BLUNDERS IN INTERNATIONAL ESTATE PLANNING

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Tags
Foreign Trusts and Estates
Form 3520
Form 3520-A
Penalties
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Wills (U.S. and Foreign)

BACKGROUND

This article explores the rarified world of U.S. estate planning for non-U.S. persons owning property in the U.S., uncovering potential pitfalls, and providing insights to navigate the complexities. Five main topics are addressed:

- The risk of two wills inadvertently revoking each other
- The importance of holding cash in the right type of accounts
- Forgetting to file international tax forms
- The complications of leaving assets in the U.S. after moving abroad
- Ensuring a will's cover matches its content

BLUNDER #1: TWO WILLS THAT REVOKE EACH OTHER

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U.S. individuals may acquire vacation homes and other assets in Europe. In turn, European individuals may acquire vacations homes in the U.S. Florida has become a popular winter destination for Europeans. Also, Europeans often may have opportunities to work for a few years in the U.S. and acquire homes and investment accounts in the U.S. In each of those fact patterns, estate planning will require international considerations. The simplest plan that comes to mind would be one Los Angeles office person having two wills, one will for the assets in each country. Care must be taken any time a person has two wills.

A will drafted in the U.S. may not be enforceable in another country, and some clients may own property in multiple jurisdictions. The gold standard for international estate planning involves offshore trusts and companies. However, these structures come with hefty costs for drafting and ongoing maintenance. Annual trustee fees and corporate registration expenses are not insignificant and increase with time as the scope of legally mandated responsibilities expands. Many international clients seek to avoid these costs, especially if their estates will not be subject to substantial U.S. estate taxes.

An affordable alternative involves executing two wills, each specifying the specific property covered.

The Case For Having Two Wills

While some attorneys are hesitant about using two wills, when precisely drafted and approved separately by attorneys in both jurisdictions, use of two wills offer a

concise method for bequeathing property in multiple locations. This approach simplifies probate for a U.S. will that is limited to specific property, in contrast to the complexity of obtaining ancillary probate in the U.S. of a foreign will that covers worldwide assets.

Potential Blunder

One red flag to note is the revocation clause of each will. Normally, a will opens with a revocation statement as follows:

> I, JANE DOE, of the City, County and State of New York, publish and declare this to be my Last Will and Testament and revoke all former Wills and Codicils.

If there are two wills, does the will signed second revoke the first will signed. To prevent this, revocation clauses in both wills are crucial and must be carefully coordinated.

Proposed Revocation Clause

A clause that clearly delineates the scope of each will's bequests and safeguards against unintended revocation is essential. I suggest the following clause:

> I, ANTONIO GONZALES, being a citizen of the United States of America and a resident of the City, County and State of New York, publish and declare this to be my United States Last Will and Testament, to control the disposition of the property hereinafter described and defined as my Estate, and I hereby revoke all Wills and codicils at any time heretofore made by me with respect to such Estate. This United States Will shall not revoke or otherwise interfere with the disposition of any property which is situated in the Republic of Freedonia.[1] This United States Will can only be revoked by another Will, which is later in date than this United States Will. This United States Will may not be revoked unless the revocation clause of another Will specifically refers to this United States Will by date of execution and explicitly revokes this United States Will.

The will continues with a clause that defines "the Estate" that is bequeathed under New York will. In this case, it would be the individual's worldwide assets other than property that is located in Freedonia. A complementary will clause would appear in the will that is drafted to bequeath solely property that is located in Freedonia.

Conclusion

The goal is to safeguard the estate and ensure that the U.S. will does not inadvertently revoke the foreign will or vice versa, safeguarding the intended distribution of assets across jurisdictions. With precise drafting and thorough review by attorneys in the respective jurisdictions, two wills can effectively distribute property situated in different countries.

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[1] In the 1933 film "Duck Soup," Groucho Marx portrays the newly installed president of the fictional country of Freedonia. Throughout this article, Freedonia is the foreign country to which a decedent has a significant contact.

