THE 15 MOST IMPORTANT QUESTIONS THAT SHOULD BE ASKED WHEN ESTATE PLANNING FOR A FOREIGN PARENT WITH U.S. CHILDREN

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INTRODUCTION

U.S. estate tax planning is said to be among the most complicated aspect of tax planning because of the numerous moving parts and the changing needs and objectives of the family. The exercise becomes complicated when the client is not a U.S. person, but the heirs live in the U.S. and have started families in the U.S.

This article is intended to guide an adviser in dealing with the specific issues that arise when a client has roots outside the U.S. and heirs in the U.S. It does so by setting up a typical fact pattern and then identifying 15 issues that are unique to this type of client. It is based on U.S. tax law currently in effect. The reader is cautioned that many provisions may change, possibly with retroactive effect.

FACT PATTERN

Mrs. Smith walks into your office. She advises that she is not a U.S. citizen and lives permanently outside the U.S. She does not hold a green card. Mrs. Smith has two adult children and several grandchildren. One child qualifies as a U.S. resident and the other is a citizen of the U.S. by naturalization.

Mrs. Smith seeks advice on how to structure her estate in order to reduce or eliminate U.S. Federal estate tax. Her assets include the following:

- All the issued and outstanding shares of a corporation formed in her home country
- A term life insurance policy issued by a U.S. insurance company
- A house in a foreign country
- All issued and outstanding shares of a U.S. corporation. The principal asset of the corporation is a condominium apartment located within the U.S.
- All the furnishings for the condominium apartment that were purchased by Mrs. Smith and which have never been contributed to the U.S. corporation
- A portfolio of publicly traded shares of U.S. corporations
- A portfolio of publicly traded bonds
- An automobile owned and registered in her name in the state where her resident child resides, which is used by that child

She has many concerns about U.S. estate tax, but does not know where to begin. Her daughters will inherit, but she wishes to provide for them during her lifetime.

She asks for your advice. Below are the 15 most important questions that should be asked and answered in fashioning a plan for her to minimize U.S. estate tax exposure – as it exists under current law – and to plan for tax issues she and her two daughters may face in the U.S.

15 ESTATE PLANNING QUESTIONS AND ANSWERS

1. **What properties listed above will be subject to U.S. estate tax for a foreign individual such as Mrs. Smith?**

For an individual that is neither a U.S. citizen nor a U.S. resident for estate tax purposes ("an N.R.N.C. individual"), such as Mrs. Smith, the only assets that are subject to U.S. estate tax are assets having a situs in the U.S.[1] This includes shares of a U.S. corporation, debt instruments issued by a U.S. person, unless specifically exempt, tangible personal property physically located in the U.S., and U.S. real property.

If an N.R.N.C. individual were to own U.S. situs property, the first $1,000,000 of taxable value will be taxed at graduated rates totaling in $345,800. Thereafter, the estate tax is imposed at a flat 40% rate at Federal level. A benefit can be claimed for a portion of global administration expenses and claims against the estate. However, direct tracing of expenses to various countries is not allowed for U.S. tax purpose. Rather, the percentage of the global estate that is situated in the U.S. controls the portion of global administration expenses and claims that reduce the gross U.S. estate. Note that deductions are allowed only if the executor files a true and accurate U.S. estate tax return that lists all of the gross estate situated outside of the U.S. There is no unlimited marital deduction for bequests to a surviving spouse. However, the estate tax can be deferred through the establishment of a Qualified Domestic Trust ("Q.D.O.T.") until a triggering event occurs. Finally, the unified credit that may be claimed by U.S. persons to eliminate estate tax on $11.7 million in 2021 is reduced to $60,000.

For Mrs. Smith, the shares of the U.S. corporation owning an apartment, the portfolio of publicly traded shares, the automobile, and the furnishings in the apartment are U.S. situs assets. Certain other assets owned are specifically treated as foreign situs assets, as discussed in the answer to the following question. For those assets that are considered to be U.S. situs assets, the estate tax in the U.S. can be burdensome.

2. **Are certain assets generally thought to be U.S. situs assets exempt from U.S. estate tax at the time of Mrs. Smith's death?**

As a matter of tax policy, certain assets that would be considered to be U.S. situs assets under the general rule discussed in the answer to the preceding question are treated as foreign situs assets and for that reason are not subject to U.S. estate tax. These assets include the following:

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[1] Code §2103.

