ESTATE AND WEALTH TAX PLANNING

EUROPEAN CLIENTS WITH U.S. ASSETS

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Agenda

- Overview of Estate and Gift Tax in the U.S.
- Planning Techniques
- Effect of U.S. Estate Tax Treaties

OVERVIEW OF ESTATE AND GIFT TAX IN THE U.S.

Estate and Gift Tax in the U.S.

- Imposed on global assets for:
  - U.S. citizens
  - Non-citizens having a U.S. domicile
- For others, imposed on U.S. situs assets only
- Imposed on the fair market value of a taxable transfer by gift during life or bequest at death
- Note: Gift of tangible or intangible asset is not treated as a deemed taxable sale followed by a taxable gift of cash
  - Recipient of gift takes a carryover basis, preserving income tax event for future sale

Estate and Gift Tax Rate

- 40% at Federal level
  - The first $1,000,000 of taxable value taxed at graduated rates totaling in $345,800.
- A benefit can be claimed for a portion of global expenses, debts, and losses
  - The portion of the global estate that is situated in the U.S. controls the portion that reduces the gross U.S. estate to a net estate
  - The deduction is 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.
- Additional tax may apply at the state level

U.S. Domicile

- Assessing subjective intention of an individual
- Green Card and temporary visas as a factor, not a conclusive fact

Domicile

≠ / =

U.S. tax resident for income tax

Estate Tax Based on U.S. Situs

- Taxable U.S. situs assets
  - Intangible assets as defined below
  - Tangible movable assets as defined below
  - Tangible immoveable assets / Real property

Gift Tax Based on U.S. Situs

- Taxable U.S. situs assets
  - Tangible movable assets as described below
  - Tangible immoveable assets / Real property
- Gift tax does not apply to intangible assets
  - Shares in co-op corporation accompanied by a proprietary lease
    - Popular in NYC residential buildings
    - Intangible or tangible?
  - Interests in partnership?
  - Check drawn against a U.S. bank or a wire from a U.S. bank
    - Is it a gift of “currency” or “gold reserves” located in the U.S.?
    - Alternatively, it is a gift of intangible in the form of a U.S. bank’s obligation?

U.S. Situs

- U.S. Situs assets
  - Real property located in the U.S.
  - Movable tangible assets such as works of art, jewelry, automobiles physically located in the U.S.
  - Interest in domestic corporations
  - Debt of a U.S. person or the U.S. government (exceptions apply)
  - Annuity contracts issued by a U.S. person

Non-U.S. Situs

- Non-U.S. Situs
  - Account balance in domestic U.S. banks and foreign branches of U.S. banks
  - Portfolio debt
    - Obligations that are publicly traded most likely will meet the requirements
  - Short-term O.I.D. obligations
  - Insurance proceeds on the life of a nonresident, non-citizen individual determined by reference to domicile ("N.R.N.C.")
  - Works of art on loan to a not-for-profit public gallery or museum in the U.S.

Situs of Partnership Interest – Unclear

- Partnership as an aggregate → apply look thru rule
  - Determine on an asset-by-asset basis within partnership
- Partnership as an entity → where is it located?
  - Place or places of doing business
  - Place of organization
- U.S. domestic L.L.C.'s with more than one single owner treated as partnerships
  - Single-owned L.L.C. is ignored
  - Entity classification election available
- Partnership debt held by third parties may reduce the value of partnership interest

Generation-Skipping Tax in the U.S.

- The Generation-Skipping Tax ("**G.S.T.**") applies on transfers that skip a generation
  - Example: Grandparents leave assets to grandchildren
  - Applies to direct transfers and transfers to trust to children, grandchildren, and possibly other descendants
- Applies in addition to estate tax / gift tax
- G.S.T. is applicable to a transfer by N.R.N.C. only if the transfer is subject to estate tax or gift tax
  - Gift of stock portfolio is not subject to U.S. gift tax
  - Consequently, gift of stock portfolio to grandchildren not subject to G.S.T.

Property Given Away During Life

- Property given away during life, may be included in a taxable estate at death, principally in the following circumstances
  - **Code §2035:**The property is given away "with strings attached" and the "string" is given away within 3 years of death; F.M.V. at death is included in estate and a credit is given for any gift tax paid;
  - **Code §2036:** The property is 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
  - **Code §2037:** The property is given away during life, but the recipient must survive the death of donor in order to enjoy possession of property
  - **Code §2038:** The property is transferred during life, but donor retains power to alter, amend, revoke, or terminate the transfer, thereby affecting the continued enjoyment of the property
  - **Code §2041:** Property over which the decedent has at the time of his death a general power of appointment

Estate and Gift Tax – Unified Credit

- U.S. citizens and domiciled individuals are eligible for a lifetime credit that excludes $11.4 million dollars of assets
  - Set to revert to $5 million (plus an inflation adjustment) in 2026
  - May be used for gifts during life or bequests at death
- An N.R.N.C. is entitled to a unified credit of $13,000
  - No tax imposed on the first $60,000 of value
  - Only available at death

Estate and Gift Tax – Marital Deduction

- N.R.N.C. bequeathing property at death to a U.S. citizen spouse is entitled to unlimited marital deduction
- U.S. citizen or domiciled resident individual bequeathing property to N.R.N.C. spouse
  - No unlimited marital deduction, but a bequest to a qualified domestic trust (“**Q-D.O.T.**”) for the benefit of surviving spouse accomplishes a comparable result – deferral of estate tax until assets are distributed
- N.R.N.C. couple owning jointly U.S. situs asset – the first to die is subject to estate tax and presumed to own the entire property
  - Can prove surviving spouse contributed funds to purchase
  - Can use Q-D.O.T. to defer tax until second to die
- Annual gifts to N.R.N.C. spouse are free of gift tax up to $155,000

EFFECT OF TREATIES

Effect of Treaties

- Estate Tax Treaties with Italy and Switzerland apply to U.S. Federal estate tax
  - Does not affect estate or inheritance taxes imposed by any State, Territory, or possession of the U.S.
- The treaties with Switzerland and Italy do not apply to U.S. gift tax (compare the German treaty)
- Major benefit is that unified credit (currently $11.4 million) is available to reduce estate and gift tax on U.S. situs assets on prorated basis
- No domicile “tie-breaker” rule (compare with German treaty)

Effect of Treaties

- Double taxation in Swiss and Italian situations handled by a credit system
- Credit is allowed for property situated in the other country and does not apply to properties located outside both countries
- The credit allowable cannot exceed the tax attributable to the property subject to tax

The Swiss Treaty

- Applies to estate tax imposed by the U.S. Federal government and to estate and inheritance taxes imposed by Swiss cantons and political subdivisions
- Situs rules under present U.S. tax law remain unchanged by the treaty

The Italian Treaty

- Applies to estate tax imposed by the U.S. Federal government and to estate and inheritance taxes imposed by Italy
- Situs of property addressed
  - But rules reiterate current domestic situs rules
  - Does not address situs of partnership interest

PLANNING TECHNIQUES

Planning Techniques – Pitfalls

- All plans require respect of structure to avoid sham / nominee treatment
  - Settlor should avoid dealing with trust or corporate assets as if settlor/shareholder owns them directly
  - Requirement to pay rent on corporate-owned apartment?
  - Adherence to procedures supports substance of structure
- Transferring U.S. real property to a corporation or partnership prior to gifting
  - Step transaction doctrine may cause steps to be ignored when purpose is simply to reduce tax due
- Gifting cash to child and selling real property to child
  - Goal is to convert gift tax at 40% of value to capital gain tax at 20% of gain
  - What are you out of pocket?

