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate; (v) the U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding to a date not earlier than three years after the maturity date of the obligation; and (vi) the U.S. transferor reports the status of the obligation, including principal and interest payments, on Form 3520, for each year that the obligation is outstanding. If an obligation treated as a qualified obligation subsequently fails to be a qualified obligation, the U.S. transferor will be treated as making a gratuitous transfer to the trust as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation. The rules for qualified obligations apply to an obligation of a related foreign trust (or of a person related to the trust) issued after February 6, 1995. A person is related to a foreign trust if such person, without regard to the transfer at issue, is a grantor of the trust, a beneficiary of the trust, or is related to any grantor or beneficiary of the trust.

e) A gratuitous transfer to a foreign trust must be reported on Form 3520 which requires disclosure, inter alia, of the amount of money or other property transferred to the trust in connection with the reportable event, the identity of the trust and of each trustee and beneficiary (or class of beneficiaries) of the trust and any other information the IRS may require. The instructions for Form 3520 make it clear that the “responsible party” is the person who must ensure that the required information is provided or pay the appropriate penalties. Section 6048(a)(4) provides that in the case of the creation of an inter vivos trust, the responsible party is the grantor; in the case of the transfer of assets to a trust, other than a transfer by reason of death, the responsible party is the transferor; and in the case of a transfer of assets to a trust by reason of death, the responsible party is the executor of the decedent’s estate. The instructions to Form 3520 provide that in the case of a change in residency of a trust from domestic to foreign, the responsible party is the U.S. individual who transferred property to the trust while it was a domestic trust and is alive when the trust becomes a foreign trust or the trust in all other cases.

5. Penalties for failure to report. See section VII.E. below.

C. Distributions from a Foreign Trust. A U.S. person who receives, directly or indirectly, a distribution from a foreign trust must be able to determine the proper characterization of such distribution for U.S. income tax purposes to be able to comply with both tax and reporting obligations arising from such distribution

1. Distributions from a foreign trust. The term “distribution from a foreign trust” includes (a) a gratuitous transfer of money or property from a foreign trust, whether or not the trust is owned by another person, (b) the receipt of trust corpus and the receipt of a gift or bequest described in § 663(a), (c) distributions constructively received e.g. credit card charges paid by the trust, (d) payments in exchange for property transferred to the trust or services rendered to the trust if the fair market value of the payment exceeds the fair market value of the property transferred or services rendered (to the extent of the excess). With very limited exceptions, direct or indirect loans of cash or marketable securities to a U.S. owner or U.S. beneficiary of the trust or to a person related to such owner or beneficiary will be treated as distributions to such owner or beneficiary. Reporting, however, is not required with respect to

distributions that are taxable as compensation within the meaning of §§672(f)(2)(B), and distributions received by § 501(c)(3) domestic organizations.

2. Distributions through intermediaries. Section 643(h) provides that, for purposes of the grantor trust rules and the reporting requirements of § 6048, any property that is transferred to a U.S. person by another person (an intermediary) who has received property from a foreign trust will be treated as property transferred directly by the foreign trust to the U.S. person if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax. This rule does not apply to the extent that either the transfer from the foreign trust to the intermediary or the transfer from the intermediary to the U.S. person is a transfer that is not a gratuitous transfer within the meaning of § 1.671-2T(e)(2). This rule does not apply if the intermediary is the grantor of the portion of the trust from which the property that is transferred is derived. Also, this rule does not apply if, during the taxable year of the U.S. person, the aggregate fair market value of all property transferred to such person from all foreign trusts, either directly or through one or more intermediaries, does not exceed \$10,000.

3. Information required for proper characterization of distributions. If adequate records are not provided to the IRS to determine the proper treatment of any distribution from a foreign trust, the distribution will be treated as an accumulation distribution includible in the gross income of the distributee. Accumulation distributions are generally taxed pursuant to §§665 through 668. Section 668, imposes an interest charge on accumulation distributions at the rate applicable to general underpayments of income tax. In the case of a grantor trust, adequate records include a foreign grantor trust beneficiary statement ("FGTBS"), a detailed statement (similar to a K-1 from a partnership) which would enable the IRS to confirm that the trust is a grantor trust with a foreign grantor who is deemed to be the owner of the trust. If the U.S. beneficiary receives a complete FGTBS with respect to a distribution from a grantor trust during the taxable year, the beneficiary can treat the distribution as a nontaxable gift from the owner of the trust. In the case of a nongrantor trust, adequate records include a foreign nongrantor trust beneficiary statement ("FNGTBS"), a detailed statement which would enable the IRS to determine the U.S. tax consequences of the distribution from the foreign nongrantor trust. If the beneficiary receives a complete FNGTBS, the beneficiary may determine such tax consequences and avoid the "default treatment" described below. It is important to note that special rules (discussed in detail below) apply to determine whether a foreign trust is a grantor or nongrantor trust.