- Account balances in domestic U.S. banks and foreign branches of U.S. banks that are not connected to the conduct of a U.S. business by the N.R.N.C. individual[2]
- Portfolio debt obligations for which interest income is not subject to U.S. tax under Code 871(h) for an N.R.N.C. individual, such as publicly traded debt instruments or privately issued debt obligations that meet certain conditions, of which the most important are that the instrument cannot be freely transferred by endorsement, the creditor cannot be related to the U.S. debtor as defined in the statute, and the rate of interest cannot be contingent because it is based, *inter alia*, on profits, cash flow, value of assets, and like items[3]
- Short-term O.I.D. obligations, generally commercial paper or Treasury instruments having a term of 183 days or less from the date of original issue[4]
- Insurance proceeds on the life of an N.R.N.C. individual[5]
- Works of art on loan to a not-for-profit public gallery or museum in the U.S.[6]

"In comparison to estate tax which covers all U.S. situs assets other than those treated as foreign situs assets, U.S. situs intangible property is not subject to gift tax when given away during life."

For Mrs. Smith, the U.S. situs assets that are treated as foreign situs assets are the portfolio of publicly traded bonds and life insurance policy. While Mrs. Smith's taxable estate will not include the foregoing items, so that nothing need be done during Mrs. Smith's lifetime to restructure ownership, her executor may face a practical problem for account balances with banks and investment portfolios held in street name by financial institutions. These institutions may refuse to release assets to Mrs. Smith's executor until such time as a closing letter is issued by the I.R.S. regarding satisfaction of estate tax liability, if any. Anecdotally, advisers have complained that the I.R.S. has taken up to two years to issue a closing letter even when the estate of an N.R.N.C. individual is involved, and the assets have a foreign situs. Consequently, it may be prudent for Mrs. Smith to raise the matter with all banks and financial institutions she uses. If written assurances are not received, it would be prudent to move the investments.

3. Are all items of U.S. situs property that are subject to U.S. estate tax at the time of Mrs. Smith's death subject to gift tax if given away during her lifetime?

No. In comparison to estate tax which covers all U.S. situs assets other than those treated as foreign situs assets, U.S. situs intangible property is not subject to gift tax when given away during life.[7] For purposes of the U.S. Federal gift tax, intangible property is not defined in the Internal Revenue Code. Over the years, various rules have developed. Some of these are as follows:

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[2] Code §2105(b)(1).

[3] Code §2105(b)(3).

[4] Code §2105(b)(4).

[5] Code §2105(a).

[6] Code §2105(c).

[7] Code §2501(a)(2).

- Cash money and currency in physical form are items of tangible property, and gift tax will be due if gratuitously transferred in the U.S. by an N.R.N.C. individual.[8]

- Treasury Regulations discussing the situs of property in the context of gifts or bequests by foreign individuals state that intangible personal property consists of a "property right," and includes stocks, bonds, and debt obligations, including bank deposits.[9]

- In Private Letter Ruling 7737063, the I.R.S. stated that intangible property refers to choses in action[10] such as corporate stock, bonds, notes, bank deposits, patents, partnership interests, goodwill, but not to physical cash.

Note that no unified credit is allowed for gifts made by an N.R.N.C. individual. However, the $15,000 annual exclusion for gifts to each recipient remains applicable to an N.R.N.C. individual. There is no unlimited marital deduction for an N.R.N.C. individual in connection with gift tax. However, the $15,000 annual exclusion for an interspousal gift is increased more than tenfold. In 2021, the amount is $157,000.

For Mrs. Smith, the shares of the U.S. corporation owning the apartment, the portfolio of publicly traded shares of U.S. corporations, the portfolio of publicly traded bonds, and the life insurance contract can be given away without triggering the obligation to pay U.S. gift tax.

4. Will Mrs. Smith become a U.S. resident for estate and gift tax purposes if she were to spend substantial periods of time in the U.S. under a tourist visa in order to be with her children and grandchildren?

No. Spending time in the U.S., by itself, is not sufficient to cause an N.R.N.C. individual such as Mrs. Smith to become a U.S. resident for estate and gift tax purposes.

In comparison to the definition of residence for income tax purposes, for which tax residence is determined based on two objective tests, the determination of residence for gift and estate tax purposes is based on a subjective test. For a non-citizen individual, the definition for estate and gift tax purposes is based on domicile.