Planning Techniques – Pitfalls

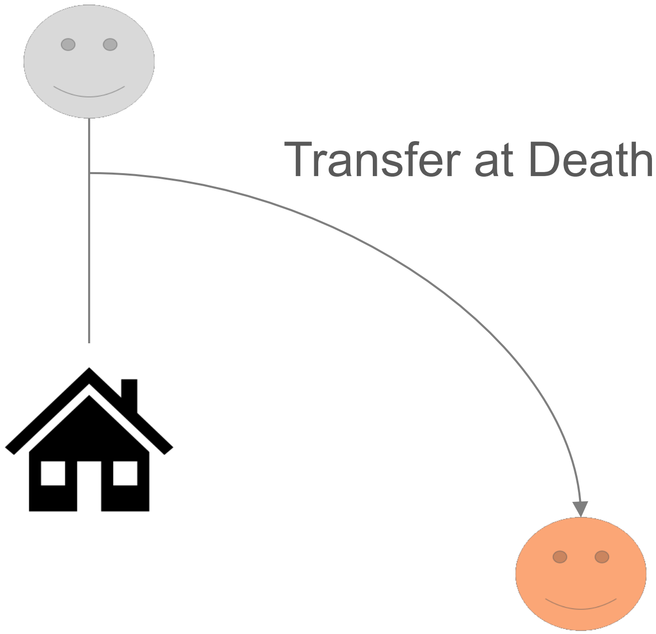
- Consider U.S. beneficiaries of N.R.N.C.
  - Transfer of property outright v. through use of structure
  - Unwind certain structures prior to transfer
  - Goals to consider:
    - Avoid imposing the property to gift, estate or G.S.T. tax by the beneficiary
    - Avoid causing beneficiary to own controlled foreign corporations ("**C.F.C.**") or passive foreign investment corporations ("**P.F.I.C.**")
    - Provide beneficiary with a tax-free step-up in basis to fair market value in shares received and in underlying assets
    - Be cognizant of anti-inversion rules in the U.S. which prevent a drop-down of shares into a non-U.S. corporation from changing situs of shares

Facts

- N.R.N.C.  owns a vacation house in Florida.
- His only son  is the sole heir.
- The property is worth $1,060,000 at the time of death.

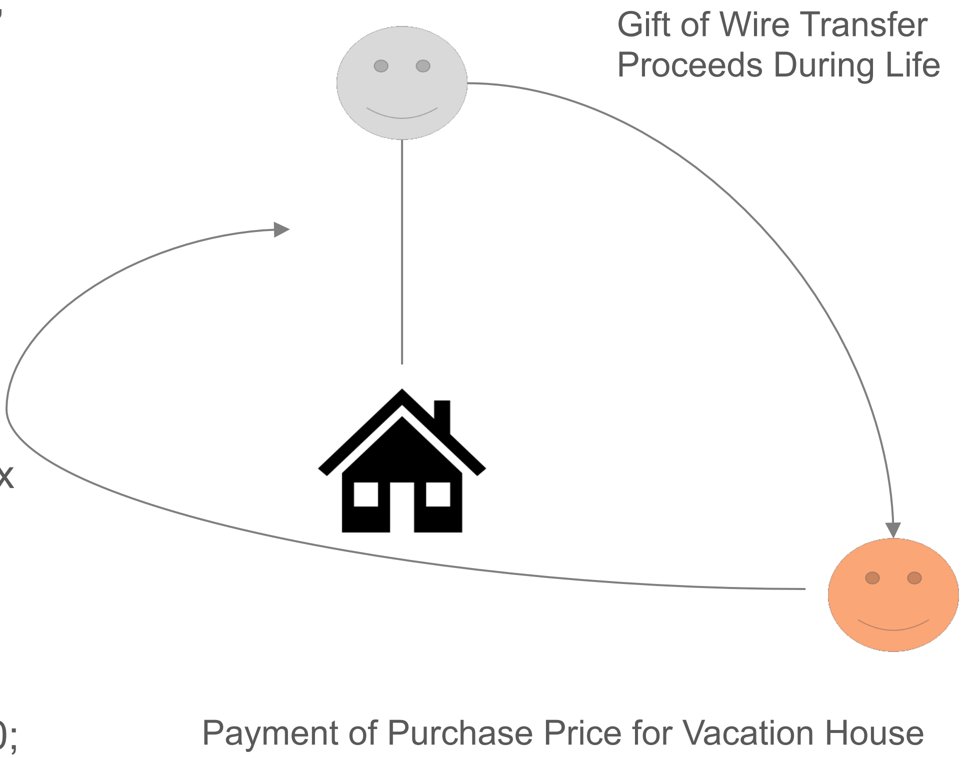
Results

- The vacation house is includible in taxable estate.
- In the absence of treaty and an estate tax return listing global assets, the estate tax is $345,800.
- New basis of $1,060,000 for son.



Facts

- Same facts as in first slide except that, to avoid inheritance tax, N.R.N.C. makes a gift to son of $1,100,000 and son purchases the property for $1,060,000.
- Assuming a zero basis, the U.S. Federal capital gains tax is $212,000.



Results

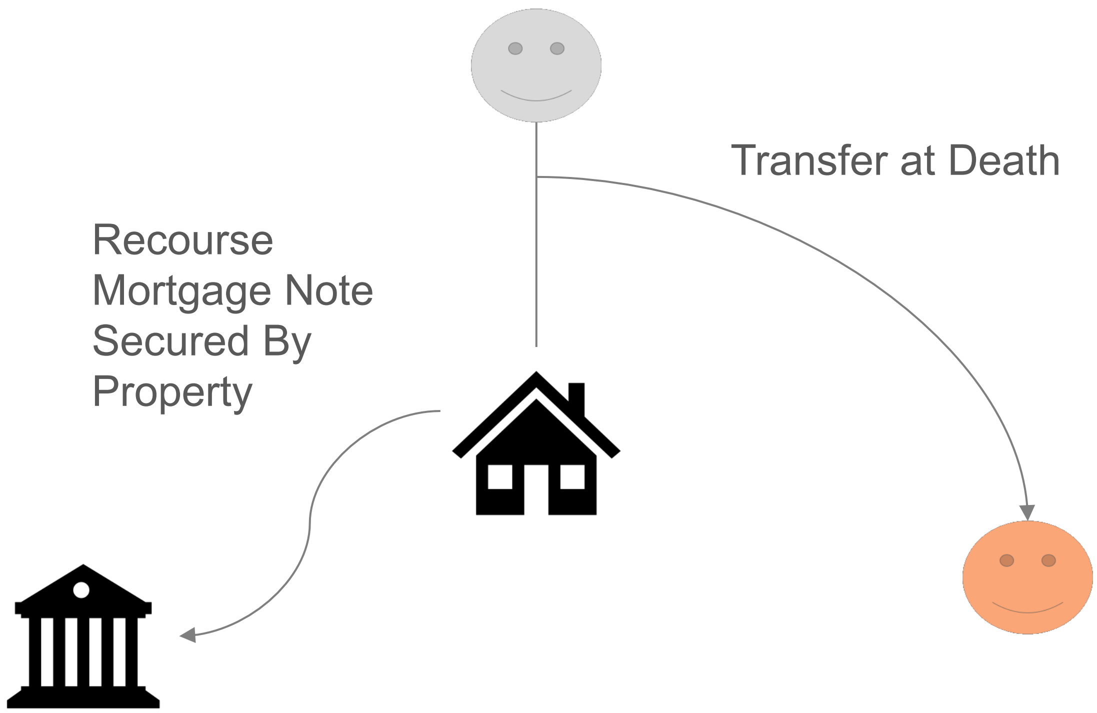
- The gift and sale are steps in an integrated plan, and as a result, the tax should be based on the substance of the entire transaction.
- Before the gift and the sale, N.R.N.C. owned the vacation house and $1,100,000; after the gift and the sale, N.R.N.C. continued to own $1,060,000; therefore, the property was given away in return for no consideration.
- Assuming no prior gifts were made by N.R.N.C. prior to this transaction, the gift tax is $345,800.
- Son has a carryover basis in property.

Facts

- Same facts as in first slide, except that a recourse mortgage of $200,000 is placed on Florida House to secure a borrowing by N.R.N.C.

Results

- The vacation house is includible in taxable estate.
- In the absence of treaty and an estate tax return listing global assets, the estate tax is $345,800.
- New basis of $1,060,000 for son.

