PRACTICAL PLANNING FOR CROSS BORDER CLIENTS

Presented by

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I. BASICS ABOUT FOREIGN SUCCESSION LAW

A. *Types of Legal Systems and Succession Laws.*

1. Common Law.

   a. Description of Legal System. All states except for Louisiana use the common law legal system that originated in England. Louisiana has a mix of common law and civil law from it's French heritage. Puerto Rico also has a civil law system. In a common law system, case law is the principal source of law, which is supplemented by statutes.

   b. Testamentary Freedom. In common law systems, an individual generally may give his or her property to whomever he/she wishes, with the exception of spousal elective share laws and community property states.

2. Civil Law.

   a. Description of Legal System. Many countries have a civil law legal system that originated from Roman law. Unlike common law which derives its rules primarily from case law, a civil law system usually has codes of law. Spain, Italy, the Netherlands, Portugal, and many Latin American countries' codes are derived from the Napoleonic Code implemented in France after the French revolution. Germany, Japan, Switzerland, Brazil, Peruvia, and Mexico also have civil codes. One very important thing to note is that trusts are generally not recognized in civil law systems.

   b. Testamentary Freedom. Civil law systems typically limit an individual's testamentary freedom through community property laws and forced heirship laws. Wills are not used as often in civil law countries as they are in common law countries.

   c. Community Property. Civil law countries with a community property system treat property acquired by married couples during the marriage as one-half owned by each, thereby limiting a person's ability to disinherit a spouse. French and Spanish countries typically have a community property system. Germany has a form of community property system as well.

   d. Forced Heirship. Forced heirship regimes require a decedent to leave a portion of his/her property to his/her children at death. Some regimes also give a surviving spouse a share in addition to

the marital property share. Countries with forced heirship include France, Spain, Italy, Germany, and Switzerland to name a few. There are also many countries that have a hybrid system.

3. Sharia Law. Islamic countries use Sharia Law which is based on the Koran. Since this law is based on religious beliefs, Islamic people may wish to follow this law even if the do not live in a country that is governed by Sharia Law. The Sharia legal system is more similar to civil law systems than to common law systems and have forced heirship.

B. *Transfer Tax Systems.* Transfer tax systems vary considerably among other countries.

1. Transfer Tax Variations. Some countries have no transfer taxes, while others have estate or inheritance taxes and no gift taxes.

2. Civil Law Countries Generally have an "inheritance" tax.

   a. With a true inheritance tax, the tax is based on the citizenship or residency of the recipient.

   b. In some civil law countries, the amount of tax depends upon the class of the beneficiary receiving the property

PRACTICE POINTER: Due to the many variations of succession laws and taxes, it is strongly recommended to use attorneys and advisors in the country where your client has property to help you with their estate planning.

C. *Is a Client's U.S. Will Valid in Another Country?*

1. A will must be formally valid under the laws of a jurisdiction to effectively dispose of property within such jurisdiction.

2. The Washington Convention provided uniform requirements for an international will.

   a. Several countries, including Canada, France, and Italy, have entered the Washington Convention.

   b. The United States signed the Washington Convention, although each state must separately enact the uniform laws provided therein. Colorado has adopted the Uniform International Wills Act.

   c. Requirements of an International Will under the Washington Convention:

(1) Must be in writing (typed or handwritten) and may be in any language.

(2) The testator must declare in the presence of two witnesses and a person "authorized to act in connection with an international Will" that the Will is the testator's Will and that he or she knows the contents of the Will.

(3) The testator must sign the Will in the presence of the witnesses and the authorized person, or if already signed, acknowledge his signature to them.

(4) The witnesses and authorized person must attest to the Will by signing in the presence of the testator.

(5) All signatures must be at the end of the Will. The testator must sign each page and each page must be numbered.

(6) The date of the Will must be noted at the end of the Will by an "authorized person."

(7) The authorized person must attached a certificate to the end of the Will that provides that the procedures for the execution of an international Will have been complied with. The uniform legislation provides a sample form for the certificate.

d. Who is "Authorized Person"?

(1) Under the Convention, an "authorized person" is an individual designated by the jurisdiction implementing the enabling domestic legislation.

(2) In the U.S., only attorneys admitted to practice law are "authorized persons."

3. Requirements of International Will Under The Hague Convention. In countries that have adopted the Hague Convention Relating to the Form of Testamentary Dispositions, a "testamentary disposition" will be valid if it complies with the internal law of:

a. The place where the testator made it, or

b. A nationality possessed by the testator, either at the time when he made the disposition or at the time of his death, or

c. A place in which the testator had his domicile either at the time when he made the disposition or at the time of his death, or

d. The place in which the testator had his habitual residence either when he made the disposition or at his death, or

e. So far as immovables are concerned, the place where they are situated.