> A 'resident' decedent is a decedent who, at the time of his death, had his domicile in the U.S. *** A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[11]

Intention is generally demonstrated by objective facts relating to how the non-citizen leads his or her life. Not unexpectedly, the cases are numerous, and conclusions

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[8] *Blodgett v. Silberman*, 277 U.S. 1 (1928). Rev. Rul. 55-143.

[9] Treas. Reg. §§25.2511-3(b)(3), (4).

[10] A chose in action is a right to sue. It is an intangible property right recognized and protected by the law, that has no existence apart from the recognition given by the law, and that confers no present possession of a tangible object.

[11] Treas. Reg. §20.0-1(b).

are not necessarily consistent. Typically, the matter is decided by the existence or absence of a hook to the U.S. that is meaningful to the decedent at the time of death or the making of a gift. In broad terms, U.S. presence under a green card may be sufficient, even if presence is limited after initial entry.[12]

For Mrs. Smith, mere presence in the U.S., by itself, should not be sufficient to cause her to be domiciled in the U.S. in the absence of a green card, in the ordinary course of events.

5. Why are trusts an attractive tool in U.S. Federal estate tax planning for an N.R.N.C. individual such as Mrs. Smith?

Trust are an attractive tool for an N.R.N.C. individual such as Mrs. Smith because they are flexible and allow assets to pass to the next generation in a tax-free way, depending on the asset transferred and the terms in the trust instrument. They also allow the settlor to feel comfortable regarding the marital rights of a child's spouse.

Trusts vary based on the needs of the settlor who creates the trust. The settlor can choose whether the trust is revocable or irrevocable. As discussed below, even if formed in the U.S., a trust can be foreign or domestic, and tax consequences flow from that characterization.

For U.S. Federal tax purposes, the treatment of a trust depends upon the purpose and the actions of the trust. If a trust is formed to protect or conserve assets for the benefit of beneficiaries, it is treated as an ordinary trust.[13] If it is formed to carry on a business, it is treated as a business entity.[14]

A gift of U.S. situs intangible property to a trust established by Mrs. Smith may provide an effective way to pass property to the next generation with no U.S. gift tax at the time of the gift and no U.S. estate tax at her death, provided that neither certain interests nor powers over the trust are retained after the trust is funded.[15]

For an N.R.N.C. individual who has married children, such as Mrs. Smith, a gift to a trust may be more attractive than an outright gift to a married child because it can effectively prevent or limit the marital interests in the property that may be asserted by a child's spouse at the time of a divorce. Where outright gifts of property are made, a co-mingling of funds may affect the status of the gift as separate property. In comparison, if the spouse is not a beneficiary and the terms of the trust are followed, the marital right of the spouse in the property owned by the trust is presumptively limited.

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12 *Estate of Khan v. Commr.*, T.C. Memo 1998-22.

13 Treas. Reg. §301.7701-4(a).

14 Treas. Reg. §301.7701-4(b).

15 Code §§2035 (property given away "with strings attached" and a "string" is given away within three years of death), 2036 (property given away during life, but donor continues to have a right to the income from the property or retains the right to designate the persons who can possess or enjoy the property or its income), §2037 (property given away during life, but the recipient must survive the death of donor in order to enjoy possession of property), §2038 (The property is transferred during life, but donor retains power to alter, amend, revoke, or terminate the transfer), and §2041 (Property over which the decedent has at the time of his death a general power of appointment).

As a cautionary point, advice regarding potential gift tax consequences in the country of residence of the N.R.N.C. individual should be obtained from a competent tax adviser before Mrs. Smith makes a gift of property to a trust. In many countries, it is not uncommon for tax authorities to be suspicious when a local resident settles a trust formed in another country, especially when the trust is discretionary.

6. What interests and powers over the trust must not be held by Mrs. Smith and why must those powers be avoided?

In some instances the scope of U.S. estate tax may reach property that has been given away during lifetime so that property not owned at death is included in a taxable estate. In broad terms, the policy expressed when property is clawed back into the taxable estate is that retention of a specific interest or power is inconsistent with a completed gift during life.

Generally, the following interests and powers cannot be retained without having an adverse effecting on the donor at the time of death:

- The property is given away during life, but the donor continues to have a right to the income from the property or retains the right to designate the persons who can possess or enjoy the property or its income.[16]
- The property is given away during life, but the recipient must survive the death of the donor in order for the recipient of the gift to enjoy possession of property.[17]
- The property is transferred during life, but the donor retains power to alter, amend, revoke, or terminate the transfer.[18]
- The decedent has at the time of his death a general power of appointment over the property, which means the donor can appoint the property to himself or to his creditors.[19]
- The property is given away during life, but subject to one or more of the foregoing interests and powers, and the retained interest or power is relinquished within three years of death.[20]

"In many countries, it is not uncommon for tax authorities to be suspicious when a local resident settles a trust formed in another country, especially when the trust is discretionary."

