INTERNATIONAL ESTATE PLANNING UPDATE

for

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I. C OMMON MISPERCEPTIONS REGARDING PLANNING FOR RESIDENT ALIENS

1. A person resident in the United States should be planned for just like a U.S. Citizen.

Under U.S. law, "residence" and "domicile" are not synonymous. "Residence" is an income tax concept, and one generally establishes residence for income tax purposes by holding a "green card" or being present in the United States for an average of greater than 183 days per year. IRC § 7701(b) "Domicile" is an estate tax concept, where domicile is equal to residence plus the intent to remain in the United States indefinitely. Treas. Regs. § 20.0-1(b) This intent is demonstrated by such facts as the location of one's family, the location of one's business, membership in clubs and the holding of various licenses. *See Paquette Est. v. Comr.,* T.C. Memo 1983-571. Thus, it is possible to be resident in the United States for income tax purposes and not be domiciled here for estate tax purposes.

The United States is unique in having this distinction between residency and domicile, and it is a distinction that we purposely manipulate in international planning. A practitioner's first question when dealing with a non-U.S. citizen who is presently resident in the United States should be something along the lines of "Where do you want to be when you die?" The next questions should be "Where is your property located and do you intend to own property there at your death?" The answers to those questions help the practitioner advise the client as to choice of domicile and the relative advantages of domicile here versus elsewhere.

Sometimes, the answers will suggest that the client should take steps not to be domiciled in the United States even though he or she may be resident here for income tax purposes. The rationale may be based not only on relative death tax advantages, but on valuation issues even the ability to bequeath one's property to one's intended heirs.

2. A Green card is the best residence status for an alien in the U.S.

(a) Current Law.

In 1996, Congress enacted the Health Insurance Portability and Accountability Act to prevent certain U.S. citizens who surrender their U.S. citizenship from fully avoiding U.S estate and gift tax after expatriation. (IRC §§ 2107 and 2501(a)(3). In addition, the Act extends this treatment to "long-term U.S. residents"—that is a permanent resident that has resided in the U.S. for at least eight of the last 15 years prior to termination of residency. Long-term permanent residence status has generally been interpreted to mean a green-card holder. Consequently, once an alien has been a U.S. green card holder for greater than eight year, he or she is "stigmatized" for U.S. tax purposes and will be subject to both income tax (not discussed in this outline) and U.S. estate tax even after exiting the U.S.

Under the Act, those individuals (whether expatriating U.S. citizens or long-term residents) who have a net worth of greater than U.S.$ 500,000 (indexed for inflation) or an annual income of greater than $100,000 (also indexed for inflation), will be presumed to be exiting the United States for tax-avoidance purposes. That presumption will cause his or her estate to be taxed not only on U.S.-situs

property, but also on certain U.S-source property for ten years following exit (generally, stock in foreign corporations owned directly or indirectly by the individual).

Upon filing his or her final income tax return, an individual may rebut the presumption of tax-avoidance purposes by seeking a private ruling from the Internal Revenue Service. (See § 877(c) with respect to expatriating citizens and Notice 97-19, 1997-1 C.B. 394, with respect to long-term residents). Generally, an individual returning to his or her country of birth (or that of his parents or spouse) may qualify for exclusion from such a "stigma." Note, however, the individual MUST submit a ruling request—an often costly procedure.

There is required coordination between agencies, as well. An expatriating citizen or exiting long-term resident must file a statement with the State Department. This statement can have long-term deleterious effects for the expatriating U.S. citizen, for under its own regulations, the Immigration and Naturalization Service may exclude an expatriate from re-entry into the United States at any time, at any border, for any purpose. Is expatriation worth never being allowed reentry?

(b) Recent Senate Finance Committee Resolution.

Senate Bill S. 2769, passed September 12, 2002 establishes an exit tax for the above-defined classes of individuals permanently leaving the United States. It imposes a capital gains tax on an expatriate's entire world-wide estate. This includes property owned by an alien that has never been brought into the U.S. and otherwise has no nexus with the U.S. The tax does not apply to U.S. real property or the individual's interest in a qualified retirement plan. What if the expatriating individual gives away the property in an attempt to avoid the tax? Proposed IRC Section 2681 imposes a tax on a U.S. citizen or resident who receives such a "covered" gift or bequest in the amount of the highest marginal rate. This Bill has not yet been enacted into law.