4. "Default Treatment". If a U.S. beneficiary is unable to obtain adequate records, as discussed above, the beneficiary may avoid treating the entire distribution as an accumulation distribution if the U.S. beneficiary provides certain information regarding actual distributions from the trust for the prior three years. Under the default treatment, the U.S. beneficiary is allowed to treat a portion of the distribution as a distribution of current income based on the average of distributions from the prior three years, with only the excess treated as an accumulation distribution. A beneficiary's use of the default treatment has no effect on the trust. If the U.S. beneficiary receives a complete FNGTBS, he or she may elect the default treatment but will be required to continue reporting under the default treatment for all future years. The only exception to this consistency requirement is that the U.S. beneficiary will be able to report the actual tax consequences of a distribution in the year the trust terminates, but only if the U.S. beneficiary receives a complete FNGTBS for that year.

5. Filing requirements. A U.S. beneficiary who receives a distribution from a foreign trust must complete and file Form 3520. The U.S. beneficiary must complete the general information required by page 1 and Part III of Form 3520. The U.S. beneficiary must describe the cash or property received, any loan received by the U.S. beneficiary or a person related to the U.S. beneficiary from a related foreign trust, any the details concerning any qualified obligation to or from the trust. The U.S. beneficiary must attach any beneficiary statement he or she received from the trust. Finally, the U.S. beneficiary must compute the amount of the distribution to be treated as an accumulation distribution (either under the actual or default treatment) and any applicable interest surcharge. The U.S. beneficiary must also report taxable distributions on his or her income tax returns.

6. Penalties for failure to report. See section VII.E. below.

7. Practical Issues. As shown herein, a distribution from a foreign trust can be anything from a tax-free gift that simply has to be reported to an accumulation distribution with potentially disastrous tax consequences (with other possibilities in between). In any case, practitioners must now be aware of whether their clients are receiving distributions from a foreign trust so they can properly advise or seek proper advice for their clients. As discussed in detail above, knowing whether a client is receiving a distribution from a foreign trust implies that the trust can be properly characterized as a domestic trust or foreign trust in the first place (a characterization which will often require more than an examination and analysis of the trust document itself). It is important to note the broad meaning that has been given to the term "distributions from a foreign trust." If the client is receiving constructive distributions from a trust, he or she is not likely to respond affirmatively to the question whether he or she is receiving distributions from the trust. More probing questions will obviously be required to elicit the information needed by a practitioner to properly characterize a particular transaction.

D. Foreign Grantor Trusts. As discussed above, distributions from a foreign grantor trust to U.S. beneficiaries can be treated as tax-free gifts from the grantor or owner of the trust. Prior to SBJPA 1996, the grantor trust rules had been affirmatively used by taxpayers to establish trusts with foreign grantors for U.S. beneficiaries. By having a foreign person who was deemed to be the owner of the trust, tax-free distributions could be made to U.S. beneficiaries. So long as the foreign trust only had foreign source income not effectively connected with a U.S. trade or business, the foreign grantor would also not be subject to U.S. income tax. Under the new rules, with very limited exceptions discussed below, the grantor trust rules only apply to the extent their application, without regard to § 672(f), results in any portion of the trust being treated as owned by a U.S. citizen or resident or a domestic corporation. Note that § 672(f) applies to domestic and foreign trusts. Any portion of the trust that is not treated as owned by a grantor or another person under these new rules will be treated as a nongrantor trust for tax purposes. The determination of the portion of a trust treated as owned by the grantor or other person will be based on the terms of the trust, the application of the grantor trust rules, and the regulations thereunder.