BLUNDER #2: OVERLOOKING THE ROLE OF CASH IS KING

There are numerous proverbs and sayings regarding money:

- You can't take it with you.
- Money makes the world go round.
- Throwing good money after bad.
- Money talks.
- Time is money.
- A penny for your thoughts.
- A fool and his money are soon parted.
- Money does not grow on trees.
- Cash is King.

In the realm of international estate planning, the last proverb takes precedence.

Understanding the U.S. Federal Estate Tax

In the U.S., a Federal estate tax exist that is imposed on the estate of the decedent. The top rate of estate tax is 40%. Fortunately for U.S. citizens and noncitizens who are domiciled in the U.S., there is a generous exclusion from the estate tax. For 2024, the exclusion is $13.61 million for an individual and $27.22 million for a married couple jointly. By contrast, for an individual who is neither a U.S. resident nor a U.S. citizen (sometimes referred to as an "N.R.N.C. individual") who owns property in the U.S., the estate tax exclusion is only $60,000. When two N.R.N.C. individuals are married, each is entitled to a separate $60,000 exclusion. An estate tax treaty between the United States and a client's home country may expand that $60,000 exclusion so that it matches an exclusion for U.S. citizens and U.S. residents for estate tax purposes.

Additional Estate Tax Exclusions for N.R.N.C. Individuals

A few additional exclusions exist from the Federal estate tax for N.R.N.C. individuals. For example, the death benefit from a life insurance policy that insures the life of a N.R.N.C. individual is not subject to the federal estate tax.

However, the most commonly used exclusion for N.R.N.C. individuals is cash on deposit with a U.S. bank. The cash that an N.R.N.C. individual leaves in a checking account, savings account, or certificate of deposit with a U.S. bank is exempt from the Federal estate tax.

The Blunder

Cash that an N.R.N.C individual leaves in a mutual fund, money market fund, or brokerage account held with a U.S. financial institution is not exempt from the Federal estate tax. Any sum of cash in a mutual fund, money market fund, or brokerage

account will be added to other items of U.S. situs property that is subject to Federal estate tax in the U.S. to the extent total assets exceed the $60,000 exemption.

Knowledge is power, especially when it comes to preserving your wealth across borders.

BLUNDER #3: FORGETTING TO FILE INTERNATIONAL FORMS

". . . while penalties for domestic tax returns can be potentially substantial, most of the time, the penalties are nominal amounts."

There are many penalties imposed by the Internal Revenue Service ("I.R.S."). For example, the penalty for failing to file a tax return is 5% of the unpaid tax per month. The penalty for a failure to file an informational return for which no tax is paid, such as the failure by an employer to issue a W-2, typically is a fixed dollar amount, which ranges between $60.00 to $630.00 for each form not filed. As one can see, while penalties for domestic tax returns can be potentially substantial, most of the time, the penalties are nominal amounts.

However, the penalties for failure to file international informational returns are far more burdensome than the penalties for domestic informational returns. Foreign forms include

- Form 8938 (*Statement of Specified Foreign Financial Assets*);
- Form 3520 (*Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*);
- Form 3520-A (*Annual Information Return of Foreign Trust With a U.S. Owner*);
- FinCEN Form 114 (*Report of Foreign Bank and Financial Accounts (F.B.A.R.)*);
- Form 5471 (*Information Return of U.S. Persons With Respect To Certain Foreign Corporations*) – in particular, the penalty for failure to file a Form 3520 is likely the most significant of any penalty issued by the I.R.S. other than those related to tax fraud; and
- Form 8865 (*Return of U.S. Persons With Respect to Certain Foreign Partnerships*).

Understanding the 3520 and 3520-A

There are four instances in which a U.S. person is required to file a Form 3520:

- A U.S. person transfers money or property to a foreign trust.
- A U.S. person is treated as an owner of a foreign trust under Code §§671-679.
- A U.S. person receives a distribution from a foreign trust or used property of a foreign trust without providing sufficient compensation.
- A U.S. person receives a gift or bequest from a foreign person.