D. ***When Should a "Situs" Will Be Used (a Will in the Country where the property is located).***

1. Situations Where Situs Will Recommended. A practitioner should consider the use of a "Situs" Will, in addition to the US Will, in the following scenarios:

   a. Situations involving the complex disposition of property located in a foreign country,

   b. Client has substantial real property or investments located in a foreign country;

   c. Client resides or owns real property in a foreign country that has not adopted the Washington Convention or the Hague Convention Relating to the Form of Testamentary Dispositions, and as a result, there is a greater risk that an issue will arise in proving the validity of a United States will;

   d. Probate of a will is required to transfer title to property located in a foreign country; and

   e. There is a potential for dispute over the disposition of property located in a foreign country.

2. Situations Where Only U.S. Will May Be Appropriate. In the following situations, it may be appropriate to use a U.S. Will to dispose of the client's property located in a foreign country:

   a. The property in the foreign country is not substantial or not expected to be permanent;

   b. When the country's estate administration or registration of property is relatively simple, which is generally the case in most common law countries;

   c. When a Will is not needed to transfer property in the foreign country. In civil law countries, property vests immediately in the

decedent's heirs on death under intestacy law and if the heirs are the people the decedent wants to leave the property to, then no Will is necessary;

d. The country has adopted the Washington Convention or the Hague Convention Relating to the Form of Testamentary Dispositions.

3. Drafting Issues.

a. If client needs a "Situs" will and a United States Will, it is important to identify the scope of the assets covered by each Will and avoid the use of broad provisions revoking all prior Wills and codicils.

b. If relying on intestacy laws in civil law country, need to specifically exclude asset in that country under U.S. Will.

c. Careful consideration must be given to the tax apportionment and payment clause, who should pay the U.S. tax and the foreign taxes. Generally, some form of apportionment is desired rather than having all taxes paid from the "residue."

d. Revocable Trusts are usually not recommended for the transfer of property in a foreign country.

E. *How Should a Client Dispose of Foreign Assets in U.S. Estate Planning Documents.*

1. Simplicity is best.
2. Leaving foreign property in trust can result in adverse tax and titling consequences.

F. *U.S. Succession Law Issues for Non-citizen Residents (Resident Aliens).*

1. Determining Domicile for Succession Purposes.

a. U.S. Domicile - Which State's Succession Laws Apply.

(1) U.S. succession laws are based on a person's domicile.

(2) In the U.S., an individual can choose his/her domicile. A domicile of choice requires a physical presence in the jurisdiction and a concurrent intention to make the place home for the time being.

(3) Physical Presence. Unlike residency for income tax purposes, there is no hard and fast rule requiring a person to reside in a jurisdiction for a certain length of time.

(4) Intent. An individual must intend to make a place his/her home. If the individual resides in one place but intends to return to his or her "home," the individual has not established a domicile of choice in the place that he/she is temporarily residing.

(5) Non-citizen. An individual's presence in the U.S. under a nonimmigrant visa, or even an illegal alien, will not as a matter of law preclude the individual from establishing domicile in a particular state for state law purposes, although it is an important factor in determining whether the individual had the intent to establish domicile.

b. Planning Issues for Noncitizens with U.S. Domicile.

(1) Community Property. Noncitizen clients may have acquired community property in a civil law country prior to moving to the U.S. bringing such property with them. Generally, such property is deemed owned one-half by each spouse for succession law purposes.

(2) Premarital Agreement in Foreign Country. Noncitizen clients may have entered into a premarital agreement prior to moving to the U.S. Under U.S. law, a U.S. state court should respect the agreement and apply its rules to the couple's acquisition of property while living in the U.S.

(3) Forced Heirship. Many civil law countries base choice of law rules for succession on the decedent's *citizenship*, rather than domicile.

(a) Movables. Forced heirship rules may be applied to the decedent's movables (personal property) even if domiciled in the U.S. The courts in the U.S. have been reluctant to recognize forced heirship claims based on a decedent's country of citizenship.

(b) Real Estate. Typically, the law where real property is located controls the succession of such property. However, if an individual is a citizen of a country that bases succession on citizenship, a conflict may arise between choice of law as to which country's succession laws apply. These rules are

complicated and beyond the scope of this outline, but should be investigated if you have a client in this situation.

G. *Choice of Law for U.S. Citizens Living Abroad*.

1. Conflicts of Laws. It may be difficult to determine which country's laws apply when a U.S. citizen dies in a foreign country. Many countries base their jurisdiction on a person's "habitual residence," rather than domicile.

2. Habitual Residence. In general, a person's habitual residence is the country that the individual has the closest connection with based on all relevant facts. Therefore, when a U.S. citizen moves abroad even temporarily, he may be determined to have his habitual residence in the foreign country even though he intends to eventually return to the U.S. These conflicts arise quite often among Europeans who move from country to country.

