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ESTATE TAX PLANNING FOR U.S. CITIZENS/RESIDENTS WITH INTERNATIONAL ASSETS (PART 1)

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In our increasingly global society, estate planning is important, if not essential, for U.S. persons with ties to non-U.S. countries or international assets, especially during certain critical junctures and life altering events (i.e., immigration to the U.S., marriage, health issues, etc.)—belying each major life decision, a critical estate tax ramification. In the U.S., estate planning is relatively commonplace, in part, owing to the complex tax system and adversarial legal system (as compared with bureaucratic legal systems abroad), and in other part, owing to the desire to have certainty, finality, and stability in the ultimate disposition of one's estate.

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Indeed, even individuals with modest estates will have "estate plans," generally consisting of a will, health care directive, power of attorney, and possibly a revocable living trust depending on the magnitude of an individual's estate and jurisdiction in the U.S. in which he or she resides.[1] For example, revocable trusts (also known as "living trusts") are commonly used in states such as California, a jurisdiction in which it is desirable to avoid probate due to the added time and expense (in addition to emotional distress) incurred in a probate proceeding.

In common law countries such as the U.S., Canada, and the United Kingdom of Great Britain and Northern Ireland ("U.K."), there is considerable control over how one may plan for the disposition of his or her estate, with few restrictions. Particularly for the high net worth taxpayer, it is not uncommon for bequests to a surviving spouse and children to have "strings" attached to the bequests. For example, a trust agreement may grant the trustee discretion to withhold distributions to a particular beneficiary, such as a child, if the child has drug or alcohol problems or perhaps because the child is not a productive member of society. Trust distribution schemes can often become quite complicated, often tailored to a client's objectives and desires, requiring distributions at various intervals, or when the beneficiary has met certain age or other achievement milestones, such as graduating from college or university.

In juxtaposition, civil law countries often have in place laws that designate classes of beneficiaries who are entitled to benefit from a decedent's estate by default. The proportion of inheritance distribution invariably depends on the composition of heirs, with children often required to receive a substantial portion of the decedent's estate. It is perhaps for this reason that estate planning is not as commonplace in civil law countries as it is in common law countries like the U.S.; there is less incentive to plan when distributions to certain beneficiaries (e.g., descendants) is mandatory.

Yet another reason that estate planning may not be as commonplace in some countries is because there simply is no death, estate, or inheritance tax (i.e., Australia). In such countries, the burden of the U.S. estate tax system may seem onerous—even draconian—as

the current gift and estate tax rate is 40percent, which is considered a historical low.

Importantly, for countries that impose death, estate, or inheritance, it is critical to determine whether there is an applicable tax treaty in place that may help to minimize or avoid double taxation. The U.S. currently has estate tax treaties with fifteen (15) countries, including Australia, Austria, Canada[2], Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, South Africa, Switzerland, and the U.K.[3]

This outline will cover a number of key non-tax factors to take into consideration when assisting a client who owns an asset or assets outside the United States and the type of estate planning document, if any, that may be preferable. Some of the factors include:

I. CHECKLIST OF CONSIDERATIONS FOR U.S. PERSONS WHO OWN FOREIGN PROPERTY

A. Understanding the Facts

1. Understanding the person—who is the client?

a. Is the client a U.S. person for estate tax purposes? For U.S. estate tax purposes, a U.S. person is a U.S. citizen or domiciliary. Whether someone is a U.S. domiciliary is based on the facts and circumstances. The Treasury Regulations state that a person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[4] Essentially, there are two requirements for determining whether an individual has changed domicile– the first is physical presence, and the second is intent.

b. Does the client have a nationality other than the United States?

c. What is the client's current residency status? What is the client's future residency goals?

d. How has the client accumulated his or her wealth?

e. Is the client married?

f. If the client is married, where did they marry? Did they make any representations, written or otherwise, concerning the characterization of their property (i.e., separate or community property)? Did the laws of the jurisdiction in which they married or in which they resided at the time of their marriage have any presumptions concerning marital assets? Will the assets be considered "community" assets, owned equally by both spouses or will the assets be considered owned only by earning or acquiring spouse?

g. Does the client have children or plan to have children? How old are the children?

h. What is the client's state of health?

i. For the U.S. citizen-client residing abroad, will the laws of the country in which the person resides apply to such person? Does the client have foreign counsel and advisors? Does the client have domestic counsel and advisors?

2. Understanding the assets —what does the client own?

a. What assets does the client own globally? What is the composition of assets by jurisdiction, by class (i.e., financial assets, real property, collectibles, other tangible personal property, etc.), and by value?

b. How is title held to such assets? Are there issues concerning actual ownership versus how title is held?

c. Are there any restrictions regarding transferring any of the assets, such as forced heirship or religious restrictions? If so, to whom do the rules apply and can or should they be avoided?

3. Understanding the objective —what does the client ultimately desire?

a. Is asset protection an objective?

b. Is anonymity an objective?

c. Is generational planning an objective?

d. Is tax optimization an objective?

e. Is charitable giving and philanthropic pursuit an objective?

f. Is carrying on a specific legacy an objective?

g. Is ensuring the proper transition of certain companies or other holdings an objective?

h. Is preventing interfamily disputes an objective? Is promoting interfamilial harmony an objective?

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4. Understanding the larger picture —who is the family?

a. Who are the beneficiaries?

b. What is the nationality of each beneficiary?

c. How old are the beneficiaries? If the beneficiaries are minor children, are there guardians for them and if so, where do they reside?

d. Where do the beneficiaries reside?

e. Is there a desire to disinherit a descendant or treat one or more descendants differently than the others?

f. Are there any tax or reporting issues concerning the receipt of a bequest or inheritance? If so, are there any planning opportunities or exemptions/exceptions that could be applied?

g. Are there any health issues concerning the beneficiaries? Is the client concerned with the planning surrounding any medical disabilities or special health care needs?

h. What are the family dynamics?

As a matter of practical application, for clients working with foreign counsel, it is important to clarify whether the attorney-client privilege applies. In the U.S., confidentiality of attorney-client communications is protected. This is not always the case in other countries. In fact, some countries place a requirement on attorneys to notify authorities of certain suspicious activities, such as money laundering.

II. WHICH LEGAL SYSTEM APPLIES?

A. Are there any restrictions on the disposition of assets?

1. Common law countries—control in one's own hands

As discussed above, in common law countries, a person typically has considerable control over how he or she disposes of his or her estate, with few restrictions. Examples of common law countries include: Australia, Belize, Barbados, Barbuda, British Virgin Islands, Canada, England and Wales, Hong Kong, India, Ireland, New Zealand, Singapore, and the U.S.

2. Civil law countries—designations by default

Civil law countries often have in place laws that designate beneficiaries who are entitled to benefit from a decedent's estate, by default. The proportion of inheritance distribution invariably depends on the composition of heirs. See forced heirship below. Examples of civil law countries include: Armenia, Austria, People's Republic of China, Chile, Columbia, Denmark, Ecuador, France, Germany, Greece, Italy, Japan, Luxembourg, Mexico, Netherlands, Russia, Spain, Sweden, and Switzerland.

3. Islamic law countries—driven by Sharia law

A number of countries are governed under Sharia law, which is often combined with elements from either common law or civil law. Although the rules may vary, Sharia law specifies how much a surviving spouse and children shall receive, similar to the requirements of forced heirship rules, with the exception that often under Sharia law, a son is typically entitled to receive twice the property of a daughter. Examples of countries with Islamic legal systems include, but are not limited to, Iran, Iraq, Oman, Saudi Arabia, Sudan, and Yemen.

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B. Will the relevant country(ies) recognize trusts?

Most common law counties recognize trusts, while most civil law countries do not. However, a few civil law countries have codified trust laws, such as Japan and South Africa.

1. Hague Convention signatory status

If the country has not codified trust laws, it is important to determine whether the applicable country is a signatory to the Hague Convention on the Law Applicable to Trusts and Their Recognition (also known as the "Hague Trust Convention"), which was concluded on July 1, 1985, and effective on January 1, 1992.[5] If the country is a signatory, the Hague Trust Convention generally requires the country to recognize a trust, provided the trust is valid under the domestic law of a jurisdiction the trust is established.

2. Practical Implications

Even if a foreign country recognizes the validity of a trust, the client may run into practical implications, e.g., to being able to title real property in the name of the trust. Moreover, it is important to properly strategize prior to the transfer of foreign assets into a trust. It is important, for example, to consider the tax ramifications

of the transfer of assets into a trust because some countries impose a tax on the transfer of property to a trust, even if the trust is a revocable trust.