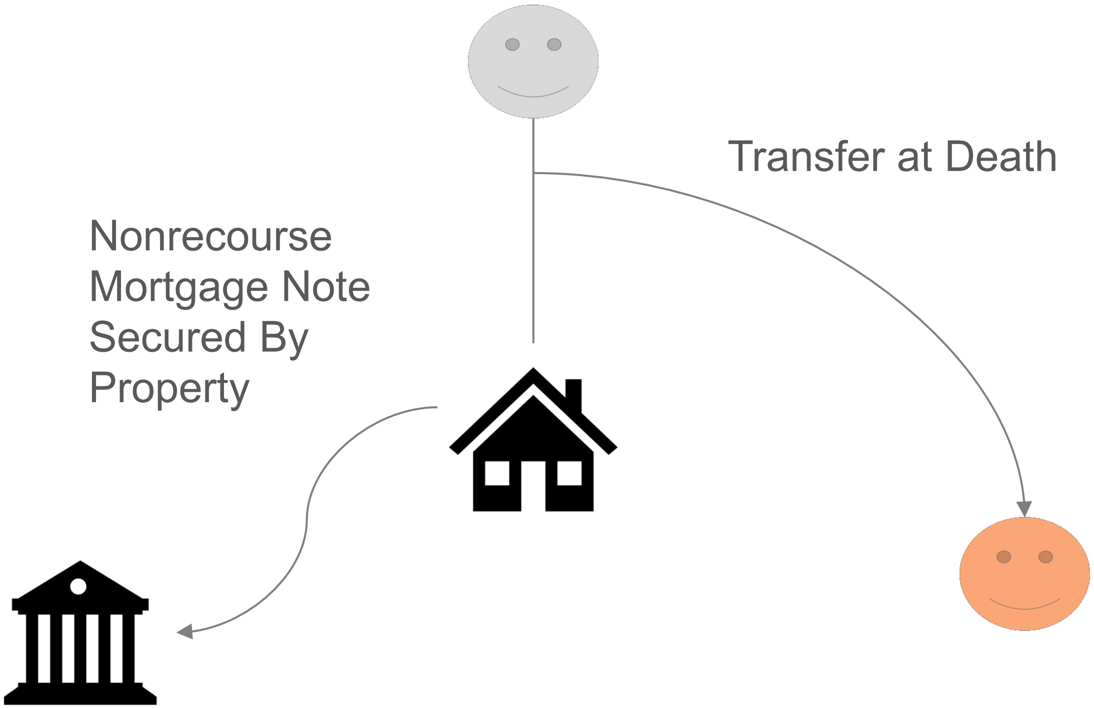


Facts

- Same facts as in prior slide except that a non-recourse mortgage of $200,000 is placed on Florida House to secure a borrowing by N.R.N.C.
- In the event of default, mortgage note holder can look only to the property for payment.

Results

- The vacation house is includible in taxable estate.
- In the absence of treaty and an estate tax return listing global assets, the estate tax is $267,800.
- New basis of $1,060,000 for son.

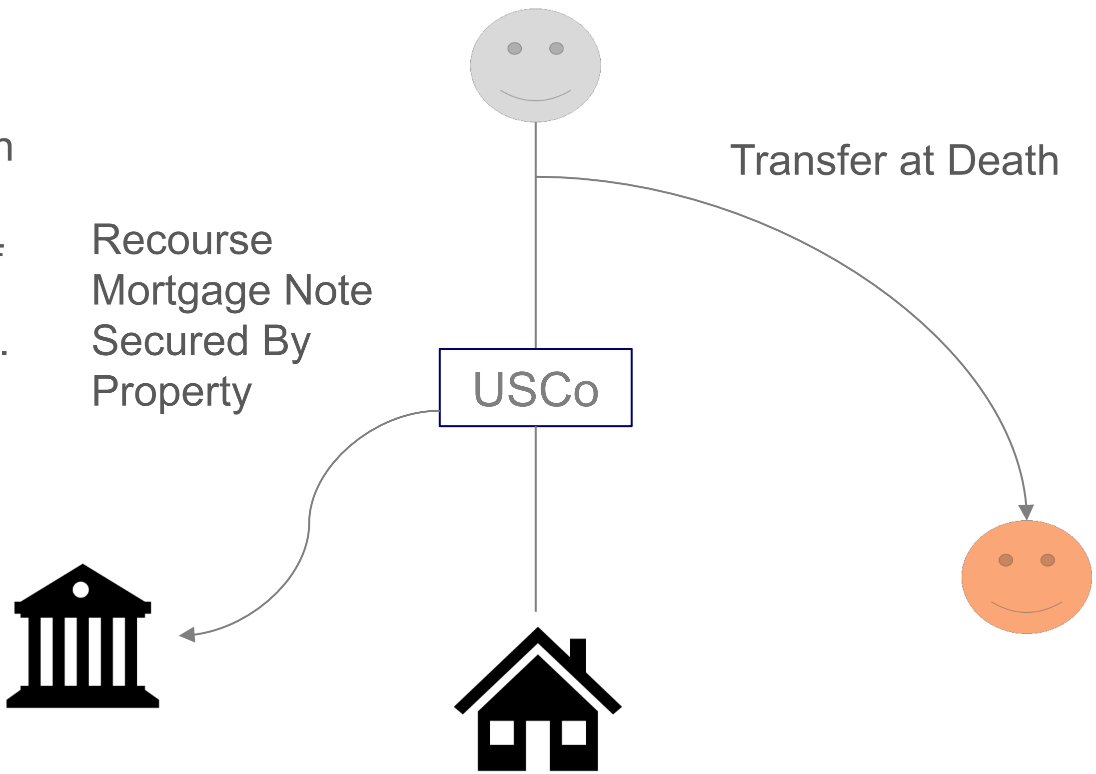


Facts

- Same facts as in first slide except that the N.R.N.C. individual borrows $200,000 secured by a full recourse mortgage of $200,000 placed on property
- N.R.N.C. transfers ownership of house to U.S. Corporation, but retains the proceeds of the loan.

Results

- The shares of USCo are includible in taxable estate at net F.M.V. of shares, *i.e.*, F.M.V. of assets less amount of debt inside USCo.
- In the absence of treaty and an estate tax return listing global assets, the estate tax is $267,800.
- New basis of $800,000 in shares
- USCo retains old basis in house.

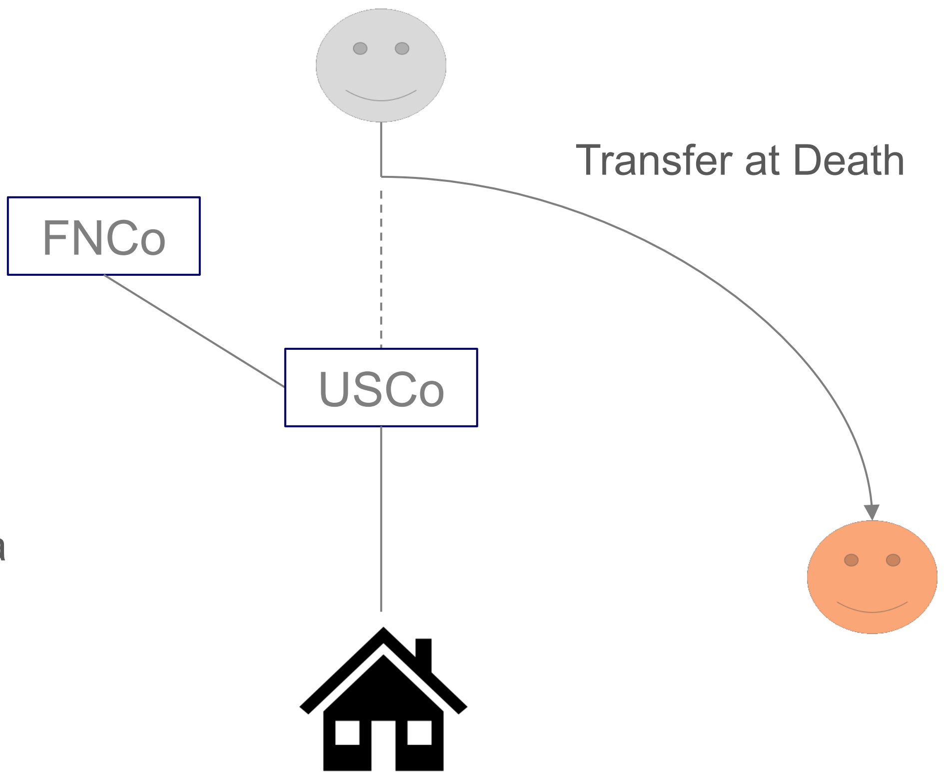


Facts

- Same facts as first slide except that N.R.N.C. formed USCo to acquire and hold vacation house.
- After the purchase, N.R.N.C. is advised that the shares of USCo will be subject to estate tax.
- N.R.N.C. transfers USCo to FNCo as a tax-free capital contribution.

