ACTEC 2012 Fall Meeting Musings

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Items 1-11 are observations from a panel discussion by The Honorable Maurice B. Foley (United States Tax Court Judge), James F. Hogan (Chief, Branch 4 [Estate and Gift Taxes] of the Internal Revenue Service Associate Chief Counsel [Passthroughs and Special Industries]), and moderated by Stephanie Loomis-Price: Practice Made Perfect-Lessons From the Tax Court, Judiciary, the IRS, and Private Practice.

Items 12-19 summarize comments by Ronald D. Aucutt, James F. Hogan, and Gordon Clay (Legislation Counsel, Staff of the Joint Committee on Taxation): The Role for ACTEC in Improving Federal Tax Laws. The Panel also discusses the roles of the Department of Treasury Office of Tax Policy, the IRS, and the Joint Committee on Taxation in legislative matters and in providing guidance regarding tax issues.

Items 20-22 are observations from a panel discussion by Ronald D. Aucutt, Beth Shapiro Kaufman, and Diana S.C. Zeydel: Dealing with the Continued Uncertainty of the Tax Law.

Items 23-35 are observations from a presentation by Ellen K. Harrison and Michael G. Pfeifer: Top Ten Things You Need to Know When There is Something Foreign in Your Estate Plan. This was an in-depth discussion of tax planning issues involving foreigners or foreign trusts.

Items 36-42 summarize observations from a panel by Leigh-Alexandra Basha and Joshua S. Rubenstein: Impact of Matrimonial and Other Property Regimes on International Estate Planning

Items 43-46 summarize observations from a panel by Michelle B. Graham (discussing Mexico), Carlyn S. McCaffrey (discussing the United States), and Clare Maurice (discussing the United Kingdom): How to Own Your Foreign Home — Tax Planning for the Foreign Real Estate Investor. This addresses the income and transfer tax issues that are faced by non-resident owners of real estate, principally in Mexico, the United States, and the United Kingdom

Item 47 is a compilation of various interesting quotations from the various seminars.

Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Introduction

Some of my observations from the 2012 ACTEC Fall Meeting Seminars in Washington, D.C. on October 19-20, 2012 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues.

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1. Internal Revenue Service Chief Counsel

"The Chief Counsel for the Internal Revenue Service provides advice to the IRS Commissioner on all matters pertaining to the interpretation, administration and enforcement of the Internal Revenue laws, represents the IRS in litigation, and provides all other legal support needed by the IRS to carry out its mission of serving America's taxpayers." Internal Revenue Manual, § 1.1.6.1.

Some of the functions of the Chief Counsel office include:

- Preparing legislative proposals, regulations, revenue rulings and procedures, actions on decisions, and other items of public guidance and legal advice, in coordination with the Treasury Department and other government agencies;
- Coordinating with the IRS and Department of Justice regarding the IRS position in litigation to ensure that the various divisions are taking consistent and appropriate technical positions;
- Making recommendations concerning defense, settlement, appeal, or *certiorari*;
- Reviewing, coordinating and processing pleadings, briefs, settlement documents, and notices of appeal;
- Developing policy, procedure, directives, and Chief Counsel Notices;
- Issuing technical advice on questions raised by IRS personnel;
- Reviewing forms, publications, and instructions; and
- Issuing letter rulings and general technical information in response to requests from taxpayers.

There is an Associate Chief Counsel for various substantive areas, including (among others) Corporate, Finance & Management, Financial Institutions & Products, International, Procedure & Administration, and Passthroughs & Special Industries. The Passthroughs and Special Industries group is broken down into various branches including Branch 4 that deals with the estate and gift tax.

2. Branch 4: Estate and Gfit Tax

Branch 4 handles estate and gift tax matters. There are 14 attorneys including Branch Chief, James Hogan. (Prior Branch 4 chiefs included Richard Grosgebauer and George Masnik.) The following topics address services provided by Branch 4.

3. Litigation Support

Litigation support is provided by either the IRS (in Tax Court proceedings) or the Department of Justice (in District Court or Federal Court of Claims proceedings).

The national office will also provide litigation support depending on the needs of attorneys in the field. Field attorneys are given a great deal of latitude and are not always required to coordinate with the national office. However, attorneys in Branch 4 can provide support in reviewing briefs, statutory notices, etc.

For district court proceedings, a field attorney writes the defense letter, which is reviewed by the national office and forwarded to the Department of Justice attorney handling the case.

4. Appeals

If the IRS loses a case, the field representative makes appeal recommendations, and the national office writes its own appeal recommendation. The field agents almost always want to appeal. The national office provides a more contemplative determination of whether or not to appeal.

If the decision is made to appeal a case, a Notice of Appeal is timely filed in the case. (The Notice of Appeal in a Tax Court case must be filed within 90 days after the decision is entered. §7483.) Filing the Notice of Appeal gives the government more time to determine whether to proceed with the appeal. Eventually the appeals court will set a briefing schedule, and the government must file its brief in a timely fashion to proceed with the appeal. If the government decides not to proceed with the appeal, it will typically file a dismissal with prejudice with the Tax Court.

For example, in *Wandry v. Commissioner,* T.C. Memo 2012-88, the Tax Court decision was published March 26, 2012, and the decision was entered June 6, 2012 (making the deadline for filing a Notice of Appeal on September 4). The IRS filed the Notice of Appeal on August 28, 2012. When the briefing schedule was set by the 10th Circuit Court of Appeals, the government's brief was due on November 7, 2012. The government filed a voluntary dismissal with prejudice on October 17, 2012.

For an appeal from a district court or court of claims case, the IRS Chief Counsel forwards a recommendation to the Justice Department, but the Solicitor General makes a final decision as to whether to appeal the case.

There are not many estate and gift tax cases for which the national office of the IRS recommends an appeal. Many cases are fact oriented and difficult to appeal.

If there is an IRS loss at the court of appeals level, the national office makes a determination of whether to seek *certiorari* from the U.S. Supreme Court.

5. Audit Examinations

Field agents can contact the national office to discuss issues. One option for advice from the Chief Counsel office is a CCA (Chief Counsel Advice). (For example, CCA 201208026 regarding whether a retained testamentary power of appointment causes a gift to a trust to be an incomplete gift has received a great deal of attention.)

6. Technical Advice Memorandum

Both the IRS field agent and the taxpayer are involved in requesting a legal opinion regarding an audit issue. Both the taxpayer and field agent agree on the facts before the national office gives an opinion in a Technical Advice Memorandum regarding the application of the law to the facts.

7. Private Letter Rulings

Branch 4 considered 150 PLRs over the last year.

The IRS will not issue a PLR on hypothetical fact scenarios or on factual determinations.

It is possible to call an attorney in Branch 4 to discuss a case before the formal ruling request is submitted. The decision of whether to have pre-submission conferences is handled by each branch separately. The Branch 4 attorneys will look at it if they have time. The taxpayer's attorney can call Jim Hogan directly.

Rulings requests must comply with all requirements in the checklists and appendix to the Revenue Procedure on ruling requests that is issued at the beginning of every year. All of the required questions must be answered seriously and objectively. A full legal analysis of the issue must be included. If the request does not provide sufficient information, the IRS can request supplemental information to provide a complete analysis. Twenty-one days is provided and if the IRS does not receive the complete information within that time, it can dismiss the ruling request and keep the filing fee. (Mr. Hogan indicated that he has never had to do that. He observes that the estate and gift tax group tends to involve wealthier Americans who generally are represented by better attorneys.)

When the ruling request is submitted, it must include a power of attorney and a check in the amount of the filing fee. If an estate and gift tax ruling is sought, the first page of the ruling request should say that the request is for the estate and gift tax group and should list the Code sections involved. Clerks (not attorneys) route the requests among the branches of the Chief Counsel office.

The taxpayer should receive a call from the attorney to whom the request is assigned within 21 days of the assignment. Rulings requests are processed within 6 months.

Two attorneys must sign off on PLRs. (Jim Hogan will be one of those two for estate and gift tax rulings.) The PLR binds the IRS as to that taxpayer.

An attorney for an individual who may be impacted by a PLR (such as the beneficiary of an estate), but who is not representing the taxpayer making the request, has no standing to discuss the ruling request with the IRS. The IRS is authorized to speak about the ruling request only with persons listed on the power of attorney filed with the ruling request. However, if the IRS realizes that there is a disagreement among the parties or ongoing litigation regarding the issue, it likely will not rule.

8. Tax Court Judge Maurice Foley

Judge Foley began his career with the Department of Treasury in 1985, and soon became involved in writing the GST regulations to the 1986 GST statutory provisions. He subsequently worked on the Senate Finance Committee staff for five years and later moved back to the Treasury Department to work on legislative drafting projects. He was appointed to the Tax Court by President Clinton 17 years ago.

9. Assignment of Tax Court Cases Among Judges

Tax Court cases are not assigned based on the technical expertise of the respective judges. The court has Spring, Fall, and Winter sessions. Six months before a session begins, the judges are asked for their preferences for city assignments, and the Chief Judge makes city assignments. At that point, the calendar is still being assembled, and there is no way to know whether estate or gift tax cases will be on the calendar for a particular city. (There are also special sessions when a case will last for a week or more. The taxpayer can request that a particular judge be assigned to the case, but assignments for special sessions are not based on substantive experience in the area.) Special sessions are generally for one or two weeks.

10. Streamlined Tax Court Procedures

Tax Court trials are often only 2-3 hours. Only rarely does a case last multiple days, but every year Judge Foley has several cases that last several days. The Tax Court has strict rules regarding stipulations and joint exhibits so that the court only considers issues that cannot be stipulated by the parties. The judges have discretion as to how to encourage stipulations.

Judge Foley requires pre-trial memos setting forth the positions, the law, witnesses, and the type of testimony expected from each witness. Judge Foley analyzes the memos and has a pre-trial conference with the parties. He is very candid in dealing with counsel, points out areas where the arguments are weak, and forces the parties to realistically assess their chances of success. That process narrows the issues to those that are the most significant and leads to many settlements.

Judge Foley also imposes a page limitation on briefs. Stephanie points out that those page limitations can be "painful," but Judge Foley says that it forces attorneys to be selective and narrow the issues. On occasion, Judge Foley may request the parties to address further an issue that was not addressed adequately in the initial briefs or to address the impact of a new case.

Judge Foley is very interactive in trials. If he has a question, he asks it. Some of the judges are more deferential than others to the attorneys in the case, but Judge Foley does not hesitate to get to the questions he thinks are important. He is very candid with counsel even during the course of the trial so that the attorneys are not guessing what he is concerned about. He wants to keep the attorneys focused on the primary issues.

Judge Foley allows opening and closing statements. He wants each side to say in their closing statements what they think they have established so that the opponents can respond to that in their post-trial briefs. That approach enables the judge to write a better opinion.

Judge Foley's pet peeves are (1) attorneys who do not listen (for example, spending their time at trial going down paths the judge has already told them are weak arguments) and (2) poorly written briefs that do not have an orderly discussion of the law and facts.

11. Types of Tax Court Opinions

There are three types of Tax Court opinions: (1) memorandum opinions; (2) "regular" opinions; and (3) "reviewed" opinions. After the trial judge writes an opinion, it is sent to the chief judge of the Tax Court for coordination purposes. *See* §7460. For example, the chief judge may know that another judge is writing an opinion on a similar issue.The chief judge makes an initial determination whether the case will be issued as a memorandum opinion, regular opinion or reviewed opinion.

A memorandum opinion is an opinion of the one judge that writes the opinion. Generally, memorandum opinions are used for cases where the law is settled. Memorandum opinions apply settled law to the facts and have less precedential value than the other two types of opinions. Indeed, at one time, the "rule" was that memorandum opinions could not be cited as precedent in other Tax Court cases. However, that is no longer the case, and Tax Court cases now sometime cite memorandum opinions.

A "reviewed" opinion is one that says "Reviewed by the Court" at the end of the opinion. It is has the strongest precedential effect of the three types of Tax Court opinions. Reviewed opinions can have majority, dissenting, and concurring opinions. Few Tax Court cases are reviewed opinions. A "regular" opinion is also an opinion of the full court, but it carries less weight than a reviewed opinion.

After the chief judge has made a determination and is ready to publish a case, the case is sent to all other Tax Court judges, who can give comments to the chief judge that may impact the decision as to how the opinion will be issued. At one time, the case was sent to all judges early in the morning, and the chief judge could release the case that afternoon, taking into consideration any comments that the chief judge may have received from other judges. Judge Foley reported that the process has now been changed so that the case is sent several days before the opinion will be released, allowing more time for judges to review the opinion and give comments to the chief judge.

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12. ACTEC Approach to Governmental Relations Issues

The ACTEC bylaws affirm that one of ACTEC's purposes is "[t]o improve and reform probate, trust and tax laws, procedures and professional responsibility."

A 1996 Statement of Policy on Governmental Relations emphasizes a distinction between technical expertise and political objectives. The guiding principle is that ACTEC does not take positions on political objectives. The following subsidiary principles in the 1996 Statement provide some guidance in applying a dividing line between technical and political comments.

- The College may comment on how best to achieve a particular political objective but not whether it approves the objective;
- The College may comment that a regulation, ruling, or decision reflects a political objective that does not have a basis in a statute or in the legislative history of a statute; and
- The College will not comment about tax rates, but aspects of rates that have implications for complexity are appropriate subjects for comment (giving the example that the income tax rates for trusts may impact the extent to which deferral strategies are used causing the necessity of complex rules [i.e., the throwback rules] to avoid abuse).

For example, ACTEC does not lobby for or against repeal of the estate tax but does respond to technical issues that must be addressed.