3. EU Regulation 650.[11]

   a. The European Union adopted Regulation 650 on July 4, 2012. The regulation became effective on August 17, 2015 and applies to individuals dying after August 16, 2015.

   b. Member States. Twenty-five (25) of the EU countries adopted the Regulation and are referred to as Member States. Three (3) EU countries did not adopt the Regulation - the United Kingdom, Ireland, and Denmark.

   c. The goal of the Regulation is to
      (1) Limit jurisdiction over succession to the courts of a single Member State;
      (2) Apply the law of one country to a succession;
      (3) Allow enforcement of a decision on succession by one Member State in another Member State; and
      (4) Establish a European Certificate of Succession to implement a decision on succession by a Member State in another Member State.

   d. Habitual Residence. Jurisdiction will primarily rely on where the decedent had a "habitual residence" at death. The preamble to the Regulation provides that "in order to determine the habitual

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[1] The Regulation (document number 32012RO650) can be found at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0107:0134:EN:PDF or http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0650&rid=1.

residence, the authority dealing with the succession should make an overall assessment of the circumstances of the life of the deceased during the years preceding death *and* at the time of death, taking into account *all relevant factual elements*, in particular the *duration* and *regularity* of the deceased's presence in the Member State concerned and the *conditions* and *reasons* for that presence. The habitual residence thus determined should reveal a *close* and *stable* connection with the State concerned *taking into account the specific aim of the Regulation*."[2]

e. Member State's Jurisdiction Controls. If a U.S. citizen had a habitual residence in a Member State at death, the courts of that Member State will be entitled to rule on the decedent's succession as a whole regardless of whether the decedent's assets were located in one or more Member States or in another country, such as the U.S.

f. Use of Two Wills. A U.S. citizen who does not want the courts of the Member State to rule on succession matters with respect to his/her property in the U.S. should consider having two Wills, a U.S. Will to dispose of the property in the U.S. and a European Will to dispose of property in the Member State(s). The European Will should state that any property located outside the Member State (i.e., in the U.S.) will be disposed of under another Will executed by the U.S. citizen.

g. If U.S. Citizen Has Assets in Two or More Member States and No Habitual Residence in Either. If a U.S. citizen has assets in two or more Member States, a succession proceeding will have to be commenced in each Member State in which the decedent had assets at death if the decedent did not have a habitual residence in a Member State at death.

h. Selecting Law of Nationality as Governing Law. The Regulation also authorizes a person to choose the law of his nationality to govern succession rather than his habitual residence. For example, a U.S. citizen can select that U.S. law will govern the succession as a whole. The law of a person's nationality must be selected at the time of making the choice (i.e., in his/her Will) or at the time of death if not in a Will. The individual can also select which U.S. State's law will govern construction of the Will, but not necessarily administrative matters if there is no probate proceeding in the State. The law of the state in the U.S. with which the deceased had the "closest connection" will govern the succession.

[2] Preamble ¶23 (italics added).

H. ***Non-Resident Beneficiaries under Wills and Life Insurance.*** Many times, non-citizen residents may wish to leave their assets to beneficiaries who do not reside in the U.S.

1. In General. Gifts or bequests to a non-resident could give rise to a gift or inheritance tax on the beneficiary in the other country.

2. Gifts in Trust. As mentioned above, gifts/bequests to a trust for a foreign beneficiary raises U.S. and foreign tax issues.

   a. From a U.S. tax standpoint, it is best to leave assets to a domestic trust (a trust located in the U.S. with a U.S. trustee) rather than a foreign trust.

   b. However, such a gift/bequest could have foreign tax consequences, especially in civil law countries that have little or no trust law.

II. FOREIGN TRUST ISSUES

A. ***What is a Foreign Trust?.*** For federal income tax purposes, a trust is a foreign trust if there is (1) no court within the United States able to exercise primary supervision over the administration of the trust (the "Court Test"), or (2) if a United States person does not control all substantial decisions of the trust (the "Control Test").[3]

1. Court Test

   a. Safe Harbor. The safe harbor[4] rule provides that a trust satisfies the court test if:

      (1) The trust instrument does not direct that the trust be administered outside of the United States;

      (2) The trust is administered exclusively in the United States; and

      (3) The trust is not subject to an automatic migration provision.

   b. Primary supervision means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.[5]

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[3] IRC §7701(a)(30)(E), (31)(B).
[4] Treas. Reg. §301.7701-7(c)(1).
[5] Treas. Reg. §301.7701-7(c)(3)(iv).

c. <u>Administration</u> means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.[6]

2. <u>Control Test</u>

a. A United States person is defined to include a citizen or resident of the United States, domestic partnership or domestic corporation.[7]

b. Substantial decisions[8] are defined as decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial, including, but not limited to, decisions concerning:

(1) Whether and when to distribute income or corpus;

(2) The amount of any distributions;

(3) The selection of a beneficiary;

(4) Whether a receipt is allocable to income or principal;

(5) Whether to terminate the trust;

(6) Whether to compromise, arbitrate, or abandon claims of the trust;

(7) Whether to sue on behalf of the trust or to defend suits against the trust;

(8) Whether to remove, add, or replace a trustee;

(9) Whether to appoint a successor trustee to succeed a trustee who ceased to act as a trustee, unless the power to make such a decision is limited so that it cannot be exercised in a manner that would change the trust's residency from domestic to foreign;

(10) Investment decisions; however, if a United States person hires an investment advisor for the trust, investment decisions made by the investment advisor will be

