

# WHAT THE FATCA IS GOING ON? NAVIGATING VARIOUS U.S. TAX IMPLICATIONS AND COMPLIANCE REQUIREMENTS FOR INTERNATIONAL CLIENTS AND ASSETS



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## I. INTRODUCTION

In an environment of growing global mobility of many families and heightened regulatory and compliance pressures, many U.S. estate planning advisors are encountering international issues for their clients with increasing frequency. For example, U.S. clients may marry non-U.S. citizen spouses, move overseas, invest in foreign real estate or companies, inherit from foreign persons, set up accounts in other jurisdictions, to name a few. Foreign clients may have children who come to the U.S. for school and then decide to stay, invest in U.S. property, open accounts in the U.S., make gifts to U.S. beneficiaries, etc. Advisors to these clients must understand the applicable rules in order to offer proper counsel.

International estate planning is a very expansive, complicated and nuanced area of practice, and while this outline cannot cover every aspect of international planning, its purpose is to provide a general guide to help U.S. advisors understand the basic principles, spot issues, and advise clients as international issues arise.

In that spirit, this outline will provide an overview of key concepts and considerations related to planning for international families and assets. First, it will discuss the general rules in determining the tax status of an individual (U.S. person versus non-resident alien) for U.S. income and transfer tax purposes. Then, the outline will address planning for two types of individual clients: 1) U.S. clients with foreign assets and 2) foreign clients with U.S. assets.<sup>1</sup> Lastly, these materials

will address the rules with respect to trusts and the tax issues, planning and reporting when a trust is involved.

## **A. Definitions of U.S. Person vs. Non-resident Alien (“NRA”)**

### **1. Determining Tax Status**

The first step in understanding and planning for the U.S. tax and reporting requirements in the international estate planning context is determining the tax status of an individual, which requires understanding the definitions of a “U.S. person” versus a “foreign person” for purposes of 1) U.S. income tax purposes and 2) U.S. transfer tax purposes.

### **2. Why Does the Tax Status of an Individual Matter?**

#### **a. U.S. Person**

For U.S. income tax purposes, an individual who is a U.S. person (a U.S. citizen or a resident alien) is subject to income tax on his or her worldwide income. Similarly, a U.S. person is subject to U.S. gift, estate, and generation-skipping transfer (“GST”) taxes on the transfer of his or her worldwide assets.

#### **b. NRA**

On the other hand, an individual who is an NRA will only be subject to U.S. income tax on: 1) income derived from sources within U.S.<sup>2</sup>; or 2) on income effectively connected with the conduct of a trade or business within the U.S. For U.S. transfer tax purposes (gift, estate and GST tax), an individual who is an NRA will only be subject to tax upon the transfer of U.S. situs assets. Planning for NRAs will be discussed in more detail later in this outline.

### **B. Who is a U.S. Person for U.S. Income Taxation?**

The next question, then, is who is a U.S. person for U.S. income tax purposes?

#### **1. U.S. Person**

Code § 7701(a)(30)<sup>3</sup> defines a “U.S. person” as:

- a. A U.S. citizen or resident;
- b. A U.S. partnership;
- c. A U.S. corporation (a U.S. corporation is a U.S. person, regardless of whether its shareholders are U.S. persons)<sup>4</sup>;
- d. Any estate (other than a foreign estate); and
- e. Any U.S. Trust.<sup>5</sup>

## **2. An Individual as a U.S. Person**

An individual is a U.S. person if he or she is either:

- a. A U.S. citizen (regardless of residence, and including a dual citizen of the U.S. and one or more other countries)<sup>6</sup>; or
- b. A U.S. resident (regardless of citizenship).

### **3. U.S. Citizenship**

For individuals, U.S. citizenship is determined by the U.S. constitution, the Immigration and Nationality Act, and the regulations and case law thereunder and is an objective factual determination generally based on whether the individual was born in the U.S. or was born to U.S. citizens.

### **4. U.S. Residency**

For U.S. income tax purposes, a U.S. resident individual (i.e., a resident alien) is an individual who is: 1) a lawful permanent resident (i.e., a green card holder) who is present in the U.S. at any time during the calendar year<sup>7</sup>; 2) deemed a resident under the “substantial presence” test (described below); or 3) elects to be treated as a U.S. resident for income tax purposes under Code § 7701(b) (known as the “first-year election”).

Typically it is easy to determine whether an individual has a green card and it is unusual for an individual to make a first-year election so we will focus on the “substantial presence” test.

### **5. Substantial Presence Test**

Under the “substantial presence” test,<sup>8</sup> a person is a U.S. resident for a given calendar year (the “current year”) if he or she is either: 1) present in the U.S. for 183 days in any given year; or 2) satisfies a weighted three-year test.

Under the three-year test, a person who: 1) is present in the U.S. for 31 days in the current year; and 2) has been in the U.S. on at least 183 days during a three-year period that includes the current year will be treated as being substantially present in the U.S. For purposes of the three-year test, each day of presence in the current year is counted as a full day. Each day of presence in the first preceding year is counted as one-third of a day and each day of presence in the second preceding year is counted as one-sixth of a day.

**Example 1:** Austin Powers (a UK citizen and not a lawful permanent resident/green card holder) spent the following days in the U.S. wooing a nice girl, Miss

Kensington, whom he met in law school and who lives in the U.S.:

|       |                |   |                |
|-------|----------------|---|----------------|
| 2016  | 120 days x 1   | = | 120 days       |
| 2015  | 150 days x 1/3 | = | 50 days        |
| 2014  | 90 days x 1/6  | = | <u>15 days</u> |
| TOTAL |                |   | 185 days       |

**Question:** Was Austin Powers a U.S. person in 2016?

**Answer:** Yes, because he meets the three-year substantial presence test:

1. Was he present in the U.S. for 183 days in 2016?  
No, but then we need to determine whether he was substantially present under the weighted three-year test.
2. For the three-year test:
  - a. Was he present in the U.S. at least 31 days in 2016? Yes.
  - (b) And was he present in the U.S. for 183 days or more using the weight three-year test? Yes.

**Result:** In 2016, Austin is subject to U.S. income tax on his worldwide income.

**Example 2:** Same as above but Austin spent the following days in the U.S.:

|       |                |   |                  |
|-------|----------------|---|------------------|
| 2016  | 31 days x 1    | = | 31.0 days        |
| 2015  | 303 days x 1/3 | = | 101.0 days       |
| 2014  | 303 days x 1/6 | = | <u>50.5 days</u> |
| TOTAL |                |   | 182.5 days       |

**Question:** Was Austin Powers a U.S. person in 2016?

**Answer:** No, because he was not present in the U.S. long enough to meet the either prong of the substantial presence test:

1. Was he present in the U.S. for 183 days in 2016?  
No, but then we need to determine whether he was substantially present under the weighted three-year test.
2. For the three-year test:
  - a. Was he present in the U.S. at least 31 days in 2016? Yes.
  - (b) And was he present in the U.S. for 183 days or more using the weight three-year test? No.

**Why?:** For purposes of the 183-day calculation, any resulting fractional days are not rounded to the nearest whole number under Treas. Reg. § 301.7701(b)-1(c)(1).

**Result:** In 2016, Austin is an NRA for U.S. income tax purposes and therefore subject to U.S. income tax only on income derived from sources within the U.S. or on income effectively connected with the conduct of a trade or business within the U.S.

Additional day-count rules and exceptions to the substantial presence test are provided below:

### a. Days of Presence

An individual is considered to be present in the U.S. on any day that he or she is physically present in the U.S. at any time during the day.<sup>9</sup> Thus, partial days, such as the day of arrival and the day of departure, each count as a day of presence in the U.S.

In computing days of presence, there are four exceptions and the following days will not count as days of presence in the U.S.:<sup>10</sup>

1. Any day that an individual is present in the U.S. as an “exempt individual” (see below for a definition of “exempt individual”);
2. Any day that an individual is prevented from leaving the U.S. because of a medical condition that arose while the individual was present in the U.S.;
3. Any day that an individual is in transit between two points outside the U.S.; and
4. Any day on which a regular commuter residing in Canada or Mexico commutes to and from employment in the U.S.

### b. Exceptions to the Substantial Presence Test

There are a few exceptions to the substantial presence test:

#### (1) Exempt Individuals

As discussed above, any day that an “exempt individual” is present in the U.S. will not be treated as a day of presence. An “exempt individual” means an individual who: 1) holds a diplomatic visa or is a full-time employee of an international organization; 2) holds a full-time student, teacher or trainee visa; or 3) is a professional athlete who is temporarily present in the U.S. to compete in a charitable sports event.<sup>11</sup>

## (2) Closer Connection Exception

A person who otherwise meets the substantial presence test for the current year may nevertheless avoid U.S. resident status by demonstrating that he or she: 1) is present in the U.S. for fewer than 183 days during the current year; 2) maintains a tax home in a foreign country during the entire current year; 3) has a “closer connection” during the current year to the foreign country in which his or her tax home is located than to the U.S.; and 4) has not personally applied, or taken affirmative steps, to change his or her tax status to that of a lawful permanent resident of the U.S. and timely files Form 8840.<sup>12</sup>

## (3) Residence under Tax Treaties

Treaties with some countries contain “tie-breaker” provisions to resolve the issue of residence for a person who would otherwise be treated as a resident of both of the treaty countries.