Corollary principles in the 1996 Statement include that there be "thoughtful and measured deliberation," meaning that comments should not just reflect the views of a few but should be collegial and reflect the views of many within ACTEC. In addition, the College should conserve its resources by limiting its comments to subjects about which it can make a significant technical contribution.

The purpose of governmental submissions is to improve the law, not to improve the lot of ACTEC Fellows or their clients.

The President of ACTEC approves governmental submissions and submits them on behalf of ACTEC.

The ACTEC Washington Affairs Committee was established in 2010. The current members are Ron Aucutt, Ed Beckwith, Ellen Harrison, and Beth Kaufman. Review of submissions by the Committee is mainly to enforce the ACTEC balanced approach of providing quality technical comments under the guidelines described above.

13. Department of Treasury, Office of Tax Policy

Catherine Hughes is the Attorney-Advisor of the Office of Tax Policy, Department of the Treasury. The Office of Tax Policy serves various functions:

- Developing and implementing tax policies and programs;
- Providing the official revenue estimates of all Government receipts for the President's budget, fiscal policy decisions, and Treasury cash management decisions;
- Establishing policy criteria reflected in regulations and rulings and guiding their preparation with the Internal Revenue Service;
- Negotiating tax treaties for the United States; and
- Providing economic and legal policy analysis for domestic and international tax policy decisions.

The Office of Tax Policy works with congressional staffs regarding legislative items.

The Office also works on the budget each year in assembling the President's "wish list" of proposals.

The Office works with the IRS Chief Counsel regarding guidance projects. Jim Hogan confirmed that Jim (as the reviewer), an attorney in his Branch 4, and a Treasury attorney work together on guidance projects (revenue rulings, guidance, notices, etc.)

Relationship of Treasury and IRS. The Treasury is not permitted to get involved in any individual taxpayer matters, such as litigation, PLRs, TAMs, or GCMs. The only exception is if the IRS is working on a ruling and realizes that a policy issue must be decided. In that case, Treasury would decide the policy issue without knowing the facts of the particular case being addressed. Jim Hogan coordinates closely with Cathy Hughes on guidance projects from the outset because he knows the project ultimately will have to be approved by Treasury.

The IRS is not very involved in legislative matters, leaving those to the Treasury. The IRS role is the implementation and enforcement of statutes and regulations, and not the development of legislation.

14. Joint Committee on Taxation

The Joint Committee on Taxation is a Congressional committee. It is comprised of members of the Senate Finance and House Ways and Means Committees. Most of the Committee's work is done by a staff of 18 attorneys and 20-22 economists. The staff is nonpartisan. The Committee will not hire persons with strong political backgrounds and rarely hires persons from any political staff.

The Committee's activities include the following:

- Involvement in all stages of legislative development;
- Publishing background documents before committee hearings; and
- Drafting all legislative history, including Committee Reports, Committee markups, and Conference Committee Reports (though it is now rare for a bill to go to a Conference Committee).

The Committee operates with political staffs on a confidential basis. It may be working with both Republican and Democratic staff members at the same time on legislative proposals, without disclosing their activities to the other staffs. Similarly, the Committee does not disclose to

Treasury about work that it has discussed with political staffs. For example, if Gordon is working with the Democratic staff on a bill and technical questions arise, he is not permitted to ask Cathy about the technical issues, because the discussions must remain confidential. (He can talk with Cathy about issues that are in the public domain, or he could get specific permission from the political staff to discuss the issue with Cathy.) If Gordon asks Cathy about possible legislative solutions, she can answer as to the technical aspects of whether particular solutions will work, but she is not permitted to comment that Treasury does not like a particular solution.

The Committee thinks proactively about possible legislative solutions. For example, in 2010, the Committee staffers spent a lot of time thinking about possible legislative solutions depending on the type of estate tax regime that Congress decided to impose. In that process, the decision was made to leave the GST tax regime in effect in 2010 but impose a zero rate, to minimize various GST planning technical complexities.

Committee staffers Christine Witt and Gordon Clay deal with technical estate and gift tax issues.

15. Comments Regarding Priority Guidance Plan, Proposed Regulations, and Legislative Ideas

a. *Priority Guidance Plan.* If planners have comments regarding items on the Treasury Priority Guidance Plan, they should contact the Treasury early. Comments are solicited that are typically due in about May of each year. If someone waits to give comments until a draft bill has been proposed, it may be too late to change the legislation as it may have "acquired a life of its own" at that point. Gordon Clay confirms that after a bill has been introduced, it is often at a procedural point that amendments to the bill are very difficult.

Similarly, if planners have ideas for items to be included on the Priority Guidance Plan, they should advise the IRS and Treasury. The more people that ask for a particular project, the more likely it is to be included. Some projects are included because there have been a number of PLRs regarding the same issue. The IRS and Treasury make decisions each year about the items to include on the Plan depending on perceived significance and the ability of the government to complete the items within the Plan year.

b. *Proposed Regulations*. Regulations implementing new statutes must be issued quickly to have full retroactive effect. Regulations cannot be retroactive to the date of enactment unless the regulations are issued within 18 months of that date. §7805(b). (The portability temporary regulations were issued within two days of that deadline.)

Cathy Hughes and Branch 4 attorneys read *all* comments to proposed regulations. The Administrative Procedures Act requires the government to respond to all comments. The preamble of final regulations typically will address comments made and reasons why suggested revisions were or were not adopted.

c. *Legislative Ideas*. Submissions of ideas about problem areas and legislative solutions are very helpful to the Joint Committee and congressional staffers. Submissions should be as specific as possible, even including proposed legislative solutions. Even if the proposed legislative language is not used, the specifics in legislative proposals help the staffers refine their thinking about an issue.

16. Revenue Estimates

The Treasury Department Office of Tax Policy makes revenue estimates of the President's Budget Proposals that are published each year in the Greenbook. The Congressional Budget Office also makes separate independent revenue estimates of those proposals (which can be quite different).

For example, the Office of Tax Policy provided a revenue estimate for the §2704 proposal, but the Congressional Budget Office revenue estimates of the budget proposals refused to provide an estimate, because the effect of the legislative proposal was based predominantly on new regulations.

When legislation is actually proposed in legislative bill form, the Joint Committee on Taxation provides revenue estimates. For example, if a legislative proposal is introduced to implement the President's §2704 proposal, the Joint Committee on Taxation would have to provide a revenue estimate at that point. (Cathy comments that she would be precluded from discussing with the Joint Committee staff what the regulations might say.)

17. What are the Staffers Doing During Periods of Congressional Inactivity?

Even though nothing is happening in a deeply divided partisan Congress, the Congressional staffers have been extraordinarily busy this year. They have been closely examining the technical ramifications of various possible legislative scenarios following the November elections.

18. Role of ACTEC in Interacting With Governmental Authorities

Jim Hogan observes that input on technical issues from ACTEC is a tremendous help. It helps the IRS spot issues faster than the IRS might otherwise see them. Advising the IRS of a problem and suggesting objective solutions is very helpful in achieving the right solution. Particularly helpful are comments about how affected transactions will be reported, and the practicalities of implementing statutory requirements. For example, the portability regulations reflect various practical factors suggested in comments from planners. Also, the comments from ACTEC regarding the private trust company guidance have been especially helpful. Government officials clearly recognize that practitioners have done much more thinking about some of the related issues than the government officials.

19. Upcoming IRS/Treasury Guidance

Cathy Hughes says "There will be some things coming out by the end of the year."

Items 20-22 are observations from a panel discussion by Ronald D. Aucutt, Beth Shapiro Kaufman, and Diana S.C. Zeydel: Dealing with the Continued Uncertainty of the Tax Law.

20. Legislative Prognostications

a. *Estate Tax Is Relatively Minor Issue.* There are many tax provisions to be addressed with significantly more importance than the estate tax provisions. Expiring provisions in the 2001 and 2003 legislation include tax rates, preferential capital gains rates, phase-out of itemized deductions and personal exemptions, child tax credits, marriage penalty relief, etc. In addition, there are about 60 tax extenders that expired at the end of 2011, the most important of which is the alternative minimum tax exemption. (If not fixed in the lame duck session, that could result in large increased taxes due for 2012.) There are other extenders that will expire at the end of 2012. Other important tax provisions include payroll tax relief that ends this year if not extended, and many new provisions that will become effective in 2013 under the Affordable Care Act (including an additional 3.8% income tax on investment income of taxpayers having income over a threshold level). All of those things impact many more taxpayers than the estate and gift tax.

b. *Effect of Elections.* The elections will impact not only the Presidency but also the control of Congress. A Republican sweep of the Presidency, Senate, and House of Representatives could dramatically alter the landscape. Even if the Democrats retain control of the Senate, a Romney win may make it less likely that the proposal to increase income tax rates on wealthy Americans would get passed in a lame-duck session in December — meaning that there is less likelihood of an agreement in a lame-duck session.

c. *Estate Tax Repeal*. While Gov. Romney's official position is to repeal the estate tax, remember that Presidents Reagan and George W. Bush also advocated estate tax repeal. Some planners suggest that estate tax repeal may be even less likely if Gov. Romney is elected under the theory that if President Obama is reelected and continues to press for increased tax rates on wealthy Americans (however that ends up getting defined), a huge "sweetener" may be required to convince the House to agree to some compromise including increased tax rates, and the estate tax could be that chit.

Beth Kaufman says that some have expressed a conspiracy theory. From a baseline of a $1 million estate tax exemption, repeal would have a high revenue loss. The cost of repeal is much lower if tested against a transfer tax system with a $5 million exemption. The conspiracy theory is that every time the estate tax exemption is increased is a closer step to estate tax repeal — at some point the lower revenue raised by the estate tax will not justify keeping the system intact.

d. *Timing*. Ron Aucutt observes that "no one could have predicted what happened in 2010, and here we are again." We thought that a tax agreement in a lame-duck session was impossible--before agreement was reached in December 2010. So it is a possibility.

If there is no estate tax legislation in December, legislative changes in 2013 would likely be retroactive to January 1, but there are no guarantees.

The elections will have an impact on the timing of legislation — whether there is an agreement in December or the timing of an agreement next year. As discussed above, if Gov. Romney wins, there is less likelihood of an agreement on taxes in a lame-duck session. Some ask, why would Congress compromise in a lame-duck session if it has not compromised all year? A big issue facing Congress is the "fiscal cliff" (the combination of tax cuts, automatic spending cuts, and the soon expiring debt limit). Each of the parties may have a motivation to compromise, to avoid the effects on the financial markets if there is not an agreement to avoid the fiscal cliff in December, and if the party thinks that it will take the blame for sending the country over the cliff.

e. *"Kick the Can" Approach?* Many have suggested a strong likelihood of an extension of 3-6 months in a lame-duck session to avoid the "fiscal cliff." If there is no tax legislation until 2013, it could be "permanent," but it would be easier to grant another temporary extension of a year or two on the theory that tax rates should not be increased currently because the economy still needs time to recover.

Permanent estate tax provisions are likely to come only in a larger tax bill. We will not see a stand-alone estate tax bill to provide permanent relief.

f. *Exemptions and Rates*. The President's budget proposal for 2012-2013 adopted the "parameters" of the 2009 provisions. That included a $3.5 million estate exemption, suggesting that the legislative compromise may be somewhere between 3.5 million and 5 million (indexed). Many believe that the exemption will most likely end up at the $5 million (indexed) amount. Rates could be anywhere between 35%-55%. It is conceivable that the top rate could even be lower than 35%, to appease those favoring estate tax repeal.

g. *Gift Exemption.* The President's budget proposal for 2012-2013 adopted the "parameters" of the 2009 provisions, which would seem to mean a $3.5 million estate exemption and a $1.0 million gift exemption. However, there appears to be space for compromise regarding the gift exemption amount. Indeed, there is some possibility that the administration is thinking of a system based on a $3.5 million estate *and* gift exemption.

h. *Specific Legislative Proposals.*

- Make portability permanent — likely.
- Basis consistency — somebody will include that and get credit for taking away an abuse that is not being used anyway.
- Valuation discount/§2704 proposal — Ron Aucutt thinks that we eventually will see §2704 legislation, and regulations will be issued within 18 months of the date of enactment; he has no predictions when that will happen.
- GRAT — the 10-year minimum term proposal (with no frontloading) has passed the House in several different bills (but without the maximum term provision).
- GST 90-year limit — this raises no revenue in 10 years, so is unlikely to get enacted.
- Grantor trusts — the proposal "does not mean what it says;" it is estimated to raise only $910 million over 10 years; there will likely be an effort at a more focused provision, perhaps focused on sales to grantor trusts; likelihood of passage of a provision dealing with grantor trusts is "hard to handicap."
- Extending estate tax lien for § 6166 deferral — this is a logical solution to the difficulty of administering the lien rules for §6166.