1. Exception applicable to certain revocable trusts. The new foreign grantor trust rules will not apply to any portion of a trust if the grantor has the power, exercisable solely by the grantor without the approval or consent of any other person, to revest absolutely in the grantor title to the trust property to which such portion is attributable. In the event of the grantor's incapacity, the power to revest title to trust assets in the grantor must be exercisable by a guardian or other person with unrestricted authority to exercise the power on the grantor's behalf. The grantor's power to revest trust assets exercisable only with the approval of a related or subordinate party who is subservient to the grantor will be treated as exercisable solely by the grantor. See examples in Reg. §672(f)-3(a)(4).

2. Exception applicable to certain irrevocable trusts. The new foreign grantor trust rules do not apply to any portion of a trust if at all times during the lifetime of the grantor the only amounts distributable (whether income or corpus) from the trust are amounts distributable to the grantor or the spouse of the grantor. The final regulations continue to provide that amounts distributable to discharge a legal or support obligation of the grantor or the grantor's spouse are treated as distributable to the grantor or the grantor's spouse. An obligation is considered a legal obligation if it is enforceable under the local law of the jurisdiction in which the grantor (or the grantor's spouse) resides. The final regulations clarify that this exception will not apply after the death of the grantor, even if the grantor's spouse survives and the grantor's spouse would be treated as owning the trust under § 678 without regard to § 672(f).

3. Exception applicable to certain compensatory trusts. Except as provided in regulations, the new foreign grantor trust rules will not apply to any portion of a trust distribution which is taxable as compensation for services rendered.

E. Penalties for Failure to Comply with Foreign Trust Reporting Obligations. Except as set forth below, in addition to any criminal penalty provided by law, if any notice or return required to be filed by § 6048 (1) is not timely filed, (2) does not include all the required information, or (3) includes incorrect information, the person required to file the notice or return is subject to a penalty equal to 35 percent of the gross reportable amount. If the failure to file continues for more than 90 days after the day on which the IRS mails notice of such failure to the person required to pay the penalty, such person will be subject

to an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period, but in no event more than the gross reportable amount. The term "gross reportable amount" means (1) the gross value of the property involved in a reportable event (see section VII.B.4.a. above), (2) the gross value of the portion of a foreign trust's assets at the close of the year treated as owned by the U.S. person in the case of a grantor trust's failure to file a required return, and (3) the gross amount of the distributions in the case of a U.S. beneficiary's failure to report distributions from a foreign trust. In the case of a foreign trust with a U.S. owner, the general civil penalty of 35% of the gross reportable amount is reduced to 5% of the gross reportable amount. Accordingly, if a foreign trust with a U.S. owner fails to file its required return as discussed above, the U.S. owner is subject to a penalty equal to 5% of the gross value of the portion of the trust assets treated as owned by that person. The penalties described in this section will not be imposed with respect to any failure that is shown to be due to reasonable cause and not due to willful neglect; however, the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information is not reasonable cause. Note that Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) will not apply with respect to the assessment or collection of the penalties described in this section.

VIII. Departures from the U.S.

A. Individuals Subject to the Expatriation Regime Prior to the most recent changes to the expatriation rules, individuals who relinquished their U.S. citizenship and long term residents (see definition below) who gave up their residence with a principal purpose of avoiding U.S. tax were subject to the expatriation regime (§§877, 2501(a)(3) and 2107). Under the current expatriation rules, a person is subject to the expatriation regime based on an objective test. With very limited exceptions, an expatriate whose net worth is at least US\$2 million and whose average annual net income tax liability for the five years prior to expatriation is more than \$131,000 (for expatriations occurring during 2006, indexed annually for inflation) is automatically subject to the expatriation tax regime without regard to the subjective reason for abandoning U.S. citizenship or residency. An expatriate who does not meet these thresholds is not subject to the expatriation regime unless he or she fails to certify under penalties of perjury that he or she has complied with his or her U.S. tax obligations for the preceding five years.

B. Long-Term Residents. A "long-term resident" is defined as an individual who was a lawful permanent resident of the U.S. (had a green card) for at least 8 out of the last 15 taxable years ending with the year in which the termination of residence occurs. Any part of a taxable year in which the individual had a green card counts as one whole year. Accordingly, a person who received his or her green card on December 31 of year one would become a long-term resident on January 1 of year 8 even though he or she was only resident of the U.S. during a period of 6 years and 2 days. An individual is not considered to be a lawful permanent resident of the U.S. for any year in which the individual is taxed as a resident of another country under applicable provisions of a treaty.