### C. Who Is a U.S. Person for U.S. Transfer Taxation?

#### 1. Domicile

The rules for determining whether an individual is a U.S. person for U.S. transfer tax purposes is very different than the objective tests for determining whether an individual is a U.S. person for U.S. income tax purposes. While the test for income tax purposes is based on an individual’s “residency” (physical presence in the U.S.), the test for transfer tax purposes is a subjective one based on an individual’s “domicile” (having both a physical presence in the U.S. and having a present intention to make a place home indefinitely).

#### 2. Definition of Domicile

The Treasury Regulations provide that an individual’s “domicile” is the place where the individual resides in the U.S. with the intent to remain in the U.S. permanently.<sup>13</sup>

#### 3. Facts and Circumstances

In addition to an individual’s intent, the determination of domicile in the international context is similar to that in the domestic context, which is based on the particular facts and circumstances of each situation and no one factor is determinative. Case law and commentators suggest that some of the factors to be considered in determining domicile are (but not limited to):

- a. Duration of stay in the U.S. and other countries and the frequency of travel both between the U.S. and other countries and between places abroad;
- b. The size, cost and nature of the individual’s houses or other dwelling places and whether the individual owned or rented them;
- c. The area in which the houses are located (e.g., transitory resort areas);
- d. The location of important and valuable personal possessions;
- e. The location of the individual’s family and close friends (including, where are your furry children?);
- f. Places where the individual maintained religious and social affiliations (e.g., club memberships)
- g. Visas, work permits or other immigration documents;
- h. Location of business interests;
- i. The jurisdiction where the individual is registered to vote;
- j. The individual’s income tax filing status;
- k. The individual’s motivations in choosing where to live; etc.<sup>14</sup>

It is important to note that U.S. citizens are considered to be U.S. domiciled regardless of where they may reside. Also, it is possible for an individual to be classified as a U.S. resident for income tax purposes but not for transfer tax purposes and vice versa. For example, a green card holder is treated as a U.S. person for U.S. income tax purposes but if the individual does not have the requisite intent to remain permanently in the U.S., the individual may not be domiciled in the U.S. and therefore not be a U.S. person for U.S. transfer tax purposes.

### D. Effect of Tax Treaties

1. The rules set forth in this introductory section on determining the tax status of an individual for U.S. income and transfer tax purposes are the default rules laid out in the Code and Treasury Regulations promulgated thereunder. Advisors should understand which jurisdictions may be applicable to an individual’s situation and then determine whether treaties exist among the U.S. and those other jurisdictions that may override the Code’s default rules. Currently there are numerous income tax treaties between the U.S. and other countries and 15 estate

and gift tax treaties (16 including Canada which is through the income tax treaty).<sup>15</sup>

2. Advisors should consult treaties to determine (a) if they apply to citizens and/or address the definition of residency and/or domicile, (b) if they address dual residency/citizenship, (c) change the rules with respect to situs of assets, (d) allow any tax exemptions or credits, etc.

## II. PLANNING FOR U.S. PERSON WITH FOREIGN ASSETS

### A. Succession and Property Considerations for U.S. Persons with Foreign Assets

Once it is determined that an individual is a U.S. person for either U.S. income and/or transfer tax purposes, if the individual owns assets located in a different jurisdiction, an advisor needs to address succession and property considerations in addition to the tax issues. A select few of the considerations are listed below.<sup>16</sup>

#### 1. Common Law vs. Civil Law vs. Religious Law

There are three primary legal systems which account for many of the differences in foreign property law: 1) common law; 2) civil law; and 3) religious law.

- a. Common law jurisdictions generally allow for freedom of disposition of property in terms of the amount of property to be disposed of, to whom, and in what form (e.g., outright, in trust, or in some other entity).
- b. Civil law jurisdictions traditionally limit the disposition of property by reserving a portion of an individual's property. That portion is not freely disposable and subject to that jurisdiction's community property laws and forced heirship laws.
- c. Some religious laws also may affect the disposition of property (e.g., Sharia and Hindu laws).

#### 2. Marital Property vs. Community Property

##### a. Marital Property

Common law jurisdictions typically provide that each spouse has separate legal and property rights with respect to his or her own assets. Assets acquired during marriage may be considered to be marital property for purposes of division upon divorce.

##### b. Community Property

Many civil law jurisdictions are community property jurisdictions. In general, under community property

law, each spouse owns a 50 percent interest in property acquired during the marriage regardless of how much each spouse actually contributed to acquire the property. This treatment restricts the transfer of the property by one spouse.

### 3. Forced Heirship

- a. Forced heirship is a civil law concept which requires a decedent to leave a portion of his or her assets to children at his or her death. In addition, forced heirship laws may give a surviving spouse a share of the decedent's estate in addition to what the spouse already may be entitled to receive under that jurisdiction's marital/community property laws.
- b. The forced heirship laws of each civil law jurisdiction can vary significantly. Often, the reserved portion of a decedent's estate subject to forced heirship and the proportions to be divided among children and sometimes the surviving spouse differ among jurisdictions. Also, some jurisdictions will "claw back" transfers made during lifetime within a certain number of years before the decedent's death.

### 4. Use and Recognition of Trusts

#### a. Not Always Recognized

While trusts are very common in the U.S. and other common law jurisdictions, they are not universally available or recognized, particularly in civil law jurisdictions. Even in common law jurisdictions that utilize trusts, each jurisdiction's trust laws may differ greatly. Because many civil law jurisdictions do not recognize trusts, their succession laws and tax laws often treat trusts harshly or make no provision for trusts.

#### b. Hague Convention on Trusts

##### (1) Contracting States

Some jurisdictions have signed onto the Hague Convention on the Law Applicable to Trusts and on Their Recognition ("Hague Convention on Trusts"), which is a multilateral treaty which (a) requires ratifying states to recognize trusts that originate in a jurisdiction, whether common or civil law, (b) allows the creation of different types of trusts, and (c) provides choice-of-law rules for trust administration and creditor issues.

##### (2) Non-contracting States

Even non-contracting state can benefit from the Hague Convention on Trusts in states that have ratified

it because it is universal in scope and does not cover only fellow contracting states.

## 5. Choice of Law and Conflicts of Law

Advisors need to be aware of choice of law issues and which law may govern the disposition of property when more than one jurisdiction is involved. Choice of law rules will vary based on: 1) how property passes (i.e., intestate or testate succession); 2) the validity, construction and administration of the instrument attempting to transfer the property (e.g., Will or trust); 3) the character of the property (i.e., immovable/real property or moveable/personal property); and 4) the decedent's domicile. For a full discussion of choice of law and conflicts of law rules, see M. Read Moore, "Tax and Estate Planning Issues for U.S. Clients Who Own Foreign Property," Southern Nevada Estate Planning Council, Feb. 2016.

### B. Reporting Requirements for U.S. Persons with Foreign Assets

Increasingly, foreign assets are subject to tax reporting and compliance requirements and advisors should be aware of all of the possible reporting obligations which may be triggered by a U.S. person owning foreign assets, some of which are listed below:

- U.S. Persons with Interests in Foreign Financial Assets:
  - FinCEN Form 114 ("FBAR") — discloses signature authority over foreign financial accounts
  - Form 8938 — discloses "specified foreign financial assets"
- U.S. Persons with Interests in Foreign Entities:
  - Form 5471 — applies to U.S. persons who are officers, directors or shareholders of a foreign corporation, including controlled foreign corporations ("CFCs")
  - Form 8621 — applies to a U.S. person who is a direct or indirect shareholder of a passive foreign investment company ("PFIC")
  - Form 8865 — applies to a U.S. person who "controls" a foreign partnership
  - Form 8858 — applies to a U.S. person who owns interests in foreign partnerships and disregarded entities

Given the complexity of the various filing requirements for foreign entities, this section of the outline will focus only on the foreign financial asset reporting obligations under the FBAR and Form 8938.<sup>17</sup>

For U.S. beneficiary reporting requirements for foreign trusts and estates and reporting requirements for a U.S. trust or estate with foreign beneficiaries are addressed later in the "U.S. Tax Compliance for Trusts with Foreign Connections" section of this outline.

## 1. FBAR (FinCEN Form 114) — Disclosing Signature Authority over Foreign Financial Accounts

### a. Reporting Obligation

This reporting is required pursuant to the Bank Secrecy Act, not the Code<sup>18</sup>, and is required by the Financial Crimes Enforcement Network "FinCEN" of the Treasury Department. The FBAR is used by a U.S. person to report a financial interest in, signature authority or other authority over one or more accounts in foreign countries if the aggregate at any time during the preceding calendar year, the balance of all such accounts equals or exceeds \$10,000.<sup>19</sup>

#### (1) U.S. Person

For purposes of the FBAR, a "U.S. person" is a U.S. citizen, a U.S. resident, an entity created or organized in the U.S. or under the laws of the U.S. (including corporations, partnerships, limited liability companies), and trusts or estates formed under U.S. laws.