21. Specifc Planning Strategies

a. *$5.12 Million Gift Exemption.* Considerable planning this year evolves around taking advantage of the $5.12 million gift exemption in light of a possible reversion of the current $5.12 million gift exemption back to $1 million. Most of the strategies discussed below are premised on the uncertainty of the $5.12 million gift exemption for future years.

b. *Caution — Will Client Be Unhappy With Gift if Gift Exemption is Extended in 2013?* Beth Kaufman warns that we have an obligation to prevent clients from putting themselves in a position they will later regret. Before entering into somewhat convoluted transactions in 2012, to take advantage of a large gift exemption that *may* disappear, carefully consider the clients other assets, the client's age, etc.

c. *Straightforward Gifts to Dynasty Trusts.* Straightforward gifts to long-term grantor trusts, without any retained interest in the donor, are the best ways to make use of the $5.12 million gift exemption — if the client can afford to do so.

d. *"As If Never Enacted" Concern.* Consider whether to take complicated defensive steps to avoid the "as if it had never been enacted" provision in case future legislation does not change that result. For example, trusts receiving $5.12 million in GST exemption allocations in 2012 might end up not being fully GST exempt if the "had never been enacted" clause is interpreted to mean that the $5.12 million GST exemption never existed.

e. *Notes.* Clients often do not view intra-family notes as "real assets," and they are more willing to give notes than other types of assets. Closing out notes from sales to grantor trusts avoids the income tax uncertainty that would exist if the note is still outstanding at the grantor's death. If the client does not wish simply to forgive the note (giving up the rights to any future payments), consider giving a note to a new trust (which might include the donor's spouse as a possible discretionary beneficiary), so the obligation remains.

f. *Life Insurance*. Make gifts to life insurance trusts to provide excess funds for paying future premiums. For transfers of life insurance policies, there is an inherent valuation uncertainty. (An ABA committee tried to address life insurance policy valuation several years ago. The process became so complicated that it gave up.)Form 712s of the interpolated terminal reserve values of policies can yield very surprising values because of the varying reserve requirements of companies.

Consider having an insured's grantor trust purchase a life insurance policy if there is a concern the grantor might die within three years.

g. *Exercise Powers of Appointment*. Exercise powers of appointment over existing trusts or decant assets into new trusts that create powers of appointment in order to move assets to GST exempt trusts or to delay imposition of the GST tax. For example, if a grandfathered trust will terminate in the future, exercise the power of appointment to add additional measuring lives. (Letter rulings have permitted that strategy without destroying the grandfathered status of the trust.)

h. *Using Beneficiaries' or Parents' Gift and GST Exemptions*. Decant assets to a new trust giving family members general powers of appointment in order to be able to utilize their gift and GST exemptions. As an alternative, provide in a trust that the client's parent would have inter vivos general power of appointment, which will lapse in 2012 (when the gift exemption amount is still $5.12 million). The lapse of the general power of appointment is treated as a gift by the parent, but would be fully covered by the parents' $5.12 million gift exemption. When the parent makes a transfer subject to transfer tax, the parent is treated as the transferor for GST purposes, and the parent can allocate his or her GST exemption to the trust.

i. *Late Allocations of GST Exemptions*. The client could make a late allocation of GST exemption to a prior trust created by the client, as a way of making use of the current $5.12 million GST exemption. (That is not a new transfer from the client, so is easier for the client to stomach than gift transactions.) The New York decanting statue was recently amended to allow decanting into a trust with an extended duration. If that can be done without impacting the grandfathered status or inclusion ratio of the trust, late allocations of GST exemptions to such extended trust would be more efficient.

j. *Sales to Grantor Trusts*. In light of the Treasury proposal to restrict the utility of grantor trusts, consider making gifts and sales to grantor trusts. There may at some point be legislation focused on sales to grantor trusts, but it almost certainly would only apply prospectively. Leveraged sale transactions can result in transferring very large values of assets to trusts with the $5.12 million gift exemption.

k. *Protection Against Valuation Uncertainty*. Defined value clauses and other planning strategies can be used to provide protection against having to pay gift taxes if gifts are made of hard-to-value assets making use of the client's remaining gift exemption amount. If possible, employ strategies allowing multiple defenses against possible audit adjustments in light of valuation uncertainties. These issues are discussed in Item 22 of this summary.

l. *"Rainy Day" Concerns*. The most difficult client for gift planning is the one that cannot part with the assets economically or psychologically. A key observation is that clients absolutely should not make gifts of assets that they can't live without. At most, just plan around true "rainy day" concerns. Planners throughout this year have been discussing possible strategies with clients who have this concern. Alternatives include:

- sales instead of gifts,
- gifts to trusts that include the donor's spouse as a discretionary beneficiary (with concerns about whether the exercise of a testamentary power of appointment by the donee-spouse into a trust including the original donor as a discretionary beneficiary would cause §2036 concerns),
- non-reciprocal trusts that each spouse would create providing some type of interest for the other spouse, or
- trusts directly naming the donor as a discretionary beneficiary that are created in a "self-settled trust state."

m. *Non-Reciprocal Trusts.* With only several months left in 2012, avoiding a reciprocal trust doctrine attack is not possible by merely creating identical trusts at different times. Preferably, a "rainy day" concern can be ameliorated by having only one spouse create a trust including the other spouse is a discretionary beneficiary. The "wealthier" spouse would not be a discretionary beneficiary at all, so that the trusts created by the spouses would not be reciprocal (although there can also be reciprocal trust concerns if the spouses are trustees of each other's trust, *see Bischoff*; *Green* held that §2036 did not apply where there were reciprocal trusteeships, but the trusts were not for the same beneficiaries).

A possible difference is to defer the interest of one of the spouses for some time. (PLR 200426008 approved trusts created by the spouses with various differences including (i) Wife's Trust provided that the husband would not be a beneficiary until three years after the wife's death and then only if the husband's net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) Husband's Trust provided that the wife would have a "5 or 5" withdrawal power after son's death and that wife would have an inter vivos limited power of appointment to dispose of the trust assets among specified persons after the son's death.)

Another possible difference is to provide that a protector could add back the grantor as a beneficiary after some lapse of time (but make sure that protector does not have fiduciary duties, or else the ability to add new beneficiaries may be questionable).

ACTEC has requested the IRS to provide guidance regarding limits of the reciprocal trust doctrine.

Some players have been faced with situations in which other advisors have recommended fairly similar "non-reciprocal" trusts. Diana Zeydel observes, "It's easy to be creative when you're not constrained by the law."

n. *Deemed §2519 Gifts From QTIP Trusts.* Consider severing an existing QTIP trust into two trusts, and having the client make a gift or sale of the income interest in one of the trusts, which would result in a deemed transfer of the remainder value under §2519. If there is a sale of the income interest, the uniform basis rule under §1001(e) would preclude the seller from having any basis in the income interest that is sold. (If an elderly spouse is making the transfer, the income interest may have relatively little value, so there would not be much gain recognition in any event.)

While a gift of a small portion of the income interest can result in a gift of the entire remainder interest under §2519, §2036 may cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. Miami Heckerling on Est. Plan. ch. 12 ¶ 1202.3 (2010).

Estate inclusion under §2036 presumably can be avoided if the spouse sells the income interest rather than making a gift of it (because of the full consideration exception in §2036). That was the fact situation in PLR 201024008, but in that PLR a ruling on the §2036 issue was not requested or given.

o. *Disclaimer Alternatives to Provide Flexibility in Uncertain Times*. Disclaimers can provide helpful flexibility into various types of situations.

- *Gift to Spouse With Disclaimer Possibility*. For example, Husband might make a $5 million gift to Wife in 2012, and provide in the transfer document that any disclaimed portion will pass to a trust for the benefit of descendants. Wife will have nine months to decide whether to disclaim; if wife does disclaim there would be a completed gift to descendants effective in 2012. Furthermore, regulations (and the *Christiansen* case) appear to permit a formula disclaimer of a dollar value amount. If the gift exemption remains at $5 million in 2013, Wife might decide to accept the entire gift and preserve Husband's remaining gift exemption.
- *Gift With Disclaimed Assets Remaining With Donor*. The trust might provide that any disclaimed assets will remain with the donor. The trustee or trust beneficiaries might decide to execute a formula disclaimer, disclaiming any gift to the trust in excess of the donor's remaining gift exemption amount. If this power is given to the trustee, consider adding a provision in the trust agreement expressing the trustor's wish that the trustee would disclaim by a formula in order to benefit the beneficiaries indirectly by minimizing the gift tax impact to the settlor's family and perhaps make the transfer to the trust as a net gift so that if there are gift tax consequences they would be borne by the trust. That may give the trustee comfort in being able to disclaim, even though doing so could decrease the amount of assets in the trust. In addition, if the transfer to the trust is of a formula dollar amount (as in *Wandry*), the formula transfer to the trust may help give the trustee comfort in making the formula disclaimer despite potential fiduciary concerns; the formula disclaimer is given in order to effectuate the settlor's intent as much as possible in making the formula transfer to the trust.

p. *Inter Vivos QTIP Trust*. As a way of leaving flexibility to determine whether or not to have a completed taxable gift in 2012, the client could make a gift to an inter vivos QTIP trust. The client would have until October 15, 2013 (if the due date of the gift tax return is extended) to decide whether to make the QTIP election. If the election is made, the gift would qualify for the marital deduction and the client would not be treated as having made the taxable gift in 2012 using up gift exemption amount. Furthermore, the client would be able to make a formula election (as allowed in the QTIP regulations) of a sufficient amount so that no gift tax is payable as a result of the transfer.

q. *Donative Promise; Section 2701 Transfer*. If a client wants to take advantage of the $5 million gift exemption in 2012 (in case the estate exemption is dramatically reduced in 2013) but does not have assets to relinquish, some planners have suggested that the client make an irrevocable enforceable promise to give $5 million. *See* Austin Bramwell, *Donative Promise Can Lock in 2012 Gift Tax Exemption*, 39 EST. PL. 3 (August 2012). One issue is whether there is sufficient consideration so that the promise is an enforceable contract. IF so (and that may be a big "IF"), Rev. Rul. 84-25 says that the irrevocable enforceable promise is a gift in the year the promise is made (not when it is later funded).

For estate tax purposes, while the debt is not deductible under §2053 (because it is not made for full consideration, §2053(c)(1)(A)), there may still be an estate tax advantage to making the gift if the estate exemption is later reduced below $5 million and if there is not "clawback." Rev. Rul. 84-25 says that the gift amount i not treated as an adjusted taxable gift for purposes of the estate tax calculation (because the client's assets are included in the gross estate directly, and adding the gift amount back as an adjusted taxable gift would result in double counting of the assets). While there is not a tentative tax calculated on the amount of the estate plus the $5 million gift amount, there apparently would be a subtraction under §2001(b)(2) of hypothetical gift taxes that would be payable on gifts made after 1976. If "clawback" does not apply, this calculation would apparently be the amount of gift tax payable on the $5 million gift using the *date of death* estate exemption amount. For example, if Congress reduces the estate exemption from $5 million (for simplicity the indexed amount is not ignored in this example) to $3.5 million, the effect is to subtract the gift tax payable on the excess $1.5 million from the estate tax calculation.

Therefore, if Congress later reduces the estate exemption amount and if there is not clawback, the client gets the advantage of removing from the tax base the amount by which the estate exemption is reduced by a future Congress. (This also assumes that a possible legislative fix to the "clawback" concern is not designed in a way to take away this possible benefit.)

A transfer of assets to a trust in 2012 (which would be reported on a gift tax return), and a subsequent repurchase of those assets by the settlor for a note in a later year would have the same long-term effect as transferring a note to the trust in the first place. The settlor may want to "live with the trust" for some period of time to determine the settlor's comfort level with not owning the trust assets. If the settlor became uncomfortable, the settlor could repurchase the assets. Under this scenario, the settlor's debt obligation would conceivably be deductible under §2053 because it would have been given for full consideration. The step transaction doctrine may apply if this were a pre-arranged plan, which doctrine may treat the settlor as originally transferring the note to the trust.

A transfer of assets with a retained life estate, that would be includible in the estate under §2036, may have the same result. Under §2001(b)(last sentence), the gift would not be includible as an adjusted taxable gift in the estate calculation (because the assets would be included in the estate under §2036). However, the hypothetical gift tax payable on the gift would be subtracted in the estate tax calculation.

A similar result may occur for a transfer that does not satisfy the requirements of §2701. For example, if a client owns all of the non-cumulative preferred stock and common stock of a corporation, and if the client gives the common stock, the client will be treated as having made a gift equal to the full value of the corporation. At the client's death, Reg. §2701-5(a)(3) provides for an "adjustment to mitigate double taxation." The amount on which the estate tax is calculated is reduced by an amount equal to the amount by which the taxable gift was increased under §2701. The effect is that the client has kept the preferred stock, and may have enjoyed the distributions from that stock over the client's lifetime, but the client still gets to subtract from the estate tax base the substantial amount by which the gift was increased under §2701.

22. Defined Values Clauses and Other Strategies to Protect Against Valuation Uncertainty

Defined value clauses can be used to provide protection against having to pay gift taxes if gifts are made of hard-to-value assets making use of the client's remaining gift exemption amount. Formula allocation clauses are preferred — four prior cases (*McCord, Christiansen, Petter* and *Hendrix*) clarify that formula allocation clauses with the "excess value" passing to charity will work.

If the client is unwilling to do that, consider formula allocation clauses with the excess passing to some other entity that does not have gift tax consequences (such as the donor's spouse, a QTIP trust, a "near zeroed out" GRAT, or an incomplete gift trust).

A gift of a defined dollar value is a possibility in light of the *Wandry* case. (The government has chosen not to proceed with its appeal of *Wandry* to the 10th Circuit.)

Another possibility is to utilize a purchase price adjustment provision, similar to what was used in the *King* case (and allowed by the 10th Circuit).

Another possibility is to have the trust agreement state that any disclaimed assets will be returned to the donor, and the trustee or trust beneficiaries might decide to execute a formula disclaimer, disclaiming any gift to the trust in excess of the donor's remaining gift exemption amount. (See Item 21.o.)

Another strategy is to arrange a sale from a client to a grantor trust for the client that is created by the client's spouse. The client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor's estate, but the client would have achieved the goal of transferring as much as possible at the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale under §1041, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments. *Gibbs v. Commissioner*, T.C. Memo 1997-196.

Where possible, use multiple defenses against possible audit adjustments in light of valuation uncertainties.

Items 23-35 are observations from a presentation by Ellen K. Harrison and Michael G. Pfeifer: Top Ten Things You Need to Know When There is Something Foreign in Your Estate Plan. This was an in-depth discussion of tax planning issues involving foreigners or foreign trusts.