C. Does the foreign country have "forced heirship" or other default rules?

1. Religious designations

Some religions designate who will inherit one's assets on death. For example, under Sharia law, as a general rule, a Muslim may not dispose by will more than one-third of the surplus of his or her estate after payment of funeral expenses and debts. Any bequests in excess of that amount require the consent of the heirs after the testator's death

2. Forced heirship

In many civil law countries, like France, Germany, South Korea and Japan, there are laws that govern who must inherit assets on death. These laws are commonly referred to as "forced heirship" laws because the legal systems force or require that certain beneficiaries, often spouses and children, have certain rights to a decedent's assets, by default. This often times generates interfamily disputes in relation to children born out of wedlock or children born without the knowledge of the decedent.

3. Common law jurisdictions—freedom and flexibility

Common law jurisdictions, in contrast, offer greater freedom and flexibility in the disposition of property such that a testator may even disinherit offspring. Spouses are generally afforded some degree of statutory protection, however.

4. State variations in the U.S.

In the U.S., the laws of each state govern the disposition of inheritances. In California, for example, a person may dispose of his or her assets to whomever he or she wants. There are no requirements that a percentage or amount must pass to a spouse or descendants.

5. Forced heirship avoidance

A client faced with forced heirship laws that do not fit with the client's estate planning objectives may take or have taken some of the following actions (not intended as an exhaustive list) to avoid forced heirship:

a. Remove assets from country with forced heirship laws.

b. Hold title to the property through an intermediate entity, such as a corporation or company, and establish a trust in the U.S. to own the shares or interests in the corporation or company.

c. Change domicile to a non-forced heirship jurisdiction.

III. WHICH COUNTRY'S LAWS WILL APPLY?

It is important to determine which country's laws are applicable because it will effect judicial jurisdiction, characterization of property, disposition of property and the recognition and enforcement of foreign judgments.

A. Choice of law in the U.S., generally

The general rule is that a U.S. court will uphold a testator's choice of law selection in a testamentary document. The choice of law rules do not require that the law selected by the testator have a substantial connection to the testator or to the real property itself, aligning with the general trend of control, freedom, and flexibility in the U.S. This does not necessarily mean the foreign country will accept that choice of law, particularly if the testamentary document attempts to dispose of real property located in that foreign country and such disposition violates the foreign country's laws on disposition, e.g., forced heirship rules.

B. Common law jurisdiction—domicile versus situs

In general terms, common law provides that the law of jurisdiction of domicile governs disposition of personal property and the law of jurisdiction of the situs governs disposition of real property. For example, if a U.S. citizen domiciled in the U.S. passed away intestate (i.e., without a will) owning personal property and real property in France, the laws of the U.S. would govern the disposition of the personal property and the laws of France would govern the disposition of the real property situated in France.

C. Civil law jurisdiction—nationality centric

In general terms, civil law provides that the law of the person's country of nationality will govern succession law matters. Note, however, that the European Union ("EU") passed legislation to harmonize succession laws across the EU, which provides generally that the law of

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the person's habitual residence will govern succession, but also allows persons to select a governing law in certain circumstances. See discussion of EU Succession Regulation below.

D. Conflicts of law

Understanding the potential conflicts of law will help in identifying what issues may arise and developing a plan to mitigate or altogether eliminate such issues. A summary outline of key conflicts of law issues that arise in relation to estate planning is included below:

1. Conflicts between choice of law rules

It is important to carefully consider and identify potential conflicts between choice of law rules. For example, if a U.S. citizen owns real estate in a civil law country that follows the succession rules based on the person's nationality, what rules will govern the disposition of the real property? In the U.S., we would look to the rules of the foreign country (i.e., the situs). As a general rule, however, many civil law countries would look to the rules of the person's nationality, e.g., the U.S. See discussion of the doctrine of renvoi below.

2. Holistic worldwide planning

It is important to avoid estate planning based solely on domestic U.S. law without considering the consequences to the foreign beneficiaries overseas or the tax ramifications in other jurisdictions. For example, under German inheritance tax laws, inheritances transferred to residents of Germany and distributions passing from a trust of any sort are treated as deriving from a non-related party, and thereby subject to the highest rate of tax. Therefore, if a revocable trust is established by a U.S. person-parent with German resident beneficiaries (even if those German resident beneficiaries are U.S. citizen children living in Germany), the distributions passing from such trust may well be treated as deriving from a non-related party and be subject to the highest rate of tax. Had the gift or bequest been transferred directly from the U.S. person-parent to the German beneficiary-children, the tax liability would have been substantially reduced. Therefore, it will be important to consider other planning options, such as payable on death accounts, beneficiary designations, outright distributions set forth in the decedent's will. Whether to use one will or multiple wills is discussed below.

E. Doctrine of Renvoi

In conflicts of law, the doctrine of renvoi (of French origin, meaning "send back" or "to return unopened") is a subset of the choice of law rules and it may be applied whenever a forum court is directed to consider the law of another state or country. In the example above in Article III D.1, the U.S. would apply the law of the civil law country (i.e., the situs where the real property is located) and the civil law country would apply the laws of the person's nationality (i.e., the U.S.). The doctrine of renvoi arises when the conflicts of law rules of one jurisdiction refers a matter to the law of another jurisdiction. The critical question is whether the reference is to the substantive law of the other jurisdiction or to the substantive law and the choice of law rules of the other jurisdiction. Generally, U.S. courts have interpreted "law" to mean only the substantive laws and not the choice of law rules. An exception to this rule involves succession law matters related to real property, in which case a U.S. court would likely apply both the substantive law and the conflict of rule laws of that country.

F. Trusts and Choice of law

1. Choice of law and treatment of trust in the U.S.

Where trusts are involved, most U.S. courts respect the law designated by the settlor to govern questions of contribution, administration, and validity (i.e., a choice of law clause). If the trust remains silent on the choice of law, courts would make a determination based on the law of the jurisdiction most significantly related to the trust or specific issue. Some of the factors taken into consideration include, but are not limited to: location of assets, place of administration, trustee's place of business, place of execution of the trust agreement, and settlor's domicile. Where the trust asset involves real property, however, less weight is given to the settlor's intent and more weight is given to the law of the situs.

2. Choice of law and treatment of trust in civil law jurisdictions

Many civil law jurisdictions do not recognize the concept of a trust. The Hague Conference on Private International Law adopted a Convention on the Law Applicable to Trusts and Their Recognition ("Convention"). While the Convention provides that a trust should be governed by the law chosen by the settlor as evidenced in the trust instrument, the Convention provides that its provisions will not prevent the

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application of some mandatory laws, such as marital rights, succession rights, and creditors' rights.

G. Hague Convention on the Conflicts of Laws relating to the Form of Testamentary Dispositions

1. Purpose of the Hague Convention

The purpose of the Hague Convention is to recognize as valid, in terms of the formalities of execution, a will that complies with the domestic law of any one of the following: the place where the testator made the will, the nationality of the testator (either at the time of making the will or at the time of death), the domicile of the testator (either at the time of making the will or at the time of death), the place of "habitual residence," or with respect to immovable assets, the place where they are situated.

2. Hague Convention and the validity of wills

If the foreign country has adopted the Hague Convention Relation to the Form of Testamentary Dispositions of 1961 ("Hague Convention")[6] and the state in which the will was or will be drafted has adopted the convention's choice of law rule with respect to the formal validity of wills, the foreign country will likely accept the will as valid.

H. Washington Convention

1. Purpose of the Washington Convention

In 1973, the International Institute for the Unification of Private Law (UNIDROIT)[7] held the Convention Providing a Uniform Law on The Form of an International Will (the "Washington Convention") to resolve the issue of conflicts of laws relating to the international recognition of wills by establishing a uniform law on the formalities of an international will without invalidating or superseding the laws of other countries. This is an especially useful mechanism for persons with assets in various jurisdictions outside of their country of domicile.

2. Formalities of an International Will

a. The signatory members to the Washington Convention all agreed to the requirements that must be met for a will to constitute a valid International Will, as recognized by the signatory members. The key requirements are as follows:

b. The will may not apply to the testamentary disposition made by two or more persons in one instrument (i.e., it may only apply to the testamentary disposition of one person) (Article 2);

c. The will shall be made in writing (Article 3.1);

d. The will may be written in any language, by hand or by other means (Article 3.3);

e. The testator shall declare in the presence of two witnesses and of a person authorized to act in connection with international wills that the document is his will and that he knows the contents thereof (i.e. legal counsel) (Article 4);

f. In the presence of the witnesses and of the authorized person, the testator shall sign the will (Article 5.1);

g. The witnesses and the authorized person shall attest the will by signing in the presence of the testator (Article 5.3);

h. The signatures shall be placed at the end of the will (Article 6.1);

i. If the will consists of several sheets, each sheet shall be signed by the testator. In addition, each sheet shall be numbered (Article 6.2);

j. This date shall be noted at the end of the will by the authorized person (Article 7.2); and

k. The authorized person shall attach to the will a certificate in the form prescribed in Article 10 establishing that the obligations of this law have been complied with (Article 9).[8]

Countries that are signatory to the Washington Convention include, but are not limited to, the following:

l. Belgium

m. Bosnia-Herzegovina

n. Canada

o. Cyprus

p. Ecuador

q. France

r. Italy

s. Libya

t. Niger

u. Portugal

v. Slovenia

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The U.S. is an original signatory of the Washington Convention. The client's counsel will need to check the relevant state law to determine whether the state has adopted the Uniform International Wills Act, either as stand-alone legislation or as part of the Uniform Probate Code.