7. If Mrs. Smith were to settle a trust formed under U.S. state law, what tests are applied to determine whether the trust is considered to be a U.S. domestic trust or a foreign trust for U.S. income tax purposes?

Mrs. Smith must be careful in who she appoints as protector or as the holder of a power over the governance of the trust. If a non-U.S. person can make a substantial decision for the trust, the U.S. trust may find that it is foreign for income tax purposes.

16 Code §2036.
17 Code §2037.
18 Code §2038.
19 Code §2041.
20 Code §2035.

Two tests must be met for a trust to be treated as a domestic trust. The tests are the Court Test and the Control Test.[21] A trust that fails to satisfy either test is a foreign trust, even if formed in the U.S.[22] As is readily apparent, U.S. tax as to this matter is written to favor the finding that a trust is a foreign trust. The reason is explained below in connection with the taxation of U.S. beneficiaries of foreign trusts.

The Court Test is met if a U.S. court exercises primary supervision over the trust's administration.[23] A U.S. court exercises primary supervision when the instrument does not direct that the trust must be administered outside of the U.S., the trust is only administered in the U.S., and the trust is not subject to an automatic migration provision if a U.S. court asserts jurisdiction to supervise administration of the trust.[24]

The Control Test is met if one or more U.S. persons, as defined by Code §7701(a)(30), control all substantial decisions relating to the trust.[25] Substantial decisions are those that persons are authorized to make under the terms of the trust instrument and applicable laws. The regulations issued by the I.R.S.[26] illustrate substantial decisions with the following non-exclusive list of decisions:

- Whether and when to distribute income or corpus
- The amount of any distributions
- The selection of a beneficiary
- Whether a receipt is allocable to income or principal
- Whether to terminate the trust
- Whether to compromise, arbitrate, or abandon claims of the trust
- Whether to sue on behalf of the trust or to defend suits against the trust
- Whether to remove, add, or replace a trustee
- 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 the decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited so that it cannot be exercised in a manner that would change the trust's residence from foreign to domestic, or vice versa
- Investment decisions – 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 when the U.S. person retains the authority to terminate the investment advisor's power to make investment decisions without any preconditions set for the exercise of that authority

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[21] Code §7701(a)(30)(E).

[22] Code §7701(a)(31)(B).

[23] Code §7701(a)(30)(E)(i); Treas. Reg. § 301.7701-7(c)(1).

[24] Treas. Reg. § 301.7701-7(c)(4)(ii).

[25] Code §7701(a)(30)(E)(ii).

[26] Treas. Reg. § 301.7701-7(d)(1)(ii).

To have control means that a U.S. person must have the power to make all substantial decisions of the trust and cannot be blocked by a foreign person.[27] In broad terms, a U.S. person means a U.S. citizen or resident (determined under the objective tests set forth in Code §7701(b)), a domestic partnership, and a domestic corporation.[28]

For Mrs. Smith, the decisions that appear on the foregoing list must be made by one or more U.S. persons. In considering which of her daughters should hold a power, care must be taken to ensure that the decision-making authority does not grant to that daughter the power to appoint assets or income to herself or her creditors.

8. Why may Mrs. Smith, an N.R.N.C. individual, find it attractive to use a U.S. domestic trust for U.S. Federal estate tax purposes when her children live in the U.S.?

There are two reasons why Mrs. Smith may decide to establish a U.S. domestic trust instead of a foreign trust.

- All beneficiaries are U.S. persons, and, if a foreign trust were established, the beneficiaries would be subject to adverse tax consequences under the throwback rules, in the event the foreign trust were to accumulate its income and gains over several years after which a substantial distribution would be made that is treated in whole or in part as an accumulation distribution.
- All beneficiaries are U.S. persons, and a U.S. beneficiary of a foreign trust is deemed to have income when she receives (i) a loan that bears no interest or an interest rate that is below an arm's length rate or (ii) the use of assets from a foreign trust without having to pay arm's length compensation.