#### (2) Financial Interest

A U.S. person is considered to have a financial interest in:

- (a) An account that he or she maintained for his or her own benefit or for the benefit of another person.
- (b) An account of which he or she was a joint owner.
- (c) An account that another person maintains as an agent, nominee attorney, or in some other capacity for a U.S. person.
- (d) An account maintained by a corporation if the U.S. person owns more than 50 percent of the stock by value or voting power.
- (e) An account maintained by a partnership in which the U.S. person owns more than 50 percent of the profits or capital of the partnership.
- (f) An account maintained by a trust if the grantor is a U.S. person and is deemed to own the trust's

items of income, gain, and loss under the grantor trust rules of IRC §§ 671-679.

- (g) An account maintained by a trust if the U.S. person has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or receives more than 50 percent of the income of the trust. The regulations misapprehend the nature of a trust. A trust is a relationship and cannot hold legal title. The trustee of the trust holds legal title. The final regulations have an exception to this rule if the trustee of the trust or agent of the trust is a U.S. person who files a report.<sup>20</sup>

### **(3) Signature Authority**

Signature authority is the authority of an individual (alone or in conjunction with others) to control the disposition of the assets of the account by direct communication with the financial institution maintaining the account.

## **(4) Foreign Financial Account**

### **(a) Financial Account**

A financial account includes:

- (i) Bank accounts, such as deposit accounts;
- (ii) Securities accounts, such as brokerage accounts;
- (iii) Commodity and futures accounts;
- (iv) Accounts that are insurance policies or annuity policies with cash value;
- (v) Mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions;
- (vi) Any other accounts maintained in a foreign financial institution or with a person performing the services of a financial institution.

### **(b) Foreign**

An account is treated as foreign if it is located outside of the U.S. and its territories and possessions. Thus, for purposes of the FBAR, financial accounts in Guam, Puerto Rico and the U.S. Virgin Islands are not considered to be foreign.

## **b. Filing Deadline**

### **(1) In General**

The FBAR is not a tax return but a calendar year report. Because the FBAR is separate from an individual's

income tax return, an extension of time to file federal income tax returns does not extend the deadline for filing an FBAR.

### **(2) Due Dates**

Certain individuals with signature authority over but no financial interest in one or more foreign financial accounts, FinCEN has extended the filing due date to April 15, 2018.<sup>21</sup> This extension applies to the reporting of signature authority held during the 2016 calendar year, as well all reporting deadlines extended by previous FinCEN Notices 2015-1, 2014-1, 2013-1, 2012-1, 2012-2, 2011-1 and 2011-2.<sup>22</sup>

For all other individuals with an FBAR filing obligation, for 2016 and later years the FBAR must be filed by April 15 of the succeeding year (the filing deadline was changed from June 30 to April 15 to coincide with the federal income tax due date). If an individual or entity does not file their FBAR by April 15, they will receive an automatic extension of six months to October 15 of the same calendar year.

## **c. Penalties for Failure to File — Criminal and Civil**

- (1) A willful violation can result in a fine of up to \$250,000 and/or imprisonment for not more than five years.<sup>23</sup> The penalties can increase where the failure to file is in conjunction with another criminal violation or part of a pattern of illegal activity.<sup>24</sup>
- (2) Civil penalties also can result in a fine up to \$10,000 without regard to whether the failure to file was willful.<sup>25</sup> The government can waive this civil penalty if the person who failed to file reported the income from the foreign account for income tax purposes and demonstrates reasonable cause for the failure to file.<sup>26</sup>

## **2. Form 8938 — Statement of Special Foreign Financial Assets**

### **a. In General**

The Foreign Account Tax Compliance Act ("FATCA") is part of the Hiring Incentives to Restore Employment Act ("HIRE Act"), which created Code § 6038D. Under Code § 6038D, a U.S. citizen or resident taxpayer who holds "specified foreign assets" with an aggregate value of more than \$50,000 must disclose those assets to the IRS on an annual basis. This disclosure is made on a Form 8938, Statement of Special Foreign Financial Assets.

## b. Specified Foreign Assets

“Specified foreign assets” includes accounts held at a foreign financial institution and assets held outside of a foreign financial institution, which include stock or securities issued by a non-U.S. person, a financial instrument or contract (if the contracting party is a non-U.S. person), or any interest in a foreign entity.

## c. Form 8938 vs. FBAR

The information requested on a Form 8938 is similar to that required on an FBAR, but the obligation to file a Form 8938 does not eliminate the need for a foreign account holder to file an FBAR. Form 8938 is supplementary to the FBAR, and broadens the disclosure requirements by applying to certain persons who may not meet the current levels of ownership to require an FBAR filing. Because the reporting threshold under this rule is value based, there will be instances in which a U.S. person may be required to file both a Form 8938 and an FBAR, and other instances in which a U.S. person’s interest may not meet the FBAR reporting threshold but may be great enough so as to require disclosure on the Form 8938.

## d. Filing Deadline

Unlike the FBAR, the Form 8938 is filed with the IRS (not FinCEN). The Form 8938 should be filed with an individual’s federal income tax return and, therefore, due on the date of such return, including extension, if any.

## e. Penalties for Failure to File

A penalty of \$10,000 will be imposed for failure to timely file a Form 8938 with the IRS. An additional penalty of \$10,000 will be due every 30 days that the failure to file continues longer than 90 days after the individual is informed of the failure, up to maximum penalty of \$50,000.

## III. PLANNING FOR AN NRA WITH U.S. ASSETS

### A. Non-Tax Issues

#### 1. Succession and Property Considerations for NRAs with U.S. Assets

##### a. What Is the Applicable Succession Law?

- i. When an NRA owns asset located in the U.S., there will often be a question as to whether the law of the NRA’s residency or nationality will govern succession rights or whether the U.S. state law, where the property is located or which the account agreement applies, will govern. Succession issues will include:

marital property rights (community property rights, elective shares, etc.), forced heirship, intestate succession rights and requirements for validity of wills and other testamentary instruments. While a survey on these issues is beyond the scope of these materials, the following cases highlight the issues that can arise:

- (1) Estate of Sendonas, 381 P.2d 752 (Wash. 1963)—applying Washington intestacy laws to estate of Greek national who was domiciled in Washington on the date of his death.
- (2) Matter of Meyer, 876 N.Y.S.2d 7 (App. Div. 2009)—holding that New York law applies to lifetime and testamentary transfers of property located in New York owned by French national who was domiciled in Bermuda and dismissing lawsuit seeking to enforce French forced heirship laws.
- (3) Estate of Moore, 223 P.2d 393 (Or. 1950)—applying Oregon law to the validity of a will giving land located in Oregon to the U.S. government.
- (4) Estate of Georg, 298 F. Supp. 741 (D.V.I. 1969)—holding that U.S. Virgin Islands law controls validity and effect of will of domiciliary of the Dominican Republic with respect to land located in the Virgin Islands, as well as disposition of personal property located in the Virgin Islands.
- (5) In the Matter of the Unanue, 605 A.2d 279 (N.J. Superior Court 1991) aff’d, 710 A.2d 1036 (N.J. App. 1998)—holding that Puerto Rican forced heirship laws did not apply to the decedent’s estate where decedent was domiciled in New Jersey at the time of death.

## 2. Nontestamentary Transfer Options for NRA Clients

- a. Although U.S. planners frequently use trusts as a nontestamentary transfer option, trusts can be problematic for NRA clients, depending on their residency and/or nationality.
  - i. The transfer of property to a revocable trust may give rise to income or transfer tax in non-U.S. jurisdictions. For example, France imposes wealth tax on trust assets where settlor or beneficiaries are French residents and requires offshore trustees to report annually to the French tax authorities.
- b. Joint tenancy may be a viable option. However, if the U.S. asset is real estate and there is a mortgage,



the payment of mortgage debt on the real estate may raise U.S. gift tax issues for the donor. Also, as discussed below, the IRS considers cash on deposit in a U.S. bank as tangible personal property for U.S. gift tax purposes, which means that U.S. gift taxes could apply to an NRA who creates joint tenancy in bank account assets.

- c. A T.O.D. or P.O.D. registration for an account may be a better alternative for a bank account (if there are no succession issues for the NRA for such a designation).

## B. Transfer Tax Issues

### 1. Residency

- a. As with U.S. income taxes, U.S. transfer taxes (gift, estate and GST) are imposed on U.S. citizens and residents on their worldwide assets. Non-residents are only subject to transfer taxes upon the transfer of U.S. situs assets (discussed below).
- b. As discussed earlier in this outline, the definition of residency for transfer tax purposes is different from the definition for income tax purposes. Non-citizens who are U.S. residents for income tax purposes are *not necessarily* residents for purposes of gift, estate and GST taxes. For transfer tax purposes, an individual's residence or residency refers to domicile. The regulations provide a general description of what it means to have "domicile" rather than a precise definition. Domicile is the place where an individual lives with no intent to remove therefrom.<sup>27</sup> Domicile will depend on the *intent* of individual.