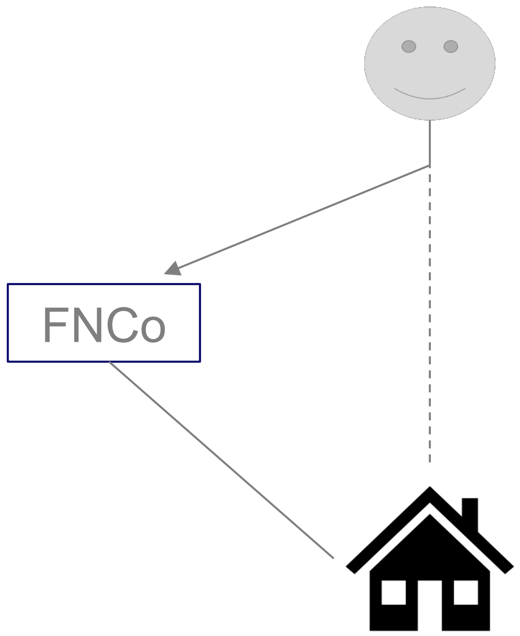
Results

- Transfer of USCo to FNCo is treated as an 80% inversion; as a result, FNCo is a treated as a surrogate U.S. corporation
- The transfer of USCo to FNCo is a tax-free transaction. F.I.R.P.T.A. tax is not due
- FNCo and USCo both must file U.S. income tax returns. No withholding tax on dividends from USCo to
- At death of N.R.N.C., U.S. estate tax is due.



Facts

- Same facts as first slide except that N.R.N.C. is advised that the ownership of the vacation home will be subject to estate tax and transfers the home to FNCo as a capital contribution
- FNCo is in the Cayman Islands



Results

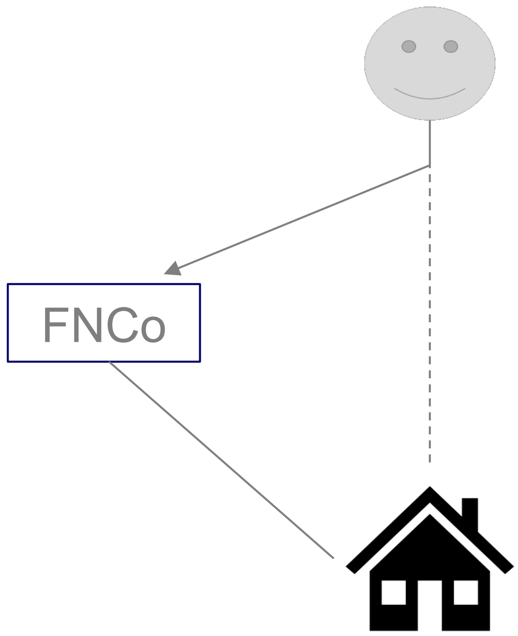
- The transfer to FNCo is taxable under F.I.R.P.T.A. tax
- At death of N.R.N.C., U.S. estate tax is not due.

Facts

- Same facts as prior slide except that FNCo qualifies for benefits under an applicable U.S. income tax treaty
- A Code §897(i) election is made to treat FNCo as a U.S. corporation for purposes of F.I.R.P.T.A., only

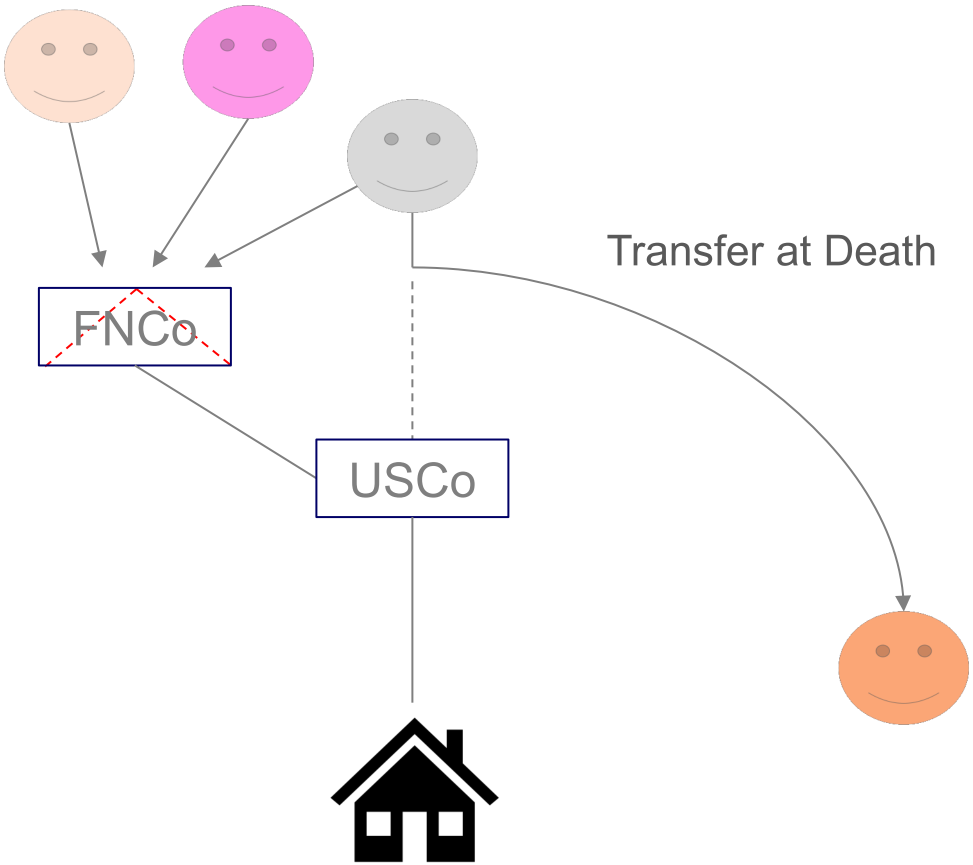
Results

- The transfer to FNCo is not taxable under F.I.R.P.T.A.
- If N.R.N.C. sells FNCo, U.S. tax will apply on the sale under F.I.R.P.T.A.
- At death of N.R.N.C., U.S. estate tax is not due.



Facts

- Same facts as in #6 except that N.R.N.C. joins with non-U.S. spouse and child to form FNCO.
- FNCo elects partnership treatment
- N.R.N.C. transfers USCo to FNCo as a capital contribution to partnership



Results

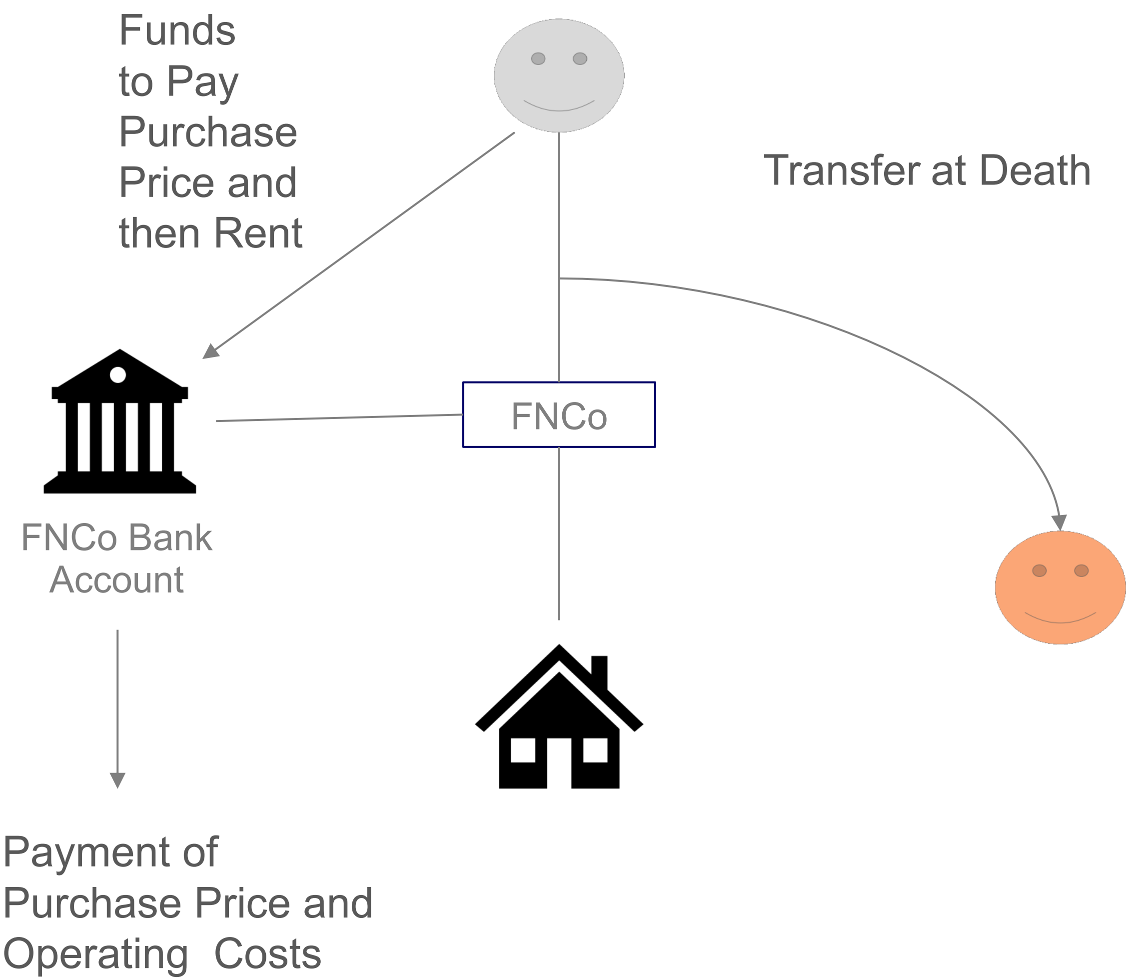
- Transfer of USCo to FNCo partnership is tax-free when all income and expense allocated based on capital accounts
- FNCo is treated as a domestic partnership under anti-inversion rules
- FNCo is engaged in no business any place in the world; it simply owns USCO shares
- Equity interest in FNCo partnership is not a U.S. situs asset under I.R.S. ruling (Rev. Rul. 55-701)
- At death of N.R.N.C., U.S. no estate tax is due