Those rules generally do not apply when a trust is a U.S. domestic trust. Consequently, because Mrs. Smith's daughters are U.S. persons and the daughters are trust beneficiaries, it may be preferable for Mrs. Smith to settle a U.S. domestic trust.

Accumulation Distributions

An accumulation distribution is a distribution that is made by a foreign trust from prior years' accumulations of income and gain (i) after the current year's income and gains have been distributed and (ii) prior to the make of distributions of capital, all as determined in accordance with U.S. income tax rules.[29] Accumulation distributions are subject to throwback rules.[30] These rules recapture the tax benefit of reinvesting income in a tax-free environment at the level of a foreign trust, especially when the trust is formed in a low-tax jurisdiction. If neither the trust nor the beneficiary is subject to U.S. tax when and as income is generated at the level of the trust, 100% of profits and gains in excess of expenses can be reinvested. In comparison, if a U.S.

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[27] Treas. Reg. § 301.7701-7(d)(1)(iii).

[28] Code §7701(a)(30).

[29] When determining the income of U.S. beneficiaries from a trust, tax consequences follow rules that treat each dollar distributed to have the same character as each other dollar. Consequently, each dollar of a distribution that is made to a capital beneficiary is treated identically to each dollar that is distributed to an income beneficiary.

[30] Codes §§ 665-668.

domestic trust were formed, only after-tax income and gains in excess of expenses can be reinvested by the trust.

Distributions from a U.S. domestic trust are not subject to the throwback rules because a U.S. domestic trust is subject to U.S. tax at the maximum rate provided under U.S. tax law on virtually all its undistributed income for the year.[31] Once a U.S. domestic trust pays the tax on accumulated income, distributions allocated to such income are not further taxed in the U.S. when distributed to a U.S. beneficiary.

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Loans and Use of Trust Property

The principal amount of a loan from a foreign trust to a U.S. beneficiary that does not meet the requirements to be treated as a qualified obligation of the beneficiary is treated as a distribution for U.S. income tax purposes.[32] When a loan that is treated as a distribution is repaid, the repayment has no additional tax consequences.[33]

Based on legislative history and the I.R.S. instructions to Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,* the I.R.S. is authorized to issue regulations defining the circumstances when a loan from a foreign trust is treated as a true loan. Although no regulations have been issued, the terms set forth in the grantor trust regulations apply to loans made by foreign nongrantor trusts to U.S. beneficiaries.[34]

To be considered a qualified obligation, the following conditions must be met:

- The obligation must be embodied in a written agreement.
- The term of the obligation must not exceed five years, inclusive of options to renew and rollover.
- All payments on the obligation must be denominated in U.S. dollars.
- The yield to maturity of the obligation must be within the range of 100% to 130% of the Applicable Federal Rate ("A.F.R.") published by the I.R.S. for the month in which the obligation is issued.
- The U.S. person agrees to extend the period for assessment of additional tax for a period of at least three years following the maturity date of the obligation, unless the loan is issued and fully repaid within one calendar.
- The U.S. person properly reports the obligation on Form 3520.

When a U.S. beneficiary derives a benefit from the use of property held by a foreign trust – often, a condominium – the beneficiary must treat the use of the property as a distribution.[35] This provision does not apply when fair rental value is paid.

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[31] A U.S. domestic trust reaches the maximum tax bracket of 37% under current law when its taxable income reaches $13,050.

[32] Code §643(i)(1).

[33] Code § 643(i)(3).

[34] Treas. Reg. 1.679-4(d).

[35] Code §643(i)(2)(E).

9. What is a grantor trust under U.S. tax law, and why should Mrs. Smith avoid using a grantor trust as a vehicle to benefit her daughters in light of the U.S. property owned by Mrs. Smith?

In light of the U.S. property owned by Mrs. Smith, she likely should avoid using a grantor trust in planning for her gifts. In connection with a grantor trust having a foreign person as grantor, it is likely that no gift or estate tax planning benefits would be realized as to her U.S. property if she were to use a grantor trust.