3. For an alien resident in the U.S., the practitioner should draft a Will that passes the client's worldwide estate.

For some clients, it may be advisable to have more than one concurrent Will: a "domiciliary" Will for assets in the primary jurisdiction (the client's intended residence at death) and a "situs" Will for assets elsewhere. If multiple Wills seem the best course, the practitioner must assist the client in obtaining counsel in the other jurisdiction who is familiar with international estate planning issues. A properly devised plan may be easily defeated by language in a foreign Will that does not properly correlate with the United States Will.

4. A resident alien may not claim treaty benefits which may exceed benefits under the Internal Revenue Code.

(a) Treaty versus IRC

Code section 7852(d) provides a "later-in-time" rule with respect to Code and treaty provisions. A taxpayer who takes the position on his or her return that a U.S. treaty overrides a particular

provision of the Code must disclose the position on a Form 8833. Such a return must be filed to claim a treaty benefit, even if a return is not otherwise required.

(b) Credit

i. In General

Treaty provisions often allow credits beyond those allowed in the Internal Revenue Code. Treaty exemptions from taxation generally apply only to the estates of those individuals who were resident in either of the treaty jurisdictions. Some treaties go further and provide a deduction for citizens of a treaty jurisdiction who reside in neither that country or the United States. (Australia, Greece, Italy, Norway, Switzerland, Germany, and the United Kingdom). It is imperative then, for the U.S. practitioner planning for a citizen of any of these jurisdictions to review (and draft for) any exemptions available under these treaties.

Section 2102(c)(3) specifically mandates that treaty credits be honored. That section provides:

> To the extent required under any treaty obligation of the United States, the credit allowed under this subsection shall be equal to the amount which bears the same ratio to the applicable credit amount in effect under section 2010(c) for the calendar year which includes the date of death as the value of the part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated. For purposes of the preceding sentence, property shall not be treated as situated in the United States if such property is exempt form the tax imposed by this subchapter under any treaty obligation of the United States."

This provision provides a fraction of the available unified credit (beyond the existing $13,000 credit) for nondomiciliary aliens, if so provided by treaty. The German treaty is one such treaty that provides such a fractional unified credit.

The Japanese treaty is problematic, since it was negotiated on the basis of former Japanese law that taxed only beneficiaries who are Japanese domiciliaries, regardless of the citizenship or domicile of the decedent. (See Convention between Japan and the U.S., April 16, 1954). The recent profound change in Japanese inheritance tax (extending Japanese tax to its citizen beneficiaries, regardless of domicile) has not yet been interpreted with respect to our existing treaty.

ii. Example Canada.

See discussion regarding Canadian treaty below.

(c) Marital Deduction

In the Technical and Miscellaneous Revenue Act of 1988 (TAMRA, Pub. L. No. 100-647), United States amended its marital deduction provisions to provide that if the surviving spouse is not a U.S. citizen, no deduction will be allowed under section 2056(a) unless property passes to the surviving

spouse in a QDOT (IRC § 2056(d)). Unfortunately, at the time of this legislation, most of the treaties the United States now has were already ratified, and thus, enforceable by both jurisdictions.

Section 7815(d)(14) of the Revenue Reconciliation Act of 1989 ("RRA") was enacted to clarify that the changes enacted under TAMRA do not supercede existing treaty obligations with respect to a non-U.S.-domiciliary decedent (and provided a transitional rule for U.S, domiciliary decedents until 1992).

i. Non-domiciliary Decedent.

The estate of a decedent who was not domiciled in the United States and is subject to one of these treaties is not required to establish a QDOT under IRC §§ 2056(d) and 2056A—regardless of the surviving spouse's citizenship. For clients who may be resident in the United States, have some nexus with these jurisdictions and who have indeterminate domicile, choice of domicile is an essential portion of the estate plan. The Will should NOT mandate that a QDOT be established.

The Swedish treaty, for example, provides that the non-community property of a person who dies domiciliary of Sweden which passes to the surviving spouse is included within the gross estate only to the extent it exceeds 50% of all property included in the U.S. gross estate. Although this provision formerly applied to domiciliaries of either Sweden or the U.S., the RRA maintains this protection only for Swedish domiciliaries.

ii. Domiciliary Decedent.