C. Taxation of Expatriates. In general, persons who are subject to the expatriation regime and are not subject to the presence rule discussed below will be taxed (for the 10 year period following their expatriation) as non-resident aliens with the following modifications.

1. The individual is subject to tax on U.S. source income or gain at the graduated rates applicable to U.S. citizens or the rates applicable to nonresident aliens, whichever produce the higher tax. The tax applies whether or not the assets giving rise to the income or gains were acquired prior to or after the date of departure.

2. The individual is also subject to U.S. gift and estate tax on U.S.-situs tangible and intangible property (such as stock or securities), as well as with respect to certain foreign corporate stock if the foreign corporation owns U.S.-situs assets.

3. Although interest received by a non-resident alien on U.S. Treasuries, certain corporate bonds, and U.S. bank and savings accounts is generally not taxable pursuant to the "portfolio

interest exception” and “bank deposit exception,” such interest is taxable to expatriates who are subject to the expatriation tax regime.

4. Gain from the sale or exchange of stock of a U.S. corporation or debt of a U.S. person (including debt issued by U.S. federal, state, or local governments) continues to be treated as taxable U.S. source income (regardless of whether it otherwise would be taxable to a non-resident alien).

5. Income or gain derived from stock in a foreign corporation is also treated as U.S. source if the individual owned, directly or indirectly, more than 50 percent of the vote or value of the stock of the corporation on the date of loss of citizenship or residence, or at any time during the two years preceding such date.

6. An expatriate who exchanges property that produces U.S. source income for property that produces foreign source income is required to recognize immediately, as U.S. source income, any gain on such exchange (determined as if the property had been sold for its fair market value on the date of the exchange). Moreover, if an expatriate removes from the U.S. appreciated tangible personal property (for example, artwork, automobiles, yachts, etc.) with an aggregate fair market value of over US\$250,000, a pro-rata portion of the relevant gain is recognized upon such removal.

D. 30 Day Presence Rule. With very limited exceptions, if an expatriate is physically present in the U.S. on more than 30 days in any calendar year for the 10 calendar years following the date of expatriation or loss of U.S. residency, the individual will be treated as a U.S. citizen or resident for such taxable year.

E. Reporting Requirements. All expatriates are required to file an expatriation information statement upon expatriation, including individuals who are not subject to the expatriation regime because they do not meet either the net worth test or tax liability test at the time of expatriation. This requirement is satisfied by filing Form 8854 with the IRS no later than the date of expatriation (whether occurring through renunciation before a U.S. consular officer or the cancellation of a certificate of naturalization through a federal court). It is important to note that an individual will not be considered as having expatriated for tax purposes until he or she has fulfilled both the notification requirements (described above) as well as filing Form 8854. Individuals who are subject to the expatriation regime must also annually complete both the balance sheet and income statement provided in Form 8854 (Schedules A and B), as well as a separate section requiring the expatriate to list countries of citizenship and the relevant days of U.S. presence during the year. Failure to comply with the annual reporting requirement will subject an expatriate to a \$10,000 penalty unless the failure is due to reasonable cause and not to willful neglect.

F. Practical Issues. A U.S. citizen contemplating loss of citizenship and a long-term resident contemplating termination of residence must seriously consider the application of the current expatriation regime. A related practical consequence of the expatriation regime is that persons intending to and immigrating into the U.S. are and should be thinking twice before obtaining a green card and commencing their lawful permanent status if there is another visa that can accomplish their purposes (which is mostly the case). Delaying permanent residence as long as possible will provide immigrants with greatest flexibility if they decide to terminate their U.S. residence at a later date

IX. Foreign Assets. Although a detailed discussion of this topic is beyond the scope of this outline, estate planners must be aware that many issues arise if a client has foreign assets.

A. Coordination. A common mistake by U.S. practitioners advising clients with foreign assets is to assume that the goal is to find a way to transfer such assets to the domestic trust the practitioner may have drafted to deal with the client’s U.S. assets. Instead, the goal is to fully understand the client’s objectives with respect to all of his or her assets and to accomplish those goals as efficiently and cost-effectively as possible using whatever tools are available in the relevant jurisdictions and to insure that the planning in one jurisdiction does not adversely affect the planning desired in another jurisdiction.