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[6] Treas. Reg. §301.7701-7(c)(3)(v).
[7] IRC §7701(a)(30).
[8] Treas. Reg. §301.7701-7(d)(1)(ii).

considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.

c. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions.[9]

d. There is a twelve month grace period to correct a change in the residency of a trust resulting from the death, incapacity, resignation, change in residency or other change with respect to any person who has the power to make a substantial decision of the trust if such change was not intended to change the residency of the trust.[10] If the trust fails to correct the change in residency within twelve months due to reasonable cause, the trust may request an extension of time to make the necessary change.[11]

B. ***Income Tax Issues with Foreign Trusts***

1. In general, any transfer of property by a United States person to a foreign trust is treated as a sale or exchange, and the transferor must recognize as gain the excess of fair market value over the adjusted basis.[12] However, an exception to this gain recognition treatment applies if the transferee trust is a grantor trust under Section 671.[13]

2. If a domestic trust becomes a foreign trust, then such trust is treated as having transferred all of its assets to a foreign trust which will result in the recognition of gain on appreciated property held by the trust.[14]

3. There is no recognition of loss for transfers to a foreign trust.[15] Therefore, any gain realized on the transfer of appreciated property to a foreign trust may not be offset by a loss on the transfer of depreciated property to such trust.[16]

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[9] Treas. Reg. §301.7701-7(d)(1)(ii).
[10] Treas. Reg. §301.7701-7(d)(2)(i).
[11] Treas. Reg. §301.7701-7(d)(2)(ii).
[12] IRC §684(a).
[13] IRC §684(b).
[14] IRC §684(c).
[15] Treas. Reg. § 1.684-1(a)(2).
[16] Id.

III. ESTATE AND GIFT TAX ISSUES

A. *U.S. Estate and Gift Taxation of Non-citizens Who Reside in the U.S. (Resident Aliens)*

1. U.S. Estate Tax. U.S. Estate Tax is imposed on the taxable estate of any decedent who is a citizen or resident of the United States.[17] For estate tax purposes, a resident is an individual who had a domicile in the United States at the time of death.[18]

2. U.S. Gift Tax. U.S. Gift Tax is imposed on the transfer of property by gift by any individual, resident or nonresident.[19] However, as discussed below, imposition of the tax is limited to certain property if the transferee is neither a citizen nor a resident.[20] For gift tax purposes, a resident is an individual who had a domicile in the United States at the time of the gift.[21]

3. Domicile for Transfer Tax Purposes. For transfer tax purposes, an individual acquires domicile by living in a place, even if only for a brief period of time, with no present intention of moving from that place, and once domicile is established intention to change domicile does not effect a change without an actual move.[22]

    a. Domicile is a fact based determination made on a case-by-case basis.

    b. Although there is no test for the determination of domicile, the cases discussed provide some guidelines.

        (1) In *Estate of Khan v. Commissioner*, T.C. Memo 1998-22, the court held that a citizen of Pakistan, who was visiting Pakistan at the time of his death, was a resident of the United States for federal estate tax purposes. In making this determination, the court consider the following facts: (1) the decedent entered the United States on a permanent resident visa; (2) the decedent later obtained a green card and a social security number; (3) most of the decedent's property was located in the United States, including bank accounts and substantial farming and business interests; and (4) the decedent's family had a long history of immigrating to the United States. The court noted that it

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[17] IRC §2001(a).
[18] Treas. Reg. §20.0-1(b)(1).
[19] IRC §2501(a)(1).
[20] IRC §2511.
[21] Treas. Reg. §25.2501-1(b).
[22] Treas. Reg. §§20.0-1(b)(1) and 25.2501-1(b).

did not consider the decedent's inability to speak English, failure to obtain a library card or a driver's license in making this determination.

(2) In *Estate of Paquette v. Commissioner*, T.C. Memo 1983-571, the court held that a citizen of Canada, who prior to his death divided his time between residences in Canada and Florida, was not a resident of the United States for federal estate tax purposes. In making this determination, the court considered that although the decedent had sold his two homes in Canada, leaving only his residence in Florida, the decedent maintained his Canadian citizenship and driver's license, most of the decedent's investment assets were located in Canada, the decedent filed Canadian income tax returns, the decedent made annual visits to Canada, and the decedent had expressed an interest in renting a residence in Canada. The court stated that ownership of a residence is only one factor indicating an individual's intent to establish a new domicile.

B. ***Applicable Exclusion For Non-Citizens.***

1. Non-Citizen Resident. A Non-Citizen Resident of the U.S. is entitled to the same Applicable Exclusion Amount as a U.S. Citizen, currently $5 million indexed for inflation.

2. Non-Citizen Non-Resident. A Non-Citizen Non-Resident who owns property in the U.S. is not entitled to an Applicable Exclusion, but is entitled to a credit against his/her estate tax liability of $13,000. This allows for a transfer of only $60,000 of assets estate tax free.