23. Who is Foreign For Income and Transfer Tax Purposes — Generally

Different rules apply for transfer tax and income tax purposes (as discussed in more detail below). A U.S. citizen is always a U.S. person regardless of residency or domicile (there are special rules for expatriates who renounce their U.S. citizenship). Clients often are not aware of their classification as foreign or U.S. persons for these purposes. Treaties may reclassify an individual's domicile or residence, but never a person's citizenship.

Foreign trusts and estates. The Code contains a very precise (and broad) definition of a foreign trust — as any trust that is not a domestic trust. To constitute a domestic trust, the trust must satisfy a court test and a control test, §7701(a)(3)(E). The definition of a foreign trust is different for tax and FBAR (Report of Foreign Bank and Financial Accounts) purposes. There is no useful definition of when an estate is classified as foreign for these purposes.

24. Foreign Person for Transfer Tax Purposes

Special transfer tax rules apply for persons who are nonresidents of the U.S. who are also not citizens (sometimes referred to as nonresident aliens). §§2101-2108.

a. *Nonresident Status Based on Domicile*. There is no bright line test for determining domicile, but a facts and circumstances test applies. The regulations provide that an individual who resides in the U.S. with intent to remain there permanently is domiciled in the U.S. Most planners interpret that to mean permanently and indefinitely.

Visa status is relevant but not controlling for this purpose. In 1984 Tax Court case (*Kahn)* is often cited for the proposition that a green card holder is domiciled in the U.S. However, the speakers do not believe that the case clearly stands for that proposition.

b. *Citizenship*. There are various ways to be treated as a U.S. citizen:

- A person born in the U.S. is a citizen;
- Most children born abroad to two U.S. citizen parents are citizens;
- Children born abroad to one citizen parent may be a citizen depending upon whether the parent met certain prior U.S. residence thresholds; and
- Children born abroad to non-U.S. parents can obtain "derivative U.S. nationality" if one foreign parent naturalized and certain other conditions are met before the child reaches age 18.

c. *Treaty Provisions*. Domicile is based on residence in the estate and gift tax treaties. There are tiebreaker rules to determine domicile for treaty purposes. Each estate and gift tax treaty is different in this regard, but the income tax treaties are mostly the same.

All treaties have a "saving clause," providing that if the taxpayer is a U.S. citizen, the U.S. can tax the individual as if the treaty were not in effect. In estate and gift tax treaty, the saving clause is often not in the physical presence or domicile provision but in one of the principal taxing rules.

25. Foreign Person for Income Tax Purposes

a. *Green Card and Substantial Presence Tests*. There are objective rules in §7701 as to when a non-citizen of the U.S. will be treated as a nonresident for income tax purposes. The person is a U.S. resident for this purpose if (1) he or she is a lawful permanent resident of the U.S. at any time during a calendar year (i.e., is a green card holder, regardless of actual presence in the U.S. during the year), or (2) meets a substantial presence test U.S. for more than 183 days over three years (applying a sliding scale weighting test).

b. *Closer Connection Exception to Substantial Presence*. There is an exception to residency based on the substantial presence test if the individual was present in the U.S. for less than half a year and if the person can establish a closer connection to a foreign country than to the U.S. §7701(b). A variety of factors are relevant for this purpose based on where the person's center of economic life is located. The individual can file Form 8840 with the original income tax return in order to qualify for the closer connection exception. Because people often do not keep careful diaries of their presence (and any part of the day counts as a full-day), individuals who wish not to be treated as U.S. residents should file that Form if there is any question of whether the individual meets the 183-day test.

c. *Exempt Individuals*. There are exceptions for diplomats, teachers, students, and trainees.

d. *Expatriates*. There are special rules for expatriates (i.e., former U.S. citizens or long-term residents).

26. General Income Tax Treatment of Foreign Persons

a. *Income*. Foreign persons are subject to U.S. income tax on (1) income derived from sources in the U.S. and (2) income connected to a U.S. trade or business. U.S. source income is defined more broadly for certain expatriates. Capital gains generally are not taxed, except that gains from U.S. real property are taxed.

Generally, tax is withheld at the source. A nonresident alien individual or foreign person does not have to file a tax return if all income tax is satisfied by withholding at the source. If there is income effectively connected with a U.S. trade or business, a U.S. tax return is required. This most often happens if the foreign person owns a partnership or LLC interest. If the partnership or LLC is doing business in the U.S, there is effectively connected income.

b. *Deductions*. Deductions are allowed only for expenses that are effectively connected to the conduct of a trade or business, and no deductions are permitted against U.S. source income except to the extent that it is effectively connected to a U.S. trade or business.

c. *Rates*. Income effectively connected to a U.S. trade or business is taxed at the normal rates applicable to individuals. Income that is not effectively connected to a U.S. trade or business is taxed at a flat 30% rate.

d. *Foreign Trusts*. There is no special tax return form for foreign trusts and foreign estates. Form 1040NR is used for this purpose, and it is difficult to adapt that Form to the rules for a foreign trust. Foreign trusts often use a fiscal year, but in the U.S. they must file on a calendar year basis.

A foreign trust is only taxed on U.S. source income accruing to the foreign trust, but when distributions are made there must be a special DNI calculation. DNI for a foreign trust includes worldwide income and capital gains. The character of income received is not "foreign" based on the status of the trust, but based on the type of income received by the trust under a look-through approach.

A "throwback rule" taxes U.S. beneficiaries on the receipt of income of foreign non-grantor trusts when distributed or deemed distributed. All of the income is taxed as ordinary income, except capital gains. It can be a very punitive tax (and is discussed further below in Item 27.c).

A foreign trust that is a "qualified revocable trust" under §645 may elect to be taxed as a foreign estate (and take advantage of the more favorable tax treatment afforded foreign estates, discussed immediately below).

e. *Foreign Estates*. Foreign estates are treated differently than foreign trusts in several respects. Foreign estates exclude foreign capital gains and foreign source income in calculating DNI. This is a very favorable rule. Foreign estates that receive foreign income can make distributions to U.S. beneficiaries that will not be taxed. In addition, the throwback rule does not apply to foreign estates.

f. *Foreign Tax Credits*. A credit for foreign tax paid on foreign source income and foreign situs assets generally avoids double taxation. Treaties provide an ordering rule to determine which country has the primary right to tax, and the other will allow a credit. If the timing of income recognition in the U.S. is different than in the foreign country, there can be a mismatch and no credit relief from double taxation.

27. Anti-Avoidance Rules

a. *Transfers to Foreign Entities.* To prevent persons from parking money offshore to avoid the U.S. income tax, §684 imposes a gain on the transfer of appreciated assets to a foreign trust unless it is a grantor trust (and in most cases foreign trusts are grantor trusts because foreign trusts with a U.S. beneficiary are treated as grantor trusts). Furthermore, this rule cannot be avoided by creating a U.S. trust and then migrating it offshore. §684(c).

Similarly, gain recognition also results if there is a transfer to a foreign corporation, but there are exceptions if there is a gain recognition agreement.

b. *Grantor Trust Rules.* A U.S. person who directly or indirectly transfers property to a foreign trust is treated as the owner of the trust under the grantor trust rules if there is a U.S. beneficiary for any portion of the trust. §679. This section is applied very broadly to actual, deemed, and constructive indirect transfers and to determine if there is a U.S. beneficiary.

A foreign person who funds a foreign trust and moves to the U.S. within five years will be subject to §679 if the trust has or may have a U.S. beneficiary at the transferor's starting date.

In applying the grantor trust rules, there are only limited situations in which a foreign person will be treated as the owner of the trust (to prevent someone who is living in a tax-haven from being treated as the owner so that the trust income would escape U.S. tax). §672(f).

c. *Foreign Nongrantor Trusts.* A throwback tax and interest charges apply on distributions of accumulated income from foreign non-grantor trusts to U.S. beneficiaries. §643. Certain transactions are treated as deemed distributions for this purpose, including loans (other than "qualified obligations"), distributions through intermediary "nominees," and allowing U.S. persons to use trust property without paying for that use.

d. *CFCs and PFICs.* Special complex rules are designed to limit artificial deferral of U.S. income tax by using offshore low-taxed entities. Under broad and uncertain stock attribution rules, U.S. beneficiaries of foreign non-grantor trusts may be treated as indirect owners of foreign corporations and subject to these U.S. corporate anti-deferral rules.

CFC. A U.S. shareholder is taxed currently on her share of the "Subpart F income" from a controlled foreign corporation, whether or not received. Subpart F income includes "foreign personal holding company income," which is mostly passive income (including dividends, interest, royalties, and capital gains). In addition, gain on disposition of CFC stock attributable to her share of earnings and profits is treated as a dividend. The CFC rules eliminate the beneficial tax rates for capital gains and qualified dividends. A CFC is any foreign corporation that is more than 50% owned by "U.S. shareholders" (defined to mean any U.S. individual or entity that owns 10% or more of the foreign corporation, after the application of complex attribution rules). The Subpart F rules have been around since 1962 and are well established. (By contrast, the original PFIC rules were added in 1986.)

PFIC. The PFIC rules are "devilishly difficult." (In connection with the Offshore Voluntary Disclosure Program, it became clear that many tax return preparers and IRS personnel were not familiar with the PFIC rules.) U.S. persons owning shares of a passive foreign investment company (PFIC) may choose between (i) current taxation on the income of the PFIC, or (ii) deferral of such income subject to a deemed tax and interest charge on the receipt of an "excess distribution" (i.e., any distribution or gain in excess of 125% of the average distributions of the prior three years) in a manner similar to the throwback rule. It is taxed at the highest rate in each of the throwback years and there is an interest charge for each year. This interest charge system can be very punitive. The interest charges are computed using daily compounding; the interest charges and prior year tax amounts may exceed the income recognized if the holding period of the shares has been long enough. There are a number of exceptions under the PFIC rules regarding when there are distributions subject to the tax and interest regime.

There are a number of broad and uncertain stock attribution rules for both CFCs and PFICs. For nongrantor trusts, one must determine if the trust beneficiaries might be deemed to have interests in underlying CFCs or PFICs. ACTEC has twice asked for more guidance because the rules are very difficult to apply if there is attribution.

There have been little guidance from the IRS regarding the PFIC rules. Proposed regulations were issued in 1992 but they have never been finalized.

The system to elect current taxation in order to avoid the deemed tax and interest charge approach can be complicated. If a shareholder wishes to make the election at a date later than the acquisition date of the shares, there are three additional optional methods that must be used to purge PFIC status for prior years under which there is a recognition of gain or deemed dividends subject to the tax and interest regime at that point.

Each U.S. person owning shares of a PFIC is required to file Form 8621.

Under a "once a PFIC always a PFIC" rule, a company that has an active trade or business, but did not do so 15 years ago and was a PFIC at that time, remains a PFIC forever. (That seems very unfair.)

Interaction of CFC and PFIC Rules. "U.S. shareholders" (generally 10% or more owners) of a CFC are not subject to the onerous tax and interest charge regime for PFICs with respect to any share that was not a share of a PFIC at any time before 1997. Such shareholders are merely subject to the CFC rules. However, pre-1998 companies qualifying as both CFCs and PFICs generally default to PFIC rules under the "once a PFIC …" rule.

e. *U.S. Persons in Possession of Assets Belonging to or Received From a Foreign Person.* Under a "statutory executor" approach, a U.S. person in possession of assets belonging to a foreign person may be obligated to file a U.S. estate tax return and pay estate tax from such property. There is a question as to whether the statutory executor has personal liability for the U.S. estate tax that the foreign individual should have paid. A Tax Court case from the late 1960s held that a statutory executor does not have personal liability for the tax. However, most foreign banks and trust companies are nervous and always assure that there is a transfer certificate from the IRS before distributing any assets to a U.S. person.

In addition, under transferee liability concepts, persons who gratuitously receive property from a foreign decedent may be liable for unpaid income and gift taxes the foreign person may have owed. The limitations on assessment is one year past the expiration of the transferor's statute of limitations, but a second year is added for subsequent transferees.

(This can create a conflict among the family members of a deceased foreign person if some of the family members are U.S. persons and others are not. The foreign beneficiaries may be unwilling to pay U.S. estate tax and only the U.S. persons have to worry about transferee liability.)

f. *Withholding Requirements*.

FDAPI. A person in control of U.S. source "fixed or determinable annual or periodic income," or FDAPI, (not including income connected to a U.S. trade or business) is obligated to withhold a statutory 30% tax (which may be reduced by treaty) when making payment to a foreign owner. §1441. FDAPI includes U.S. source payments of dividends, interest, rents, royalties and many other payments, but generally does not include capital gain income.

FIRPTA. Under "FIRPTA," a person who purchases a "U.S. real property interest" from a foreign owner is obligated to withhold 10% of the purchase price unless the IRS agrees to a lesser amount under a FIRPTA certificate.

FATCA. Under the Foreign Account Tax Compliance Act (FATCA), withholding may be required on the gross proceeds (not just gain) from the sale of securities that would produce interest or dividends from sources within the U.S. The rules are not fully developed under this Act and regulations are expected shortly. These withholding rules will not apply until 2014. *See* Eric van Aalst, *The Foreign Account Tax Compliance Act*, TR. & ESTS. 52 (Nov. 2012).

28. Situs Rules for Transfer Tax Purposes

a. *Significance*. U.S. transfer tax exposure applies only to U.S. situs assets. There are different situs rules for estate tax and for gift tax purposes. (A major difference is that stock of a U.S. corporation is a U.S. situs asset for estate tax purposes but not for gift tax purposes.)