A grantor trust is tax term given to a trust where the settlor or the person who funds the trust retains certain rights and powers over the trust, its assets, or its income, and as a result, the grantor is deemed to be the owner of the trust's assets and income.[36] In broad terms, a trust is treated as a grantor trust in any of the following fact patterns:

- The grantor has a reversionary interest in either the corpus or the income therefrom, and if, as of the inception of that portion of the trust, the value of that interest exceeds 5% of the value thereof.[37]
- The grantor has the power to control beneficial enjoyment of the income or corpus.[38]
- The grantor retains certain administrative powers, including the right to substitute property in the trust and the right to borrow from the trust on an interest-free basis.[39]
- The grantor has a power to revoke the trust.[40]
- The income of the trust is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the lives of, the grantor or the grantor's spouse.[41]
- A person other than the grantor has the power, exercise solely by her, to appoint the assets or the income of the trust to herself.[42]
- The grantor of the trust is a U.S. person, the trust is foreign, and one or more actual or potential beneficiaries are U.S. persons.[43]

While the foregoing seven fact patterns delineate when a trust is considered to be a grantor trust, only two apply when the person who would be the grantor is not a U.S. person. An N.R.N.C. individual is treated as the grantor of a grantor trust when (i) the trust is revocable or (ii) the only persons who may receive distributions from

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[36] Code §§671-679.

[37] Code §673.

[38] Code §674.

[39] Code §675.

[40] Code §676.

[41] Code §677.

[42] Code §678.

[43] Code §679.

the trust during the lifetime of the foreign grantor are the grantor and the grantor's spouse.[44] If neither condition is met, the trust is a non-grantor trust.

In the facts, Mrs. Smith wants her daughters to be current beneficiaries of her trust. As a result, a trust can be treated as a grantor trust only if it is revocable. However, if a revocable trust owns U.S. property, the U.S. situs of the assets of the trust will be included in a U.S. taxable estate at the time of the grantor's death. Consequently, Mrs. Smith should take steps to avoid settling a trust treated as a grantor trust.

10. Are there circumstances in which Mrs. Smith may wish to invest in a foreign grantor trust?

Yes, if Mrs. Smith were to invest in assets located outside the U.S. that produce foreign source investment income and gains subject to little or no income tax, she might want to settle a foreign grantor trust. The trust could be formed outside the U.S. or inside the U.S.

During the time that the Trust qualifies as a grantor trust, distributions made from the Trust to a U.S. beneficiary would be treated as gifts made directly from Mrs. Smith to the beneficiary. The distributions would not constitute taxable income for a U.S. beneficiary.[45] Consequently, the U.S. beneficiaries of the foreign grantor trust would not be subject to income tax on the receipt of trust distributions.

Even though no income tax is imposed on a U.S. beneficiary in connection with the receipt of a distribution from a foreign grantor trust having a foreign grantor, Form 3520[46] reporting obligations are imposed on the U.S. beneficiary and penalties are imposed on a U.S. beneficiary's failure to properly report amounts actually received as distributions from the trust.[47] The penalties are capped at 25% of the amount that should have been reported.

11. Mrs. Smith owns shares of a U.S. corporation having a condominium unit as its principal asset. Are the shares of the corporation considered to be a U.S. Real Property Interest?

Yes. The shares of the corporation likely are considered to be a U.S. Real Property Interest ("U.S.R.P.I.").

A U.S.R.P.I. is an interest, other than solely as a creditor, in either of the following assets:

- Real property located within the U.S., such as a condominium unit or investment real property
- Any interest in a U.S. Real Property Holding Corporation ("U.S.R.P.H.C.")[48]

A U.S.R.P.H.C. is any domestic corporation that owns a U.S.R.P.I. with a fair market value that is equal to or exceeds 50% of the combined fair market value of its

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[44] Code §672(f).

[45] Rev. Rul. 69-70.

[46] Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*.

[47] Code §6039F.

[48] Code §897(c)(1)(A).

U.S.R.P.I.'s, interests in foreign real property, and any other of its assets which are held or used in a trade or business.[49] If the U.S.R.P.H.C. is not a domestic corporation, a foreign shareholder is not taxed in the U.S. on the gain generated from the sale of shares.

All U.S. corporations are deemed to be U.S.R.P.H.C.'s unless otherwise demonstrated. Where a U.S. domestic corporation operates a business other than rental real estate or real estate development and the business is housed in premises owned by the corporation, it may not be easy to demonstrate that the corporation is not a U.S.R.P.H.C. To address the issue, the fair market value of the corporation's U.S.R.P.I.'s is presumed to be less than 50% of the fair market value of the aggregate of its assets if the total book value of the U.S.R.P.I.'s held by the corporation is not more than 25% of the book value of the aggregate of the corporation's assets on an applicable determination date.[50] The applicable determination dates are

- the last day of a taxable year,
- any date on which its U.S.R.P.I. is acquired,
- any date on which a foreign real property interest or an asset used in a trade or business is disposed of, and
- any date that would be a determination date in for a lower-tier entity owned by a corporation.[51]

Mrs. Smith owns shares of a U.S. corporation that owns a condominium unit. The unit is not part of a separate business and the principal asset of the corporation is the condominium unit. Consequently, she owns a U.S.R.P.H.C.