C. ***Non-Citizen Spouse***

1. Gift Tax Marital Deduction. The unlimited marital deduction for lifetime gifts to a donor's spouse only applies if the donor's spouse is a citizen of the United States.[23] However, there is an annual exclusion amount of $100,000, indexed for inflation, ($185,000 for 2024) which may be applied to gifts to non-citizen spouses.[24] As a result, care must be taken in re-titling assets between spouses as is typical for estate planning purposes.

2. Estate Tax Marital Deduction. An estate tax marital deduction generally is not allowed for property that passes from a decedent to a non-citizen

[23] IRC §2523(i).
[24] IRC §2523(i); Rev. Proc. 2023-34.

surviving spouse unless such property passes to a qualified domestic trust (QDOT).[25]

a. In addition to the requirements of Section 2056 (relating to QTIP requirements), the trust instrument must provide that at least one trustee of the trust be a U.S. citizen or a domestic corporation (the "United States Trustee") and must provide that no corpus distribution can be made from the trust unless the United States Trustee has the right to withhold the amount of estate tax liability that will be imposed upon the distribution.[26]

b. .If the fair market value of the assets passing to the QDOT exceeds $2 million[27] or if more than thirty-five percent (35%) of the fair market value of the trust's assets determined annually consist of real property located outside of the U.S.,[28] the trust instrument must also include at least one of the following requirements: (1) designation of a domestic bank or a U.S. branch of a foreign bank to serve a co-trustee with a United States Trustee; or (2) the United States Trustee must furnish a bond or letter of credit In determining whether the $2 million threshold is exceeded, the executor of decedent's estate may exclude up to $600,000 of the combined value of the principal residence and one other residence (as well as related furnishings).[29]

D. ***U.S. Estate and Gift Taxation of Non-Citizens Who Do Not Reside in U.S. (Non-Resident Aliens)***

1. U.S. Estate and Gift tax applies to non-citizens who do not reside in the United States to the extent such individuals own property *situated* within the United States.[30] Although this rule applies to both tangible and intangible property for estate tax purposes, IRC § 2501(a)(2) provides an exception for transfers of intangible property for gift tax purposes. As a result, only transfers by non-citizens who do not reside in the United States of real property and tangible personal property physically situated in the United States are subject to gift tax.

2. Treas. Reg. § 20.2105-1 provides that for non-citizens who do not reside in the United States property is situated outside of the United States if it is any of the following:

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[25] IRC §2056(d).
[26] IRC §2056A.
[27] Treas. Reg. § 20.2056A-2(d)(1)(i).
[28] Treas. Reg. § 20.2056A-2(d)(1)(ii).
[29] Treas. Reg. § 20.2056A-2(d)(1)(iv).
[30] IRC §§2103 and 2511.

a. Real property or tangible personal property located outside the United States;

b. Works of art imported into the United States solely for exhibition purposes;

c. Certain types of bonds, notes, or other forms of debt;

d. Shares of stock issued by a foreign corporation;

e. Amounts receivable as insurance on the decedent's life; and

f. Deposits with a branch outside of the United States of a domestic corporation or domestic partnership, if the branch is engaged in the commercial banking business.

3. A Tax treaty between the taxpayer's country of residence and the United States, if any, may provide further exceptions.

E. ***Tax Treaties***

1. Avoiding Double Taxation. There is a risk of double taxation for individuals owning property or residing in a foreign country. As a result, the United States has entered into transfer tax treaties with several countries, including the United Kingdom, France, and Germany.

2. Types of Transfer Tax Treaties.

a. Situs-type treaties provide rules for determining the situs of property and allocate taxing jurisdiction to the treaty country in which particular property is situated.

b. Domicile-type treaties provide rules for determining domicile and allocate taxing jurisdiction to the treaty country of domicile. To avoid a situation in which an individual may be considered a dual domiciliary, treaties often provide a tie-breaking provision.

IV. EXPATRIATION

A. ***Expatriation Tax***

1. There is a mark to market tax on unrealized appreciation imposed on the property of "covered expatriates," as if the property has been sold the day before expatriation.[31]

2. Net gain is recognized to the extent it exceeds $600,000, indexed for inflation ($866,000 for 2024).[32]

3. Gains and losses subsequently realized are adjusted for gains and losses taken into account under the deemed sale rules without regard to the $600,000.[33]

4. Deferred compensation items. Mark to market does not apply.

    a. "Specified Tax Deferred Account." IRAs, qualified tuition plan, education savings accounts, health savings accounts, and Archer MSAs. Payor must withhold thirty percent (30%) from any taxable payment to expatriate.

    b. "Non-Specified Tax Deferred Account." Expatriate treated as having received present value of the accrued benefit on the day before expatriation which is included in net income. Includes simplified employee pensions and simplified retirement accounts.

5. Distributions From Non-Grantor Trusts To Covered Expatriate. Trustee must without thirty percent (30%) of any distribution to expatriate that would be included in income if subject to US income tax. Distribution of appreciated property treated as if sold at fair market value and trust recognizes gain.