I. Country Not Signatory to Washington Convention or Hague Convention

In countries that have not adopted the Washington Convention or the Hague Convention, you will need to determine which law applies to determine the validity of the will and then analyze the will under those laws.

J. EU Succession Regulation Affecting Governing Law

1. EU Succession Regulation

a. On July 4, 2012, the European Union adopted the EU Succession Regulation 650/2012 ("Brussels IV"), applicable to estates of decedents after August 17, 2015. The Brussels IV applies to all EU member states except the U.K., Denmark, and Ireland. Brussels IV attempts to harmonize the succession regime for a decedent's property located throughout the Brussels IV zone such that the decedent's entire estate is treated under a single law and by a single authority.

b. Under Brussels IV, the law that governs the succession of the estate of a decedent "as a whole" shall be the law of the state of the decedent's habitual residence at the time of death, unless the decedent chose the law of the state of his nationality (at the time of the choice or the time of death) to govern his succession. It is important to note that the law chosen need not be the law of a Brussels IV member state, nor does the state of habitual residence need to be a Brussels IV member state. The governing law shall apply to the succession of the decedent's estate as a whole. Brussels IV also allows one state's court to have jurisdiction of the entire estate succession, and to issue a European Certificate of Succession that will be recognized in all Brussels IV member states.

c. As a result of Brussels IV, it may now be possible to avoid the forced heirship laws of EU countries in which a testator resides or has property, if the testator is a national or habitual resident of a country without forced heirship laws. Practitioners must still consider conflicts of law principles, as the doctrine of renvoi applies if no election is made. For example, if U.S. law is applied as the governing law under the default rule of the testator's habitual residence, the doctrine of renvoi would result in the application of the law of the situs to real property. By contrast, if an election is made by the testator, the election applies the substantive law of the governing nation, and the doctrine of renvoi is not applied. As an additional caveat, a Brussels IV state may refuse to apply the law of another state if it would be "manifestly incompatible with the public policy" of the Brussels IV state.

d. Note that Brussels IV only applies to the law of succession. The regulations do not apply to other laws such as matrimonial property law, trust law, and tax law.

2. Dubai Wills and Probate Registry for Non-Muslims

a. Effective April 30, 2015, Dubai has created a registry to allow Non-Muslims to register a will bequeathing their Dubai assets to their chosen beneficiaries, without regard for Sharia law. This will also allows Non-Muslims parents the freedom to nominate guardians for their minor children, and to devise jointly-owned property to their spouse or civil partner by survivorship, both otherwise prohibited under Sharia law.

b. The Dubai International Financial Centre (DIFC) has established a Wills and Probate Registry that will register English-language wills for non-Muslim expatriates and will work with the DIFC courts to produce grants and court orders for the distribution of assets and guardianship of dependents, simplifying the succession process for non-Muslims residing in Dubai.

IV. HOW IS TITLE TAKEN?

A. Restriction on foreign ownership

Some countries, such as parts of Mexico, the People's Republic of China, and some parts of Switzerland, do not allow a foreigner to hold title to real property directly in the foreigner's individual name. In such instances, title is usually taken through a vehicle established in that particular country for the specific purpose of allowing a foreign person to take title, e.g., a fideicomiso in Mexico. In other instances, title may be taken through a third-party under a nominee arrangement

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in which a nominee is the legal holder of title and the foreigner is the beneficial owner.

B. Individual name

With the exception of the restrictions on foreign ownership noted above, most countries will permit a person to take title to property in his or her own name.

C. Concurrent Estate (Co-ownership), including joint tenancy

A concurrent estate is a concept in property law that provides for the various methods in which two or more persons may hold title to real property as co-owners. One common form in which two or more persons hold title to real property in the U.S. is by "joint tenancy with rights of survivorship," a form of concurrent estate in which co-owners are entitled to a right of survivorship (i.e., if one owner dies, such owner's interest in the property will automatically pass to the surviving owner(s) by operation of law) - a probate avoidance and time/cost savings mechanism (in addition to maintaining privacy). However, many civil law countries do not recognize the concept of joint tenancy with rights of survivorship. Rather, the interests of concurrent estates in many civil law countries must pass through a formal probate proceeding to transfer the decedent's interest to beneficiaries. Because of the lack of recognition of the joint tenancy with rights of survivorship in civil law countries, it is very important to undertake proper planning, from a worldwide planning perspective, to optimize interspousal and generational wealth transfer for clients.

D. Trust Structure

As noted above, many civil law countries do not recognize trusts. Further, some countries will impose taxes upon the transfer of assets into the trust (e.g., the United Kingdom) and periodic taxes thereafter on property held in the trust (e.g. Canada). Therefore, the global asset position and residency of the client and the client's family needs to be considered in determining whether a trust structure is feasible and optimal.

E. Entity Structure

Holding title in an entity, whether foreign or U.S., is a common tool for estate planning purposes. For countries that have forced heirship laws, entity structures, such as a limited liability company ("LLC"), may be established as a means to avoid the application of the forced heirship rules. For U.S. income tax purposes, if a foreign entity is used the formation documents should be carefully reviewed to determine the proper tax treatment of such entity for U.S. tax purposes and whether there will be informational reporting. If an LLC is used, it should be possible to have the client's U.S. estate planning documents, e.g. a revocable trust, to control the disposition of the LLC and thus the foreign asset.

F. Alternative vehicles to hold foreign property

Civil law countries often provide vehicles for holding property that allow owners to achieve results similar to holding property through trusts, though such alternative vehicles are often less flexible and are generally of limited duration.[9] The following are a few examples:

1. Usufruct

A usufruct is a civil law construct. It is a limited in rem right that divides property between the usufructuary and the bare owner. The usufructuary interest holder possesses the right to use the property for a term of years or measuring life, has a duty to maintain the property, and is entitled to the income. The bare owner holds legal ownership and may transfer title but may not disturb the usufructuary interest. Because there is no separate fiduciary, the usufruct generally should be treated as a life estate under U.S. law. However, in one IRS private letter ruling, a German usufruct was treated as a trust where the usufructuary served as the executor for the duration of the usufruct. One must therefore look to the particular facts and circumstances to determine the proper classification of a usufruct for U.S. purposes.[10]

2. Stiftung or foundation

Generally, a stiftung or foundation is a civil law construct. It is a statutory entity with a separate legal identity from the founder and is established to pursue a purpose of such founder. Assets are irrevocably transferred to the foundation and managed by a council for a specific purpose. Foundations can have charitable or non-charitable purposes. The IRS will look to the actual purpose of the foundation to determine if it should be treated as a foreign private foundation, trust, or business entity.[11]

3. Fideicomiso

The Mexican trust or fideicomiso is required to be used by non-Mexican nationals to acquire and hold land in

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the "restricted zone." The restricted zone includes 50 kilometers from all Mexican coastlines and 100 kilometers from all Mexican borders. Pursuant to the Mexican Constitution, real property located within the restricted zone that will be used for residential purposes may only be owned by Mexican nationals (those individuals who are Mexican by birth or naturalization) and Mexican entities, provided, however, that such Mexican entities may not be owned by non-Mexican persons. If, however, the real property is used for nonresidential purposes, the property may be owned by a Mexican entity, which in turn may be owned by non-Mexican persons.

a. For real property that is located within the restricted zone and is used for residential purposes, title to such property must be held in a Mexican trust or fideicomiso. By law, only a Mexican bank or financial institution may serve as trustee. Although the title to the real property is held in the name of the trustee, the beneficiary (i.e., non-Mexican national) has all the corresponding rights to use, lease, or sell the rights derived from the trust. The Mexican government must grant a special permit to establish these type of trusts. The permits are granted for a fifty-year renewable term.