For gift tax purposes, a foreigner is subject to U.S. gift tax on real property and tangible property located in the U.S., but not on gifts of intangible property (even if that property has a connection to the U.S.).

The U.S. situs rules for estate tax purposes are broader. U.S. situs assets include real property and tangible property located in the U.S., shares of stock in a U.S. corporation, and debt obligations of U.S. persons or political subdivisions (but not including publicly traded debt securities). (The treatment of partnerships and LLCs that conduct business in the U.S. is unclear.) Life insurance, certain bank accounts, and "portfolio debt" are not included. Private debt obligations from U.S. obligors are included.

There are more inclusive U.S. situs rules for some expatriates.

Treaties may change the situs rules. (For example, OECD treaties [i.e., France, Germany, Holland, the United Kingdom, Austria, and Denmark] typically provide that stock in U.S. corporations will not have a U.S. situs for foreigners from those countries. As another example, a UK domiciliary who resides in the U.S. will be subject to the U.S. estate tax only on U.S. real estate and some business assets, but not stock in U.S. corporations or debts of U.S. persons, including nonqualified deferred compensation promises from U.S. companies.)

Trusts do not affect the situs of assets. There is a "look through" approach to apply the situs rules to the particular trust assets.

b. *Using Foreign Corporations to Avoid U.S. Situs*. Assets are sometimes transferred to foreign corporations in order to avoid U.S. situs — stock of a foreign corporation is not a U.S. situs asset for either estate or gift tax purposes. However, there are significant complications in this approach, because shareholders who own interests in foreign corporations may become subject to the very complicated CFC and PFIC rules. Furthermore, the traditional approach of contributing otherwise U.S. assets to a foreign corporation is vulnerable to attack as a sham that serves no legitimate non-tax purposes, but to date the strategy of shifting assets to a foreign corporation has been effective to operate as a shield against U.S. estate taxation.

For income tax purposes, U.S. persons generally should not own shares of a foreign company unless it is engaged in an active trade or business (which avoids the CFC and PFIC rules). If a foreign corporation owns passive assets, the goal is to eliminate the corporate structure when it no longer provides tax advantages. One way of doing so is to liquidate the corporation. A liquidation within 30 days of the foreigner's death avoids adverse tax consequences to the U.S. beneficiary (because the corporation would not satisfy the definition of a CFC unless shares have been held by a U.S. Shareholder for at least 30 days). If this is done, the gain that would be realized at the corporate level on the liquidation would not be taxable to the U.S. beneficiary. Accomplishing anything within 30 days of a person's death, however, can be difficult.

Another strategy is to make a "check the box" election that is available to some (but not all) foreign corporations. (*See* Reg. 301.7701-2.) (There is a long list of corporations in the regulations that are not eligible for this election; if a foreign corporation will be used to own assets, it should be structured so that it does qualify for this election in case making the election would be beneficial at a later time.) An election can be made to treat the corporation as a flow-through entity, either as a disregarded entity if there is just one owner or as a partnership. (In this context, the foreign individual is typically the only owner, so it is treated as a disregarded entity.) The election can be retroactive up to 75 days, and it can be retroactive to immediately before or immediately after the date of death, depending on which is the most attractive. If the election is made effective prior to the date of death, the "blocker" function of having a foreign corporation to avoid U.S. estate tax would not be available. If there is U.S. real estate in the corporation, there will be U.S. gain on the liquidation or deemed liquidation.

A deemed liquidation via the "check the box" election may give rise to DNI/UNI for trust shareholders. Also, if the company is a CFC, gain resulting from the deemed liquidation may flow through to U.S. shareholders currently, and if the company is a PFIC, the gain from the deemed liquidation might be subject to excess distribution treatment. Any U.S. real property held by the company will be taxed as if that were sold. A positive is that the deemed liquidation may cause a step up in basis of the corporation's assets.

c. *Troublesome Situs Rules*.

Cash. Cash is apparently tangible personal property, and a gift of cash from a foreigner should be made outside the U.S. to avoid U.S. gift tax.

Wire Transfers; Checks. Wire transfers outside the U.S. to a U.S. account *should* be exempted from U.S. gift taxation, but a gift of a check to a U.S. person who deposits the check in the U.S. could be treated as a transfer in the U.S. subject to U.S. gift taxation.

Partnerships and Disregarded Entities. The situs rules are unclear. Rev. Rul. 55-701 concluded that a partnership interest held by a foreigner in a New York partnership that was engaged in business in the U.S. was a U.S. situs asset for estate tax purposes (but some treaties would change that result). Some treaties change this rule (e.g., Germany and France treaties) to look through the partnership to determine the situs of partnership assets.

Retirement Plans and Deferred Compensation. Situs and source may depend upon the nature of the plan and whether or not it is a U.S. qualified plan. Under the OECD treaties (with European countries), a foreigner's interest in U.S. tax deferred compensation plans would not be subject to U.S. estate taxes (because they do not relate to carrying on a business in the U.S.). Clients from other countries could (if possible) direct the investment of their 401(k) and IRA assets in non-U.S. situs assets, such as foreign stocks, bond funds, and bank deposits.

Nonqualified deferred compensation is an unsecured debt of the employee's employer. If that employer is a U.S. person, any nonqualified deferred compensation from that employer would likely be included in the gross estate as a private debt of a U.S. obligor.

Inconsistent Classification by Different Countries. As an example, if real estate in a foreign country is owned by a single member LLC, the foreign country might treat that as intangible property and the U.S. may treat it as U.S. real estate, and that may impact the ability to avoid double taxation (if each country is claiming primary taxing authority due to the different classifications).

String Provisions of §§2035-2038. U.S. situs assets held in a trust subject to the §§2035-2038 "string" provisions will be subject to U.S. estate tax at the death of grantor if the assets are situated in the U.S. either when the trust was funded or at the time of the grantor's death. §2104(b). (There is only one PLR addressing that issue.)

29. Gift and Estate Tax For Nonresident Aliens on U.S. Situs Assets

a. *Rates*. The transfer tax rates for foreigners are the same as for citizens and residents. §2001(c).

b. *Exemptions*. The applicable credit amount is zero for gifts, and $60,000 for estates (i.e., a unified credit amount of $13,000). (The $60,000 amount has never been increased or indexed; it is unrealistically low.)

Some treaties alter this result. For example, various treaties give a nonresident alien decedent's estate a proportion of the "specific exemption" available to U.S. citizen or resident estates under U.S. tax law (in proportion to the ratio of U.S. property to worldwide property). (The IRS construes the reference to "specific exemption" to now apply to the applicable credit amount. Rev. Rul. 90-101.) The proportionate amount will likely be larger than the $60,000 exemption amount.

c. *Marital Deduction*. An estate tax marital deduction is allowed for property in the U.S. as long as the requirements of §§2056 and 2056A (if the surviving spouse is a non-citizen) are satisfied. A gift tax marital deduction is allowed, but transfers to a non-U.S. citizen spouse do not qualify for the marital deduction but instead have an annual exclusion of $100,000 indexed (the indexed amount is $139,000 for 2012 and $143,000 for 2013). §2523(i).

d. *Charitable Deduction*. There are limitations on the charitable deductions for gifts or estate transfers from foreigners. The charitable deduction is allowed for transfers to a U.S. charitable corporation, to trusts where the transfer will be used for charitable purposes within the U.S., or transfers to a veterans organization. §§2106(a)(2), 2522(b).

e. *Administrative Expense and Debt Deductions*. Foreigners may deduct only a proportionate part of the deductions for expenses and debts that would otherwise be available under §§2053-2054. The deductions are allowed in proportion to the ratio of U.S. assets to worldwide assets. No deduction is permitted unless the foreigner's executor files a U.S. estate tax return disclosing worldwide assets, and many foreigners are unwilling to do so, and therefore claim no administrative expense or debt deductions.

f. *Gift Splitting*. Gift splitting is not allowed if either spouse is a foreigner. §2513(a)(1).

g. *Treaties*. Treaties often avoid a double tax that might otherwise occur because of limits on allowable foreign tax credits. All treaties have a saving clause, providing that if the taxpayer is a U.S. citizen, the U.S. can tax the individual as if the treaty were not in effect. Treaties generally allow the estate of a U.S. citizen who is domiciled in a treaty country to take the foreign tax credit for all taxes imposed by the foreign country except for taxes imposed on assets for which the U.S. has primary taxing rights under the treaty (such as U.S. real estate).

30. Basis Adjustments Under Section 1014

A basis adjustment is allowed in the U.S. for assets inherited from a foreigner decedent even if the assets are not U.S. situs assets that are subject to the U.S. estate tax. However, the assets may not also acquire a new basis in the foreign residence country.

A basis adjustment also applies in limited circumstances to assets held in trust that were received from a foreign person. Only specific types of trusts qualify for this basis adjustment, as described in §1014(b)(2-3).

31. Reporting Obligations

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 US Owner (this return is due March 15 rather than April 15 [the due date of the other returns]; an extension to file one's income tax return typically extends the time for filing the other returns, but not the Form 3520-A; an extension request for Form 3520-A must be filed on Form 7004)

Form 926 Return by US Transferor of Property to a Foreign Corporation

Form 5471 Information Return of US Persons with Respect to Foreign Corporations

Form 5472 Information Return of 25% Foreign-Owned US Corporation or Foreign Corporation Engaged in US Trade or Business

Form 8621 Return by Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund

Form 8858 Information Return of US Persons with Respect to Foreign Disregarding Entities

Form 8865 Initial and Annual Expatriation Information Statement

Form 8938 Statement of Specified Foreign Financial Assets

Form TD F 90.22.1 Report of Foreign Bank and Financial Assets ("FBARs") (there is no extension of time allowed; June 30 is a "drop dead" date)

Substantial monetary and other serious penalties can apply if returns are not timely filed. Penalties generally may be abated for "reasonable cause" but FBAR penalty abatement turns on whether the failure to file is "willful."

32. Steps to Take Before Becoming U.S. Tax Resident

- Accelerate income (particularly to use losses, if any) and postpone deductions.
- Step-up basis in assets if that can effectively be done through liquidations or "checking the box."
- Consider restructuring trusts that were created by the immigrant of which he or she is a beneficiary; the grantor trust rules applicable to foreign persons are now very limited, but once someone moves to the U.S., all of the broad grantor trust rules apply.
- Consider disposing of CFC and PFIC holdings.
- Consider making large gifts (including implementing freeze strategies) before establishing domicile in the U.S.
- Think twice about applying for a green card; that could have a bad result if the individual later expatriates after living in the U.S. for at least eight of the 15 taxable years preceding expatriation, §877(e).
- Individuals moving to the U.S. from Europe may have retirement benefits and life insurance products (very common in Europe). If those products do not qualify as life insurance for U.S. purposes, there will be no effective tax deferral wrapper and growth of assets within the policy will be treated as investment income in the U.S. Try to exchange the foreign policies for U.S. policies.
- Consider closing foreign bank accounts, or the individual will have to file FBAR forms after moving to the U.S.

33. Steps to Take Before Emigrating From the U.S.

- Check on exposure to the "exit tax" under §877A (mark-to-market exit tax on worldwide property).
- Check on exposure to tax under §684 (recognition of gain on certain transfers to certain foreign trusts, estates, and nonresident aliens)
- Make gifts of U.S. situs assets (such as real estate) using any remaining applicable gift exclusion amount
- Make gifts to spouse (or others) of appreciated assets if the exit tax applies. However, significant balance sheet changes in the five pre-expatriation years must be disclosed on Form 8854.
- Consider making a taxable disposition of appreciated assets to avoid a basis mismatch in the new country of residence.
- Consider potential tax under §2801 if the entire family does not expatriate. If a taxpayer expatriates and leaves assets to U.S. persons, the receipt of those assets by the U.S. persons is taxable income. There are various exceptions. Cathy Hughes indicates that there will be guidance/regulations regarding §2801 coming soon.

34. Advice for Foreign Donor Making Gifts to U.S. Persons

- Create a grantor trust to minimize U.S. income and eventual estate tax.

- Incorporate provisions to allow the grantor trust status to continue as long as possible (for example, the resettlement by a non-U.S. holder of a general power of appointment).
- Avoid holding U.S. situs assets in trust if §§2035-2038 may apply.
- Avoid holding assets that will become CFCs or PFICs when the grantor ceases to be the owner of the trust.
- Make gifts of stock of U.S. corporations rather than holding them until death (when they would be subject to U.S. estate tax).
- Be careful with making gifts of cash, to make sure the transfer occurs outside the U.S.
- Be careful with transfer strategies that could give rise to the IRS invoking the step transaction or other judicial doctrines.
- Make any trust perpetual since the GST tax will not apply if there is no transfer subject to U.S. gift or estate tax.
- Allow trust modifications so that a foreign trust can become a U.S. trust to avoid the onerous rules that apply to foreign trusts.
- Do not give U.S. beneficiaries rights that expose them to gift or estate tax.

35. Advice Concerning Foreign Assets Owned by U.S. Persons

- Typical probate avoidance techniques (such as funded revocable trusts) may have unintended tax consequences under foreign law.
- Consider a "situs will" to dispose of foreign assets.
- Consider forced heirship rules, spouses' elective share rules, and marital property regimes of the foreign country.
- Realize the trust may not be recognized in civil law jurisdictions or that higher tax rates may apply to trusts under foreign laws.
- Consider that entity ownership may cause higher wealth tax rates to apply in the foreign country.