The penalties for failing to file Form 3520 depend on the event that triggered the filing requirement and are as follows:

- If the reportable transaction is a transfer of money or property to a foreign trust, the penalty is 35% of the gross value of the property transferred to a foreign trust.
- If the reportable transaction is the treatment of a U.S. person as an owner of a foreign trust, the penalty is 5% of the gross value of the portion of the foreign trust's assets treated as being owned by a U.S. person.
- If the reportable transaction is the receipt of a distribution or the use of property of a foreign trust without providing sufficient compensation, the penalty is 35% of the gross value of the distribution received from a foreign trust.
- If the reportable transaction is the receipt of a gift or bequest from a foreign person, the penalty is 5% of the amount of the foreign gift with a maximum penalty of 25%.

The Blunder

First, let's give an example of the 25% penalty for failure to report the receipt of a gift or bequest from a foreign person. Let's say that, in 2016, a U.S. person received $5.0 million as a gift from a close relative who is not a citizen and who lives in Freedonia and has never resided in the U.S. The U.S. person did not know of the requirement to file Form 3520 to report the gift. Fast forward to the present day when Form 3520 is filed late upon the advice of a tax return preparer. The I.R.S. will automatically issue a notice for penalty and interest related to the failure to file a Form 3520 to report a gift from a foreign person. The penalty is $1.25 million, to which seven years' worth of interest will be added.

Next is an example of the 35% penalty for failure to report the transfer of property to a foreign trust. Let's say that, in 2016, a U.S. person transferred $5.0 million to a trust established under the laws of Freedonia. Again, the U.S. person did not know of the requirement to file Form 3520 to report the transfer to and the interest in the foreign trust. Fast forward to the present day when Form 3520 is filed late upon the advice of a tax return preparer. The I.R.S. will automatically issue a notice for penalty and interest related to the failure to file a Form 3520 to report the transfer of property to a foreign trust. The penalty is $1.75 million, to which seven years' worth of interest will be added.

Avoiding the Blunder

It is hard to fathom the size of these penalties. The easiest way to avoid the blunder is to remember the four instances in which a Form 3520 must be filed. Even if the error is that of the tax return preparer who failed to ask the relevant questions the I.R.S. may not view the error of the C.P.A. as an exoneration of the taxpayer. A taxpayer is required to carefully choose a tax return preparer or adviser based on that person's knowledge and expertise as to reporting obligations for international transactions. In other words, not all tax return preparers are created equal.

Streamlined Domestic and Offshore Procedures

U.S. taxpayers residing in the U.S. facing huge international tax form penalties may be eligible to enter into the Streamlined Domestic Offshore Procedures. If the taxpayer is eligible, rather than the 25% or 35% penalty outlined above, the penalty for the Streamlined Procedures is 5% of the highest aggregate balance/value of the

taxpayer's foreign financial assets that are subject to the miscellaneous offshore penalty related to the F.B.A.R. filing obligation.

In order to be eligible for the Streamlined Domestic Offshore Procedures, the taxpayer must meet the following four requirements:

- The taxpayer is not be eligible for the Streamlined Offshore Procedures discussed below.
- The taxpayer filed a U.S. tax return for each of the most recent three years for which the U.S. tax return due date has passed.
- The taxpayer failed to report gross income from a foreign financial asset, failed to pay tax as required by U.S. law, and may have failed to file one or more international information returns with respect to the foreign financial asset.
- The compliance failure of the taxpayer resulted from nonwillful conduct.

If the U.S. taxpayer resided outside the U.S., the Streamlined Foreign Offshore Procedures may be applicable. Under those Procedures, no penalty is imposed. In order for a U.S. taxpayer to be viewed as residing outside the U.S., the taxpayer must meet two tests in at least one year of the three-year period:

- The taxpayer did not have a U.S. abode.
- The taxpayer was physically outside the United States for at least 330 full days.

Conclusion: Consult a Competent Attorney or Accountant

If a U.S. person who receives gifts from a foreign person, has interests in a foreign business entity, has an interest in a foreign trust, or owns or has signatory authority over one or more foreign bank accounts, an adviser with international tax experience should be retained to review U.S. tax compliance obligations. The I.R.S. has no sympathy and a noncompliant taxpayer may be embroiled in the equivalent of a high-stakes poker game.