b. Any individual or legal entity, whether Mexican or foreign, may be the beneficiary under a fideicomiso. This includes but is not limited to a U.S. person, a U.S. LLC, a U.S. trust, or a company (U.S. or Mexican). Most fideicomiso instruments do not contemplate U.S. estate taxes. Accordingly, care should be taken to review the instrument carefully and tailor the trust instrument to fit the particular family situation and to provide for an orderly succession and minimize or defer U.S. transfer taxes. At a minimum, where the beneficiary is not a body corporate, the fideicomiso instrument should provide for successor beneficiaries. Based on experience, a Mexican trustee generally will not designate successor beneficiaries based on a U.S. will or "pour over will" designating such beneficiaries. Rather, the Mexican trustee may well require a probate proceeding and a U.S. court order, which must then be domesticated under Mexican law before the beneficial property rights are passed to the successor beneficiary. Thus, care should be taken in scenarios where the client has opted for having separate multiple wills, for example a U.S. will for U.S. situs properties and a Mexican will for Mexican situs properties.

c. In the past, there was doubt whether a U.S. revocable trust could be named as the beneficiary of a Mexican fideicomiso. As noted above, it is now generally recognized that a U.S. revocable trust may be named as the beneficiary or successor beneficiary. In one such instance that the authors encountered, the Mexican trustee required an order from a U.S. court recognizing the authority of the successor trustee of the U.S. revocable trust in order to allow the transfer of interest under the Mexican trust. As was previously discussed, an alternative structure has been to name a U.S. Limited Liability Company as a beneficiary of the Trust and apparently this approach has been better received by the involved parties, particularly the Mexican trustee and the participating notary.

d. As discussed in more detail below, care must be taken to comply with all United States foreign reporting. U.S. taxpayers have long questioned whether fideicomisos are "trusts" for U.S. tax purposes. If a fideicomiso is considered a trust for U.S. tax purposes, an Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520) and Annual Information Return with a U.S. Owner of Foreign Trust (Form 3520-A) likely will be required, along with a Statement of Specified Foreign Financial Assets (Form 8938) and possibly Report of Foreign Bank and Financial Accounts (Form TD F 90-22.1). In Revenue Ruling 2013-14, the fideicomiso in the ruling was ruled not to be a trust based on the terms of the fideicomiso. Key in that decision was the fact that the trustee did not engage in activity other than holding title to the land. Thus, the terms of the fideicomiso should be reviewed to determine if the Revenue Ruling applies.

4. Anstalt

A Liechtenstein anstalt is a type of incorporated organization established when the founder transfers assets to a board of directors, which manages the assets as directed by the articles of incorporation. The anstalt has a separate legal identity from the founder. Under default Liechtenstein law, the founder reserves the right to amend the articles. The anstalt may be treated as a trust or corporation, depending on its operations or the purposes for which it is established.[12] One must

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therefore look to the particular facts and circumstances to determine the proper classification of an anstalt for U.S. purposes.

V. WHAT ESTATE PLANNING DOCUMENTS SHOULD BE DRAFTED FOR THE DISPOSITION OF THE FOREIGN PROPERTY, AND WHAT ISSUES SHOULD BE CONSIDERED BY THE DRAFTING ATTORNEY?

A. Recognition of trusts

As noted above, most civil law countries do not recognize trusts, which is often times the central, if not important, component of U.S. estate plans. Therefore, taking title in the name of a trust or having a pour over will that pours assets into a U.S. trust may not work from the foreign country's perspective. If the foreign country recognizes trusts and there are no negative tax consequences associated with holding and administering the property in the trust, a trust may be considered.

B. Will Options. If not a trust, what type of will should be used?

1. U.S. will

It may be possible for the client to use a U.S. will (i.e., a will prepared in accordance with the laws of one of the 50 states) to dispose of foreign property. While using one U.S. will would be a simple and straightforward method, you will need to confirm that the foreign county will accept the will as a valid will. See above discussion on the Hague Convention and the Washington Convention.

a. Advantages of a U.S. will to dispose of foreign assets:
   i. Simplicity
   ii. Arguably less expensive
b. Disadvantages of a U.S. will to dispose of foreign assets:
   i. Possible issues with validity in foreign country
   ii. Possible need for translation of document(s)
   iii. If pour over will, pouring assets into a trust where trusts are not recognized in country where asset is situated
   iv. If the foreign court requires the production of the original will, there may be issues complying if the will has been lodged for probate with a court within the U.S.
   v. Some courts will require full disclosure of all assets if the will disposes of all assets (i.e., loss of privacy)
   vi. Possible need to name a person to administer the estate who is not resident in the country in which the assets are located, particularly if foreign country has restrictions on who may serve as executor

2. Situs will

A situs will is a type of will that specifically states it is disposing of property situated within a certain country, for example, a German will that disposes of only German real property and business interests. The drafter should be careful to define what property is being disposed of under the will and the scope of the will. In particular, the drafter should be sure all wills are coordinated to avoid inadvertent revocation of one will and/or inadvertently failing to cover assets in other jurisdictions. Although costs for multiple wills may be more expensive at the outset, there are often cost savings when the estate is administered as a result of the foreign country administering a will that has familiar provisions and covers only assets in such country. For EU countries under Brussels IV, consider whether the election should be made to the law of the jurisdiction of the testator's nationality or habitual residence.

a. Advantages of a situs will to dispose of foreign assets:
   i. It is simpler and more efficient to administer assets limited to those located within the jurisdiction
   ii. It is less expensive to administer estate because there are less assets in estate to administer
   iii. A will is drafted tailored to the specific jurisdiction so there are fewer issues of ambiguities and clearer application of relevant laws
   iv. There is no need for translation of the will into a foreign language if jurisdiction is one in which English is not the primary language
   v. Whether the will is valid in the country should not be an issue as it will have been drafted in compliance with such country's laws and rules regarding will execution formalities

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vi. The original will may be produced to the local court without the potential issue of complying if the will has been lodged for probate with a court within the U.S.

vii. The administration (and thus disclosure) may be limited to the assets disposed of under the will

b. Disadvantages of a situs will to dispose of foreign assets:

i. Accidental revocation and unintended consequence

ii. Possible need for translation of document

iii. Inefficiency and potential conflict issues of administering several situs wills (if assets are located in several jurisdictions)

3. International Will

The client may also consider using an international will if the foreign country the client is subject to is a signatory of the Washington Convention, as discussed above. The primary benefit of using an international will is that there is certainty and finality that the will would be deemed valid in a country that is a signatory to the convention.

C. Use of Notary Publics

If the property is located in a civil law country, it is likely that the client will require civil law notarial service. Civil-law notaries undertake a drastically different role than their common-law counterparts, the notary public. Civil-law notaries are lawyers of non-contentious private civil law who draft, deliver, and record legal instruments for private parties; render legal advice; and are public officers vested with the authentication power of the State. Unlike common-law notary publics, civil-law notaries are highly trained and licensed practitioners providing a full range of regulated legal services. While they hold a public office, they nonetheless operate usually—but not always—in private practice and are paid on a fee-for-service basis. They often receive the same education as attorneys at civil law but without qualifications in advocacy, procedural law, or the law of evidence, somewhat comparable to solicitor in training in certain common-law countries.

D. Probate proceedings in foreign countries

The client will want to consult with local counsel to determine the level of complexity of the relevant matter should a probate be required. In some civil law countries, the process of probate may be handled by a notary public and may be quite straightforward. In other countries, however, the property will pass by operation of law without the need for a formal probate proceeding.

E. Drafting considerations

When undertaking planning for a client with an international footprint, there are significant drafting considerations whether you draft a U.S. situs will, an International will, or a trust as part of his or her estate plan. A summary overview of such key considerations are included below:

1. Scope

A U.S. situs will must state its scope, that is, is it applicable to all of the testator's assets excluding those located in a specific foreign jurisdiction, or does the will only cover U.S. situs assets? One must ensure that the scope of the U.S. situs will and that of the foreign will(s) do not overlap.

2. Revocation

Typically, a will includes a provision revoking all prior wills and codicils, which may not be the testator's intent if he or she already has a situs will in place. Careful steps must be taken to ensure that one does not (inadvertently) revoke a foreign will. This often times requires coordination with local counsel to confirm that a foreign will does not revoke the U.S. situs will. To avoid accidental revocation, it would be prudent to include a provision that the will may only be revoked if specifically referred to in the revoking document.

3. Definitions Section

Although often considered as "boilerplate" language, the definitions section in a will or trust should be carefully reviewed and tailored, as required under the circumstance, to ensure that the terms meet the client's objectives. For example, the term "children" in one jurisdiction may include adopted children, but in another jurisdiction, children may refer only to biological descendants unless explicitly defined to include otherwise. By no means intended to serve as an exhaustive list, other examples include the terms "per stirpes," "incapacitated," and "perpetuity date," all of which should be defined in the will or trust agreement as interpretations may vary under the laws of different jurisdictions.

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4. Fiduciary Provisions

The will or trust agreement should include detailed provisions stating how fiduciaries are appointed, compensated, removed (including who may remove and appoint successor fiduciaries), resigned (including to whom notice of such resignation must be provided) as well as whether the requirement for bond should be. In drafting a will that may be probated in a foreign jurisdiction, one may desire to include a provision providing fiduciaries the power to appoint a local resident to serve as a fiduciary for the foreign probate process.