Items 36-42 summarize observations from a panel by Leigh-Alexandra Basha and Joshua S. Rubenstein: Impact of Matrimonial and Other Property Regimes on International Estate Planning

36. Overview of Complicating Issues Upon Dissolution of Marriages Between Partners of Different Nationalities

Josh Rubenstein observes that "all marriages and, either vertically or horizontally" (i.e., by divorce or death). The issue of property ownership may be different depending upon whether the dissolution is by divorce or death. At divorce, the spouses typically each receive one-half of the marital property. At death, the surviving spouse may just receive a marital share, which is typically one-third, but that represents one-third of *all* of the decedent's estate, not just of marital property.

International marriages have more strains, including cultural or religious differences. A variety of complex and frequent issues arise at the dissolution of marriages between partners of different nationalities. Cross-border issues of divorce and estate planning may overlap. In dealing with spouses with international marriages, planners should be sensitive to these complicating issues, including the following:

- Tax implications for divorcing spouses with respect to equitable distribution, alimony and child support;

- Estate planning opportunities of divorce because there is consideration being given for transfers;
- Estate planning and tax implications, including spousal and forced heirship rights, as well as tax residency and domicile issues in order to take advantage of particular tax benefits;
- Forum shopping on an international level, with parties often carrying on two divorce actions into countries with each racing to achieve a more favorable judgment; for example, laws may vary based upon whether prenuptial agreements are enforced, recognition of trusts, equitable distribution rights, grounds of divorce being relevant, and custody guidelines;
- Same sex marriages;
- Immigration marriage fraud (approximately 30% of marriages between United States citizens and nonresident aliens are fraudulent);
- Jurisdiction issues regarding which country has authority to dissolve the marriage and to determine property settlement/alimony/child support; jurisdiction is often a highly contested issue in divorces of international spouses; choice of law provisions in prenuptial agreements are common;
- Discovery in litigation is considerably more difficult when assets are located in another country;
- Posting security for alimony/child support obligations by a spouse residing in another country;
- Enforceability of divorce judgments in foreign countries can be difficult and expensive; and
- Upholding secular aspects of religious law.

The incidence of divorce varies dramatically in different cultures. The incidence in the population at any one time of divorce is the following in various countries:

- Western countries is 6-8%,
- Soviet Union about 10%,
- Unites States, 10.4%
- China 0.6%,
- Cook Islands 33% (the highest).

37. Community Property Considerations

Community property considerations are important for international couples, because that is the default marital property regime in many countries. The planner cannot trust the couple's understanding of the marital property regime where they live. (For example, Virginia residents often think they have community property because Virginia is a "Commonwealth.")

a. *United States*. There are 10 community property jurisdictions in the United States. Eight are based on community property systems derived from Spanish and French law (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington), one has adopted the Uniform Marital Property Act (Wisconsin), and one has adopted an elective community property system (Alaska). Puerto Rico also has community property. Interestingly, about 40% of Americans live in community property regimes even though there are only 10 community property states. For example, California and Texas alone account for approximately 20% of the country's population.

b. *Foreign Community Property Regimes*. There are three types of foreign community property regimes: (1) universal community (all of the couple's assets are community, whether acquired before or during marriage); (2) community after-acquired property (assets acquired during marriage are community except that gifts and inheritances may be exempt); and (3) community upon dissolution (community property rights do not crystallize until the marriage ends by death or divorce). Be aware that many foreign countries with community property regimes also have forced heirship rights at death. In the Shariah world, there are no community property rights; spouses receive a forced share, but it is not generous.

c. *Change of Domicile*. Property moved from a community property jurisdiction to a common law jurisdiction generally retains its character as community property.

Fourteen states have adopted the Uniform Disposition of Community Property Rights at Death Act (Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Virginia and Wyoming). This act creates a rebuttable community property presumption that property acquired while married and domiciled in a community property jurisdiction is considered as community property but only for death time transfers, not impacting management rights or other rights during marriage or the rights upon divorce. Even in states that have not adopted the Uniform Act, the Restatement (Second) of Conflict of Laws §259 adopts the same approach.

d. *Income Tax Treatment*. For community property, each spouse is generally subject to income tax on 50% of the community income. *Poe v. Seaborn*, 282 U.S. 101 (1930). However, §879 has special allocation rules for various situations:

- Earned income is taxed as separate income of the spouse performing the services;
- Trade or business income and related deductions (other than for a partnership) are reported by the spouse carrying on the trade or business;
- A distributive share of partnership income or loss is the income or loss of the spouse who is the partner;
- Community income from separate property (other than partnerships and trade or business assets) are taxed to the spouse owning the property;
- All other community income is split between the spouses under the applicable community property laws.

e. *Gift Tax Treatment*. A gift of community property to a third party is deemed to be made one-half by each spouse. That is typically an advantage. For example, a gift of $26,000 or less in 2012 is made one-half by each spouse and does not require gift splitting or the filing of a Form 709. (Gift splitting is not available unless both spouses are U.S. citizens or U.S. domiciliaries, §2513.)

If the spouses by agreement convert their community property into separate property, gift treatment may result if the assets are not divided equally. That can have adverse gift tax consequences if the transferee spouse is not a U.S. citizen and is therefore ineligible for the unlimited gift tax marital deduction.

f. *Estate Tax Treatment*. The community property regime is generally more advantageous for estate tax purposes. Each spouse is deemed to own 50% of the assets. When one spouse dies, only half is included in that spouse's gross estate. However, assets titled in the name of the surviving spouse will be included one-half in the decedent's estate if the assets are community property.

A distinct advantage is that the assets are balanced between the spouses. For example, for an international couple where the U.S. person owns most of the assets and dies first, a

QDOT must be used for assets passing to the surviving spouse. Equalizing assets can be difficult because the annual exclusion for making gifts to the nonresident spouse is $143,000 (indexed) and no marital deduction is allowed, which limits the ability to shift assets between spouses.

Another advantage of community property is that there is a 100% basis step up on both community halves at the death of the first spouse to die.

g. *S Corporation Qualification.* Shares of an S corporation owned as community property may be owned one-half by a nonresident alien. If so, that would disqualify the corporation from making an S election.

h. *Preserving Community Property Character.* Preserving the community property character of assets can be important for various reasons. A prime nontax advantage is for creditor planning purposes (and preserving the ownership rights of each of the spouses in the community property). Methods of preserving the community property character of assets may include accountings, tracing, joint revocable trusts, or a community property agreement.

38. Planning Considerations for Spouses If One Spouse is a Non-Citizen or Non-Domiciliary of U.S.

a. *Jointly Tenancy Property (Other Than Community Property).* Joint tenancy property of U.S. citizens is treated as being owned one-half by each, but if one spouse is a non-U.S. citizen, a consideration furnished test applies. If joint tenancy property is sold, the spouses must be very careful to split the proceeds according to the consideration furnished test, or taxable gifts between spouses may result (and there is no gift tax marital deduction if the donee-spouse is a non-citizen).

b. *Equalizing Estates.* Equalizing the estates of spouses can be advantageous, in order to avoid having to leave assets into a QDOT for a non-citizen spouse at the death of the U.S. spouse. The wealthier spouse may make gifts to the less wealthy spouse, but gifts to a noncitizen spouse qualify only for an annual exclusion of $139,000 (indexed, adjusting to $143,000 in 2013).

A pre-immigration planning strategy is to balance assets among spouses. Treaties may be helpful in allowing interspousal transfers without adverse transfer tax affects.

c. *No QDOT for Lifetime Gifts.* The availability of a marital deduction for assets passing to a QDOT applies only to death transfers, not lifetime gifts.

d. *Loans to Non-Citizen Spouse.* Loans to a non-citizen spouse at low interest rates may provide an opportunity for shifting wealth to the borrowing spouse.

e. *Treaty Provisions.* Some treaties contain marital deduction provisions that override the U.S. federal marital deduction. For example, under the U.S./France estate and gift tax treaty, property acquired during marriage while domiciled in or a citizen of the U.S. will be treated as community property unless the spouses expressly elect different treatment under French civil law. Similar treaty provisions with Canada and Germany may also render a QDOT unnecessary for bequests of half of the assets to a non-citizen spouse.

f. *Limitations on Use of Portability.* The portability regulations provide that the portability election cannot be made on behalf of a nonresident noncitizen decedent. In addition, a nonresident noncitizen surviving spouse cannot utilize the deceased spousal unused exclusion amount of any predeceased spouse, except to the extent allowed under a treaty.

39. Forced Heirship

Most of the world, other than English-speaking countries, has forced heirship. Forced heirship laws are most prevalent in civil law jurisdictions and in countries applying Islamic (Shariah) law. For example, decedents who were French domiciliaries and owners of French immovables must leave a minimum "legal reserve" to the decedent's children (1/2 of the estate if there is one child, 2/3 of the estate for two children, and 3/4 of the estate for three or more children).

Germany applies its forced heirship rules based on the decedent's nationality rather than residency. Therefore, even if a decedent was a dual U.S./German citizen and lived in the U.S. with solely U.S. assets, a family member may make a claim under Germany's forced heirship rules.

Forced heirship rules are often a major "hot topic" in estate planning discussions if one spouse is a nonresident alien. For example, the client may not want to leave assets to a wayward child. The forced heirship rules can have dramatic estate tax consequences, because assets passing to a child obviously cannot qualify for the marital deduction. Accounting for forced heirship rules is a very important aspect of estate planning for a nonresident alien. If a client has any connection to a foreign country, engage foreign counsel to advise on non-tax ramifications, including forced heirship rules.

U.S. courts generally try to avoid recognizing forced heirship claims based on the laws of the decedent's country of citizenship, but instead tend to uphold the testator's dispositive scheme. Various cases have applied the U.S. principles of testamentary freedom rather than forced heirship laws in that circumstance. There may be a "race to the courthouse" to obtain a ruling in the court most likely to be friendly to one's position. The second reviewing court will often feel bound by the prior judgment of the court in the other jurisdiction. Two New York cases are vivid examples of this approach. *Estate of Renard* applied New York law where the testator was a U.S. citizen who retired in France and had provided in her will that New York law would apply. The New York court refused to recognize the son's forced heirship rights under French law. On the other hand, in *Watts v. Swiss Bank Corp.*, a dispute was decided in France before a New York court decided the case, and the Court of Appeals in New York upheld the French verdict in New York on the basis of res judicata rather than on conflict of laws principles.

40. Choice of Law

Determining which jurisdiction's law applies to govern estate dispositions is very important for a variety of issues, such as (1) validity and construction of wills, trusts and testamentary arrangements, (2) rights of the spouses, (3) forced heirship rights, and (4) conflict of laws. Determining which jurisdiction's law applies is based upon a variety of factors, including which jurisdiction has the most significant relationship to the given particulars of the situation. These include relevant policies of the forum state and relevant policies of the other interested state or countries and the relative interest of each of those places on the particular issue. Restatement (Second) of Conflicts of Law §§258 (marital property rights), 259 (intestate succession), 263-264 (wills).

In applying the law of another country, one must apply its choice of laws rules also. For example, in *In re Schneider's Estate*, someone in New York died with real estate in Switzerland. Originally, the court was going to apply Swiss law as to the real estate, but under Swiss choice of law rules, domicile controls. Therefore, New York applied New York law because Switzerland would have applied New York law.

Some jurisdictions base the choice of law issue on the type of property as well as the nationality or domicile of the decedent. Many civil law countries (including Germany, the Philippines, and some Scandinavian countries) base their choice of laws rules on a person's *citizenship* rather than domicile. However, France and Belgium use *domicile* in choice of law on succession law matters. Switzerland has an unusual law that uses different rules based on whether the non-Swiss citizen is or is not domiciled in Switzerland.

New York has a unique statute that permits a testator to choose New Yorl law to apply to his or her estate. EPTL § 3-5.1 (allowing non-New York decedent to opt for application of New York law to testamentary dispositions).

The European Union Parliament and EU Council passed a regulation on June, 2012 permitting a person to elect the law of nationality to govern the disposition of that person's estate. However, that regulation does not take effect until 2015. For example, a U.S citizen could decide that U.S. law would apply, and that could avoid forced heirship for those assets.

Traditional conflict of laws principles applied the law of the situs jurisdiction to real or tangible property located in the jurisdiction, and the law of the domicile jurisdiction to other property. However, most foreign countries do not have the concept of tangibles and intangibles or real or personal property. Instead, many foreign civil law countries apply distinctions of "immovable" and "movable" property. A particular jurisdiction will generally apply its law as to movable property located in the jurisdiction and immovable property owned by a domiciliary of that jurisdiction.

An example of the importance of these concepts is that the U.S. typically views leaseholds and mortgages as intangibles, but foreign countries view leaseholds and mortgages associated with real estate in the country as immovables. Therefore, if a U.S. citizen held mortgages secured by French real property, although mortgages are typically classified as personal property in a common law jurisdiction, French law considers mortgages with respect to French property as immovable property, and therefore French law would govern the disposition of the mortgage.

Again, there is often a "race to the courthouse," because once one court has ruled, it is likely that a court in another jurisdiction will defer to the prior ruling.

41. Premarital Agreements

Premarital agreements are not recognized in many parts of the world. The U.K. did not recognize them until recently, but they are now enforceable in some circumstances (*Radmacher v. Granatino* [2010] UKSC 42). In France, couples may select the type of separate or community property regime that will apply to their marriage.