BLUNDER #4: LEAVING THE UNITED STATES? TAKE YOUR ASSETS WITH YOU

When an N.R.N.C. individual who may have spent time working or residing in the U.S. decides to return to his or her country of origin, failing to liquidate U.S. investment assets may lead to expensive procedures for foreign beneficiaries.

Understanding the U.S. Federal Estate Tax

The U.S. has a Federal estate tax that is imposed on death. The top rate of estate tax is 40%. Fortunately for U.S. citizens and noncitizens who are domiciled in the U.S., there is a generous U.S. exclusion from the estate tax. For 2024, they have a $13.61 million exclusion for an individual and a $27.22 million exclusion for a married couple. By contrast, for an N.R.N.C. individual. who owns property in the U.S., the estate tax exclusion is only $60,000 and an aggregate of $120,000 for a married couple. An estate tax treaty between the U.S. and a client's home country may occasionally expand that $60,000 exclusion.

Who Must Pay the U.S. Federal Estate Tax

If the estate of a U.S. or non-U.S. citizen owes estate tax, the estate is generally liable for the estate tax. However, the estate may not have sufficient liquid cash, or the I.R.S. may be unable to access liquid assets outside the U.S. The I.R.S. has other recourse.

- An executor may be held *personally* liable for the estate tax if the executor distributed estate funds to the beneficiaries without retaining an amount to pay the U.S. estate tax.
- Beneficiaries of the estate who have received distributions from the estate can be personally liable for the estate tax, to the extent of the assets received.
- A U.S. bank, investment manager, mutual fund, or cooperative apartment house that gives estate property to the estate beneficiaries may be liable for the estate tax. Even if the decedent signed a transfer-on-death or beneficiary designation, or if the account or property is held jointly, the I.R.S. can impose the estate tax on the bank, investment manager or co-op apartment corporation that gave the property to the beneficiary before the estate tax was paid.
- A purchaser of U.S. real estate owned by the estate or heir of an N.R.N.C. individual should be certain that no U.S. or state estate tax lien exists on the real estate. An estate tax lien can remain attached to the property, and a title company may refuse to insure the title to the property.

This problem arises in the context of an N.R.N.C. individual who worked or resided in the U.S. for a time and returned home. To a lesser extent, the issue will also be relevant to the estate of a U.S. citizen who, during life, decide to retire outside the U.S.

Documentation Required to Distribute Real Property and Funds

It may be years before a decedent's estate tax is settled and the I.R.S. issues a closing letter to confirm that all U.S. estate tax has been paid. However, the estate beneficiaries may want or need their inheritance as soon as possible.

There are a few ways that a bank, investment manager or property manager can distribute estate property to beneficiaries and limit the institution's liability for the estate tax.

- **Local Executor or Estate Administrator.** Financial institutions can require the estate to petition a local probate court for the appointment of a U.S. executor or estate administrator. Where that occurs, a financial institution may distribute estate funds to the U.S. executor or estate administrator. This is possible because the executor or estate administrator will assume any liability for the estate tax, instead of the financial institutions. However, the financial institutions generally will not distribute estate funds to an executor or estate administrator who was appointed by a court outside of the U.S. Such a foreign executor or estate administrator would have to commence an ancillary court proceeding in the U.S. and be appointed the U.S. estate fiduciary by a U.S. court.
- **I.R.S. Transfer Certificate.** An alternative to a U.S. court proceeding is for the estate to apply for an I.R.S. "transfer certificate." This is a protracted

procedure which requires the preparation of a U.S. estate tax return and the payment of any estate tax that is due. A transfer certificate can be required for the estates of both U.S. citizens and non-U.S. citizens who resided outside the U.S.

Each of the above procedures may also be available to a real estate manager such as a cooperative apartment house or a condominium association. They can require the court appointment of a local executor or estate administrator, an I.R.S. transfer certificate, and a release of any state estate tax lien. They all have some discretion. Banks, investment managers, co-op apartment houses, and real estate managers may require only a local executor or a transfer certificate. They could also require a Federal transfer certificate, state release of lien, and a court appointed U.S. executor or estate administrator.