B. Recognition of Trusts. Although more and more countries, even civil law countries, are starting to recognize trusts and even pass trust legislation of their own, recognition of common law trusts is far from universal. Accordingly, a client's trust may have limited or no use in a jurisdiction in which the client may own assets. As discussed above, careful analysis of tools available in the relevant jurisdiction will in all cases be required.

C. Situs Wills/Testamentary Documents. Consistent with the principle of coordination discussed above, it will frequently be necessary or advisable for the client to dispose of foreign assets with documents that are recognized in the relevant jurisdiction. Situs (local) wills, beneficiary designations with respect to certain assets or even certain ways of holding title may be appropriate to most effectively accomplish the client's goals in the particular jurisdiction. Again, the key is to understand and make full use of all tools and planning available in the relevant jurisdiction and to avoid potentially disastrous pitfalls.

D. Qualifying Transfers of Foreign Assets for U.S. Tax Benefits. Even if local documents are used to dispose of assets located in other jurisdictions, practitioners must remain vigilant of U.S. tax principles that will apply to the transfer of such assets in any event. For example, assume the client is a U.S. citizen or is domiciled in the U.S., which means that he or she will be subject to U.S. estate tax. If the client is married and wants to leave assets in a foreign jurisdiction to his or her spouse, the fact that the asset is located in another jurisdiction or will pass through a foreign will or trust does not mean that the transfer no longer needs to be structured so that it qualifies for the U.S. marital deduction if the marital deduction is desired. In that case, technical U.S. tax requirements may need to be carefully included in foreign documents.

E. Forced Heirship. Clients with foreign assets and their advisors should be aware that some countries, like Switzerland, have forced heirship laws. In general, forced heirship rules limit a testator's freedom of disposition and grant certain dependents the right to participate in the distribution of the estate of the decedent, even if it the distribution would be against the testator's express intention. Sometimes the forced heirship rules are consistent with the client's dispositive wishes but sometimes they are not. In some cases, changes to the client's estate plan in the U.S. or other jurisdictions will be required to accomplish the client's global objectives.

F. Association of Competent Local Counsel. Given the need to understand opportunities and pitfalls that may exist in a particular jurisdiction, practitioners representing clients with foreign assets will almost inevitably have to associate competent local counsel. As discussed above, competent local counsel means someone who is not only familiar with local tax and non-tax issues but also with cross-border matters, clients and transactions.

X. Non-U.S. Persons with U.S. Assets. A general discussion of how non-U.S. persons are taxed in the U.S. is contained in section II. above. If a practitioner has a non-U.S. client with U.S. assets, planning to minimize the U.S. tax consequences attributable to those assets should take into account the consequences of such planning in the client's country of residence. Again, association of competent counsel or exclusion of this analysis from the scope of engagement with a written recommendation that the client seek such counsel is essential to minimize the risk of a later claim by the client that the practitioner should have known the planning was going to have adverse tax or other consequences elsewhere. An example of a situation in which this problem arises is situs planning. As discussed in section II. above, non-U.S. residents for transfer tax purposes are not subject to U.S. transfer tax with respect to non-U.S. situs assets (i.e. shares of a foreign corporation). Accordingly, if the client holds U.S. situs assets (otherwise subject to transfer tax) through a foreign corporation (no matter where established), the same assets will escape U.S. transfer tax. Assume a Mexican client owns U.S. situs assets through a Cayman Islands corporation. The structure works to avoid U.S. transfer tax but neither the client nor the advisor may be aware that such a structure has tax and reporting obligations in Mexico which are avoidable, which the client may not like and which could land the client in jail if they are not met.

XI. Possession of Assets of a Foreign Decedent. Domestic and foreign financial institutions and others who hold a decedent's assets and subsequently release such assets to the person they believe in good faith is entitled to such assets may be surprised to know that, under certain circumstances, they can be held liable for the decedent's unpaid U.S. estate taxes. Effectively, if no one has been appointed and qualified as an executor under the applicable local law (defined below as a "U.S. Executor"), such a person is treated as an executor of the decedent's estate for U.S. estate tax purposes (defined below as a "Statutory Executor"), a designation which carries with it important consequences.