Facts

- Same facts as in #1 except that N.R.N.C. funds FNCo with capital to purchase residence. Funds are maintained in a FNCo account or an attorney trust account for the benefit of FNCo.
- FNCo charges N.R.N.C. an arm's length rent for use of premises and the proceeds fund payment of maintenance, operating costs, and taxes.
- All payments are made by FNCo's account.

Results

- FNCo must file U.S. income tax return and will pay 21% tax on net income and possible gains from the sales of property. Also, 30% branch profits tax is generally imposed on after-income tax earnings.
- At death of N.R.N.C., no U.S. estate tax is due.
- Son takes F.M.V. basis in shares of FNCo and FNCo retains old basis in house.

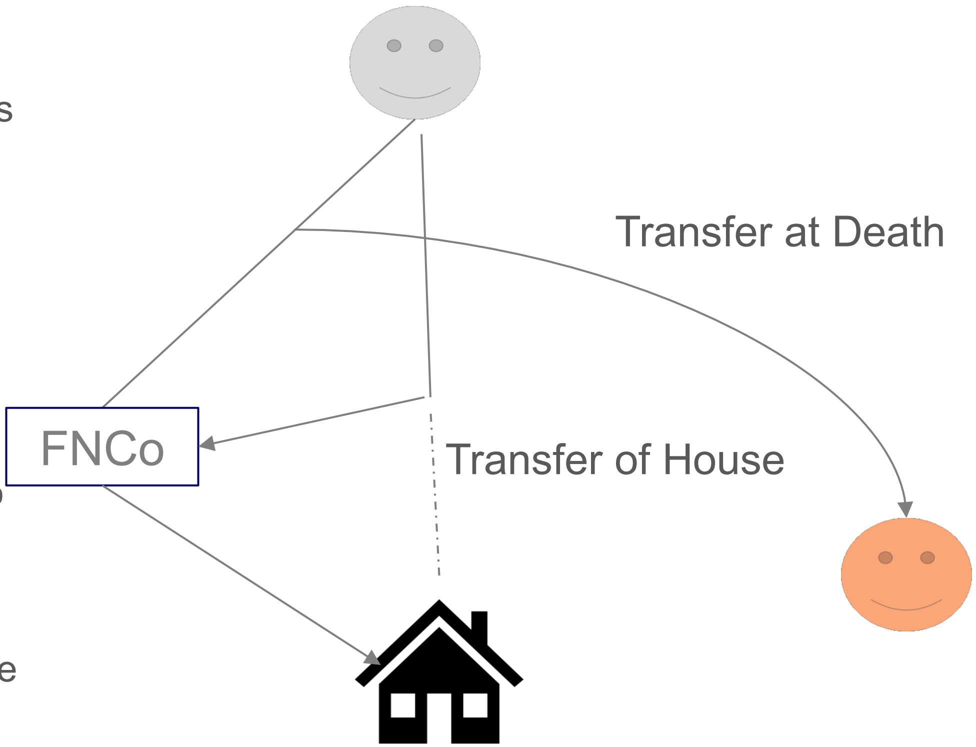


Facts

- Same facts as in first slide except that after owning property for a period of time, N.R.N.C. transfers property to a non-U.S. company as capital contribution.
- FNCo charges N.R.N.C. an arm's length rent for premises and uses rent proceeds to pay for maintenance, operating costs, and taxes.
- FNCo maintains its own bank account in the U.S. to receive rent and pay expenses.

Results

- The transaction is not an inversion as no U.S. corporation or partnership owned property prior to transaction.
- The transfer to FNCo is a taxable event under Code §897(e)(1). Tax is 20% of the gain and branch profits tax of 30%.
- The shares of FNCo are not subject to U.S. estate tax.
- Son takes new basis in shares; FNCo retains old basis in house.

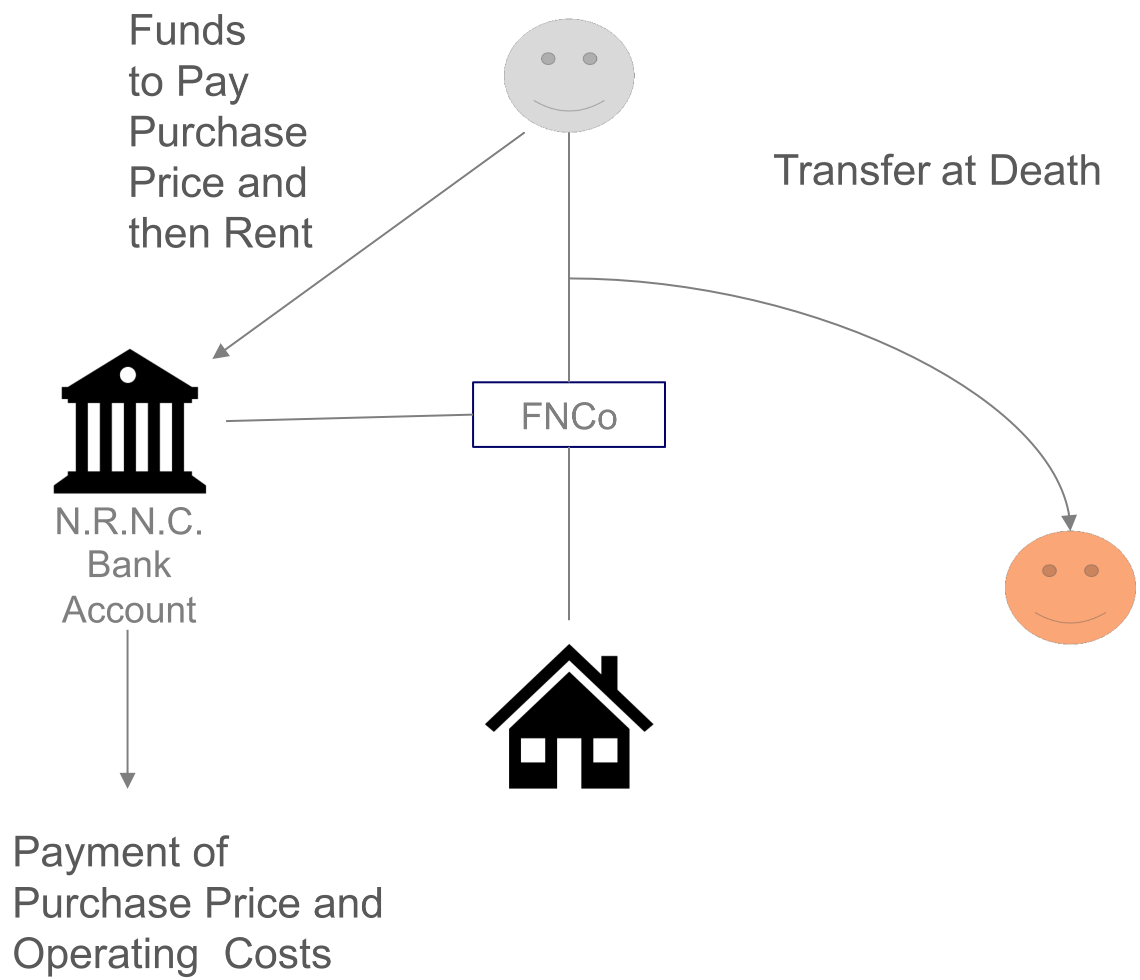


Facts

- Same facts as in the first slide except that FNCo purchases the house from an unrelated seller.
- N.R.N.C. advances the purchase price directly to closing agent for sale.
- N.R.N.C. pays no monthly rent and directly pays all operating costs of the house. FNCo’s tax return treats the payment of these expenses as payments of rent.