5. Beneficiaries

If situs wills are used and different beneficiaries receive assets in different countries, care should be taken to avoid issues such as running afoul of forced heirship, lack of liquidity to pay taxes and expenses in one estate, disproportionate distribution of estate assets without equalization if desired, and preemptively addressing issues if an asset is sold.

6. Choice of Law Provisions

To eliminate any doubt regarding the law governing the trust or will instrument, it is recommended to include a provision that specifies the law that will govern. In many cases, such a clause will be honored if the jurisdiction specified has sufficient contact with the testator or settlor and the clause does not violate public policy.

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7. Tax apportionment

A U.S. citizen or domiciliary will be taxed on his or her worldwide estate for U.S. federal estate tax purposes, and foreign property owned by the client may also be taxed by the foreign jurisdiction. Thus, it is important to ensure that the tax apportionment and payment clauses are coordinated if there are situs wills or if property will pass outside of the wills (such as in trust or by operation of law). One should also consider whether to specifically allocate any tax credits to offset U.S. or foreign estate taxes.

VI. PLANNING AND TAX MATTERS CONCERNING FOREIGN TRUSTS

A. Definition of Trust

A trust is generally "an arrangement by which title to property is held by a person or entity with a fiduciary responsibility to conserve or protect the property for the benefit of another person(s)." Usually, the beneficiaries of a trust do no more than accept the benefits of the trust. Generally, an arrangement will be classified as a trust under the Internal Revenue Code if it can be demonstrated that the purpose of the arrangement is to vest in the trustee responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business or profit. In general terms, an entity that conducts an active trade or business will likely be classified as an association or partnership.

B. Tax Treatment of Trust

A U.S. trust is subject to U.S. income tax on its worldwide income, while a foreign trust is generally subject to U.S. income tax in the same way as non-resident aliens, namely on its U.S. source income and on income or gain that is effectively connected with a U.S. trade or business. The rules, and therefore, planning, are necessarily more complicated when undertaking planning for individuals that begin spending significant amounts of time in the U.S. or are planning to immigrate to the U.S. At every major juncture, the tax ramifications of the trust structure must be thoughtfully considered.

C. Definition of Foreign Trust

The Small Business Job Protection Act of 1996 established a two part objective test for determining the situs of a trust. Specifically, a trust will be treated as a U.S. trust for tax purposes if (a) a court within the U.S. is able to exercise primary supervision over the administration of the trust (the "Court Test"), and (b) one or more U.S. persons have the authority to control all substantial decisions of the trust (the "Control Test"). Any trust that does not meet these two criteria will be considered a foreign trust.[13] The term "U.S. persons" includes a citizen or resident of the U.S. The definition of "resident" for this test is whether the person is a resident for income tax purposes (rather than for immigration or transfer tax purposes).[14]

1. Court Test

A trust will meet the Court Test if: (a) the trust instrument does not direct that the trust be administered outside of the U.S.; (b) the trust in fact is administered exclusively in the U.S.; and, (c) the trust is not subject to an automatic migration provision (a provision

that causes the situs of the trust to change if a court attempts to exercise jurisdiction).[15] It is important to keep in mind that even if you have a U.S. citizen who is the trustee of his or her standard U.S. revocable trust that applies the laws of a U.S. state, it may fail the Court Test if that person moves outside of the United States and administers the trust outside of the U.S.

2. Control Test

A trust will meet the Control Test if one or more U.S. persons have the authority to control all "substantial decisions" of the trust.

a. "Substantial decisions" means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law that are not ministerial. Decisions that are ministerial include decisions regarding bookkeeping, collecting rent, and executing investments decisions. Substantial decisions include, but are not limited to, decisions concerning:

   i. whether and when to distribute income or corpus;

   ii. the amount of any distributions;

   iii. the selection of a beneficiary;

   iv. whether a receipt is allocable to income or principal;

   v. whether to terminate the trust;

   vi. whether to compromise, arbitrate, or abandon claims of the trust;

   vii. whether to sue on behalf of the trust or to defend suits against the trust;

   viii. whether to remove, add, or replace a trustee;

   ix. whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited in such a way that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and

   x. investment decisions; however, if a U.S. person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the U.S. person if the U.S. person may terminate the investment advisor's power to make investment decisions at will.[16]

b. The term "control" means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether U.S. persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust (not only the trust fiduciaries).[17]

c. If a U.S. trust contains certain powers, such as the power to remove and replace the trustee, it may be exercised in such a way as to cause the trust to become a foreign trust (i.e. appointing a foreign person as sole successor trustee). If this happens, the trust will be treated as having made, immediately before becoming a foreign trust, a gratuitous transfer of all of its assets to the foreign trust and such a transfer will be treated as a sale or exchange of the assets for an amount equal to the fair market value of the property transferred. As a result, the trust would have to recognize as gain the excess of (a) the fair market value of the property so transferred, over (b) the adjusted basis (for purposes of determining gain) of such property in the hands of the trust.[18]

d. In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed twelve (12) months from the date of the change to make necessary changes, either with respect to the persons who control the substantial decisions or with respect to the residence of such persons to avoid a change in the residency of the trust. For this purpose, an inadvertent change means the death, incapacity, resignation, change in residency, or other change with respect to a person that has a power to make a substantial decision of the trust that would cause a change to the residency of the trust but that was not intended to change the residency of the trust. If the necessary change is made within twelve (12) months, the trust is treated as retaining its pre-change residency during the twelve (12)-month period. If the necessary change were not made within twelve (12) months, the residency of the trust would change as of the date of the inadvertent change.[19]

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D. Income Taxation of Foreign Trust

Once a determination has been made that the entity is a foreign trust, it will be classified as either a foreign grantor trust or a foreign nongrantor trust, each having different income and estate tax consequences that must be carefully considered and explained to the client. As discussed further below, there are several special rules applicable to foreign trusts with U.S. grantors and/or beneficiaries.

1. Foreign Grantor Trust

A trust established by a non-U.S. person generally will be treated as a grantor trust if: (i) it is revocable by the grantor (either alone or with the consent of a related or subordinate party who is subservient to the grantor); or (ii) distributions (whether of income or corpus) may be made only to the grantor or the grantor's spouse during the grantor's lifetime.[20] In the case of a foreign grantor trust, all items of income, deductions, and credits of the trust are includible in the grantor's income as if the assets were owned by the grantor personally.[21]

2. Foreign Nongrantor Trust

If a foreign trust is not a grantor trust, then it is a nongrantor trust. This means that the grantor is not treated as the owner of the trust assets for income tax purposes. A foreign nongrantor trust is treated as a separate taxpayer for income tax purposes and is treated as a nonresident alien individual.

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a. In calculating its taxable income, a foreign nongrantor trust will receive a deduction for distributions to its beneficiaries to the extent that these distributions carry out the trust's distributable net income ("DNI") for the taxable year.[22] The term DNI is generally defined to mean taxable income of the trust with certain modifications, such as adding back certain deductions (e.g., distribution deduction, personal exemption, capital losses, extraordinary dividends, and tax exempt income).[23]

b. A foreign nongrantor trust is subject to the "throwback" rules.[24] The throwback rule effectively results in tax being levied at the recipient's highest marginal income tax rate for the year in which the income or gain was earned by the trust. The throwback rule adds an interest charge to the taxes on a throwback distribution in order to offset the benefits of tax deferral. The interest charge accrues for the period beginning with the year in which the income or gain is recognized and ending with the year that the undistributed net income amount is distributed, and is assessed at the rate applicable to underpayments of tax, as adjusted, compounded daily.[25] Further, any capital gain accumulated by a foreign trust for distribution in a later taxable year will lose its tax favored status as a capital gain and will be taxed at the currently higher rate as ordinary income.

VII. PLANNING AND TAX MATTERS CONCERNING FOREIGN CORPORATIONS

A. Introduction

For the U.S. person who owns an interest in a closely held business in a foreign country (directly or indirectly), there are a number of U.S. tax considerations. The Tax Cuts and Job Acts was signed into law by President Trump on December 22, 2017 (the "2017 Tax Reform") and included numerous changes that impacted the taxation of foreign income. While many of the changes targeted U.S. multinationals doing business abroad, a number of the changes impacted smaller businesses and U.S. individuals who inherit from a foreign person through commonly structured foreign holding companies. Set forth below is an overview of the rules pertaining to foreign corporations, along with a brief summary of the 2017 Tax Reform that impact the tax and reporting of a controlled foreign corporation, along with some specific examples as they relate to U.S. persons who own or acquire a controlled foreign corporation ("CFC"). The summary below focuses on those rules as they pertain to U.S. persons from an estate planning perspective and does not intend nor cover the broader application rules of CFCs.

