

INTERNATIONAL ESTATE PLANNING 101

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I. Introduction

The objective of this presentation is to identify some important U.S. tax planning considerations with respect to cross-border wealth ownership and, particularly, the transfer of that wealth in gratuitous transactions. This flow of wealth can occur in two different directions:

- 1) The U.S. person may own assets located outside the United States, or have family members residing outside the United States to whom assets are to eventually be transferred (i.e., “outbound transactions”); and
- 2) The foreign person may have assets in the United States or may intend to acquire assets in the United States (i.e., “inbound transactions”).

In either event, the laws of both the United States and the other jurisdiction (or multiple foreign jurisdictions) will be relevant in determining both (i) the mechanics for implementing wealth transfers and (ii) the taxation (income and transfer tax) of the transfers of this wealth.

The purpose of this paper (labeled “International Estate Planning 101”) is to identify some common situations which practitioners can encounter in this context.¹ These deal with issues concerning both “inbound” and “outbound” investment planning. This tax environment could be changed dramatically during late Summer or Fall 2005 if the advocates of estate tax repeal are able to force through repeal or (more likely) some significant liberalizing changes. As noted, below, the foreigner having assets in the United States (but no vote) is treated more unmercifully, and that treatment could be anticipated to be continued in this context.

¹ For a detailed analysis of many of these issues see Streng, “U.S. International Estate Planning,” available electronically on RIAG Checkpoint, Estate Planning Library. Additional resources include the study materials for periodic ALI-ABA courses often entitled “International Trust and Estate Planning.”

II. Beware of the Client Regularly in the U.S. Who States He is Not A U.S. Resident

U.S. taxpayer status is determined differently for federal estate (and gift) tax purposes than for federal income tax purposes (assuming non-U.S. citizenship status).

For federal income tax purposes U.S. residency status is determined through the application of one of two “bright line tests.” The alien individual may have permanent resident status in the U.S. (i.e., may have a “greencard”) and, similar to U.S. citizen status, is, therefore, subject to the worldwide applicability of the U.S. income tax.² Alternatively, U.S. residency status may occur for U.S. income tax purposes because an individual meets the “substantial presence” test (a “day counting” test).³ When U.S. residency status is established the individual is then subject to the worldwide applicability of the U.S. income tax. If non-residency status is retained the U.S. income tax is applicable to the non-resident only on the basis of a U.S. source of income, rather than on the basis of the U.S. tax status of the individual.

For federal estate tax purposes the test is far less precise. A nonresident decedent is a decedent who, at the time of his death, had his domicile outside the United States. For this purpose 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.”⁴ The objective, therefor, for the alien individual is ordinarily to retain foreign status. As noted below, in some situations this position may be reversed because of the significant difference in the available unified credit for federal estate tax purposes but, in many instances, U.S. assets held by alien individuals will be

² Code § 7701(b)(1)(A)(i).

³ Code § 7701(b)(1)(A)(ii).

⁴ Reg. § 20.0-1(b).

immune from estate tax, thereby obviating the necessity to qualify for the unified credit.

The determination of an individual's residence status for either the income tax or the estate tax can be impacted by a bilateral tax treaty. The U.S. has about 60 bilateral income tax treaties, but has only a limited number of estate tax treaties (as discussed further below). One purpose of these treaties is to establish "tie-breaker" rules to enable the better resolution of the process of determining residency, thereby allocating primary tax jurisdiction to one of the treaty partner countries. However, for U.S. individuals, a "savings clause" will ordinarily apply, meaning that, even though the foreign country may have primary tax jurisdiction, the U.S. retains the right to tax its citizens on a residual basis.

III. Estate Taxation of the U.S. Assets of the Foreign Non-Resident Alien

The U.S. estate tax can be much more onerous on the U.S. assets of the foreigner than on the estate of a U.S. citizen or resident. The unified credit amount for the estate of a U.S. citizen or U.S. resident during 2005 is \$1,500,000 and is increasing to \$2,000,000 for 2006, 2007 and 2008, and then is increasing in 2009 to \$3.5 million.⁵ The unified credit for the estate of a nonresident alien is only \$13,000, enabling the protection from U.S. estate tax of only \$60,000 in those assets (which are exposed to U.S. estate tax inclusion).⁶ This amount is not increasing, unlike the unified credit amount applicable to U.S. taxpayer estates. This unified credit amount might be increased to allow a portion of the Code § 2010 credit when certain tax treaty provisions apply.⁷ For planning purposes, however, the assumption should ordinarily

⁵ Of course, this assumes no legislative changes in the interim, probably not a very valid assumption.

⁶ Code § 2102(b)(1).

⁷ Code § 2102(b)(3)(A). This portion is determined by the ratio of the U.S. assets to the decedent's worldwide assets. A tax treaty may provide a greater exemption. For example, the Canada-U.S. income tax treaty, Article XXIXB

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be that the exclusion limit will be at the \$60,000 net U.S. asset value level.

provides for an estate tax exemption of \$1.2 million for the U.S. estates of Canadian residents.