## 2. Foreign Situs Assets vs. U.S. Situs Assets

### a. Gift Tax

The definition of U.S. situs property for gift tax purposes is slightly different from the definition for estate tax purposes. For gift taxes, only real property and tangible personal property physically located in the United States have a U.S. situs.<sup>28</sup> Intangible personal property does not have a U.S. situs, whatever its source or location.<sup>29</sup>

### b. Estate Tax

For estate tax purposes, real property and tangible personal property physically located in the United States have a U.S. situs.<sup>30</sup> In addition, intangible personal property has a U.S. situs if it is derived from a U.S. person or entity. As such, stock issued by a U.S.

domestic corporation<sup>31</sup> and debt obligations issued by or enforceable against any U.S. person or entity<sup>32</sup> have a U.S. situs for estate tax purposes. However, the Code specifically excludes the following types of property as U.S. situs property for estate tax purposes:

- i. Proceeds from and interest on a life insurance policy issued by a U.S. company;<sup>33</sup>
- ii. U.S. bank and savings and loan association deposits;<sup>34</sup>
- iii. Portfolio debt obligations issued after July 18, 1984;<sup>35</sup> and
- iv. Works of art on loan for exhibition.<sup>36</sup>

Cash in a U.S. institution (that is not a deposit) is considered a U.S. situs asset.<sup>37</sup>

## 3. Transfer Tax Treaties

- a. As mentioned earlier in this outline, while many countries have income tax treaties with the United States, there are many fewer that have gift, estate and GST tax treaties with the U.S. These treaties should be consulted to see if they: 1) apply (i.e., if they apply to citizen and/or address the definition of residency and/or domicile); 2) address dual residency/citizenship; 3) change the rules as to situs of assets; and/or 4) allow any transfer tax exemption/credits.
  - ii. The Irish treaty applies to the estates of individuals who were domiciled in Ireland. Under traditional principles of Irish law, an individual will have a domicile in Ireland: 1) if he or she was born in Ireland of Irish parents and resided in Ireland at his or her death; or 2) if he or she has settled permanently in Ireland.
  - iii. The South African treaty situs rules apply to individuals who are "ordinarily resident" in South Africa, which is a test of the facts and circumstances of the individual's life (rather than based on presence or days spent).
  - iv. The newer U.S. estate tax treaties with France, Germany, Holland, the United Kingdom, Austria and Denmark (the "OECD treaties") provide that the country in which the decedent is *not* domiciled, which is determined under the treaty rules, can tax only certain items of property with a connection to that country, such as real property or the property of a business permanently established in that country. The

OECD treaties allow the country of domicile to tax all the other items of property passing on the decedent's death. If the country of domicile also taxes the property located in the other country, the country of domicile must generally provide a credit against that country's tax for the situs country's tax.

- v. The United States-Swiss treaty is unique; it does *not* have any rules governing the situs of property for estate tax purposes. Instead, the treaty provides each Swiss decedent who has U.S. situs property with a pro rata portion of the U.S. applicable transfer tax credit. Instead of the limited \$60,000 applicable credit equivalent, a Swiss decedent will receive a pro rata share of the current \$5,490,000 estate tax exemption (2017 exemption amount; indexed for inflation).
- vi. Canada does not have an estate tax. It imposes a capital gains tax at death. Canada and the United States adopted a Protocol that attempts to solve the double taxation problem through the use of credits against the two taxes. The Protocol does not change the situs rules of assets for U.S. estate tax purposes.

#### **IV. U.S. TAX COMPLIANCE FOR TRUSTS WITH FOREIGN CONNECTIONS**

##### **A. Domestic vs. Foreign Trust**

###### **1. Domestic Trust**

A trust is treated as a "domestic trust" for U.S. income tax purposes if 1) the trust is subject to supervision by a U.S. court; *and* 2) the trust is controlled *solely* by a U.S. person or persons.<sup>38</sup>

###### **a. Court Test**

A trust satisfies the court test if the trust instrument does not direct that the trust be administered outside of the United States, the trust is in fact administered exclusively in the United States and the trust is not subject to an automatic migration provision (e.g., a provision that requires migration from the United States if a U.S. court attempts to assert jurisdiction).<sup>39</sup> The "administration of the trust" means carrying out the duties under the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing assets, defending the trust from suits by creditors and determining the amount and timing of distributions.<sup>40</sup>

###### **b. Control Test**

A trust satisfies the control test if only U.S. persons can control the substantial decisions (i.e., non-ministerial decisions) regarding the trust. Decisions that are ministerial include decisions regarding details such as bookkeeping, the collection of rents, and the execution of investment decisions. Substantial decisions include (but are not limited to) decisions concerning: 1) whether and when to distribute income or corpus; 2) the amount of any distributions; 3) the selection of a beneficiary; 4) whether a receipt is allocable to income or principal; 5) whether to terminate the trust; 6) whether to compromise, arbitrate, or abandon claims of the trust; 7) whether to sue on behalf of the trust or to defend suits against the trust; 8) whether to remove, add, or replace a trustee; 9) whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, regardless of whether there is an unrestricted power to remove a trustee, unless the power is limited to removal/appointment of U.S. person; and 10) investment decisions.<sup>41</sup>

###### **c. Grace Period for Inadvertent Change**

The regulations provide a 12-month grace period in the event of an inadvertent change in any person who has the power to make a substantial decision of the trust that would cause a domestic trust to become a foreign trust or vice versa. The trust is allowed 12 months 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. An inadvertent change is the death, incapacity, resignation, change in residency or other change in the person who has a power to make a substantial decision of the trust.<sup>42</sup>

- i. For example, at the death of an income beneficiary, a U.S. trust may continue for the benefit of a non-U.S. person, who has the right to remove and replace the trustee with no requirement that the trustee must be a U.S. person. Unless the non-U.S. person renounced the right to remove and replace the trustee within 12 months, the trust would become a foreign trust.

###### **2. Foreign Trust**

All non-domestic trusts are foreign trusts.<sup>43</sup>

## B. Foreign Grantor Trust vs. U.S. Grantor Trust

### 1. Grantor Trust Status

The rules as to when a trust is treated as a grantor trust are different depending on whether the settlor or grantor is a U.S. person or a foreign person and depending on whether the trust created is a U.S. trust or a foreign trust.

### 2. U.S. Person Creates U.S. Trust

- a. When a U.S. person creates a U.S. trust, the U.S. person is treated as the owner of the assets of the trust if:
  - i. The grantor or a nonadverse party<sup>44</sup> has the power to revoke the trust or return the corpus to the grantor;
  - ii. The grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse;
  - iii. The grantor has retained more than a five percent reversionary interest in the trust property or income;
  - iv. The grantor has retained a reversionary interest in the trust which enables him or his estate to receive back the trust property within a period of 10 or fewer years from the date of the transfer;
  - v. The grantor or a nonadverse party has the power over the beneficial interests in the trust; or
  - vi. Administrative powers over the trust exist under which the grantor can or does benefit.<sup>45</sup>

### 3. U.S. Person Creates Foreign Trust

- a. When a U.S. person creates a foreign trust, the U.S. person is treated as the grantor if the foreign trust has a U.S. beneficiary, regardless of any powers the U.S. grantor/settlor may or may not have retained.<sup>46</sup>
- b. Because of the perceived tax avoidance potential if a U.S. person creates a foreign trust that benefits another U.S. person, the Code imposes grantor trust status so that the U.S. settlor/grantor must report and pay tax on all items of income and deduction of the trust rather than the trust being treated as a separate foreign taxpayer.

## 4. Foreign Person Creates U.S. or Foreign Trust

- a. Where a non-U.S. person creates a trust, the non-U.S. person is treated as the owner of the assets of the trust if either:
  - i. That non-U.S. person has the power to revoke the trust without the approval or consent of any other person, or
  - ii. Distributions of income and principal from the trust may only be made to the non-U.S. person who created the trust or such person's spouse while that non-U.S. person is living.<sup>47</sup>
- b. If the trust does not meet either of the above two criteria, it is a "non-grantor trust."

### 5. Beneficiary as "Grantor"

- a. A beneficiary who is a U.S. person is treated as the owner of any part or all of the assets of a trust if the beneficiary has the power, exercisable alone, to vest any part or all of the corpus or the income of the trust in himself or herself, provided the settlor of the trust is not otherwise treated as the owner of the trust.<sup>48</sup>
- b. If a foreign beneficiary has these powers, the trust will still be a non-grantor trust.