42. Same Sex Marriages

The Second Circuit recently held that the Defense of Marriage Act is unconstitutional, in an estate tax refund case involving the denial of a marital deduction for assts passing to a same sex partner. *Windsor v. U.S.*, 110 AFTR 2d 2012-XXXX (2nd Cir. October 18, 2012)(finding unconstitutionality of DOMA on the basis of the "intermediate scrutiny" test of the Equal Protection Clause) *aff'g* 833 F. Supp.2d 394 (S.D.N.Y. June 6, 2012). The case allowed an estate tax refund of $353,053 plus interest and costs. The First Circuit previously ruled that DOMA was unconstitutional in two separate cases. (*Commonwealth of Massachusetts v. United States Department of Health and Human Services* and *Gill v. Office of Personnel Management*). The tax advantages that same sex marriages have enjoyed in some countries as compared to the U.S. may be disappearing. Certiorari is being requested form the Supreme Court in a variety of different DOMA cases, and it is possible that the Supreme Court will address the issue in the current term of the Court. For planning considerations in light of these attacks on DOMA, see David J. Simmons, *Planning for the Demise of DOMA*, TR. & ESTS. 22 (Nov. 2012).

Items 43-46 summarize observations from a panel by Michelle B. Graham (discussing Mexico), Carlyn S. McCaffrey (discussing the United States), and Clare Maurice (discussing the United Kingdom): How to Own Your Foreign Home — Tax Planning for the Foreign Real Estate Investor. This addresses the income and transfer tax issues that are faced by non-resident owners of real estate, principally in Mexico, the United States, and the United Kingdom.

43. Overview of Problem Areas

A client looking to purchase a residence or other real property in a foreign jurisdiction must worry about various challenges. The foreign country may have laws that actually restrict foreign ownership. There may be complicated patterns of taxes including stamp duty and other forms of transfer taxes, periodic wealth taxes, real estate taxes and other kinds of annual charges, taxes on rental income and on disposition of the property, taxes in some cases on a donative transfer of the land, estate taxes, gift taxes, GST taxes, and inheritance taxes. To add to the challenge, devices that may seem attractive to minimize taxes in the home country may result in higher taxes in the country where the land is located. If the client will be using the residence in the foreign country, she must also be concerned with the rules for establishing residence so that she does not become subject to the foreign country's income taxes.

The most important takeaway of this discussion is that the U.S. attorney cannot do it alone. If you think you know the rules of a particular foreign jurisdiction today, the chances are you will not know them tomorrow. U.S. attorneys with U.S. clients who want to purchase homes in a foreign country need to partner with an attorney in the foreign country, and vice versa for foreigners who wish to purchase homes in the U.S.

44. Issues for Non-Resident Owners of Real Estate in Mexico

a. *Background History*. A historical background is helpful to understand the current system in Mexico for ownership of real estate by foreigners. In the mid-1850s, Mexico lost California, Texas, Arizona, Utah, Colorado and New Mexico to the United States. A major goal emerged of protecting further loss of real estate, and the Mexico Constitution provides that only Mexicans by birth or naturalization and Mexican entities have the right to own Mexican real estate. Each state in Mexico is empowered with the ability to grant foreigners similar rights with two caveats: (1) the foreigner must agree to be treated as a Mexican national as to the real estate, and (2) they must agree not to invoke the protection of their own government in any dispute regarding the real estate. In addition, and most importantly, foreigners cannot by any means acquire direct ownership of land in the "Restricted Zone" (which includes a strip within 100 km of the borders and within the 50 km of the coasts [and foreigners typically want to buy property near the coasts, such as in Cabo]).

b. *Foreigners Can Own Property Outside Restricted Zone*. Property outside the Restricted Zone can be owned by a foreign individual or trust. If an individual owns Mexican real estate, there should be a situs will, prepared by a notary public in Mexico. After the individual dies, property can be transferred pursuant to the terms of the will under an easy procedure.

c. *Fideicomiso For Acquiring Real Estate In Restricted Zone*. In the 1970s, in order to encourage investment dollars in Mexico, a system was created allowing foreign individuals and entities to acquire land within the Restricted Zone using a "fideicomiso."A fideicomiso looks like a trust. The seller is the trustor, the trustee is a Mexican financial institution, and the beneficiary is the foreign individual or entity that wishes to acquire the property. The term of years of the trust is 50 years, but it is renewable, and almost always is renewed upon request). The beneficial interest itself can be assigned. A permit is required for the trustee to be able to acquire real estate within the Restricted Zone. The terms of the trust are pretty generic, with no planning about succession or accomplishing estate planning objectives. It is merely a device to hold ownership of real estate.

The beneficiary can be an individual, an entity (such an LLC, if there are liability concerns), or a trust. However, there are some complications in using a trust is the beneficiary because Mexico is a civil law country and does not have established rules or regulations for recognizing trusts. Mexico looks through trusts to the individual owners.

d. *U.S. Reporting*. Various reports must be filed in the United States regard regarding foreign real property ownership. A panelist indicates that the IRS treats a fideicomiso as a trust for purposes of these reporting requirements, and it is a grantor trust because of the beneficiary's broad power over the trust. (However, an author reports that she very recently received a PLR from the IRS concluding that a fideicomiso is not a trust for foreign trust filing purposes, but that the fideicomiso beneficiary is treated as holding an interest in the Mexican residence directly. Amy Jetel, *Fideicomisos: Clarity at Last?* TR. & ESTS. 59 (Nov. 2012).)

Form 3520-A. Form 3520-A must be filed by March 15 of each year (the other various reporting forms are due April 15), but Mexican trustees will not file these. The IRS is aware that foreign trustees may not cooperate, so it allows the U.S. beneficiary to sign the Form if the trustee will not do so. The Form must include a balance sheet, income statement, listing of distributions from the trust, etc. A thorough report is required but it is relatively straightforward if there is just real estate in the trust.

Form 3520. Form 3520 must be filed when a foreign trust is funded, when distributions are made from it, or when the trust terminates. While there are no distributions from a fideicomiso, uncompensated use of real estate is treated as a deemed distribution, and the fair rental value for the use of the property must be reported.

Form 8938. Form 8938 is a new form that must be filed beginning for tax year 2011 to report ownership of "specified financial assets" (the definition of which includes fideicomisos) over a threshold value. (This does not take the place of any of the other foreign informational returns).

Penalties and Amnesty Program. There are significant penalties for failure to file the report forms. For example, the penalty for failure to file the Form 3520-A is 5% of the property value each year, but the penalty can be abated for reasonable cause. There is currently an amnesty program (the "Offshore Voluntary Disclosure Initiative") waiving all penalties *if* there is no unreported income from the foreign ownership. The IRS website for this program addresses foreign information reporting in questions 17 and 18, such as failure to file Form 3520 or 3520-A. No penalties at all are imposed if all back-filings are made (eight years). The speaker files the Forms with a transmittal letter stating that all penalties should be abated and attaching a copy of Questions 17 and 18 from the IRS website.

There is currently no deadline for this amnesty program, but it will probably close at some point in the future.

e. *Tax Exposure in Mexico.*

Transfer Tax. There is no estate, inheritance, or gift tax. However, there is an income tax on the transfer of stock in a Mexican company or Mexican real estate to an unrelated party. There is an exemption from that income tax for transfers to a spouse, child, or grandchild. Convincing Mexican authorities that one of the exemptions applies when real estate is owned by a trust can be complicated.

Income Tax. There is a robust U.S./Mexico tax treaty. Nonresidents of Mexico are subject to the Mexican income tax on Mexican source income, which includes rental income (at a 25% rate) or proceeds from the sale of Mexican real property. The highest rate is 30%. There is also a minimum flat tax (17.5% rate), and taxpayers are required to pay the higher between the income tax and the flat tax. A foreign tax credit is allowed in the United States for income tax paid in Mexico (including the flat tax).

For purposes of determining the capital gains tax in Mexico, the basis of property in Mexico is adjusted every year for inflation.

VAT. Mexico's Value Added Tax (at a standard rate of 16%) does not apply to the sale of land, improvements to personal homes, or residential leases. However, the VAT may apply to leased property that is furnished.

Acquisition Tax. There is an acquisition tax of 1-5% (depending on the state in which the property is located) when property is acquired. For example, there is a 2% tax in Cabo. There are also registration fees and notary fees on the acquisition of property in Mexico.

45. Issues for Nonresident Ownership of Real Estate in United States

This is a brief summary of the U.S. tax effects for a foreign person (particularly as to owning U.S. real estate). A more extensive discussion of the U.S. tax effects for foreign persons is in the summary of the panel discussion by Ellen Harrison and Michael Pfeifer.

a. *Generally*. Foreign individuals owning real estate in the United States will be subject to income tax on rental income or gain on the sale of the property. The federal estate, gift, and GST tax can apply to transfers of U.S. real property by the foreigner. The foreigner must also worry about state and local income taxes. For example, in New York there is an acquisition tax (colloquially called the "mansion tax") of 1% when property is bought that is worth over $1 million. State income taxes can apply to rental income and gain from sale of the real estate.

b. *Who is a "Foreigner" For These Purposes?* If a foreign client wants to buy U.S. real estate, the first planning step is to determine if the individual is really a foreigner for U.S. tax purposes. The planner should point out carefully how the status can be lost if the foreign person purchases property and spends a certain amount of time in the United States.

For income tax purposes, an individual is treated as a U.S. resident if the person is a U.S. citizen, holds a green card, or if the person is physically present in the U.S. for more than 183 days during a three-year period (a sliding scale approach is used for the 183 day test, counting one day for each day in the current year, 1/3 of a day for each day in the prior year, and 1/6 of a day for each day in the year before that). For transfer tax purposes, the test is based on domicile rather than on counting the days in the U.S.

c. *Income Tax*. A foreigner is subject to the U.S. income tax on U.S. source income, which includes real estate rental income and income from the sale of U.S. real estate.

Rental income is taxed at a flat 30% rate (unless an election is made to treat it as effectively connected with a U.S. trade or business), but this can be decreased by an applicable treaty. There is no imputed rental income when the foreign individual uses the home or allows the home to be used by others. Rental income is generally not treated as effectively connected with a U.S. trade or business. If the taxpayer elects to treat rental income as effectively connected with a U.S. trade or business (*see* §871(d)(1)), the normal income tax rates under §1 apply, but the individual is entitled to deductions that are connected with the income.

Gains on the disposition of U.S. real estate (which includes interests in a U.S. corporation in which U.S. real estate is at least 50% of the value of all real estate and trade or business assets in the corporation, §897(c)(2)) by a foreign individual is subject to taxation under FIRPTA. It generally provides that gains will be treated as effectively connected with a U.S. trade or business, which means that the gain is taxed the same as a U.S. person would pay on the income. Therefore, if the foreigner has owned the U.S. property for more than a year, the normal long-term capital gains rate of 15% (scheduled to increase to 20% in 2013) will apply. However, if the real estate is owned by a foreign corporation, long-term capital gain rates are not available and the normal corporate tax rate would apply (highest rate of 35%). If the U.S. real property is sold following the death of the foreigner, a basis adjustment is available (whether or not the property is subject to U.S. estate tax) so there would typically not be any income tax if the property is sold shortly after death.

d. *Estate Tax*. An individual's status as a nonresident for transfer tax purposes is based on domicile. The transfer tax rules that apply to a person who is neither a U.S. citizen nor resident are described below. The U.S. estate tax applies to U.S. situs assets. The situs rules are different for estate and gift tax purposes.

For estate tax purposes, U.S. real estate owned individually has a U.S. situs. Stock in a U.S. corporation also has a U.S. situs. The traditional thinking has been that stock in a foreign corporation is not subject to the U.S. estate tax. However, planners are no longer completely confident that owning assets in a foreign corporation can avoid the U.S. estate tax (and indeed ownership of a foreign corporation causes other tax problems).For example, the IRS success of including assets that are transferred to partnerships because of a retained interest or control over the partnership in the gross estate of the individual might conceivably be extended to ownership in a foreign corporation where there was no other purpose for the corporation other than to avoid the estate tax.

The situs of assets in partnerships or LLCs for U.S. estate tax purposes is not clear.

Debts are generally deductible in calculating the estate tax, but for foreigners, only a proportionate part of the debt (the proportionate part of worldwide assets that are U.S. assets) may be deducted. However, for nonrecourse debt, only the net value of the property is included in the gross estate, in effect allowing a full reduction for the amount of the debt.

The estate tax exemption for foreigners is just $60,000.

e. *Gift Tax*. Shares of any corporation (whether domestic or foreign) are not treated as U.S. situs assets for U.S. gift tax purposes. Therefore, transfers of stock of a corporation owning U.S. real estate is not subject to the U.S. gift tax. The rules would conceivably be the same for entities other than corporations, but for some reason the IRS refuses to rule that an interest in a partnership is an intangible for this purpose.

f. *Foreign Corporation Income Tax Effects*. Ownership of U.S. real estate in a foreign corporation can cause U.S. income tax problems.

The corporation must pay tax on its rental income (corporate tax rates can be as high as 35%). If the foreign corporation makes the "effectively connected" election so that the normal rates apply rather than the 30% flat rate, it must also pay a 30% "branch profits tax" on that same income to the extent that it is not reinvested in other U.S. assets. (The 30% rate is applied to the effectively connected earnings and profits of the corporation, after subtracting the regular corporate income tax on the rental income. The concept is to apply a tax analogous to the separate U.S. tax that would be applied to a domestic corporation when it pays dividends.)

As a practical matter, when the owner wishes to sell the U.S. real estate, few buyers will be willing to buy the owner's stock of the foreign corporation without applying a huge discount, and the real property will have to be sold by the corporation. When the corporation sells the property, there is no preferential long-term capital gain rate, but tax would be paid at the normal corporate income tax rates, as high as 35%. Furthermore, unless the foreign corporation is dissolved in the year of the sale or unless the sale proceeds are reinvested in other U.S. assets, it would have to pay a 30% "branch profits tax" on the corporation's earnings and profits (which would be determined after subtracting the normal income tax) for that year.

There are a host of possible state and local franchise taxes that can apply to the corporation.