This U.S. tax exposure may be significantly moderated because certain assets are not included in the U.S. estate tax base for the estate of a nonresident alien.⁸ U.S. based assets held by a nonresident alien but not subject to U.S. estate tax include:⁹

- U.S. bank deposits
- U.S. government (including state and local) and corporate bonds

Corporate stock issued by U.S. corporations (but not a foreign corporation) is included in the U.S. estate tax base for the nonresident alien estate.¹⁰ Of course, this assumes that the corporation is actually a U.S. corporation.¹¹

● Note, for example, that the stock of Royal Dutch Shell is not the stock of a U.S. corporation. Those Houston corporations that have engaged in corporate inversions, becoming Bermuda (or other country) corporations while continuing to trade on the U.S. stock exchanges are also not U.S. corporations for this purpose. Many foreign corporations have stock listed on a U.S. exchange (often identified as ADRs or ADSs) so these shares are beyond the applicability of U.S. estate tax jurisdiction.¹²

⁸ See Code §§ 2104 and 2105.

⁹ See Code § 2105(b).

¹⁰ See Code § 2104(a).

¹¹ This raises the question of the potential applicability of the “choice of entity” under the §7701 regulations concerning the classification of entities.

¹² The impact of the Sarbanes-Oxley legislation appears to be that many foreign corporations are reconsidering their

- Note that under some U.S. bilateral estate tax treaties the stock of a U.S. corporation may not be subject to U.S. estate tax when owned by a resident in the treaty partner country. See, e.g., Article 5(1)(a) of the U.K.-U.S. Estate Tax treaty.

This potential exposure suggests that the U.S. estate planner should seek to assure the availability of an effective durable power of attorney to enable the “attorney in fact”, acting on behalf of a failing non-resident alien individual, to take certain action to eliminate this potential U.S. estate tax exposure, including the following:

U.S. listing and some are seeking to withdraw to listings only on foreign stock exchanges.

- Transfer the assets by gift prior to death to the intended beneficiaries. The lifetime donative transfer of the stock of a U.S. corporation by the non-resident alien is not a gift for U.S. gift tax purposes. Code §2501(a)(2) specifies that the gift tax does not apply to the transfer of intangible property by a nonresident not a citizen of the United States.¹³

- If the gift transfer cannot be implemented at least the client's broker might be vested with authority to sell the stock and, upon notice of impending death, actually sell the stock prior to death. As noted above, cash (or certificates of deposit) are not in the U.S. tax base. The capital gain derived on the sale of the stock is not subject to U.S. income tax to the non-resident alien.¹⁴

IV. How Should U.S. Real Estate be Held by the Foreign Individual?

Many foreigners own properties in the United States (whether residences, apartment buildings, office buildings, ranches, etc.). They may have invested in the U.S. as a safe haven, but may also experience their investments declining in real value (as measured by reference to their home country currency). If the U.S. dollar continues to decline (vs. the Euro and the Yen) U.S. properties will become increasingly price attractive and this inbound investment will continue, particularly for new investors seeking “bargain basement” prices (notwithstanding the “real estate bubble”). This investment will not be limited to large commercial projects acquired by significant corporate real property conglomerates, but will also attract foreign national individuals (and small groups of investors).¹⁵

¹³ Local law will ordinarily determine whether property is intangible or tangible. Query, e.g., with respect to the holding of U.S. dollars in cash (as contrasted with coins held for their numismatic value).

¹⁴ Code § 871(a)(2). Bilateral U.S. income tax treaties have similar provisions.

¹⁵ Consider the Inverworld saga and moderately wealthy Mexican citizens investing into the U.S. through the investment vehicle created by Inverworld. See *Inverworld, Ltd. v. Commissioner*, 979 F.2d 868 (1992).

The question then becomes the manner in which these smaller investments can be held in the U.S. This inquiry often presents a conflict between U.S. income tax planning objectives and U.S. estate tax objectives. For U.S. income tax planning the desire for individual investment would be to hold the U.S. real property either directly or through some intervening vehicle which constitutes a flow-through (or conduit) entity for federal income tax purposes. This enables the property income to be taxed only once, rather than at the individual level and again at the entity level.¹⁶ If held inside a corporation the distribution of the post corporate level taxed profits would cause applicability of a further tax, a U.S. tax withholding at source on the dividend distribution. This distribution would be subject to a 30 percent tax rate (imposed on the gross amount distributed), unless reduced by an applicable income tax treaty (ordinarily not below 15 percent for dividends to foreign individuals). This suggests the use of a conduit entity for U.S. income tax planning to enable avoidance of a dividends withholding tax.

For U.S. estate tax purposes the objective is to avoid inclusion in the U.S. gross estate of the foreign national individual. This can be accomplished through the direct ownership of the property by a wholly owned foreign corporation (which will not “die”, at least for U.S. estate tax purposes) with the U.S. property being held by the foreign corporation. But, this approach frustrates the U.S. income tax planning since the use of the foreign corporation could cause applicability of the branch tax (in addition to the regular corporate tax).