## C. Foreign Estate vs. U.S. Estate

1. Generally, the estate of a person who was a non-resident alien will be a foreign estate and the estate of a person who was a U.S. resident will be a U.S. estate. However, the status of an estate as U.S. or foreign depends on all of the facts involved, including the appointment of an administrator in the United States and the extent and duration of the activities of such administrator in the United States.<sup>49</sup>
2. A foreign estate is not taxable under subtitle A of the Code (except for income that is effectively connected with the conduct of a trade or business within the United States).<sup>50</sup>

## D. Other Foreign Entities

1. Foreign countries may allow for the creation of various types of entities for which there is no U.S. equivalent. In those cases, the foreign entity will typically be characterized (for U.S. tax purposes) according to the U.S. entity that is the most appropriate corollary, such as a trust, partnership or corporation. For example, Switzerland and Liechtenstein provide by statute for a foundation

or “stiftung,” which has some features similar to those of a corporation but also to those of a trust because it allows for the holding of property, controlled by the managers of the foundation or stiftung, for the benefit of another.<sup>51</sup>

### **E. U.S. Income Taxation of Foreign Non-Grantor Trusts**

1. Generally, a foreign trust is subject to U.S. income tax rules as a non-resident alien (i.e., it is subject to U.S. income tax, and U.S. income tax withholding, on U.S. source income).
2. If a foreign non-grantor trust has a U.S. beneficiary, special tax rules apply to the U.S. beneficiary.

#### **a. General Rules**

As with U.S. non-grantor trusts, a U.S. beneficiary is subject to U.S. income tax when a foreign non-grantor trust makes a distribution to or for the benefit of the U.S. beneficiary. The tax consequences of distributions depend on whether the distribution is characterized as: 1) a distribution of the trust’s “distributable net income” or “DNI”; 2) an accumulation distribution; or 3) a principal distribution. Unless a foreign non-grantor trust provides the IRS or the U.S. beneficiary with adequate information regarding the foreign trust, all distributions will be treated as accumulation distributions, and taxed accordingly, as discussed below.

#### **b. DNI of Foreign Trust**

Subject to the disclosure requirements, distributions from a foreign non-grantor trust are first treated as distributions of the trust’s DNI. Generally, for foreign non-grantor trusts, DNI is all of the current taxable income of the trust, both its U.S. and non-U.S. income (as would be defined by the Code), and, unlike a U.S. trust, always *includes* capital gains from the sale of any assets.<sup>52</sup> Capital losses will offset capital gains but are not offsets to ordinary income for purpose of computing DNI.<sup>53</sup> The character of DNI is the same for the beneficiary as for the trust (e.g., dividends and realized capital gains are taxed to the beneficiary as dividends and the capital gains).

#### **c. UNI (or accumulated DNI)**

If a foreign non-grantor trust does not distribute all of its DNI to a beneficiary each year, that excess DNI is deemed accumulated for future distribution and is referred to as “undistributed net income” or “UNI”.<sup>54</sup> If distributions to a U.S. beneficiary in a year exceed a

foreign non-grantor trust’s current year DNI and there is UNI from prior years, the excess will be treated as an accumulation distribution to the extent of the prior years’ UNI. UNI distributions are subject to a special tax rule known as the “throwback rule.” Although the throwback rule was repealed in 1996 with respect to U.S. trusts, it remains in effect for foreign trusts. The throwback rule is designed to impose on the U.S. beneficiary approximately the same income taxes that would have been imposed had the foreign non-grantor trust distributed its DNI each year.

- i. The tax on an accumulation distribution from a foreign trust is computed on Form 4970, Tax on Accumulation Distribution of Trusts. The beneficiary must attach Form 4970 to Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Form 3520 filing and reporting requirements are discussed in further detail below.
- ii. UNI is taxed as ordinary income. Accumulated income does not retain its character as dividends, capital gains, foreign income, etc. The U.S. beneficiary therefore loses the reduced tax rate on long-term capital gains and “qualified dividends” from U.S. domestic corporations and qualified foreign corporations, and the U.S. beneficiary may be unable to claim any foreign tax credit for foreign income.
- iii. In addition to paying tax on accumulation distributions from foreign non-grantor trusts, a U.S. beneficiary must also pay an interest charge on the accumulation distribution for each year of the accumulation.<sup>55</sup> The interest charge on accumulation distributions is the same compound interest rate charged by the IRS for underpayments of tax. Where the accumulation distribution arises from UNI from several different years, the interest charge is based on the average number of years of accumulation.

#### **d. Accumulation Term**

In calculating whether a trust has made an accumulation distribution, the Code requires that the taxpayer look back at any “preceding taxable year” where the trust was a non-grantor trust. The term “preceding taxable year” serves to identify and limit the taxable years of a non-grantor trust to which an accumulation distribution may be allocated. For trusts, other than foreign non-grantor trusts created by U.S. persons, the term “preceding taxable year” is any taxable year after December 31, 1968.<sup>56</sup> For foreign non-grantor trusts created by U.S. persons, the term “preceding taxable year”

is any taxable year after August 17, 1954.<sup>57</sup> The Code provides an exception for amounts accumulated before a beneficiary was born or attained age 21. However, this exception does not apply to foreign non-grantor trusts.

### **e. Principal Distributions**

To the extent a foreign non-grantor trust makes distributions in excess of its DNI and there is no UNI from prior years (or the distribution exceeds DNI and any UNI), the excess distribution is treated as a principal distribution or a distribution from the corpus of the trust, provided appropriate information is made available to the beneficiary identifying the composition of the distribution. Principal distributions are not subject to income tax.

## **3. U.S. Reporting Requirements of Foreign Non-Grantor Trust**

### **a. Form 1040NR**

A trustee of a foreign trust with U.S. source income files Form 1040NR instead of Form 1041 (there is no non-resident 1041). Because U.S. tax on U.S. source income is typically satisfied by withholding and filing requirements imposed on U.S. payors, a foreign trust will generally only file Form 1040NR in order to claim a refund for over-withholding.

### **b. Foreign Non-Grantor Trust Beneficiary Statement**

As stated above, distributions from a foreign non-grantor trust to a U.S. beneficiary will be treated as accumulation distributions and taxed as such, unless adequate records are provided to determine the proper treatment of the distribution. To avoid this rule, the foreign non-grantor trust should provide the U.S. beneficiary with a Foreign Non-Grantor Trust Beneficiary Statement. A Foreign Non-Grantor Trust Beneficiary Statement must include the following information:

- i. The first and last date of the taxable year of the foreign trust to which the statement applies.
- ii. A description of the property (including cash) distributed or deemed distributed to the U.S. beneficiary during the taxable year, and the fair market value of the property distributed.
- iii. A statement as to whether the foreign trust has appointed a U.S. agent. If the trust has a U.S. agent, the name, address and taxpayer identification number of the agent should be given. The appointment of a U.S. agent is discussed below.
- iv. An explanation of the appropriate U.S. tax treatment of any distribution or deemed distribution for U.S. tax purposes, or sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes.
- v. A statement identifying whether the owner of the trust is a partnership or foreign corporation.
- vi. A statement that the trust will permit either the IRS or the U.S. beneficiary to inspect and copy the trust's permanent books of account, records and such other documents as are necessary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes. This statement is not necessary if the trust has appointed a U.S. agent. As an alternative to making such a representation, a foreign trust may designate a U.S. agent. A U.S. agent must be a U.S. person and may be a U.S. beneficiary of the trust. In order to authorize a U.S. person to act as an agent, the trust and the agent must enter into a binding agreement.
- vii. To enable a U.S. beneficiary to establish the appropriate treatment of any distribution for U.S. tax purposes, the Foreign Non-Grantor Trust Beneficiary Statement should provide the amount and character of all items of income, the deductions directly attributable to each item of income, and all taxes paid with respect to each item of income, including capital gain income. The information required by the IRS on Schedule K-1 to Form 1041 will normally provide sufficient information to the beneficiary.
- viii. If a U.S. beneficiary cannot obtain such a statement from the foreign trust, the U.S. beneficiary may avoid treatment of the entire amount of a distribution as an accumulation distribution if the beneficiary can provide certain information regarding actual distributions from the trust for the prior three years. However, absent compelling non-tax reasons for not supplying a Foreign Non-Grantor Trust Beneficiary Statement to a U.S. beneficiary, it will generally be in the best interest of the U.S. beneficiary for the trust to supply such a statement in order to minimize the tax burden (and the interest charges) on the U.S. beneficiary.

## F. U.S. Income Taxation of Foreign Grantor Trusts

### 1. Foreign Grantor

If a foreign trust is treated as wholly owned by one or more foreign persons, it is treated as a disregarded entity for U.S. income taxes and the applicable U.S. tax rules. The withholding rules and reporting requirements will be those rules applicable to the foreign person(s).

### 2. U.S. Grantor

If a foreign trust is treated as owned wholly or in part by a U.S. person, U.S. person will report and pay income tax on all or that part of the items of income or deduction of the foreign grantor trust. In addition, special reporting requirements apply.