Generally, the estates of decedents who are clearly domiciled in the United States are entitled to the marital deduction for property transfers to the surviving spouse only if the estate establishes a QDOT. But that is not necessarily clear for estates of decedents who may be able to claim the benefits of treaties negotiated and entered into after TAMRA. Two such treaties exist: Article 14 of the Protocol Amending U.S.-Canada Income Tax Convention (ratified November 9, 1995) and the Protocol Amending United States-Germany Estate and Gift Tax Treaty (ratified December 14, 2000).

The German Protocol provides various marital deductions. First, it provides that the estate of a German citizen who dies domiciled outside Germany who is subject to U.S. estate tax will be entitled to a marital deduction to the extent of 50% of the property included in the U.S. gross estate. This deduction is no longer available to a U.S. citizen domiciled in Germany.

A further provision, however, allows a full marital deduction (expressly not in the form of a QDOT) equal to the lesser of the applicable exclusion amount available to the estate (determined without regard to any gifts previously made by the decedent) or the value of the property transferred. To qualify for this deduction, it is necessary that: 1) the decedent be domiciled in the U.S. or Germany; 2) the surviving spouse be domiciled in the U.S. or Germany; 3) if the decedent and the surviving spouse were both U.S. domiciliaries, one or both of them was a German citizen; and 4) the executor elects this limited marital deduction on the estate tax return and waives the right to establish a QDOT.

Under the treaty, the applicable exclusion amount for a non-U.S. citizen domiciled in Germany is a fraction (based upon the percentage of U.S. assets), so the equivalent marital deduction may be less than that available under the QDOT provisions. A careful analysis of the relative benefits of electing under the treaty versus establishing a QDOT must be carried out before any elections are made.

Note that the marital deduction provisions of the German treaty DO extend to a U.S. citizen decedent domiciled in the U.S with a German citizen-surviving spouse also domiciled in the U.S.

iii. Example: Canadian-Citizen Decedent or Surviving Spouse.

Assume a Canadian citizen decedent, domiciled in the U.S. who owns only U.S.-situs property left to his spouse who is also a Canadian citizen. Article 14, Section B (3) of the U.S. Canadian Protocol gives the benefit of doubling the usual unified credit available to the estate, without making use of a QDOT.

Paragraph 3 states:

> "In determining the estate tax imposed by the United States on an individual's estate with respect to property that passes to the surviving spouse of the individual (within the meaning of the law of the United States) and that would qualify for the estate tax marital deduction under the law of the United States if the surviving spouse were a citizen of the United States and all applicable elections were properly made (in this paragraph and paragraph 4 referred to as "qualifying property"), a non-refundable credit computed in accordance with the provisions of paragraph 4 shall be allowed in addition to the unified credit allowed to the estate under paragraph 2 or under the law of the United States, provided that
>
> (a) the individual was at the time of death a citizen of the United States or a resident of either Contracting State;
>
> (b) the surviving spouse was at the time of the individual's death a resident of either Contracting State;
>
> (c) if both the individual and the surviving spouse were residents of the United States at the time of the individual's death, one or both was a citizen of Canada, and
>
> (d) the executor of the decedent's estate elects the benefit of this paragraph and waives irrevocably the benefits of any estate tax marital deduction that would be allowed under the law of the United States on a United States Federal estate tax return filed for the individual's estate by the date on which a qualified domestic trust election could be made under the law of the United States."

Paragraph 4 states:

> "The amount of the credit allowed under paragraph 3 shall equal the lesser of
>
> (a) the unified credit allowed under paragraph 2 or under the law of the United States

(determined without regard to any credit allowed previously with respect to arty gift made by the individual), and

(b) the amount of estate tax that would otherwise be imposed by the United States on the transfer of qualifying property.

The amount of estate tax that would otherwise be imposed by the United States on the transfer of qualifying property shall equal the amount by which the estate tax (before allowable credits) that would be imposed by the United States if the qualifying property were included in computing the taxable estate exceeds the estate tax (before allowable credits) that would be so imposed if the qualifying property were not so included. Solely for the purpose of determining other credits allowed under the law of the United States, the credit provided under paragraph 3 shall be allowed after such ocher credits."