A. Executor. Generally, an executor is the person duly appointed under applicable law to administer a decedent's estate. If the decedent was domiciled in the U.S., a U.S. executor may be appointed in the state of the decedent's domicile. If the decedent was not domiciled in the U.S. at the time of his or her death, a U.S. executor may be appointed by the appropriate court of a state in which the decedent held assets at the time of the decedent's death.

B. Statutory Executor. If a person has been duly appointed and has qualified to administer the decedent's estate within the U.S., such person will be the only person treated as a U.S. executor for tax purposes (the "U.S. Executor"). If no person has been appointed and has qualified to administer the decedent's estate within the U.S. (there is no U.S. Executor), any person in actual or constructive possession of any property of the decedent's estate is treated as an executor for U.S. estate tax purposes (a "Statutory Executor").

C. Situs of Assets. For U.S. estate tax purposes, the legal situs or the actual physical location of the estate's property is immaterial to the determination of who is treated as a Statutory Executor. Therefore, even a person in actual or constructive possession of assets of the decedent which are not physically located in the U.S. would be treated as a Statutory Executor and would be responsible for discharging the duties imposed on such executor for U.S. estate tax purposes.

D. Filing Requirements. A Statutory Executor is responsible for filing the decedent's U.S. estate tax return and for paying any U.S. estate tax, interest and penalties that may be assessed and become due. This responsibility exists even if other persons are also in possession of estate assets and are also treated as Statutory Executors.

E. Personal Liability. A Statutory Executor's duty to pay U.S. estate tax does not itself give rise to personal liability for the tax. Personal liability can, however, be imposed on a Statutory Executor who is deemed to act in a fiduciary capacity and who pays a debt of an estate before satisfying unpaid U.S. taxes for which the U.S. has a priority claim against the estate at a time when the estate's liabilities exceed its assets. For this purpose, payments made to beneficiaries are considered estate debts. Accordingly, a person who holds assets of a decedent's estate and distributes such assets to a beneficiary of the estate or the person next entitled to the assets may be held personally liable for any estate tax owed by the estate. Although there is authority in support of the position that a Statutory Executor is not per se a fiduciary of the estate and only acts as the executor for purposes of filing the estate tax return and paying the estate tax (see, e.g., *Occidental Life Ins. Co. of Cal. v. Comm'r*, 50 T.C. 726 (1968)), there is also authority holding a Statutory Executor personally liable for unpaid U.S. estate taxes of an estate on the basis of the actions taken by the Statutory Executor (see, e.g., *Allen v. Comm'r*, T.C. Memo 1999-385 (1999)). Although there are not many cases that illustrate when a Statutory Executor might be treated as a fiduciary and therefore subject to the law that imposes personal liability for unpaid tax, it is arguable that paying estate debts or making distributions to beneficiaries or others determined to be entitled to the assets in question are actions normally taken by an executor acting in a fiduciary capacity and should render the Statutory Executor a fiduciary potentially subject to personal liability.

F. Practical Issues. A Statutory Executor who wishes to assure that no claim will be made against it for unpaid U.S. estate tax owed by the estate should seek competent legal advice regarding the appropriate steps to take before releasing the estate assets in its possession. The appropriate steps that should be taken depend upon the facts and circumstances of each case. This determination is based in part on whether a U.S. Executor has been or will be appointed. If a U.S. Executor is appointed, the

Statutory Executor may release the assets to the U.S. Executor without risking personal liability for the estate's unpaid taxes. However, if a U.S. Executor is not appointed, the Statutory Executor must determine whether the estate is subject to U.S. estate tax, and if so, whether it is more appropriate for the estate's foreign representative to file the U.S. estate tax return. In addition, the Statutory Executor must determine whether a request for a formal discharge from personal liability or a transfer certificate provides sufficient protection from liability for the estate's unpaid taxes under the circumstances.

XII. Enforcement. Since the mid-1990s, significant attention has been focused on the transfer of funds across international borders. Tax authorities worldwide are, jointly and individually, spending substantial resources to gather information and to understand the flow of funds across international borders because they know or suspect that a substantial portion of those funds is unreported. Although these efforts are directed at tax evaders, they have resulted in greater reporting and other requirements that apply to families who have international connections and those who inadvertently fail to comply with the rules risk getting caught up in enforcement efforts targeted to those with intent to evade tax. The enforcement strategies tax authorities in the U.S. and elsewhere are employing include:

A. Many countries have stricter and stricter information reporting requirements with respect to any international connections a taxpayer may have. In the United States, information reporting is extensive, though not widely known or understood, and failure to comply can result in substantial penalties. It is important that tax advisors, including estate planners, be familiar with the reporting requirements discussed in this outline.