B. Definition of a foreign corporation

A foreign corporation is a corporation incorporated in a country other than the United States.

C. General planning considerations

If your client owns an interest in a foreign corporation, the general non-tax guidelines discussed above should be followed. For example, if your client owns shares in an Italian company, you will need to consider whether U.S. or Italian law applies, how title in the shares should be taken, will Italian taxes apply as a result of owning the shares, what taxes will result when the person dies owning shares in the Italian, company, will forced heirship rules apply, etc. In addition to the

nontax consideration, there are a number of important U.S. tax issues and reporting obligations to take into account, as briefly described below and in Article XII on tax reporting obligations. For U.S. tax purposes, the starting point will be to determine if the corporation is a *controlled* foreign corporation.

D. Definition of a controlled foreign corporation

A foreign corporation is a *controlled* foreign corporation ("CFC") if on any day during its tax year one or more "U.S. shareholders" directly, indirectly, or constructively own more than 50 percent of the total combined voting power of all classes of the foreign corporation's voting stock or more than 50 percent of the total value of the foreign corporation's stock.[26]

1. Who is a U.S. Shareholder?

A U.S. shareholder is defined as a U.S. person who owns, directly, indirectly or constructively 10 percent of the stock of a CFC either by vote or by value.[27] A U.S. person includes a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust (other than a foreign estate or trust).

a. Prior to the 2017 Tax Reform, only *voting* stock that the U.S. shareholder owned was taken into consideration.

b. The 2017 Tax reform changed this so that a U.S. person who owns, directly, indirectly or constructively, 10 percent or more of the total *value* of shares of all cases of stock are now taken into consideration. Therefore, a U.S. person will no longer be able to avoid U.S. shareholder status or prevent a foreign company from being a CFC by holding only non-voting stock. It is believed that the change to the definition of U.S. shareholder was in response to planning techniques that avoided U.S. shareholders from having voting stock in order to avoid subpart F inclusion for such U.S. shareholders.

2. Example

Assume there are 11 U.S. persons, each owning a five percent interest in a Hong Kong company ("HK Company"). Assume further that the U.S. persons are all unrelated to each other. HK Company is not a CFC because none of the U.S. shareholders meet the definition of owning directly, indirectly or constructively 10 percent of the stock of HK Company. This is true despite the fact that 55 percent of HK Company is owned by U.S. persons. However, if the U.S. persons were related, i.e., parents, children and grandchildren, the attribution rules discussed below would apply and HK Company would be deemed a CFC.

3. Elimination of 30 Day Rule

Prior to the 2017 Tax Reform, if a foreign corporation was not a CFC for an uninterrupted period of at least 30 days or more during a tax year, then there was no Subpart F inclusion for the U.S. shareholder. The 2017 Tax Reform eliminated the 30 day uninterrupted period as a CFC during the tax year. As described more thoroughly below, this change eliminated a common tax planning strategy used when a CFC was owned by a foreign person or foreign grantor trust that would pass at death to U.S. person.

E. Direct, Indirect or Constructive Ownership

A U.S. shareholder can own shares in a CFC directly, indirectly, or constructively.

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1. Direct ownership

Direct ownership by an individual is when the individual owns shares in his or her individual name. [28]

2. Indirect ownership

If a U.S. person has an interest in a foreign corporation, foreign partnership, foreign estate, or foreign trust that owns shares in a foreign corporation, the foreign entity will be deemed to be "indirectly" owned proportionately by its shareholders, partners, grantors or (other persons treated as owners under income tax rules), or beneficiaries.[29] Any interest attributed to a U.S. person under the indirect ownership rules is considered to be actually owned by such person.

a. This indirect ownership rule applies only up to the first U.S. person that is deemed to own a foreign entity. Thus, if a U.S. person owns a domestic corporation, which in turn owns a foreign corporation, the attribution rules stop at the domestic corporation (i.e., the owner of the domestic corporation is not considered a U.S. shareholder)[30]

b. The Treasury Regulations provide that the determination of a beneficiary's "proportionate interest" in a foreign entity, including a foreign estate, depends on the facts and circumstances of the situation. The CFC indirect ownership regulations

have one example that addresses beneficiaries of a foreign estate. The example provides that among the assets of foreign estate W are Blackacre and a block of stock, consisting of 75 percent of the one class of stock of foreign corporation T. Under the terms of the will governing estate W, Blackacre is left to G, a nonresident alien, for life, remainder to H, a nonresident alien, and the block of stock is left to United States person K. By the application of this section, K is considered to own the 75 percent of the stock of T Corporation, and G and H are not considered to own any of such stock.[31]

3. Constructive ownership

A U.S. person is deemed to constructively own shares of a foreign corporation that are owned by a U.S. family member (a spouse, parents, children, and grandchildren).[32] There is also attribution from corporations, partnerships or trusts to shareholders, partners and beneficiaries. There is no attribution from siblings, and there is generally no attribution from family members who are nonresident aliens.[33]

a. The constructive ownership rules apply for certain purposes, including the determination of whether a U.S. person is a U.S. shareholder, and whether a foreign corporation is a CFC, but do not apply for purposes of determining the amount included in a U.S. shareholder's Subpart F income.

b. Prior to the 2017 Tax Reform, stock owned by a foreign corporate shareholder, a foreign partner, or a foreign beneficiary of a trust or estate was not downwardly attributed to a U.S. person such as domestic corporation partnership or trust, respectively for purposes of defining a CFC or a U.S. shareholder. The 2017 Tax Reform changed that by allowing downward attribution of stock from a foreign corporation, foreign partnership, foreign estate or foreign trust to a U.S. person.[34] Thus, for example, X, a foreign corporation, owns 100 percent of Y, a foreign corporation, and also owns 100 percent of Z, a domestic corporation. Under the new constructive ownership rules, Y will be considered a CFC, and Z will be a U.S. shareholder of Y. Note, however, Y will not be considered as being owned by Z for purposes of determining its Subpart F income

4. CFC attribution rules regarding foreign grantor trusts

For foreign grantor trusts, the foreign grantor will be treated as the owner of the trust's stock. Accordingly, the CFC attribution rules will not come into play.

5. CFC attribution rules regarding nongrantor trusts

The Treasury Regulations under the CFC regime establish two different approaches for determining a proportionate interest in a foreign corporation held by a foreign nongrantor trust with U.S. beneficiaries.

a. For purposes of determining a U.S. person's *indirect* ownership (such as through a foreign trust) of a foreign corporation, the Treasury Regulations provide that the determination of a U.S. beneficiary's proportionate interest in a foreign trust under such subsection will be made on the basis of "all the facts and circumstances."[35] The regulations go on to say that: the purpose for which the rules of section 958(a)…are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation. If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a persons' proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person.

b. The Service has provided some guidance in interpreting the above-quoted Treasury Regulation in a 1999 Field Service Advice. In such advice, the Service determined that, for purposes of Code §958(a), the trust beneficiaries who were entitled to receive all current income should be treated as owning all of the stock of the foreign corporation held by the trust, while the remainder beneficiaries were treated as owning no stock.[36]

c. For purposes of determining a U.S. person's *constructive* ownership (such as through family attribution) of a foreign corporation, the Treasury Regulations state that for purposes of this subsection, CFC stock owned by a trust will be considered as owned by its beneficiaries in proportion to their

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actuarial interests in the trust. This rule implies that the remainder beneficiaries will be attributed some portion of the ownership of the foreign corporation, unlike the Service's conclusion with regard to Code §958(a).

d. There appears to be no specific guidance in either the Treasury Regulations or from the Service with regard to the application of the above two approaches in the case of a discretionary trust.

F. INCOME TAX CONSEQUENCES OF CFC SHARE OWNERSHIP[37]

1. In General

In general terms, a shareholder of a corporation will not be subject to income tax until the income is distributed to the shareholder as a dividend. However, if the corporation is a CFC, each U.S. shareholder with a 10 percent or more interest in the CFC (directly or indirectly, but not constructively) is subject to U.S. income tax on the shareholder's proportionate share of the CFC's "Subpart F" income.[38] Subpart F income, broadly speaking, is income from the CFC's non-operating or passive assets. This is true regardless of whether or not the CFC distributes that income. Subpart F income typically includes dividends, interest, rents and royalties, but importantly should not include life insurance proceeds.[39]

2. How taxed

Subpart F income is effectively taxed as dividend income that does not qualify for the 15 percent federal rate on qualified dividends. This characterization applies regardless of the source of the Subpart F income, including realized capital gains. Said another way, capital gains will not qualify for the currently lower capital gain tax rate. Rather, the U.S. shareholder will be required to treat such gain as dividend income subject to the higher ordinary income tax rates. Note that a U.S. shareholder will have Subpart F income only if the corporation has earnings and profits in the relevant calendar year, computed using U.S. tax principles.