- a. The foreign grantor trust must file Form 3520A, Annual Information Return of Foreign Trust With a U.S. Owner. Form 3520A requires the foreign grantor trust to: 1) appoint a U.S. agent or provide the IRS with a copy of the trust documents (at least every three years); 2) provide an income statement and a trust balance sheet; and 3) identify any distributions to any U.S. owner(s) or any U.S. beneficiary.
- b. The foreign grantor trust must provide the U.S. owner with a Foreign Grantor Trust Owner Statement (the statement is found at page 3 of Form 3520A). In addition, if the foreign grantor trust has a U.S. beneficiary, the trustee must prepare a Foreign Grantor Trust Beneficiary Statement for each U.S. beneficiary (the statement is found at page 4 of Form 3520A), which the U.S. beneficiary must include with his or her own reporting obligations, discussed below.
  - i. Form 3520A is due on the 15th day of the third month after the end of the trust's tax year. The U.S. owner of the foreign grantor trust is subject to a penalty equal to five percent of the gross value of the trust owned by the U.S. person if the foreign grantor trust fails to timely file Form 3520A or does not provide all of the required or correct information. Although there is a reasonable cause exception to the filing requirements, the fact that a foreign country would impose penalties for disclosing the required information, reluctance on the part of the foreign fiduciary to provide the information or a provision in the trust instrument prohibiting disclosure does not establish reasonable cause.

- c. In addition to reporting the income and deductions of the foreign grantor trust on the U.S. person's income tax return, the U.S. person must file Form 3520 to report any transfers to the foreign grantor trust during the taxable year and, if the foreign grantor trust did not file Form 3520A, must prepare and attach a substitute Form 3520A for the foreign grantor trust.

## G. U.S. Beneficiary Reporting Requirements for Foreign Trusts

### 1. Form 3520

A U.S. beneficiary who receives a distribution from a foreign trust (non-grantor or grantor) is required to file IRS Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts).

- a. Form 3520 requires the U.S. beneficiary to report the date of each distribution and cash amounts or the fair market value of property received (with a description of the property received), directly or indirectly, during the current tax year from the foreign trust.
- b. Form 3520 must have all required attachments to be considered complete. If the U.S. beneficiary received a Foreign Non-Grantor Trust Beneficiary Statement or a Foreign Grantor Trust Beneficiary Statement, the statement must be attached to Form 3520. In addition, if the U.S. beneficiary received an accumulation distribution from a foreign non-grantor trust, a copy of Form 4970, calculating the accumulation distribution tax, must be attached to Form 3520.
- c. Form 3520 is due on the date that the U.S. beneficiary's income tax return is due, including extensions. Form 3520 is attached to the U.S. beneficiary's individual income tax return *and* a copy of Form 3520 is filed with the Internal Revenue Service Center in Philadelphia, Pennsylvania.
- d. A penalty generally applies if Form 3520 is not timely filed or if the information is incomplete or incorrect. Generally, the penalty for failure by a U.S. person to report receipt of the distribution is equal to the greater of \$10,000 or 35 percent of the gross value of the distributions received from a foreign trust. No penalties will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect. However, reluctance on the part of a foreign fiduciary to disclose the tax reporting information or provisions

in the trust instrument that prevent the disclosure of required information are generally not considered reasonable causes. If any failure to file continues for more than 90 days after the day on which IRS mails notice of a failure to file to the person responsible for the penalty, that person must pay an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which the failure continues after the expiration of the 90-day period.

## 2. Foreign Bank Reporting (“FBAR”)

A U.S. beneficiary of a foreign trust may also be required to file FinCen Report 114, Report of Foreign Bank and Financial Accounts, or FBAR.<sup>58</sup>

- a. A U.S. beneficiary must file FBAR if: 1) he has a beneficial interest in more than 50 percent of the assets or income of a trust; 2) the trust owns or holds a foreign financial account; and 3) the aggregate value of all foreign accounts exceeds \$10,000. However, if the trust, trustee or agent of the trust is a U.S. person that files an FBAR disclosing the trust’s foreign financial accounts, the trust beneficiary is not required to file an FBAR. A financial account includes any bank, securities, derivatives or other financial instruments account and certain depository accounts.
- b. For deadlines and penalties, see the prior discussion of FBARs in the “Reporting Requirements for U.S. Persons with Foreign Assets” section of this outline.

## 3. Form 8938

Form 8938 (Statement of Specified Foreign Financial Assets) is not required if the U.S. beneficiary files Form 3520.

### H. Reporting Requirements for U.S. Trust/Estate with Foreign Beneficiaries

#### 1. General Income Tax Requirements

##### a. Withholding

A U.S. trust or estate that has a foreign beneficiary has additional income tax requirements. All non-resident alien individuals or entities are subject to U.S. income tax on: 1) all income from whatever source which is effectively connected to the conduct of a U.S. business; and 2) a flat tax of 30 percent on all fixed or determinable annual or periodic income from U.S. sources which is not connected to the conduct of any U.S. business.<sup>59</sup> The tax liability imposed by the Code is generally collected by way of withholding.<sup>60</sup> The duty to withhold is imposed on the persons, in whatever

capacity, having control, receipt, custody, disposal or payment of the income items subject to withholding.

- i. A U.S. trust or estate that makes distributions to a foreign individual or foreign entity is required to withhold any U.S. income tax imposed on payment or distributions to the foreign person.
- ii. For a U.S. simple trust that makes distributions to a foreign beneficiary, the trust is required to withhold on the distributable net income or DNI which is includible in the gross income of the foreign beneficiary, to the extent the DNI includes income subject to withholding.<sup>61</sup> The trust withholds when a distribution is made to the foreign beneficiary. To the extent the trust is required to, but does not actually, distribute the income to a foreign beneficiary prior to year-end, the trust must withhold on the foreign beneficiary’s allocable share of DNI subject to withholding at the time the income is required to be reported.<sup>62</sup>
- iii. For a U.S. complex trust that makes distributions to a foreign beneficiary, the trust is required to withhold on the DNI includible in the gross income of the foreign beneficiary, to the extent the DNI consists of income subject to withholding and the income actually is, or is required to be, distributed currently. The trust withholds when a distribution is made to the foreign beneficiary, or if the distribution is required but not made prior to year-end, at the time of reporting.
- iv. A U.S. estate is also required to withhold on the DNI includible in the gross income of the foreign beneficiary to the extent the DNI consists of income subject to withholding and the income is actually distributed.
- v. For a U.S. grantor trust with a foreign owner, the trust must withhold on any income includible in the gross income of the foreign person who is treated as the owner of the trust to the extent such income consists of income subject to withholding. The withholding must occur at the time the income is received by, or credited to, the trust.<sup>63</sup>
- vi. A U.S. trust that makes distributions to an expatriate is subject to additional withholding rules (as discussed below).
- vii. For 2010 only, there is a special income tax recognition rule on transfers to non-resident alien individuals. Under the Code, any transfer of appreciated property by a U.S. person to a non-resident alien individual, except for “lifetime transfers,” will cause a recognition of the gain.<sup>64</sup> This recognition rule has

previously only applied to transfers by U.S. persons to foreign trusts or estates (as discussed in Section V, below). However, the rule was expanded (but only for transfers occurring between January 1, 2010 and January 1, 2011) to include transfers to foreign individuals unless a transfer is a lifetime transfer.<sup>65</sup>

### **b. Income Tax Filing Requirements**

- i. The U.S. trust or estate reports the tax withheld for the foreign beneficiary on Forms 1042 and 1042-S, which are due March 15th. The tax withheld is required to be deposited with either a Federal Reserve Bank or an authorized financial institution. Deposits of the tax withheld are made quarterly, monthly or annually depending on the amounts withheld.<sup>66</sup>
- ii. The U.S. fiduciary is required to request a Form W-8BEN from the foreign beneficiary.<sup>67</sup> If the foreign beneficiary does not provide the W-8BEN, withholding is required at the 30 percent tax rate regardless of any reduced withholding rate or modified withholding rules provided by an applicable tax treaty.<sup>68</sup>

## **I. Reporting Requirements for U.S. Persons/Trusts/Estates Making Distributions to Foreign Trusts/Estates**

### **1. Income Tax Treatment**

- a. Any U.S. person (i.e., any U.S. citizen or resident, domestic trust or estate) who transfers property to a foreign non-grantor trust or a foreign estate must recognize gain (if any) at the time of a transfer (i.e., the transfer of appreciated property to a foreign non-grantor trust will trigger income tax). The transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred.<sup>69</sup> The gain recognition rule applies even if the U.S. transferor might otherwise have been eligible to defer gain recognition under another Code provision.
- b. This gain recognition rule is expanded to include transfers to non-resident alien *individuals* for transfers by U.S. persons in 2010 (unless it is an *inter vivos* transfers).<sup>70</sup>
- c. If a trust changes from a U.S. trust to a foreign trust (for example, at the death of the grantor or beneficiary, or through the exercise of a power of appointment (whether limited or general)), there is a deemed transfer from the U.S. trust to a foreign trust, which triggers the gain recognition rule.<sup>71</sup> There is an exception to this rule for a trust

that is treated as owned by a foreign person, after application of the rules regarding grantor trust treatment of a trust with a U.S. beneficiary.<sup>72</sup>

- i. Recall that, under the definition of foreign trust, the Treasury Regulations provide a 12-month grace period in the event of a change from a foreign trust to a U.S. trust or vice versa due to an inadvertent change in the person who has the power to make a substantial decision. This grace period may allow for the disclaimer, release or reformation of a trust to avoid the recognition of gain when a trust changes from a U.S. trust to a foreign trust.