In applying paragraph 3, one should note:

(a) The decedent was at the time of his death a US resident, so that subpara (a) applies:

(b) The surviving spouse was at the time of the decedent's death a resident of the United States, so that subpara (b) applies;

(c) Both spouses were residents of the United States at the time of the decedent's death and both the surviving spouse and the decedents were Canadian citizens, so that subpara (c) applies: and

(d) Nothing prevents the executor of the estate from waiving the benefits of transferring the property left to the surviving spouse to a qualifying domestic trust (a QDOT); if the executor does so, subpara (d) applies

All four requirements of paragraph 3 can apply,

(a) Since all the decedent's property is situated in the United States and he died "resident" (that is, domiciled) in the United States, his estate qualifies under United States law for the full unified tax credit, which presently shelters [$675,000 US] of the estate from tax, and

(b) Since para 3 applies and all of his property has been left to his spouse, who is a Canadian citizen, the executor, by waiving the tight to transfer this property to a QDQT, obtains a further credit in lieu of the usual marital deduction, equal to the amount of the unified credit, thereby sheltering a further [$675,000 US] of the estate from tax.

(Note that the amount of [$675,000] mentioned above will be increased over the next few years to [$1,000,000], with the result that in a few years' time a total of

[$2,000,000] will be sheltered,)

> Of course, if the decedent's estate, as calculated for US estate tax purposes, is substantially greater than twice the amount of the unified credit, so that there is still a substantial amount of tax payable by the estate, it will still be worthwhile for the executor to elect to transfer the property to a QDOT, thereby deferring the estate tax liability from the first death until the death of' the surviving spouse (or until the property is withdrawn from the QDOT during the survivor's lifetime). However, if the decedent's estate is not substantially greater than twice the amount of the unified credit, it may be preferable for the executor to waive the benefit of a transfer to a QDOT and to pay whatever tax is required at the first death. In many cases, no tax need be paid, because of the doubling of the unified credit by reason of para 3.

This option is also available if the decedent were a US citizen who died resident in the United States, leaving his estate, consisting entirely of US property, to his surviving spouse, who is a Canadian citizen. That is, by waiving the benefits of transfer of the property to a QDOT, the estate can shelter from estate tax twice the amount of the unified credit.

5. A United States Will is enforceable world wide.

In many civil law jurisdictions, a testator's Will (and transfers into trust) will be overridden in favor of specific classes of persons who are entitled to a claim against the estate (a "forced share") under the law of that jurisdiction. Generally, that class of persons includes the surviving spouse, the children or the testator's parents.

A forced share right under a particular jurisdiction may only be asserted over property within that jurisdiction, as determined by conflicts of law rules. Personal property is ordinarily controlled by the law of domicile; so domicile is a key issue in determining whether the law of a jurisdiction which creates a particular forced share entitlement applies to the personal property of that decedent. Real property is generally controlled by the law of the property's situs and such property's exposure to a forced share claim is more easily determined.

The use of situs and domiciliary Wills may help segregate assets located in a jurisdiction with forced heirship laws while maintaining complete dispositive power over U.S. assets. Such an approach may not be necessary, however, if proper conflicts language is employed.

For example, Japanese law recognizes disposition of one's assets by Will, but certain close relatives may override the Will. The law provides forced shares of either one-third, to be shared by any successors who are all lineal ascendants (parents, siblings, etc.), or a one-half share if the successors are the spouse and lineal descendants. Thus, if a testator's Will should purport to pass Japanese real property, it will only be given effect in Japan *vis à vis* one-half of the property. The remaining one-half will be divided among the spouse (who will get one-half of that one-half) and the children (who will divide among themselves one-half of that one-half).

6. Our standard Credit/QTIP Will is enforceable with respect to property and property rights in other jurisdictions.

(a) In General

A significant part of our United States estate planning involves the creation of trusts; and certain trusts are generally mandated for international planning purposes (the Qualified Domestic Trust). The concept of "trusts" is not a part of the law of civil law jurisdictions in countries such as France, Germany, Spain, Italy and Japan, however. Thus, if a trust is created under United States law, the trustee will either have full legal and equitable title to the trust corpus (as in Germany) or will only be considered an agent of the beneficiaries (as in Japan). In these countries where the trust is simply ignored, the beneficiaries or "trustee" as the case may be will be taxed as the legal recipients of the property.