3. 30-day rule eliminated

Prior to the 2017 Tax Reform, there was a limitation as to when a U.S. shareholder who owned CFC stock had to include their pro rata share of certain income earned by the CFC annually. Such limitation provided that the U.S. shareholder had to include such income only if the foreign corporation had been a CFC "for an uninterrupted period of 30 days or more during any taxable year." That 30 day limitation period provided tax planning opportunities. The 2017 Tax Reform removed the limitation. Thus U.S. shareholders are now required to include Subpart F income as long as the foreign corporation is a CFC "at any time" during any taxable year.

4. Non-Subpart F Income

Prior to the 2017 Tax Reform, a CFC's non-Subpart F income was not taxed to a shareholder until the CFC distributes that income to a shareholder. As discussed directly below, the 2017 Tax Reform changed this with the addition of the Global Intangible Low-Taxed Income.

G. Global Intangible Low-Taxed Income (New)

1. New tax on non-Subpart F income

The 2017 Tax Reform added a new category of income referred to as the Global Intangible Low Taxed Income or "GILTI".[40] Despite the fact that the name refers to intangibles and low tax income, the tax is more far reaching than that as described below. Prior to the 2017 Tax Reform, there was no U.S. income tax on business income from an operating business other than certain types of related party sales and service income.

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2. Computation of tax

The introduction of GILTI dramatically changed the U.S. taxation of CFCs. Essentially, GILTI is income of a CFC that exceeds a nominal return of 10 percent on tangible assets.[41] The 10 percent return on the aggregate adjusted tax base of the CFC's tangible assets, but not its intangible assets, is first allowed; then, any excess return over this 10 percent level of return becomes an additional Subpart F inclusion.[42] A U.S. corporation that must include GILTI in income receives a Section 960 deemed foreign tax credit based on foreign taxes paid by the CFC on this income.[43] This deemed foreign tax credit is subject to an 80 percent limitation.[44] Neither carryback nor carry forward of these foreign tax credits is permitted.

3. GILTI included in gross income

A U.S. shareholder of a CFC must include in income its GILTI similarly to how it accounts for Subpart F income. Like Subpart F income, GILT is generally treated as previously taxed income and is thus not taxed again when distributed.

4. Potential timing issues

Timing differences between U.S. and foreign laws could result in recognizing GILTI for U.S. tax purposes, before foreign tax credits (FTC) for foreign taxes paid on the income are available. This timing issue will create higher taxes for the U.S. shareholder as a result of not being able to take advantage of FTCs.

5. Lack of deductions and credits for non-corporate shareholders

It is important to note that an individual CFC shareholder or one in a flow-through entity with GILTI is taxed at ordinary tax rates without the benefit of the FDII 50 percent deduction discussed below, GILTI deductions, or foreign tax credits and can thus be taxed on GILTI income up to the maximum federal tax rate. Note, U.S. shareholders who are individuals (including estates and trusts) may make an election to be taxed at corporate rates, which would entitle them to the foreign tax credit as well as a 21 percent tax rate on Subpart F income.[45]

6. CFC's with only Subpart F income

The GILTI rules do not apply to a CFC whose only income is passive investment income as that income would generally already be taxed under the Subpart F rules.

7. Effective date

The application of GILTI is effective for the first tax year of a CFC beginning after December 31, 2017.

H. FOREIGN DERIVED INTANGIBLE INCOME (NEW)

1. In general

The 2017 Tax Reform provides, in effect, significant tax breaks to domestic corporations' earnings from offshore exports of tangible and intangible assets, foreign services, and other offshore income (so-called "foreign-derived intangible income" or "FDII").[46] The deduction is available to U.S. C corporations that sell goods and/or produce services to foreign customers. This deduction reduces the effective tax rate on qualifying income to 13.125 percent. As most estate planning clients will not qualify for this deduction because it only applies to U.S. based corporate exporters of goods and services, only a brief summary of the deduction is provided below.

2. What is FDII?

Despite its name, FDII is not directly traced to intangible assets. Rather, it assumes a fixed rate of return of 10 percent on tangible business assets and the balance of the income is the FDII, which is nominally deemed to be generated by intangibles. FDII is derived from income from the sale of property (including leases and licenses) to foreign individuals for their use, disposition or consumption outside of the United States and services performed by a person or for property outside the United States.[47]

3. *Deduction*

A U.S. corporation includes FDII in gross income then takes a related deduction, which also appears to be allowed to a U.S. corporation owned by non-U.S. persons.[48] FDII produces an effective tax rate, based on the newly enacted 21% corporate tax rate, as follows:

a. 13.125 percent for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026; and

b. 16.406 percent for tax years beginning after Dec. 31, 2025.[49]

I. TRANSITION TAX (NEW)

1. In general

The 2017 Tax Reform added a new tax that taxes past income earned indirectly by U.S. corporations through overseas companies which has been retained offshore and has yet to be taxed by the United States. Foreign income accumulated in "specified foreign corporations" and not distributed by January 1, 2018, now gets collectively taxed.[50] This income will be taxed to corporations at a 15.5 percent rate on cash, and at 8 percent on less liquid assets (for individuals and other non-corporate U.S. taxpayers, at 17.5 and 9.05 percent, respectively,[51] with S corporations being curiously alone in their ability to elect to defer this income acceleration).[52]

2. Option to defer

Shareholders are able to elect to pay the tax over eight years.[53] The deferred foreign income is the greater amount of such income as determined as of November 2, 2017, or, alternatively, as of December 31, 2017 (curiously without referring to the end of the fiscal year date of foreign corporations with non-calendar fiscal years).

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3. Acceleration of tax on certain events

Payment of the elected transition tax installments is accelerated if a taxpayer pays late, or sells or substantially liquidates the corporation.

4. Corporations to which tax applies

Specified foreign corporations whose shareholders are subject to the transition tax include CFCs and any other foreign corporation that has one or more U.S. corporations which is a defined United States shareholder (i.e., owning directly, indirectly, or by attribution 10 percent by vote or value of the foreign corporation).[54] But once there is a specified foreign corporation, all United States shareholders, whether corporate or non-corporate domestic shareholders, are taxable on their pro rata shares of the specified corporation's deferred, accumulated foreign income at the above-mentioned rates. Once taxed, the foreign corporation's distribution of these accumulated earnings avoids taxation a second time upon its distribution as previously taxed income.[55]

5. Indirect foreign tax credit

While a domestic corporation currently receives an indirect foreign tax credit for the foreign corporation's income taxes associated with the taxable percentage of the accumulated earnings,[56] a non-corporate taxpayer does not. As a result, the non-corporate taxpayer could now end up facing a much larger transition tax bill. Non-corporate U.S. shareholders, therefore, may want to consider whether they want to elect under Section 962 to be treated as corporate shareholders in order to access the Section 960 indirect foreign tax credit; by so electing, they will forego having future distributions from the foreign corporation treated as excluded previously taxed income.

VIII. PASSIVE FOREIGN INVESTMENT COMPANIES

A. Definition of a passive foreign investment company

A foreign corporation is a passive foreign investment company ("PFIC") if it meets either the income or asset test.

1. Income test

Seventy five percent or more of the corporation's gross income for its taxable year is passive income.

2. Asset test

At least 50 percent of the average percentage of assets held by the foreign corporation during the taxable year are assets that produce income or that are held for the production of passive income.[57]

B. Examples of PFICs

Examples of common PFICs include foreign mutual funds and shares in a foreign holding company and such holding company holds stocks and bonds.

C. Ten Percent Shareholder

The PFIC tax regime does not apply to a U.S. taxpayer who is a 10 percent shareholder of a controlled foreign corporation.[58] Because such a shareholder is currently taxable on her share of the CFC's Subpart F income (and now GILTI), it is unnecessary to subject him or her to the PFIC tax regime; the CFC rules accomplish Congress's anti-deferral objectives. However, if a foreign corporation that was originally considered a PFIC subsequently also meets the CFC rules, it will continue to be subject to the PFIC rules for any period that it was not considered a CFC.

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D. Tax treatment of a passive foreign investment company

All U.S. persons who own stock in a PFIC (regardless of their percentage of stock ownership) are generally subject to U.S. federal income tax (at ordinary income tax rates) on any gain from the sale or exchange of, and certain distributions in respect of, their stock in a PFIC. For this purpose, a disposition of shares of a PFIC by a foreign non-grantor trust may be treated as a disposition of PFIC stock by the U.S. beneficiaries of such trust. As with the CFC regimes, PFIC stock owned directly or indirectly by a partnership, estate or trust is considered to be owned proportionately by its partners or beneficiaries, respectively.[59]

1. Excess Distributions

Distributions to U.S. shareholders of "excess distributions" are taxed at ordinary rates, regardless of original character, and do not qualify as "qualified dividends." "Excess distributions" are the portion of the distribution that exceeds 125 percent of the average distributions made to the U.S. shareholder over a holding period and the realized appreciation on a sale of the interest.