12. <u>If Mrs. Smith were to sell the shares of the U.S.R.P.H.C., what U.S. Federal income tax consequences would she encounter if the property were sold at a gain?</u>

In general, Mrs. Smith would recognize gain from the sale of the shares of the U.S.R.P.H.C.

Capital gains derived by an N.R.N.C. individual from the sale of shares of stock generally are not subject to U.S. Federal tax. However, the sale of shares of a U.S.R.P.H.C. is taxed because it constitutes a disposition of U.S.R.P.I.[52]

Although the tax base ultimately will be the net gain realized on the sale,[53] the amount realized is subject to U.S. withholding tax that is collected by the purchaser.[54] In most circumstances, the withholding tax is imposed at the rate of 15% of the amount realized. If the U.S.R.P.I. is acquired for use by the purchaser as a residence

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[49] Code §897(c)(2).

[50] Treas. Reg. §1.897-2(b)(2).

[51] Treas. Reg. §1.897-2(c)(1).

[52] Code §897(a)(1).

[53] Treas. Reg. §1.1445-1(g)(5). The amount realized is the sum of the cash paid, the fair market value of other property transferred, and the outstanding amount of liability assumed by the transferee.

[54] Code §1445(a). The transferee is required to deduct and withhold a tax equal to 15% of the amount realized on the disposition.

and the amount realized does not exceed $1.0 million, the rate of withholding tax is reduced to 10% of the amount realized.

Generally, the amount realized is the sum of

- the cash paid, or to be paid (principal only);
- the fair market value of other property transferred, or to be transferred; and
- the amount of any liability assumed by the transferee or to which the property is subject immediately before and after the transfer.[55]

The amount that must be withheld from the disposition of a U.S.R.P.I. can be reduced pursuant to a withholding certificate issued by the I.R.S. The purchaser or seller may request a withholding certificate.[56] The I.R.S. will generally act on these requests within 90 days after receipt of a complete application including the Taxpayer Identification Numbers of all the parties to the transaction. A transferor that applies for a withholding certificate must notify the transferee in writing that the certificate has been applied for on the day of or the day prior to the transfer. Several categories of withholding certificates exist, each relating to a different fact pattern. The most common category of withholding certificate relates to a fact pattern in which the withholding tax exceeds the transferor's maximum tax liability.

"The amount that must be withheld from the disposition of a U.S.R.P.I. can be reduced pursuant to a withholding certificate issued by the I.R.S. The purchaser or seller may request a withholding certificate."

Regarding Mrs. Smith, a sale of the shares of the U.S. corporation would be subject to a 15% withholding tax imposed on the amount realized for the shares.

13. If Mrs. Smith were to gift the shares of the U.S.R.P.H.C. to a U.S. domestic trust, would the gift be subject to withholding tax?

Were Mrs. Smith to gift stock of a U.S.R.P.H.C. to a trust, no tax would be due, and no withholding would be required, because the gift of shares of a U.S.R.P.H.C. to a trust is a transaction in which no amount is realized. An example of a nonrecognition transaction is a transfer of a U.S.R.P.I. to a U.S. corporation that is a U.S.R.P.H.C. in a transaction to which Code §351. Gain is realized by not recognized. In comparison, a gift is made gratuitously, so that no consideration is received as consideration for the transfer. The I.R.S. regulations state,

> If the amount realized * * * by the transferor is zero, then no withholding is required. For example, if a real property interest is transferred as a gift (*i.e.*, the recipient does not assume any liabilities or furnish any other consideration to the transferor) then no withholding is required.[57]

However, the donor must notify the donee that the event was a nonrecognition event and the donee must mail a copy of that notice to the I.R.S. within 20 days after the transfer.[58] The adjusted basis in the U.S.R.P.H.C. carries over to the trust.

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55 See "Rates of Withholding."

56 Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*.

57 Treas. Reg. § 1.1445-1(b)(1).

58 Treas. Reg. §1.1445-2(d)(2)(i)(B).

14. Why Is it preferable for Mrs. Smith to transfer the shares of the U.S.R.P.H.C. to a trust rather than to owned a foreign corporation?