Results

- N.R.N.C. does not respect the structure established to block indirect ownership of the house from U.S. estate tax.
- FNCo may be viewed to be alter-ego of N.R.N.C.
- If so, estate tax is $345,800 in the absence of treaty and a listing of global assets.
- New basis of $1,060,000 for son.

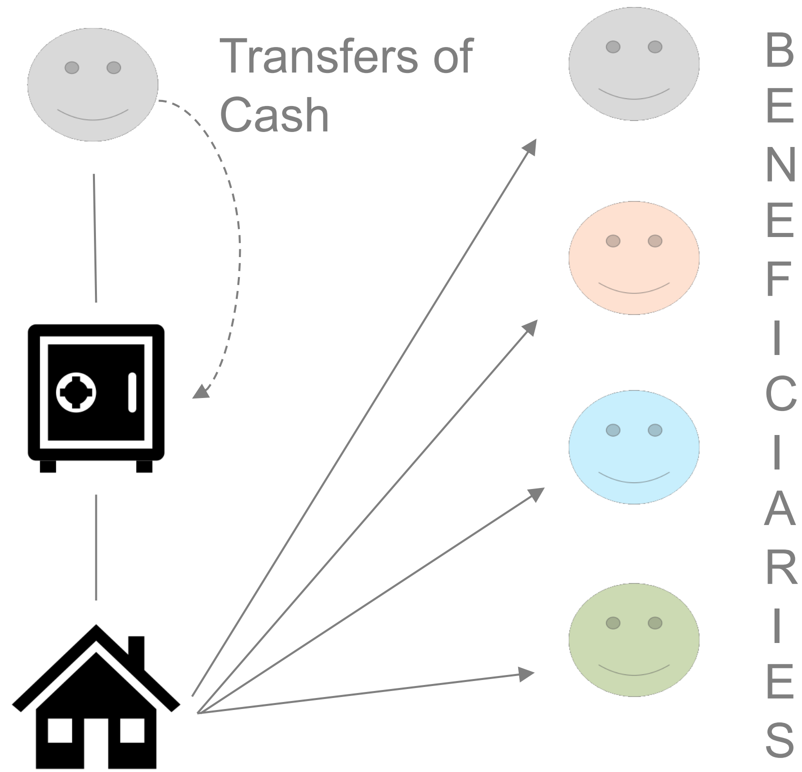


Facts

- N.R.N.C. forms a U.S. domestic trust with funds that are used to purchase a condominium for use by beneficiaries
- Annual operating costs are funded by earnings on endowment established for trust
- Beneficiaries are all non-U.S. members of the family and trustee is independent

Results

- No gift tax on the funding of the trust, but U.S. domestic trust must report the transfer on information return
- Assuming trustee or designee furnishes key to beneficiaries each time apartment is used, and all beneficiaries use apartment, no estate tax

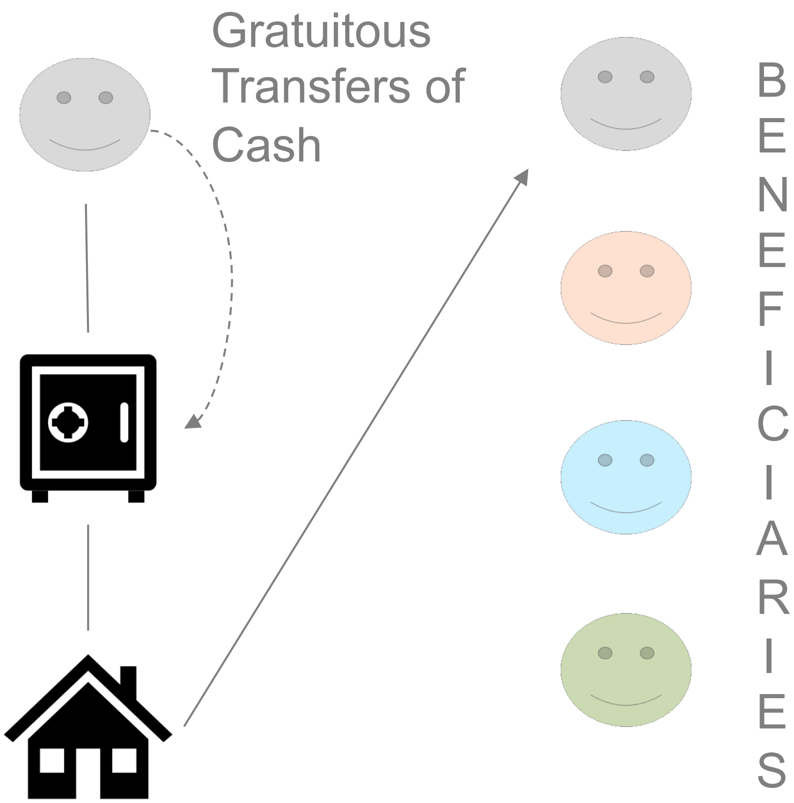


Facts

- N.R.N.C. forms a U.S. domestic trust with funds that are used to purchase a condominium for use by beneficiaries.
- Annual operating costs are funded by endowment established for trust.
- Beneficiaries are all non-U.S. members of the family and trustee is independent.
- N.R.N.C. is the only beneficiary that uses apartment.

Results

- No gift tax on the funding of the trust, but U.S. domestic trust must report the transfer on information return
- No income tax consequence for apartment used rent-free because trust is domestic and beneficiaries are N.R.N.C.'s
- Estate tax exposure exists because N.R.N.C. is sole user – suggests a right to use property

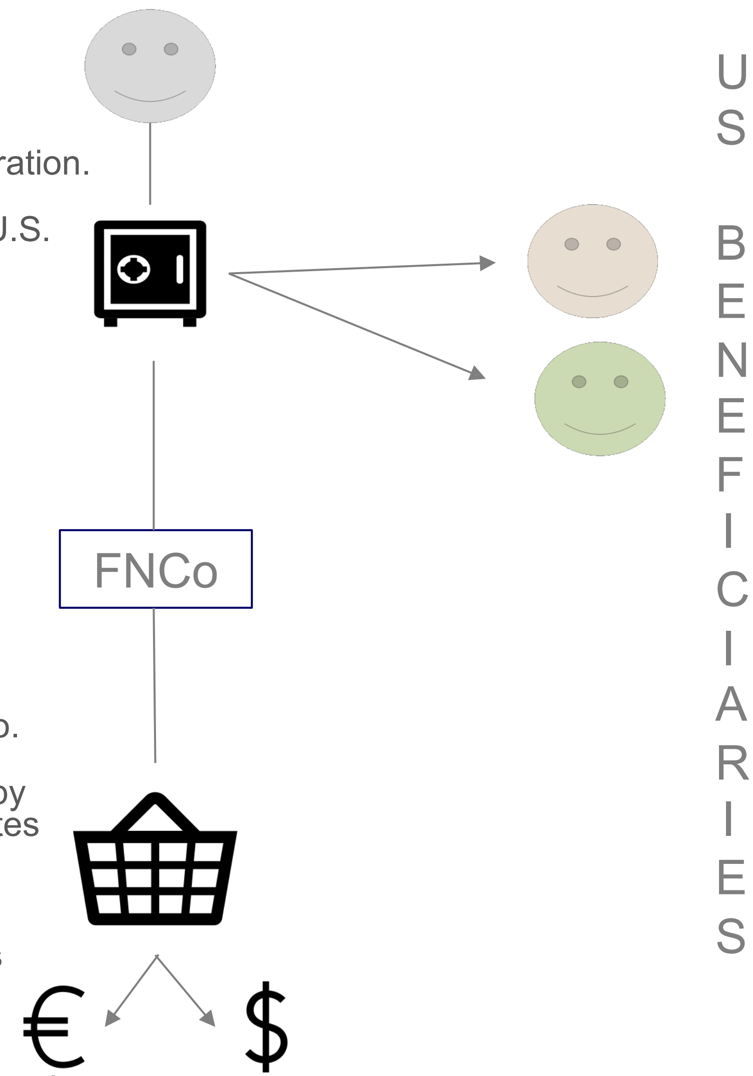


Facts

- N.R.N.C. establishes a revocable trust outside the U.S. The beneficiaries are her U.S.-resident children.
- Trust owns one asset: all the shares of FNCo, a non-U.S. corporation.
- FNCo owns a portfolio of publicly traded shares issued by non-U.S. and U.S. entities.
- N.R.N.C. dies.