B. In addition to gathering information through "voluntary" information reporting, the IRS is now gathering information by issuing subpoenas to credit card companies and other businesses to try to identify taxpayers with offshore assets.

C. The IRS has substantially strengthened the U.S. withholding tax regime and has succeeded in getting foreign banks to enter into agreements (Qualified Intermediary Agreements) pursuant to which the banks agree to gather information about their depositors and turn over information concerning U.S. taxpayers in exchange for maintaining the confidentiality of their foreign customers (the vast majority) and allowing reduced withholding that may be applicable to such customers. Since only banks in jurisdictions with acceptable "know your customer rules" were permitted to be qualified intermediaries, this regime caused many jurisdictions to strengthen their "know your customer" rules. This system has been so effective that it is being used as a model in European and other countries.

D. To gather additional information and better understand how taxpayers came to have funds offshore, in 2003, the IRS announced a one-time partial amnesty ("Offshore Voluntary Compliance Initiative") inviting taxpayers with undisclosed income to come clean voluntarily and provide detailed information about their undisclosed assets offshore and the promoter(s) who assisted them or encouraged them to take their funds offshore in exchange for substantially reduced penalties and no criminal prosecution. At the same time that tax authorities worldwide are stepping up their enforcement efforts and have substantially greater resources available to them, many countries are using amnesties to invite taxpayers to become compliant voluntarily before they are caught and suffer the full consequences of their failure to comply. Although the IRS was encouraged to extend its one-time partial amnesty, it did not do so.

E. Although the U.S. no longer has an amnesty, it continues to have its voluntary disclosure program, which is designed to encourage taxpayers to come clean before they are under investigation. As enforcement efforts are strengthened and greater resources become available to tax authorities, more and more taxpayers are recognizing the benefits of participating in a voluntary disclosure.

F. Since substantial reduction of penalties and other adverse consequences for failure to comply with U.S. tax and reporting obligations were and are available to taxpayers who participated in the Offshore Voluntary Compliance Initiative and those who now participate in a voluntary disclosure, the IRS is committed to imposing full penalties and aggressively prosecuting those who fail to take advantage of these opportunities.

G. The IRS has also engaged in education and public awareness activities, which include having representatives participate in conferences, publishing guidance concerning abusive tax schemes and frivolous tax arguments.

H. In addition, the IRS has appointed a Senior Counsel to Chief Counsel to act as primary advisor on abusive transactions.

I. It is only a matter of time before interagency sharing of information becomes a reality. The General Accounting Office has recently conducted a study and is recommending that there be greater information sharing between the IRS and the Citizenship and Immigration Services of the Department of Homeland Security.

J. The IRS has entered into a partnership with at least 40 states and the District of Columbia to better utilize their resources and share information.

K. The IRS' recently published 5-year plan shows the largest part of the tax gap to be high income individuals and lists areas of focus, which include abusive tax schemes, misuse of offshore transactions and non-filing and underreporting by high income individuals.

L. On the international front, the IRS is aggressively negotiating and entering into tax treaties and exchange of information agreements, which now include exchange of information agreements with some of the traditional tax haven jurisdictions. In addition, the U.S. is a member of a recently created joint task force of the tax commissioners of Australia, Canada, the United Kingdom and the U.S. The purpose of the task force is to increase collaboration and coordinate information about abusive tax transactions.

M. Finally, many countries in virtually every region of the world are modernizing and expanding their money laundering legislation. In some jurisdictions, tax evasion (including foreign tax evasion) is starting to be included in the list of money laundering offences. In many cases, professional advisors who assist those involved in what turns out to be money laundering are also being targeted and aggressively prosecuted.

Estate planning practitioners, even those who believe their practices are purely domestic, must know their clients and must be alert to international issues they may face so that they can effectively and competently assist their clients, minimize their malpractice exposure, and minimize their risk of being involved in what may later turn out to be criminal conduct.

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Pursuant to requirements relating to practice before the Internal Revenue Service, any tax advice in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties imposed under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another person any tax-related matter.

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