A huge disadvantage is that at the owner's death, the basis of the owner's shares in the corporation are adjusted under §1014, but not the assets inside the corporation.

g. *Foreign Trust*. Foreign trusts are subject to the same income tax rates as individuals, but the compressed trust brackets for trusts apply. There is no imputed income if the trust permits beneficiaries to use the property.

A gift of U.S. real estate to a foreign trust by a foreign individual is subject to the U.S. gift tax (unless the transfer is incomplete for gift tax purposes, in which event the assets in the trust will be subject to the U.S. estate tax when the foreign individual dies). A planning strategy to avoid the gift tax is to have the foreign individual transfer cash to the foreign trust and sometime later the trust would invest in U.S. real estate.

For estate tax purposes, if the foreign individual uses the real estate that she gave to the trust, §2036 will likely apply unless the individual pays rent. (Any rent would be U.S. source income and be subject to U.S. income tax as rental income.)

If a foreign individual is a beneficiary of the trust created by another person, the trust could purchase U.S. real estate. There would be no imputed income on the beneficiary's use of the property. There would be no estate tax (or basis step-up) at the individual's death.

g. *Avoiding Income and Estate Tax But Achieving Basis Step-Up*. Carlyn McCaffrey describes a strategy that may allow a foreign individual to avoid income and estate tax but still achieve a basis step-up at the foreign individual's death.

46. Issues for Nonresident Ownership of Real Estate in United Kingdom

a. *Attitude Toward Tax Avoidance*. Tax avoidance is an unwelcome expression in the UK. The Prime Minister says it is immoral. Clients should be made aware that tax avoidance is viewed culturally as bad form and antisocial in the UK.

The following quotation exemplifies this harsh attitude:

> "I will not hesitate to move swiftly, without notice and retrospectively, if inappropriate ways around these rules are found." Chancellor of the Exchequer The Rt Hon. George Osborne MP.

b. *Deemed Domicile*. Very different tax systems apply for domiciled persons and persons not domiciled in the UK. Even if there is no intention to change one's domicile, a person will acquire a "deemed domicile" in the UK for inheritance tax purposes if the person is "resident" in the UK for 17 out of 20 years. There are specific rules for determining if a person is a "resident" of the UK during a year.

c. *Tax Effects on Buying Property*. A Stamp Duty Land Tax (SDLT) is imposed on the purchase of real estate in the UK. The rate is based on the purchase price (if no consideration passes, the market value). The rates range from 0-7% (the maximum rate applies for values over £2 million. In addition, since March 21, 2012, a 15% rate is applied (rather than the normal 0-7% rates) if the property is acquired by a "non-natural person," which includes a company or partnership.

d. *Tax Effects on Holding Property*. There is a proposal to impose an annual charge beginning April 6, 2013 on residential property owned by a non-natural person. The charge applies to properties valued at £2 million or more, and ranges from £15,000-140,000 (the maximum annual charge applies for properties having a value greater than £20 million). The burden will be on the owner to establish the value property, and valuations will have to be refreshed every five years. The annual charge amounts will increase annually.

At this point, it is not clear that this annual charge will be implemented. The purpose is to discourage persons from using companies or partnerships to buy real estate.

e. *Tax Effects on Selling Property*. A capital gains tax (CGT) of 18% or 28% (depending on the owner's income level) applies to the sale or gift of UK real property. However there are important exceptions — the tax does not apply to principal private residences or to non-residents. Non-residents do not pay capital gains taxes — they've never paid capital gains tax. That was a policy decision in 1965 to encourage investment in the UK. But the following proposal may change that.

Proposal. The Chancellor of the Exchequer has announced a "consultation" into applying the CGT to non-resident non-natural persons disposing of residential property valued at more than £2 million. For this purpose, there is a broad definition of non-natural persons, including trusts and personal representatives, as well as corporations, foreign LLPs, and charities located outside the EU. It is quite strange that the capital gains tax would apply to the sale of property after the death of an individual under this proposal. The speaker made her feelings very clear about this proposal:

> "But George Osborne seems to be throwing the baby out with the bath water. He is now suggesting to extend the capital gains tax to non-resident non-natural persons when selling residences valued at more than £2 million.

> It's ridiculous. He's completely mad. How can we possibly run a country by telling them on the one hand we welcome them and then whacking this tax on them? ... I'm appalled. But anyway, what do I know?"

f. *Tax Effects on Death of Property Owner or Gifts by Owner*. There is an inheritance tax (IHT) of 40% on the value of property exceeding £325,000. There is a full exemption for transfers to a spouse or to a trust for spouse giving the spouse the exclusive right to trust income. However, for a transfer from a UK domiciled spouse to a non-UK domiciled spouse, the spousal exemption is limited to £55,000. (Therefore, there is a full exemption for spousal transfers if both spouses are UK domiciliaries or if neither spouse is a UK domiciliary.)

The IHT also applies to lifetime transfers, but there is an exemption if the transfer is to an individual and the donor survives the transfer by seven years. (This is referred to as a "potentially exempt transfer," or PET.) No IHT is paid with respect to the gift if the donor lives seven years after the transfer (and a reduced rate applies if the donor survives at least three years). There is an exemption for lifetime transfers to a spouse who has a permanent home in the UK. The UK also allows a £3,000 annual exemption and exempts certain wedding gifts, small gifts, and regular payments that are part of the person's normal expenditures.

There is a comprehensive UK/U.S. estate tax treaty. One of the results under the treaty is that immovable property is taxed in the country in which the property is situated. If a U.S. person dies owning UK real estate, the IHT tax is due to the UK, but a credit is given in the U.S. for tax paid in the UK.

g. *Trust Transfers*. Gifts to trusts in excess of the £325,000 inheritance tax threshold are subject to a 20% tax, payable by the trust. If the donor dies within seven years, the estate must pay an additional 20% tax (so that the overall tax is 40%). If the donor is a beneficiary of the trust, the trust has to pay the 20% tax, and the asset will still count as part of the donor's estate for inheritance tax purposes at the donor's death (but the total tax would not exceed 40%). This tax applies to all UK domiciled persons and to UK situs assets for persons not domiciled in the UK.

The speaker was very clear in her feelings as well about this tax and the impact on trust planning:

> "This time it was Gordon Brown….Bastard. He pretty well killed the estate planning industry by saying that if you transfer assets into trust now there is an upfront 20% inheritance tax charge."

Ten Yearly Charge. If UK situs property is held in a trust established after 2006, an IHT charge is imposed on each 10th anniversary of the trust (the ten yearly charge) and when principal is distributed from the trust (the exit charge). The rate is currently 6% of the value of the UK property. If principal is distributed from the trust, the ten yearly charge is prorated.

h. *Inheritance Tax Avoidance Strategies*.

Direct Individual Ownership. Direct individual ownership is a simple and straightforward solution that is the most cost-effective solution in many situations.

SDLT. The basic SDLT rate would apply, not the special 15% rate that applies to non-natural persons.

Annual Charge. Similarly, there would be no annual charge because the owner is not a non-natural person.

CGT. Non-residents are not subject to the CGT tax on a subsequent disposal of the real estate.

IHT. The downside of this simple straightforward strategy is that the IHT tax would apply, but because of the spousal exemption, it would only be imposed at the death of the surviving spouse. (There are complicated rules on the deductibility of debt.) The payment of IHT to the UK could be used as a credit against the U.S. estate tax.

Direct Ownership by Trustees with Debt. A trust established by an independent third party for the U.S. person would be established, with as little as $100. Careful drafting of that trust is essential and the trustees must be resident outside the UK. The trustees would borrow from the U.S. person the funds for purchasing UK property, and a nominee company incorporated outside the UK would act as nominee for the trustees in acquiring the UK property. (A company acting as nominee is not treated as a non-natural person owner.)

SDLT. The trustee is not a non-natural person, so the basic SDLT rate would apply, not the special 15% rate that applies to non-natural persons.

Annual Charge. Similarly, there would be no annual charge because the owner is not a non-natural person.

CGT. The trustees are not resident in the UK. Non-residents are not subject to the CGT tax on a subsequent disposal of the real estate, so the CGT tax would not apply to the trust.

IHT. The trustees are treated as owning UK situs property. There is no IHT on the death of the U.S. person beneficiary. There will be ten yearly charges and possible exit charges, but the debt should be deductible to depress the value of the property subject to the tax.

Ownership by Trustees Through Offshore Company. The U.S. person could establish a trust with trustees that are not resident in the UK. The trustees would incorporate a non-UK company (probably an LLC) that would purchase real estate in its name. The U.S. person would transfer funds to the trust, which funds the trustee would contribute to the LLC, which the LLC would use to purchase the UK property.

SDLT. The purchaser (the LLC) is a non-natural person, so the 15% rate would apply where the property value exceeds £2 million.

Annual Charge. Similarly, the annual charge would apply because the owner is a non-natural person. This annual charge begins at £15,000 (for property values between £2 million and £5 million).

CGT. If the proposal to apply the CGT tax to non-natural persons is adopted, the CGT would apply to a subsequent sale of the property by the LLC. The trustees are not resident in the UK. Non-residents are not subject to the CGT tax on a subsequent disposal of the real estate, so the CGT tax would not apply to the trust.

IHT. This approach is disadvantageous as to the three taxes described above. The advantage of this approach is that no IHT would apply on the death of the settlor nor would there be any exposure to the ten year or exit charges. The trust settlement would be an excluded property settlement so that assets would not be subject to IHT even if the settlor later acquired a domicile in the UK.

Summary of this strategy: "Convert the UK house into shares of an offshore corporate and you're home and dry. There's still a problem. You acquire a deemed domicile in the UK if you're resident in the UK for 17 out of 20 years. The solution is to put the shares of the offshore corporate into an offshore trust. That protects the assets even if the client becomes domiciled in the UK, either by the 17 out of 20 years test or by common law."

Item 47 is a compilation of various interesting quotations from the various seminars.

47. Interesting Quotations

a. *Conservative to Aggressive*. A Dave Barry column about drivers in Miami noted the apparent meaning of traffic lights in Miami : green – proceed; yellow – proceed faster; red – proceed while gesturing. – Diana Zeydel

b. *The Line Between Aggressive and Abusive*. Diana Zeydel noted that in Turney Berry's discussion of long-term GRATs, he says that he uses 99 year GRATs – because 100 years is abusive.

c. *Overly Aggressive Strategies*. In noting some of the super-aggressive strategies that some advisors have presented to clients and that clients bring to the attorney, Diana Zeydel observes: "It's easy to be creative when you're not constrained by the law." – Diana Zeydel

d. *No Out*. "100% of all marriages end – either vertically or horizontally." – Josh Rubenstein

e. *It All Depends on Your Perspective*. A Texas farmer visited a small ultra-modern farm in Israel to view Israeli farming techniques. The Israeli farmer is very proud of his two hector farm. It only takes about 15 minutes to see the entire farm, but everything is state of the art with hydroponics, vertical growth to preserve ground space, and with methods of catching rainwater, etc. After the 15 minute tour, the Israeli farmer asked the Texas farmer what he thought of it. The Texas farmer said it was all quite impressive. He invited the Israeli farmer to come to visit his farm but noted that it was quite different. The Israeli asked how. The Texan responded, "I can get in my car at one end of my farm and drive all day and all night still not reach the other end." The Israeli farmer responded, "I once had a car like that too." – Josh Rubenstein

f. *Problems of Partners in Large Law Firms*. Josh Rubenstein said when he was managing partner of his firm he was once asked by the American Lawyer to give them a list of all of his partners broken down by sex. He responded that alcohol was more of a problem at his firm." – Josh Rubenstein

g. *Divorce is a Good Thing*. A fable engraved in the main gate leading to the city of Agra, India (where the Taj Mahal is located) reported that during the first year of King Julief's reign, magistrates divorced two thousand couples. When he heard about these divorces, the King was so outraged that he abolished divorce. During the year following his proclamation, the number of marriages dropped by 3,000, while the number of convicted adulteries rose by 7,000. Officials estimated that embattled couples destroyed three million rupees' worth of furniture. In addition, three hundred wives were burned alive for poisoning their husbands, and seventy-five men were executed for murdering their wives.

Upon learning of the consequences of his divorce abolition decree, the emperor re-established divorce, recognizing it as a necessity. – Josh Rubenstein

h. *Remarriage*. On second marriages: “Remarriage represents the triumph of hope over experience.” – Samuel Johnson in 1772 (as quoted by Josh Rubenstein)

i. *Good Housekeeping*. “He taught me housekeeping; when I divorce I keep the house.” – Zsa Zsa Gabor (as quoted by Josh Rubenstein)

j. *Success and Marriage*. “Many a man owes his success to his first wife and his second wife to his success.” – Jim Backus (as quoted by Josh Rubenstein)

k. *Secret to Successful Marriage Between Spouses of Different Nationalities*. A blogger (*Sobering Advice)* about cross cultural marriages apparently was having troubles with his Japanese wife. His conclusion was “Be sure you are both fluent in at least one language in common.” – Leigh-Alexandra Basha

l. *Tax Avoidance*. “Tax avoidance is an unwelcome expression in the UK. The Prime Minister says that it is immoral. Clients should understand that tax avoidance is seen as bad form and antisocial in the UK .” – Clare Maurice

m. *And We Thought the IRS Could be Hard-Nosed*. “I will not hesitate to move swiftly, without notice and retrospectively, if inappropriate ways around these rules are found.” Chancellor of the Exchequer The Rt Hon. George Osborne MP (United Kingdom). – as quoted by Clare Maurice

n. *News Flash*. “There will be some things coming out by the end of the year.” – Catherine Hughes

o. *Our Partners*. Lou Nostro says that attorneys should fire clients who are unethical, unreasonable, unresponsive or unstable. One Fellow told him that describes half his law partners. – Louis Nostro