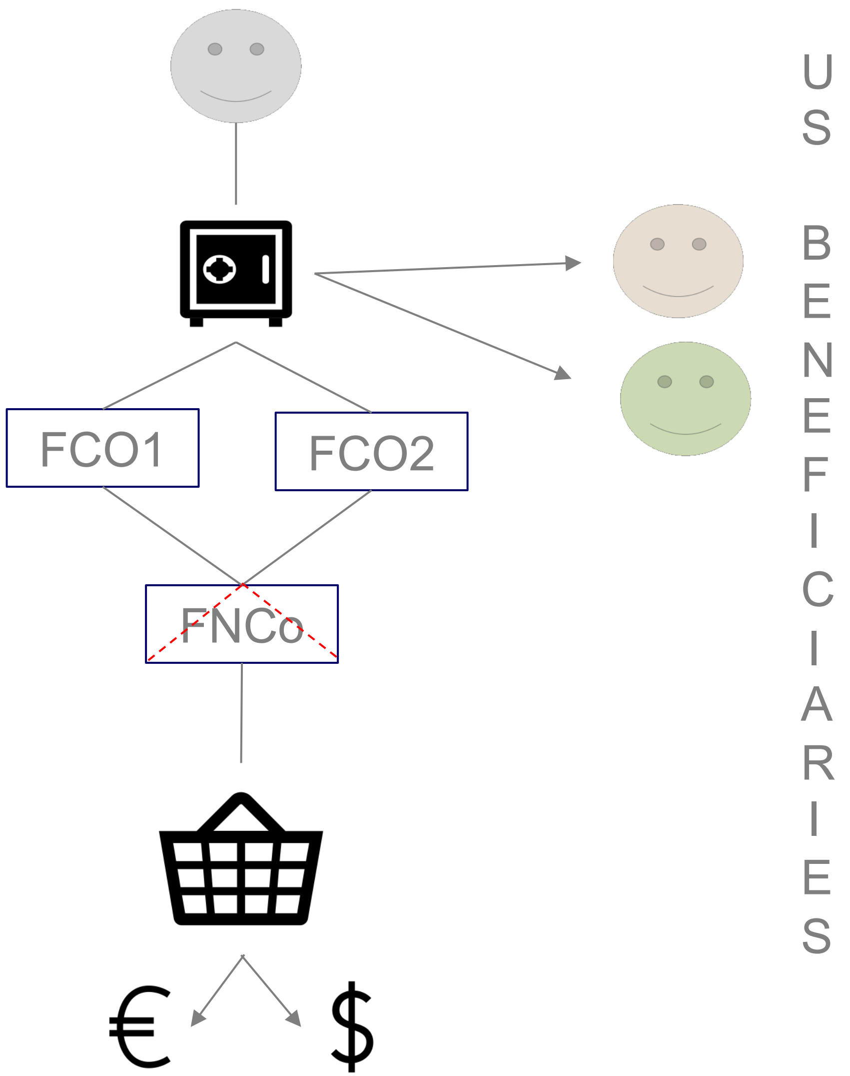
Results

- No U.S. estate tax.
- Because it is revocable, FNCo shares get a step-up in basis to F.M.V. once trust becomes irrevocable at death of N.R.N.C.
- FNCo becomes a C.F.C. at death of N.R.N.C.
- FNCo is NOT given a step-up at death in the basis of its portfolio.
- Once FNCo is a C.F.C., dividends received and gains received by FNCo are immediately taxed to U.S. beneficiaries at ordinary rates under Subpart F.
- If FNCo elects to be tax transparent effective after the date of death, FNCo is treated as if it were liquidated; U.S. beneficiaries are taxed as if the portfolio were sold; and net earnings are treated as ordinary income under Subpart F.
- Previously taxed income account is created to prevent double taxation in U.S. whenever actual distributions are received.



Facts

- Same facts as in preceding slide, except that:
  - Trust owns two non-U.S. corporations – FCO1 and FCO2.
  - The only assets of FCO1 consist of more than 20% of shares of FNCo, but less than 80%.
  - The only assets of FCO2 consist of the balance of the FNCo shares.
- Within 75 days after the death of N.R.N.C., Trustee elects to treat FNCo as tax transparent, effective on or before the date of death.

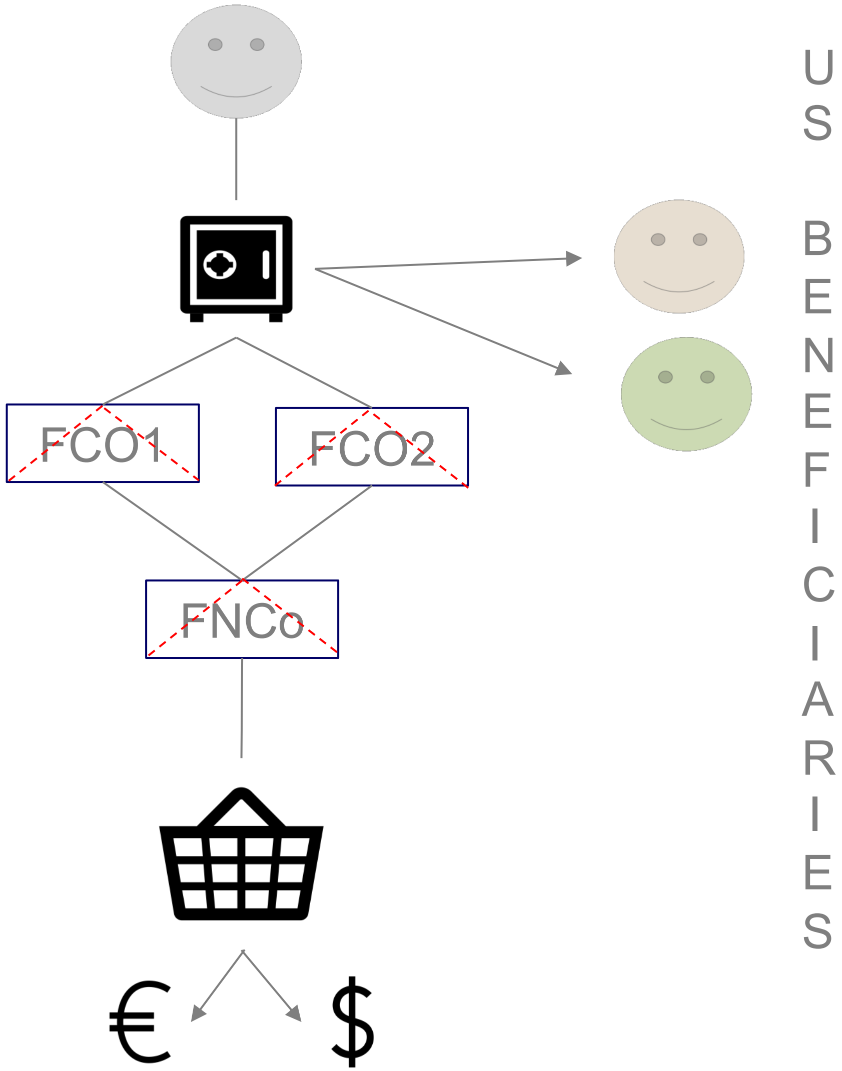


Results

- No U.S. estate tax
- Because trust is revocable, the shares of FCO1 and FCO2 are given a step-up in basis when the trust becomes irrevocable at the death of N.R.N.C.
- Because an election is made for FNCo to be tax transparent FNCo is treated as if it were liquidated for U.S. income tax purposes; the deemed liquidation is tax-free because it occurs prior to the date of death.
- FCO1 and FCO2 are given a F.M.V. basis in the respective portions of the portfolio each receives.