### **2. Tax Reporting**

- a. A U.S. transferor who, directly or indirectly, transferred money or other property during the current tax year to a foreign trust or estate must file Form 3520 (if the transfer occurs as a result of death, the executor files Form 3520). If gain is triggered by reason of the transfer, the gain is reported on the appropriate schedule (e.g., Schedule D if capital gain property). The special reporting rules for a foreign grantor trust that is owned by a U.S. person was discussed above in connection with foreign grantor trusts.

### **CASE STUDY #1<sup>73</sup>**

Clark Griswold is a successful executive who is often hired by Big Deal Private Equity Firm ("Big Deal") to run its different portfolio companies as CEO until the companies hit it big and then are sold to strategic third party buyers. Clark and his wife, Ellen Griswold, have two teenage kids, Rusty Griswold and Audrey Griswold. The Griswold family currently lives in Chicago, IL and all are U.S. citizens.

Clark had taken a short break after one CEO role and now Big Deal has asked Clark to run the London-based company, Wally World, and move his family to London for the next five years or so until Clark can maximize the value of Wally World and Big Deal can sell it.

This will be the Griswold family's first time living outside the U.S. and they are excited to make the trek across The Pond. They think it will be an adventure to live abroad (a "European vacation" of sorts) and then they plan on returning to the U.S. They are not sure what they should do to plan for the time they will live in London and proactively seek advice from their advisors.

Clark and Ellen currently have a basic estate plan in place (i.e., Wills, revocable living trusts of which each



is trustee of his/her own respective trust, and Illinois powers of attorney for property and health care). Clark and Ellen also created a family limited partnership of which Clark is the General Partner and he and Ellen already had made gifts of the Limited Partner Units to the Griswold GST Exempt Family Trust for the benefit of Rusty and Audrey and their future descendants. Aunt Edna is Trustee and Cousin Eddie is named as Successor Trustee. Aunt Edna and Cousin Eddie both are German citizens temporarily residing in Chicago with Clark. Aunt Edna is super excited about Clark's stint at Wally World and decides that this is her shot to go with the family and live in London and she wants to live out her remaining years there because of her not-so-normal crush on Prince Charles.

Clark explains all of this to you as his trusted advisor. How would you advise him before the Griswolds leave for London?

### CASE STUDY #2<sup>74</sup>

Art Vandelay is an executive at a multinational corporation XYZ in Madison, WI. He originally came to the U.S. from the Netherlands on an L-1 Visa 14 years ago with his brother, Cal Varnson. Art was able to secure his Green Card in 2008 and is considering applying for U.S. citizenship, but he is unsure at this point. His brother has become naturalized but Art is still unsure if he intends to stay in the U.S. indefinitely.

Art owns a small flat in the Netherlands and has a large home in the Madison area and a cottage in west Michigan. While Art spends a lot of time in Madison during the year, he makes at least one trip back to the Netherlands annually, where most of his family and friends are located.

While he doesn't need the money, he is amazed and grateful that each year his wealthy uncle from the Netherlands has his company distribute \$25,000 USD to him. So this year, he is going to spend more time

with him when he goes back. Art is not married but has been seeing another executive at his company for several years now. She is a U.S. citizen. In addition to a sizeable salary, Art has a large investment portfolio, which is comprised of mostly foreign mutual funds and equities. Art also owns investment real estate and several bank accounts in the Netherlands.

Your friend is in-house counsel at corporation XYZ and encourages Art to seek professional advice on his tax and estate planning. Art is directed to call you. What issues do you raise with Art?

### IMPORTANT INFORMATION

The material herein is not in any way endorsed or approved by J.P. Morgan, or any affiliate thereof. The views set forth herein were the personal views of the author and do not necessarily reflect those of J.P. Morgan, its employees and its affiliates.

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#### Notes

- 1 Unless otherwise provided, this outline will focus on planning for these two types of clients and their interests in U.S. or foreign assets. For example, this outline does not cover planning when a U.S. citizen client marries a non-U.S. citizen spouse (e.g., Qualified Domestic Trusts) or when clients have other U.S. or foreign connections or relationships.
- 2 Income tax on source income generally is withheld at the source at a 30 percent rate, unless a treaty applies a lower rate.
- 3 References to "Code §" are to sections of the Internal Revenue Code of 1986, as amended (the "Code"). References to "Treas. Reg. §" are to sections of the Treasury Regulations promulgated under the Code.
- 4 Treas. Reg. § 301.7701-7(d)(1)(i).
- 5 See discussion below on determining whether a trust is a foreign trust or a U.S. trust for U.S. income tax purposes.
- 6 Dual citizens (individuals who are citizens of the U.S. and another country) are taxed as U.S. citizens and any other citizenship generally is ignored for U.S. tax purposes. *U.S. v. Matheson*, 532 F.2d 809 (2d Cir.); *Vriniotis Estate v. Comm'r*, 79 T.C. 298 (1982). An applicable treaty may change this tax treatment.
- 7 Code § 7701(b)(1)(A)(i). A green card holder will continue to be considered a U.S. resident until his or her green card is revoked or abandoned. Code § 7701(b)(6)(B). There are

- special rules for the first and last year of lawful residence. See Code §§ 7701(b)(2)(A)(i) and 7701(b)(2)(B).
- 8 Code § 7701(b)(3)(A).
- 9 Treas. Reg. § 301.7701(b)-1(c)(2)(i).
- 10 Treas. Reg. § 301.7701(b)-3(a).
- 11 Treas. Reg. § 301.7701(b)-3(b).
- 12 Code § 7701(b)(3)(B) and (C); Treas. Reg. § 301.7701(b)-2.
- 13 Treas. Reg. § 20.0-1(b)(1).
- 14 See *Estate of Edouard H. Paquette v. Comm’r*, T.C. Memo. 1983-571; Brian P. Tsu, “What Every Domestic Estate Planner Should Know About International Estate Planning,” ALI-CLE Estate Planning in Depth (June 2014), at 13; Leslie A. Share, “Domicile is Key in Determining Transfer Tax on Non-Citizens,” *Est. Plan*, Jan./Feb. 1995, at 31; D. Chase Troxell, *Aliens – Estates, Gift and Generation-Skipping Taxation A-5* (BNA 1991).
- 15 Currently, the 15 estate and/or gift tax treaties between the U.S. and other countries are: 1) Australia, 2) Austria, 3) Denmark, 4) Finland, 5) France, 6) Germany, 7) Greece, 8) Ireland, 9) Italy, 10) Japan, 11) the Netherlands, 12) Norway, 13) South Africa, 14) Switzerland, and 15) the United Kingdom. The Protocol to the 1980 treaty between the U.S. and Canada is an income tax treaty (Canada does not have an estate or gift tax), but it tries to alleviate double taxation based on Canada’s capital gains tax at death and other deemed dispositions.
- 16 For another helpful overview of these considerations, see Brian P. Tsu, “What Every Domestic Estate Planner Should Know About International Estate Planning,” ALI-CLE Estate Planning in Depth (June 2014).
- 17 For an excellent discussion of the reporting requirements related to U.S. persons with respect to control or interests in foreign entities, see M. Read Moore, “Tax and Estate Planning Issues for U.S. Clients Who Own Foreign Property,” Southern Nevada Estate Planning Council, Feb. 2016.
- 18 31 U.S.C § 5314; 31 C.F.R. § 103.
- 19 31 C.F.R. § 1010.350(a).
- 20 31 CFR §§ 1010.350 (e)(1), (e)(2), (g)(5).
- 21 FinCEN Notice 2016-1.
- 22 *Id.*
- 23 31 U.S.C. § 5322(a).
- 24 31 U.S.C. § 5322(b).
- 25 31 U.S.C. § 5321.
- 26 31 U.S.C. § 5321(a)(5).
- 27 Treas. Reg. §20.0-1(b)(1).
- 28 Treas. Reg. § 20.2104-1(a)(1), (2); § 25.2511-3(b)(1), (2). Currency is treated as tangible personal property. Treas. Reg. § 20.2104-1(a)(7); § 25.2511-3(b)(4)(iv).
- 29 Code § 2501(a)(2). In PLR 9119049, the IRS ruled that a mutual fund, which consisted of municipal bonds and securities, was intangible personal property and the non-resident alien was not subject to U.S. gift tax.
- 30 Treas. Reg. § 20.2104-1(a)(1), (2); § 25.2511-3(b)(1), (2). Currency is treated as tangible personal property. Treas. Reg. § 20.2104-1(a)(7); § 25.2511-3(b)(4)(iv).
- 31 Treas. Reg. § 20.2104-1(a)(5); § 25.2511-3(b)(3). In TAM 9748004, the IRS ruled that shares in an open-ended U.S. investment company (, a mutual fund) are treated as stock of a U.S. domestic corporation for purposes of the situs rules.
- 32 Treas. Reg. § 20.2104-1(a)(7); § 25.2511-3(b)(4).
- 33 Code § 2105(a).
- 34 Code §§ 2105(b)(1), 871(i)(3). U.S. bank deposits include money in a checking, savings or unrestricted agency account and certificates of deposit. See *Estate of Gade*, 10 T.C. 585 (1948); *Estate of Forni*, 47 B.T.A. 76 (1942); Rev. Rul. 82-193, 1982-2 C.B. 219. Cash in a bank’s safe deposit box is not a U.S. bank deposit. Rev. Rul. 55-143, 1955-1 C.B. 465. In addition, funds held by a bank in a fiduciary capacity where the beneficiary’s access is restricted do not constitute U.S. bank deposits. Rev. Rul. 69-596, 1969-2 C.B. 179. A brokerage firm is not in the banking business, and cash held by a U.S. brokerage firm will still have a U.S. situs. Rev. Rul. 65-245, 1965-2 C.B. 379.
- 35 Code §§ 2105(b)(3), 871(h). The types of obligations that can qualify as portfolio debt obligations include U.S. government obligations, obligations issued by agencies of the United States, obligations issued by states, counties, cities and public authorities and obligations issued by U.S. corporations and partnerships. However, it is unlikely that debt obligations issued by a U.S. individual would qualify. See Code § 871(h) (2), (3). In TAM 9748004, the IRS held that a unit investment trust that held portfolio debt obligations was treated as non-U.S. situs property under Code § 2105(b)(3).
- 36 Code § 2105(c).
- 37 Cash in a bank’s safe deposit box is not a U.S. bank deposit. Rev. Rul. 55-143, 1955-1 C.B. 465. In addition, funds held by a bank in a fiduciary capacity where the beneficiary’s access is restricted do not constitute U.S. bank deposits. Rev. Rul. 69-596, 1969-2 C.B. 179. A brokerage firm is not in the banking business, and cash held by a U.S. brokerage firm will still have a U.S. situs. Rev. Rul. 65-245, 1965-2 C.B. 379.
- 38 Code § 7701(a)(30)(E).
- 39 Treas. Reg. § 301.7701-7(c)(1).
- 40 Treas. Reg. § 301.7701-7(c)(3)(v).
- 41 Treas. Reg. § 301.7701-7(d)(1)(ii).
- 42 Treas. Reg. § 301.7701-7(d)(2).
- 43 Code § 7701(a)(31)(B).
- 44 A nonadverse party is anyone whose interest is not adverse to the grantor. Code § 672(b); Treas. Reg. § 1.672(b)-1. Generally, an adverse party is anyone who has a “substantial beneficial interest” in the trust that would be adversely affected by the exercise or non-exercise of the power in question. Thus, a person may be nonadverse because: 1) he or she has no beneficial interest; 2) his or her beneficial interest is not substantial; or 3) his or her interest, while beneficial and substantial, would not be adversely affected by the exercise of the power with regard to the trust.
- 45 Code §§ 671-677.
- 46 Code §§ 679. Effective March 18, 2010, Code § 679(c) broadens the circumstances when a foreign trust has a U.S. beneficiary, including: 1) trust accumulations for the benefit of a U.S. person whose interest is contingent on a future event; 2) any trust with discretionary distribution unless no permissible distributee is a U.S. person; and 3) uncompensated use of trust property by a U.S. person as payment to a U.S. person.