Interest is then applied on the unpaid tax at the applicable federal underpayment rate (the surcharge).[60]

2. Unrealized Appreciation

Similar to a CFC, upon liquidation of the PFIC, a U.S. person would be taxed on his or her *pro rata* share of unrealized appreciation and, if the interest in the PFIC is received as a bequest, only the income tax basis of the shares in the PFIC (and not its underlying assets) would receive the IRC §1014 adjustment at the NRA donor's demise.

E. Gains on Disposition

If no qualified electing fund ("QEF") election (discussed below) is made or if a QEF election is not made for the first year of the U.S. shareholder's holding period, gains on disposition of PFIC stock will be subject to ordinary income tax rates (plus an interest charge).

F. Elections

1. Qualified Electing Fund

Instead of paying the additional tax when the PFIC is disposed or deemed to be disposed, a U.S. shareholder of a PFIC may elect to treat the corporation as a qualified election fund ("QEF").[61] If a QEF election is made, the electing U.S. shareholder must take into account on an annual basis his or her pro rata share of the PFIC's ordinary income and net capital gains.[62]

a. Unlike the CFC provisions that result in ordinary income to the U.S. shareholder, PFIC income inclusion retains the character of the income (ordinary or capital gain) as earned by the corporation.[63] A QEF election can also preserve the possibility of a capital gains tax treatment under certain circumstances upon the disposition of a U.S. shareholder's PFIC stock.

b. The inclusions are made for the shareholder's tax year in which or with which the QEF's tax year ends. Once made, the QEF election is revocable only with the IRS's sent and is effective for the current ax year and all subsequent tax years. [64]

c. A QEF election may be made for any year during which PFIC stock is owned, but, in order to maximize the benefit of a QEF election, a U.S. shareholder is generally required to make the election by the due date (determined with extensions) for filing his or her U.S. federal income tax return for the first year that he or she was a holder of the PFIC stock. To the extent that a U.S. shareholder's share of QEF income is subject to taxation under the CFC regime, such income will generally not be subject to taxation under the QEF regime.[65]

2. Market-to-Market election

A U.S. shareholder of a PFIC may elect to mark-to-market the PFIC stock if the stock is "marketable stock." Marketable stock is PFIC stock that is regularly traded on (i) a national securities exchange that is registered with the Securities and Exchange Commission (SEC); (ii) the national market system established under section 11A of the Securities Exchange Action of 1934; or (iii) a foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located, along with stock in certain PFICs.

a. A shareholder who makes a mark-to-market election must include in gross income as ordinary income an amount equal to the excess fair market value of the PFIC stock as of the close of the tax year over its adjusted basis. If the stock has declined in value, ordinary loss deduction is allowed limited to the net amount of gain previously include in income.[66]

G. PFIC attribution rules

Code §1298(a)(3) specifies that stock owned directly or indirectly by a trust is treated as owned proportionately by its beneficiaries. Although there are no final regulations interpreting this rule, proposed regulations suggest that the determination of a person's indirect ownership should be made on the basis of "all the facts and circumstances in each case." The proposed regulations go on to say that "the substance rather than the form of ownership is controlling, taking into account the purpose of section 1291." There does not appear to be any further guidance under the proposed regulations, or provided by the Service, regarding the application of the facts and circumstances test.[67]

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Notes

1 Different jurisdictions in the U.S. will employ alternate naming conventions and terminologies for these general estate planning documents. This list is not meant to serve as an exhaustive list of estate planning documents and is included for general purposes of discussion.
2 Article XXIXB of the United States-Canada Income Tax Treaty.
3 Please see IRS website "Estate & Gift Tax Treaties (International)," last updated January 23, 2017, available at https://www.irs.gov/businesses/small-businesses-self-employed/estate-gift-tax-treaties-international.
4 Treas. Reg. § 20.0-1(b)(1).
5 There are currently fourteen (14) signatories to the Hague Trust Convention, including Australia, Canada, the PRC, Cyprus, France, Italy, Luxembourg, Malta, Monaco, Netherlands, Panama, Switzerland, the U.K., and the U.S. Please see HCCH website "30: Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition: Status Table," last updated 19-November-2017, available at https://www.hcch.net/en/instruments/conventions/status-table/?cid=59.
6 The U.S. has not ratified the Hague Convention, but about 40 other countries have, including Australia, Belgium, Denmark, France, Germany, Italy, Japan, the Netherlands, Norway, Spain, Sweden, Switzerland, and the U.K.
7 There are currently 63 signatory member nations to UNIDROIT. Please see UNIDROIT website "Membership," last updated 09-February-2018, available at https://www.unidroit.org/about-unidroit/membership.
8 See Annex, UNIDROIT website "Convention Providing a Uniform Law on The Form of an International Will," last updated 07-November-2013, available at https://www.unidroit.org/instruments/international-will.
9 See generally, Christensen, Henry, III, International Estate Planning (Second Edition), Matthew Bender, 1999.
10 See P.L.R. 9121035 (Feb 25, 1991) (usufruct determined to be a trust).
11 See Estate of O.T. Swan, 24 T.C. 829 (1955), aff'd 247 F.2d 144 (2d Cir. 1957); PLR 200302005; and IRS Advice Memorandum 2009-012.
12 See Rev. Rul 79-116; IRS Advice Memorandum 2009-012.
13 Internal Revenue Code of 1986, as amended ("IRC") §7701(a)(30)(E).
14 Treasury Regulations ("Treas. Reg.") § 301.7701-7(d).
15 Treas. Reg. § 301.7701 -7(c).
16 Treas. Reg. § 301.7701-7(d)(1)(ii)(A)-(J).
17 Treas. Reg. §301.7701-7(d)(1)(iii).
18 IRC §684.
19 Treas. Reg. §301.7701-7(d)(2).
20 IRC §672(f).
21 IRC §671.
22 IRC §661 (a).
23 IRC §643(a).
24 See IRC §666.
25 IRC §668.
26 IRC §957(a).
27 IRC §951(b).
28 Treas. Reg. §1.958-1(c)(2).
29 Treas. Reg. §1.958-1(b).
30 Treas. Reg. §1.958-1(b).
31 Treas. Reg. §1.958-1(d), Example 4.
32 IRC §318 and IRC §958.
33 IRC §958(b)(1).
34 IRC §958(b)(4).
35 Reg. 1.958-1(c)(2).
36 FSA 199952014.
37 This outline is meant to provide a brief overview of all aspects to consider when a U.S. person has foreign assets. For a detailed discussion of the income tax issues relating to trusts and estate that own CFCs and PFICs, please see Moore, Don't Block the Box: U.S. Federal Income Tax Issues for Trusts and Estates That Own Shares in Foreign Corporations, presented at ALI Continuing Legal Education, International Trust and Estate Planning, Nov. 1-2, 2018.
38 IRC §951(a)(1).
39 IRC §952.
40 IRC §951A(b)(2)(A).
41 IRC §951A(b)(2)(A), 951A(d).
42 IRC §951A(a) (new).
43 *See* §960.
44 IRC §960(d)(1).
45 IRC §962(a). Treas. Reg. § 1.962-2(a).
46 IRC §250(a).
47 IRC §250(b)(4).
48 IRC §250(b)(4) and §250(b)(5).
49 IRC §250(a).
50 IRC §965.
51 IRC §965(c).
52 IRC § 965(i)
53 IRC §965(h).
54 See IRC §951(b).
55 See IRC §959.
56 The indirect foreign tax credit under §902 was repealed but only with respect to tax years beginning after December 31, 2017. Act §14301(a). See IRC §965(g) which limits the foreign tax credit to the percentage of the accumulated earnings taken into income under the transition tax computation.
57 IRC §1297.
58 IRC §1297(d).
59 IRC §1298(a)(3)
60 IRC §1291.
61 IRC §1293-1295.
62 IRC §1293-1295.
63 It should be noted that although he QEF election is often thought of as making the foreign corporation with respect to which the election is made a pass-through entity for the electing U.S. shareholder, only gains, not losses, pass through the corporation to the shareholder.
64 IRC §1294.
65 *See* Code §951(f) for the priority of the CFC rules over the QEF rules. *See* Code §551(g) for the priority of the FPHC rules over the QEF rules
66 IRC §1296.
67 IRC §1291(f); Prop. Treas. Reg. §1.1291-1(b)(8)(iii).

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