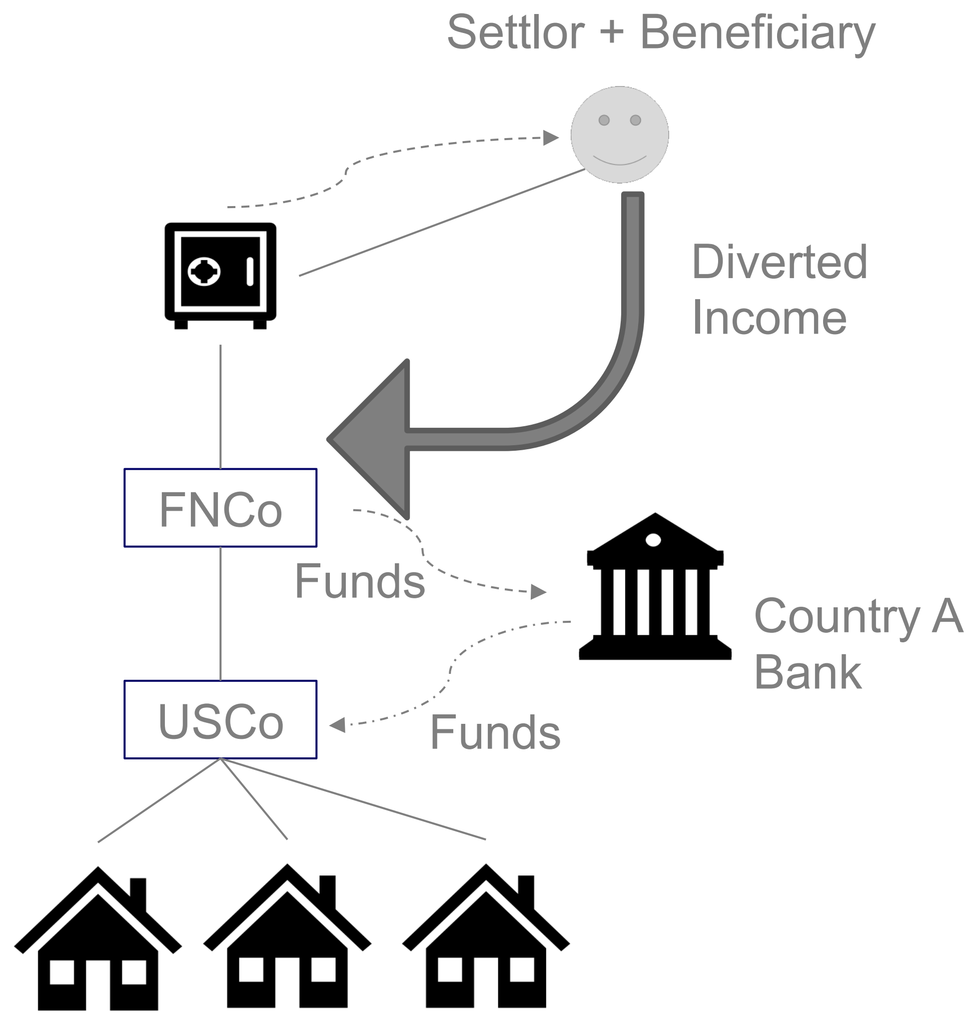
Results (Continued)

- If FCO1 and FCO 2 elect to be treated as tax transparent, those corporations are deemed to be liquidated
- If the liquidation occurs at a point in time after the effective date of the liquidation of FNCo, little or no gain is recognized by FCO1 and FCO2 and little or no gain is recognized at the level of the Trust
- No C.F.C.'s are deemed to exist after the steps are completed
- The net result for U.S. tax purposes affecting the U.S. beneficiaries is that the Trust is given a F.M.V. basis in the investment portfolio with little or no gain recognized for U.S. purposes
- Dividends and gains realized by the foreign trust can be distributed on a current basis to the U.S. beneficiaries at favorable tax rates



Facts

- Mr. X is a resident and a citizen of Country A, a member of the E.U.
- For years, Mr. X was the settlor and beneficiary of a foreign trust that owned FNCo, a company formed and resident in an offshore jurisdiction
- Mr. X's ownership of FNCo was not reported to the Country A tax authorities
- Mr. X used FNCo to receive certain income that was not reported to Country A tax authorities
- Once funds were built-up in FNCo, formed USCo, a U.S. corporation that acquired and owned a portfolio of U.S. real property
- All funds invested in the U.S. originated in a bank account owned by FNCo



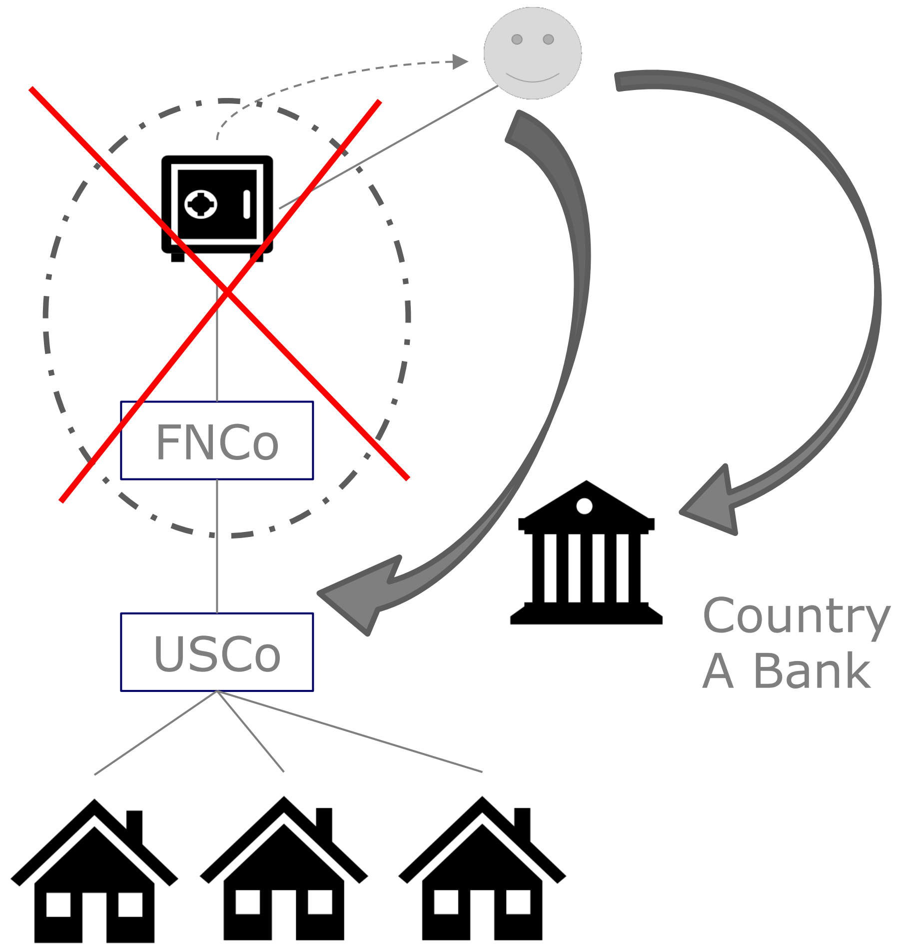
Facts (Continued)

- Country X adopted a voluntary disclosure program that provided amnesty for those with undeclared income diverted to foreign bank accounts and resulting money laundering
- Mr. X participated and made full disclosure of his beneficial ownership of FNCo and the diversion of income
- In his submission, he stated that under guidelines published by the tax authorities, Company A was deemed to be an interposed artificial entity and he should be viewed to be the owner of the assets of FNCo for purposes of Country X tax
- Mr. X dies before winding up FNCo
- Under the estate tax treaty between Country X and the U.S., shares of stock of a U.S. corporation are considered to be U.S. situs assets and the U.S. is entitled to impose estate tax

Query

- For U.S. estate tax purposes, is Mr. X considered to be the owner of USCo or is FNCo the owner of USCo?

View Under Country X Law



Important Notice

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