The result can be a total stalemate and paralysis. A bank may not release any funds in advance of the issuance of an I.R.S. transfer certificate. However, the I.R.S. may not issue a transfer certificate until the estate pays the Federal estate tax. This becomes extremely problematic when the bank holds the only cash available to pay the estate tax.

Blunder

The estate or the heirs may incur extensive legal fees to liberate the estate funds and any U.S. real estate which the decedent owned at the conclusion of life.

Conclusion: Getting Money to Beneficiaries

If a departing U.S. citizen or N.R.N.C. individual wishes heirs to receive their inheritance in a timely way with minimal legal fees, financial assets should be transferred to a bank or investment manager outside the U.S. Real estate in the U.S. should be owned directly or indirectly by a foreign entity, which raises other issues that are beyond the scope of this article.

"The estate or the heirs may incur extensive legal fees to liberate the estate funds and any U.S. real estate which the decedent owned at the conclusion of life."

BLUNDER #5: DO NOT JUDGE A WILL BY ITS COVER

Occasionally, an attorney may draft a U.S. will for an international client who holds assets in more than one country. The attorney may pull a model will out of their file cabinet or off the computer and change the first page. This could involve adding a preamble on the first page stating that this will pertains only to U.S. property. The printed back of the will may declare that this is the client's "United States Will." Thus, both the front and back covers of the will indicate that it covers only U.S. property.

Inside the Will: Residuary Clause

While the will may contain several bequests or legacies, every well-drawn will invariably incorporates an omnibus clause called the Residuary Clause. This clause consolidates all property not explicitly bequeathed and distributes it to one or more individuals or charities, either outright or in trust.

Most Residuary Clauses begin with the phrase, "All the rest, residue and remainder of my property, wherever situated, I hereby give, devise, and bequeath to X, Y, and Z." The challenge arises in reconciling the declaration on page one of the will,

specifying coverage limited to U.S. property, with the Residuary Clause, which covers all my property "wherever situated."

Blunder

The discrepancy between the front and back covers of the will and its contents poses a significant issue. An attorney or client might mistakenly assume that converting a standard will to one covering only U.S. property is straightforward, merely requiring a preamble on page one of the will. However, conflicts with other clauses within the will can arise, undermining the efficacy of such a preamble.

We recently administered the estate of a man born in a European country who spent over 20 years working in the U.S. During his time here, he established bank and brokerage accounts in the U.S. Before retiring and relocating to his home country, he signed a U.S. will. The preamble on the first page of this will indicated that it covered only his U.S. assets. However, the Residuary Clause contained conflicting language, stating that he bequeathed all remaining property "wherever situated" to a specific group of relatives.

Following the conclusion of the European individual's life, his family in Europe informed us that, as a young man, he prepared a will in Europe that left his European property to a select group of relatives. Those excluded from the earlier European will now sought inclusion in the Residuary Clause of his subsequent U.S. will, which bequeathed "all his property wherever situated" to include them and his European property.

The disappointed relatives under the early European will and those who received specific bequests under the decedent's later U.S. will have already spent tens of thousands of dollars on legal fees. Despite the passing of more than two years from the date of the decedent's death, not a single cent of the U.S. funds has been distributed to any of the relatives. There is yet to be a discussion of compromise or settlement in the U.S., and we are unaware of such negotiations taking place in Europe.

Conclusion: Avoiding the Blunder

In conclusion, the case of misaligned covers and content in will drafting serves as a stark reminder: never judge a will by its cover. The discrepancy between the Preamble and the Residuary Clause can lead to legal battles and financial strain for heirs.

To prevent such blunders, it is imperative for attorneys and international clients to meticulously examine every aspect of the will. Mere statements on the cover, both back and front, asserting the limitation of the will to property in the U.S. are inadequate. Each sentence must align with the intended scope and jurisdiction of the estate. Remember, the true essence of a will is not in its cover but in its content – a lesson vital for preserving the integrity of estate planning in the global arena.