It is preferable for Mrs. Smith to transfer the shares of the U.S.R.P.H.C. to a trust rather than to a foreign corporation because the latter likely will run afoul of the anti-inversion rules of U.S. tax law, and for that reason, likely will be treated as a U.S. corporation for U.S. income tax purposes.

If a foreign corporation were used to hold the share of the U.S.R.P.H.C. instead of a trust, the anti-inversion rules of Code §7874 likely will apply. Code §7874 is meant to discourage the restructuring of a U.S. corporation owned by one or more shareholders into a foreign corporation primarily owned by the same shareholders by reason of holding stock in the domestic corporation. Where the ownership interest in the foreign corporation equals or exceeds 60%, certain adverse tax consequences are realized by the transferor upon as a result of the restructure. Where the ownership interest in the foreign corporation equals or exceeds 80%, the foreign corporation is treated as a U.S. domestic corporation.[59]

15. Were Mrs. Smith to make no changes in the ownership of her assets, what problems likely will be encountered regarding Mrs. Smith's U.S. estate tax liability, and what other problems would be inherited by her daughters in the U.S. at the conclusion of Mrs. Smith's lifetime? What action steps might be considered to remedy that problem during Mrs. Smith's lifetime?

Under current U.S. Federal tax law, the basis of the shares of stock in the foreign corporation will be stepped up to fair market value when the daughters of Mrs. Smith inherit her property. The adjusted basis of property acquired from a deceased individual by reason of her death is the fair market value on the date of death.[60] However, the adjusted basis of assets owned by a foreign corporation that is owned by Mrs. Smith will not be stepped up simply by reason of her death.

If Mrs. Smith were to make no revisions to the way her assets are held, her estate and her daughters will face various problems. Using the list of assets that appears at the beginning of this article, the assets, potential tax problems, and potential remedial action for consideration are as follows.

ASSET	PROBLEMS	POTENTIAL ACTION
All the issued and outstanding shares of a corporation formed in her home country	The daughters will obtain a step-up in basis for the shares of the foreign corporation. However, the basis for assets owned by that corporation will not be stepped up.	If the entity is eligible, an entity classification elec-tion can be made for U.S. tax purposes, so that it becomes a disregarded entity. Daughters will obtain a step-up in basis at time of inheritance.

[59] Code §7874(b).

[60] Code §1014(a)(1).

ASSET	PROBLEMS	POTENTIAL ACTION
A term life insurance policy issued by a U.S. insurance company	None. The term life insurance policy is a foreign situs asset.	No action is required.
A house in a foreign country	None, because the house is a foreign situs asset for estate tax purposes.	No action is required.
All issued and outstand-ing shares of a U.S. corporation having a condominium apartment located within the U.S. as its principal asset	The shares of a U.S. corporation will be subject to U.S. estate tax if owned at death.	Consider gifting the shares to a nongrantor U.S. domestic trust. No gift tax will be due. No gain realized. No income tax will be due in connection with the gift.
The furnishings for the condominium apartment that were purchased by Mrs. Smith and never contributed to the U.S. corporation	The furnishings will be subject to U.S. estate tax if owned at death and gift tax if given away during life.	Prior to the transfer of shares to the trust, consider transferring furnishings to U.S. corporation. No gain should be recognized.
A portfolio of publicly traded shares of U.S. corporations	The shares will be subject to U.S. estate tax if owned at death.	Consider transferring the shares to a U.S. domestic nongrantor trust, or altering the investment to publicly traded bonds and short-term commercial paper. Alternatively, consider a transfer of shares to a corporation in the home country of Mrs. Smith; plan for an entity classi-fication election effective retroactively to the second day following date of death.

ASSET	PROBLEMS	POTENTIAL ACTION
A portfolio of publicly traded bonds	None. The publicly traded bonds are foreign situs asset.	No action is required other than to obtain assurance as to the release of the portfolio at death.
An automobile owned and registered in her name in the state where her resident child resides, which is used by that child	The automobile will be subject to estate tax if owned at death and gift tax if given away during life.	Consider selling the automobile to a nongrantor domestic trust at some point in the future.

CONCLUSION

These are not the only questions a N.R.N.C. parent will have. However, these questions provide a basis for understanding how one can adequately assist a Non-Resident Non-Citizen to reduce or eliminate U.S. Federal estate tax. U.S. estate tax planning may be the most complicated aspect of international tax planning, but with a basic understanding any client's needs can be met.

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