6. A "covered expatriate" is any U.S. citizen who relinquishes U.S. citizenship or long term resident who terminates U.S. residency, if such individual that meets one or more of the following tests:

    a. Tax Liability Test. Has an average annual net income tax liability for the five (5) preceding years ending before the date of loss of U.S. citizenship or residency termination that exceeds $124,000, adjusted for inflation ($201,000 for 2024);[34]

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[31] IRC §877A(a).
[32] IRC §877A(a)(3); Rev. Proc. 2023-34.
[33] IRC §877A(a).
[34] IRC §877A(a)(2)(A); Rev. Proc. 2023-34.

b. Net Worth Test. Has a net worth of $2 million or more on such date;[35] or

c. Failure to Certify. Fails to certify under penalties of perjury that he or she has complied with all U.S. federal tax obligations for the preceding five years or failure to submit such evidence of compliance as the Secretary may require.[36]

7. Long Term Resident. An individual, other than a U.S. citizen, who is a lawful permanent resident ("green card holder") in at least 8 of the prior 15 tax years. Any day of lawful permanent residence within the calendar year counts as a year of residency for purposes of this test.[37] Green card must be revoke or there must be an administrative or judicial determination that is has been abandoned.

8. Exceptions.

a. Dual Citizenship. A person born with dual citizenship (U.S. and another country) provides that (i) as of the expatriation dates, the individual continues to be a citizen of, and is taxed as a resident of, the other country, and (ii) the individual has been a resident of the United States for not more than 10 tax years during the 15 tax years ending with the year of expatriation. [38]

b. Minors. A person who relinquishes U.S. citizenship before reaching the age of 18 1/2 provided that the individual was a resident of the U.S. for not more than 10 tax years before such relinquishment.

B. ***Taxation of U.S. Citizens or Residents Receiving Gifts or Bequests from Expatriates.***

a. Background Section 2801 Tax. The Heroes Earnings Assistance and Relive Tax Act of 2008 ("HEART Act"), which contains the current expatriation tax on U.S. citizens and long term green card holders who expatriate from the United States, also imposes tax on U.S. citizens or residents who *receive* gifts or bequests from individuals who expatriate on or after June 17, 2008.[39]

b. Deferred Reporting. Reporting and tax obligations relating to such gifts was deferred until guidance issued.[40]

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[35] IRC §877A(a)(2)(B).
[36] IRC §877A(a)(2)(C).
[37] IRC §877A(g)(5); 877(e)(2).
[38] IRC §877A(g)(1)(B)(i).
[39] IRC §2801.
[40] Notice 2009-85, 2009-45 I.R.B. 598.

c. Proposed Regulations. Proposed regulations were issued on September 9, 2015.[41] Reporting and payment of tax will be due within reasonable time after Final Regulations issued.

2. General Rules of Liability and Definitions.[42] Forty percent (40%) tax imposed on *U.S. citizens and residents* who received gifts or bequests from "covered expatriates."

a. U.S. Recipient.

(1) U.S. domestic trusts and foreign trusts electing to be treated as U.S. domestic trusts are treated in same manner as U.S. citizens.

(2) "Resident" of the United States based on domicile, not income tax definition of resident.

(3) Includes U.S. citizen or resident shareholders, partners, members, or other interest-holders of a U.S. domestic entity that receives a covered gift or bequest.

(4) Includes distributions from foreign trusts *not* electing to be treated as U.S. domestic trust for 2801 if the distributions are attributable to covered gifts or bequests received by the foreign trust.

b. Covered Gift or Bequest.

(1) "Covered Gift" any property acquired by gift directly or indirectly from a covered expatriate at the time it is received.

(2) "Covered Bequest" any property acquired directly or indirectly by reason of death of a covered expatriate.

(3) Regardless of situs of property or whether property was acquired by expatriate before or after expatriation.

c. Indirect Acquisition of Property. Includes the following:

(1) Property acquired as a result of a transfer that is a covered gift or bequest to a corporation or other entity other than a trust or estate (based on U.S. Recipients interest in corporation or entity);

[41] 26 CFR Part 28 [REG-112997-10]
[42] Prop. Reg. §28.2801-1(a); §28.2801-2.

(2) Property acquired by or on behalf of U.S. Recipient, either from a covered expatriate or from a foreign trust that received a covered gift or bequest, through one or more other foreign trusts, other entities, or from a person not subject to the 2801 Tax;

(3) Property paid for by a covered expatriate, or distributed from a foreign trust that received a covered gift or bequest, in satisfaction of a debt or liability of a U.S. citizen or resident (regardless of the payee of that payment or distribution);

(4) Property acquired by or on behalf of a U.S. citizen or resident pursuant to a non-covered expatriate's power of appointment granted by a covered expatriate over property not in trust, unless the property was previously subjected to Section 2801 tax upon the grant of the power or the covered expatriate had no more than a non-general power of appointment over the property; and

(5) Property acquired by or on behalf of a U.S. citizen or resident in other transfers not made directly by the covered expatriate to the U.S. citizen or resident.

d. "Covered Gift".[43] Same meaning as for U.S. gift tax purposes, but disregarding certain exceptions under 2501, the per -donee annual exclusion under 2503(b), and exclusion for medical and educational expenses under 2503(e).

e. "Covered Bequest".[44] Property acquired "by reason of the death of a covered expatriate" includes any property that would have been includible in the expatriate's gross estate if U.S. citizen at time of death.