With respect to assets in civil law jurisdictions that have not ratified the Hague Convention with Respect to Trusts and their Application, it is advisable to avoid creating trusts unless the local law of the jurisdiction affords some protection to the trust beneficiaries. Many jurisdictions utilize a contractual notion based on the laws of agency to interpret a common law trust. Such an analogy may not protect against claims to ownership by the trustee, however. In the event of claims made by the trustee, the beneficiaries have recourse only to a lawsuit.

Other jurisdictions have passed special legislation to deal with trusts validly created under another jurisdiction. German law recognizes intervivos trusts created in a foreign jurisdiction, and although it does not recognize a testamentary trust, the named trustee may be granted extended authority, as a *Testamentvollstrecker* to manage the estate of the decedent in a manner most in accordance with the decedent's wishes

(b) Example, Canada

U.S. estate planning practice frequently involves the use of a revocable inter vivos trust which is initially funded with the client's major assets, along with a "pour over" Will which transfers to the trust any assets remaining in the client's own name at death. This procedure has two serious problems.

Canada has abolished its inheritance tax, and, indeed, many research publications simply indicate that Canada has no death tax. But Canadian law does impose a capital gains tax at death upon the world-wide estate of an individual resident in Canada and upon the Canadian property of a non-Canadian resident decedent. Further, almost any inter vivos disposition of Canadian property will

trigger a capital gains tax (see paragraph e of the definition of disposition in section 54 of the Canadian Income tax Code).

Various Revenue Canada rulings have indicated that the transfer of Canadian property into a revocable trust is a disposition of property for Canadian Capital gains tax purposes. There will be a capital gains tax, then, on the transfer of Canadian property to a U.S. revocable trust. Such a transfer, then, should be avoided.

A further issue confounds this problem. A revocable trust is incorporated by reference into the "pourover" Will, such that the trust may be amended without the formalities required for the execution of Wills. Such authority is clarified in the United States by a state's adoption of the Uniform Testamentary Additions to Trusts Act, which validates this pourover arrangement. (See Scott on Trusts, 4th ed., 1987, section 54.3). Unfortunately, no Canadian province has adopted this type of legislation. Many Canadian estate planners are of the opinion, then, that the passing of Canadian property under the provisions of a U.S. pourover Will is invalid. Canadian property, then, should be transferred pursuant to a properly drafted Canadian-situs Will, with careful carving out of the property from the U.S. Will; or in a U.S. Will that passes the Canadian property as a specific bequest.

7. Code Section 2014 fully prevents double taxation.

It is important to note that although a credit applies to correct double taxation, variations in the valuation of property from jurisdiction to jurisdiction can lead to excess taxation. For example, in Japan real property is valued in accordance with the "Valuation Basic Circular" for inheritance tax purposes. In the United States, real property is valued at its fair market value. The Japanese valuation is often much lower than the property's fair market value, and although both our treaty with Japan and Code section 2014 apply, careful planning would generally suggest avoidance of U.S. estate tax on Japanese real property.

II. INTERNATIONAL ESTATE PLANNING UPDATE

1. Italy just repealed its inheritance tax (October 18, 2001).

Planning tip: A non-U.S.-citizen client with close connections to Italy should establish domicile there.

2. A Canadian resident over the age of 65 may establish a revocable intervivos trust (an "alter-ego trust") without incurring Canadian capital gains tax on the transfer.

Planning tip: Many Canadian provinces have costly probate proceedings that may be overridden by such trust planning. Note: this option does not apply to Canadian property owned by non-Canadian residents nor to Canadian residents under the age of 65.

3. A resident of Mexico now must report world-wide income. Income from a controlled foreign corporation in a tax-free jurisdiction will be taxed.

Planning tip: It is still a great idea for a non-U.S. citizen to establish domicile in Mexico, since Mexico has no inheritance tax. Presumably, income derived from most non-Mexican sources (e.g., the U.S.) will be subject to income tax withholding in the source jurisdiction and no tax will be due Mexico.

4. Japan now imposes unlimited (worldwide) taxation on a nonresident heir who is a Japanese citizen if the decendent OR the heir was a resident of Japan in the five years prior to death. (April 1, 2000).

Planning tip: It is not clear what effect this revision has on the U.S.-Japan tax treaty. Clearly many second-generation Japanese citizen heirs resident in the United States must re-consider their planning with respect to the estates of their Japanese citizen/resident parents.

5. Read the Canadian, German and French tax treaties.

Planning tip: Even with respect to U.S.-domiciliaries!