- 47 Code § 672(f).
- 48 Code § 678.
- 49 Rev. Rul. 62-154, 1962-2 CB 148.
- 50 Code § 7701(a)(31)(A).
- 51 See *Estate of Swan v. Commissioner*, 24 T.C. 829 (1955), acq., 1956-2 C.B. 8, *aff'd in part and rev'd in part on other grounds*, 247 F.2d 144 (2d Cir. 1957) (holding that Liechtenstein and Swiss *stiftungen* were found to be more comparable to trusts under U.S. law rather than corporations for U.S. transfer tax purposes even though the laws of neither country at that time recognized trusts).
- 52 Code § 643(a)(3), (a)(6)(C).
- 53 Code § 643(a)(6)(C).
- 54 UNI, for any taxable year, is defined as the amount by which the trust's DNI exceeds: 1) the amount distributed to the beneficiary; and 2) the amount of tax imposed on the trust for the DNI. Code § 665(a).
- 55 Code § 668.
- 56 Code § 665(b).
- 57 Code § 665(e)(1).
- 58 31 U.S.C. § 5314; 31 C.F.R. 103.
- 59 Code §§ 871(a) and 881(a). Income taxable under these provisions includes interest, dividends, royalties, compensations and other fixed or determinable annual or periodic income and certain gains.
- 60 The withholding rules are found at Code §§ 1441, 1442 and 1443.
- 61 Treas. Reg. § 1.1441-2(a). Treasury Regulation § 1.1441-2(a) states that the income subject to withholding means amounts from sources within the United States that constitutes either fixed or determinable annual or periodic income ("FDAP income"). The regulation defines FDAP income as all income included in gross income under Code § 61 (*i.e.*, all income unless it is specifically excluded by the Code). There are several exceptions to this all-inclusive rule. One important exception is for gains. There is no withholding required for gains derived from the sale of property (including market discount and option premiums) except for gains described in Code § 631(b) or (c) (relating to the treatment of gains on the disposition of timber, coal or domestic iron ore with a retained economic interest) and gains subject to the 30 percent tax under § 871(a)(1)(D) or § 881(a)(4) (relating to contingent payments received from the sale or exchange of patents, copyrights and similar intangible property). Treas. Reg. § 1.1441-2(b)(2)(i). Other items of income that are excluded from the withholding requirements are: 1) non-U.S. source income; 2) portfolio interest paid on a debt obligation; 3) bank deposit interest; 4) interest or OID on a short-term OID obligation; and 5) insurance premiums paid on a contract subject to Code § 4271 excise tax or paid to a foreign insurer. Treas. Reg. § 1.1441-2(a), (b)(2)(ii).
- 62 Treas. Reg. § 1-1441-5(b)(2)(ii). Because DNI cannot be correctly determined until the end of the year, the trust may make a reasonable estimate of the portion of any distribution that constitutes DNI consisting of income subject to withholding and apply the appropriate rate of withholding to the estimated amount. No penalties are imposed for failure to withhold and deposit the tax if the trust's estimate was reasonable.
- 63 Treas. Reg. § 1.1441-5(b)(2)(iv).
- 64 Code § 648(a)(1), (b)(2), effective for transfers after December 31, 2009.
- 65 While the exception for "lifetime transfers" applied to a U.S. individual transferor seems clear, Code § 648(b)(2) applies to all U.S. persons, which includes U.S. trusts and estates. How, or whether, this exception is to apply in the case of a transfer by a U.S. trust or estate is not clear.
- 66 Deposits of the tax withheld are made quarter-monthly, monthly or annually depending on the amounts withheld. If the amount withheld is less than \$200 in the taxable year, the deposit is made when the agent files the annual 1042 form. If the withholding agent has withheld between \$200 and \$2,000 at the end of any month, the deposit is made 15 days after the end of the month. If the withholding agent has withheld \$2,000 or more at the end of any quarter-monthly period, the deposit must be made three (3) banking business days after the end of the quarter-monthly period. Quarter-monthly periods fall on the 7th, 15th, 22nd and last day of each month.
- 67 A Form W-8 that contains a taxpayer identification number (TIN) is valid indefinitely so long as there is any annual reporting of at least one item of income paid by a withholding agent to the beneficial owner. If a Form W-8 does not have a TIN, or has a Form W-8 with a TIN but does not make any payments of an amount subject to withholding, the W-8 is only valid for three (3) calendar years after the year of receipt. A change in circumstances which makes the form incorrect (*i.e.*, a change of address to a different country with different treaty reductions or a change of address to the United States) will invalidate the form at any time.
- 68 Treas. Reg. § 1.1441-6. The foreign beneficiary may also need to acquire a taxpayer identification number from the IRS in order to claim certain treaty benefits. See Treas. Reg. § 1.1441-6(c)(2).
- 69 Code § 684(a)(1).
- 70 Code §§ 684(a), 684(b)(2), effective for transfers after December, 31, 2009.
- 71 Code § 684(c).
- 72 See Code § 672(f).
- 73 This case study originally was prepared by Benetta P. Jenson for the "Tax Planning and Compliance Issues Faced by International Executives" panel at the 11th Annual Convention of the South Asian Bar Association of the of North America (June 20, 2014) with panelists, Raj Malviya, of Miller Johnson, Benetta P. Jenson, of J.P. Morgan Private Bank, Rahul P. Ranadive, of Global Tax and Estate Counsel, Annie Li, of Deloitte Tax, and Nicole Renchen, of Hyatt Hotels. Slight modifications have been made to the original case study.
- 74 This case study originally was prepared by Raj Malviya, of Miller Johnson, for the "Tax Planning and Compliance Issues Faced by International Executives" panel at the 11th Annual Convention of the South Asian Bar Association of North America (June 20, 2014) with panelists, Raj Malviya, Benetta P. Jenson, of J.P. Morgan Private Bank, Rahul P. Ranadive, of Global Tax and Estate Counsel, Annie Li, of Deloitte Tax, and Nicole Renchen, of Hyatt Hotels. Slight modifications have been made to the original case study.