3. Exceptions to Covered Gifts and Bequests.[45]

a. Reported Taxable Gifts. Transfers reported on donor's timely filed Form 709. However, annual exclusion gifts are not excluded, even if reported on Form 709.

[43] Prop. Reg. §28.2801-3(a).
[44] Prop. Reg. §28.2801-3(b).
[45] Prop. Reg. §28.2801-3(c).

b. Property Subject to Estate Tax. Property included in covered expatriate's gross estate and reported on timely filed Form 706 or 706-NA, provided tax is timely paid.

c. Transfers to Charity. Charitable bequests under Section 2522(b) or 2055(a) are not included as covered gifts/bequests.

d. Transfers to Spouse. Transfer from covered expatriate to his/her spouse not included to extent marital deduction would have been allowed.

e. Qualified Disclaimers. Transfer as a result of covered expatriate's qualified disclaimer excluded.

4. Covered Gifts and Bequests Made in Trust.[46] Transfer of property by covered expatriate to a trust is treated as covered gift or bequest without regard to beneficial interests in trust or whether any person has a general power of appointment over trust.

a. Domestic Trust or Electing Foreign Trust. Treated as U.S. citizen. Trust pays the tax.[47]

b. Foreign Trusts. Tax applies to distributions attributable to the covered gift or bequest to the trust to a U.S. citizen or resident.[48]

5. Powers of Appointment.[49]

a. Covered Expatriate as Holder of Power.[50] Exercise or release of general power of appointment by covered expatriate for benefit of U.S. Citizen or resident is covered gift or bequest.

(1) Lapse in excess of the greater of $5,000 or 5% treated as release of power.

(2) Exercise of power that creates another power of appointment for benefit of U.S. citizen or resident is covered gift or bequest.

b. Covered Expatriate as Grantor of Power. Grant of general power of appointment by covered expatriate to U.S. citizen or resident

[46] Prop. Reg. §28.2801-3(d).
[47] Prop. Reg. §28.2801-3(d); IRC §2801(e)(4)(A).
[48] Prop. Reg. §28.2801-3(d); IRC §2801(e)(4)(B).
[49] Prop. Reg. §28.2801-3(e).
[50] Prop. Reg. §28.2801-3(e)(1).

over property not in trust is covered gift or bequest.[51] If property in trust, see rules on transfers to trusts above.

6. Liability for Tax.[52]

   a. U.S. Citizen or Resident. U.S. citizen or resident receiving covered gift or bequest is liable for Section 2801 Tax.

   b. Domestic Trust. Domestic trust treated as U.S. citizen for this purpose.

   c. Foreign Trust. Foreign trust may elect to be treated as domestic trust for Section 2801. If no election, then U.S. citizen or resident beneficiary liable for the tax when receives distribution attributable to covered gift or bequest.

7. Computation of Tax.[53]

   a. Total value of all covered gifts and bequests received during calendar year less the per-donee annual exclusion multiplied by highest rate of U.S. Gift Tax (for a covered gift) or U.S. Estate Tax (for a covered bequest).

   b. Value of gift/bequest is fair market value of property on date of receipt using U.S. gift and estate tax valuation principals.

   c. No $10 Million (indexed for inflation) Applicable Exclusion.

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[51] Prop. Reg. §28.2801-3(e)(2).
[52] Prop. Reg. §28.2801-4(a).
[53] Prop. Reg. §28.2801-4(b).

V. REPORTING REQUIREMENTS FOR US CITIZENS OR RESIDENTS

A. *Foreign Accounts*. U.S. citizen or resident (including U.S. entity) must file FinCEN Report 114 (formerly FBAR) if own or has signature authority over foreign account if value exceeds $10,000 at anytime during calendar year.[54]

1. Foreign Bank, Securities, and "other Financial Accounts."

   a. Accounts with financial agency;

   b. Account that is an insurance or annuity policy with cash value;

   c. Accounts with a broker or dealer of futures or options;

   d. Some pensions.

2. Financial Interest in Foreign Bank, Securities, and Other Financial Accounts. U.S. Citizen or resident must file FinCEN Report 11 over the following types of accounts if he/she has a *financial interest* in the account, whether or not has signature authority:
   a. Account for benefit of another person;
   b. Account of which he/she is a joint owner;
   c. Account of a corporation if U.S. person owns more than 50% of stock or voting power;
   d. Account of a partnership in which U.S. person owns more than 50% of profits and capital;
   e. Account of a trust if grantor is a U.S. person and is a grantor trust;
   f. Account of a trust if U.S. person has a present beneficial interest, either directly or indirectly, in more than 50% of the assets or receives more than 50% of the income of the trust. There is an exception to this rule if trustee or agent of the trust is a U.S. person who files the report.

3. Penalties. Failure to file penalty up to $10,000. Can be waived for reasonable cause. Also, criminal penalties if willful, fines not exceeding $250,000, or imprisonment of not more than 5 years.

B. *Disclosing Specified Foreign Financial Assets ("FACTA") Form 8938*[55]

1. Filing Requirements for Individuals. U.S. taxpayers must file Form 8938 if value of "specified foreign financial assets" meets following thresholds:

   a. Individual U.S. resident not filing jointly, $50,000 of value on last day or taxable year or $75,000 on any day during taxable year.

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[54] 31 CFR §1010.350(a).
[55] Treas. Reg. 1.6038D-2.

b. Individual U.S. resident filing jointly, $100,000 of value on last day of taxable year or $150,000 on any day during taxable year.

c. Individual Non U.S. resident not filing joint return, $200,000 of value on last day of taxable year or $300,000 on any day during taxable year.

d. Individual Non U.S. resident filing joint return, $400,000 of value on last day of taxable year or $600,000 on any day during taxable year.

2. Interest in Specified Foreign Financial Asset.

a. A person has an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included, or otherwise reflected by the specified person on an annual return.[56]

b. Specified Foreign Financial Assets Include:

(1) Stock issued by a foreign corporation;

(2) Capital or profits interest in a foreign partnership;

(3) A note, bond, debenture or other form of indebtedness issued by a foreign person;

(4) An interest in a foreign trust;

(5) An interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty; and

(6) An option or other derivative instrument with respect to any of the above or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer. [57]

[56] Treas. Reg. §1.6038D-2(b)(1).
[57] Treas. Reg. §1.6038D-3(d).

c. Specified Foreign Financial Assets do not include financial accounts maintained by:[58]

(1) U.S. financial institution;
(2) Foreign branch of a U.S. financial institution; or
(3) U.S. branch of a foreign financial institution.

3. Exceptions From Filing Requirements.[59]

a. If asset reported on Form 3520; Form 5471; Form 8621; Form 8865; or Form 8891.

b. Individual is treated as the owner of (under the Grantor Trust rules) widely held fixed investment trust or a liquidating trust.

4. Penalties. Failure to file penalty $10,000. If continues for more than 90 days, $10,000 for each 30 day period after initial 90 days, up to $50,000.

C. *Gifts From Nonresident Aliens.* Gifts from nonresident alien (for income tax purposes) to U.S. citizen or resident.

1. Not taxable to recipient.[60]

2. Must report gifts from foreign individuals or estates that exceed $100,000 in calendar year on Form 3520.[61]

3. Must report gifts from foreign corporations or partnerships if they exceed $10,000 adjusted for inflation ($19,570 for 2024).

D. *Distributions From Foreign Estates.*

1. U.S. citizen or resident who receives a distribution from a foreign estate must report on Form 3520 if exceeds $100,000 in a calendar year.

2. Penalty for not reporting, 5% of bequest for each month failure to report continues up to maximum of 25%.[62] Can be waived for reasonable cause.

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E. *Beneficiaries of Foreign Trusts*.

1. Distributions. U.S. citizen or resident beneficiary must report distributions from foreign trusts on Form 3520. No minimum threshold.

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[58] Treas. Reg. §1.6038D-3(a)(3).
[59] Treas. Reg. §1.6038D-7.
[60] IRC §102.
[61] IRC §6039F; Notice 97-34, 1997-1C.B. 422; Rev Proc 2023-34.
[62] IRC §6039F(c)(1).

2. Throwback Rules. Distributions from foreign trust presumed to be accumulation distribution, subject to throwback tax and interest.[63]

   a. Presumption can be rebutted.

   b. If trustee provides Foreign Grantor Trust Beneficiary Statement to beneficiary, can treat as gift.[64]

   c. If trustee provides Foreign Non-Grantor Trust Beneficiary Statement to beneficiary, it will indicate portion that is accumulation distribution and portion that is not.

F. *Foreign Trusts with U.S. Grantors*

1. U.S. grantor must file annual report of trust's activities with IRS.[65]

2. Trust must file Form 3520-A each calendar year and attach "Foreign Grantor Trust Statement" and provide statement to U.S. grantor and each beneficiary receiving a distribution during the year. U.S. owner responsible for ensuring filing.[66]

3. Penalty for non-filing is 5% of gross value of trust's assets.[67]

4. If trust is a grantor trust as to U.S. citizen or resident, must also file Form 3520.

G. *Other Reporting Situations*

1. Form 5471-Information Return of US Persons with Respect to Certain Foreign Corporations.

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

3. Form 8865 - Return for US Persons with Foreign Partnerships

4. Form 8858 -Information Return of US Persons with Respect to Foreign Disregarded Entities.

5. Form 8621 - Information Return by a Shareholder of a Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF)

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[63] IRC §6048(c)(2).
[64] Notice 97-34, 1997-1 C.B. 422.
[65] IRC §6048(b)(1)(A).
[66] Notice 97-34, 1997-1 CB. 422.
[67] IRC §6677(a).