An option in this context is to utilize a partnership to hold the U.S. real property, with the partnership having conduit status for federal income tax purposes and with several family members perhaps holding partnership interests. The argument would be that the partnership interest represents an intangible property interest, similar to shares of stock. Since U.S. intangible property can be transferred by a non-resident alien individual free of U.S. gift tax, the planning objective would be to transfer this “intangible property” by gift shortly before death to the “natural objects of the bounty” of the owner.

¹⁶ Note that disposition gain will also be subject to U.S. income tax under the FIRPTA provisions, Code § 897.

The problem with this position concerning the partnership structure is that the status of the partnership interest as “intangible property” cannot be assured. For many years the Service has refused to rule on this precise issue, i.e., the Service will not rule whether a partnership interest is intangible property for purposes of Code § 2501(a)(2).¹⁷ Little possibility exists that the Service will acquiesce that a partnership interest is categorized as intangible property, particularly when the partnership assets consist totally of U.S. real property.¹⁸

V. How Should Foreign Real Estate be Held by the U.S. Individual?

Many U.S. citizens and residents own properties (e.g., a resort condominium or house in Mexico or the south of France). The estate planning (including income tax planning) issues in this context also concern the manner in which the property should be held by the U.S. citizen in the foreign jurisdiction. Many foreign advisors suggest

¹⁷ See Rev. Proc. 2005-7, 2005-1 I.R.B. 240, which provides at § 4.01(26) that the Service will not ordinarily rule “whether a partnership interest is intangible property for purposes of § 2501(a)(2) (dealing with transfers of intangible property by a nonresident not a citizen of the United States.).”

¹⁸ See “*U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests*,” 99 Tax Notes 1683 (2003); and, 31 Tax Notes Int'l 563 (2003) (William Streng, with co-authors Michael J.A. Karlin, Richard A. Cassell, and Carlyn S. McCaffrey).

the use of some entity or trust vehicle to hold the direct ownership, but this will be dependent upon the law of the destination jurisdiction. This necessitates the use of local legal counsel or other competent assistance in the particular destination country.

If the property is producing income (e.g., it may be in a condominium rental pool), that income will often be subject to tax in the jurisdiction where located. The question then becomes whether that foreign income tax can be used to offset the U.S. income tax liability which may accrue on that same income. The U.S. income tax does apply on a worldwide basis to the income of U.S. individuals and U.S. corporations. For this reason, the use of a foreign entity treated as a corporation for U.S. tax purposes may be useful, but only if the foreign country tax is significantly lower than the applicable U.S. income tax on that same income. In this situation the deferral of the U.S. income tax may be permitted until the profit is repatriated into the hands of the U.S. owner.¹⁹ When the profit is repatriated by the U.S. shareholder into the U.S. through a dividend distribution any withholding tax imposed at source in the foreign country (treated as imposed on the recipient) should be creditable for U.S. income tax purposes to offset the U.S. income tax liability incurred on that dividend distribution when received.

If the foreign property is residential property not producing any significant income the objective often will be to use an ownership entity in the foreign jurisdiction that is treated as a flow-through or conduit for U.S. income tax purposes. If the property appreciates significantly and then is sold, the foreign jurisdiction might impose a significant tax on the property gain or on the earnings derived by the entity itself. The tax planning objective would be to assure that this tax paid to the foreign jurisdiction can be credited against the U.S. income tax liability arising from this property disposition. This would occur with the use of a foreign entity not treated as an entity for U.S. tax purposes, with the tax being treated as paid directly by the U.S. owner. For example, this would not occur if (i) the foreign entity is treated as a corporation for U.S. tax purposes and (ii) the tax is imposed in the foreign jurisdiction at the entity level. The tax paid by the corporation cannot be used as a foreign tax credit by the recipient individual shareholder. The profits distributed to the U.S.

¹⁹ Note that the Subpart F rules (Code §§ 951 through 964) could be applicable to cause certain income to be treated as immediately received by the U.S. shareholders, even though not actually distributed to them.

owner as dividends received by the individual would be subject to U.S. income tax.

This would not be the situation if the foreign entity can be treated as a conduit for U.S. income tax purposes (even though treated as a taxable entity for taxing purposes in the foreign jurisdiction). Consequently, when a U.S. client is considering such a foreign property investment an appropriate exit strategy (to minimize total tax liability on accrued property gains) must be carefully examined.

VI. Retirement Income & Annuity Tax Basis Rules

A. The Code Section 72 Computation

Under Code § 72 an annuity payment received by a U.S. taxpayer is includible in gross income except to the extent that an exclusion is permitted for that portion attributable to the annuitant's "investment in the contract." Many annuities are received because of a participation in a qualified pension or profit sharing plan, have no tax basis for federal income tax purposes, and, therefore, the entire amount is includible in gross income of the annuitant. Where tax basis can be established, tax free recovery of the annuity proceeds is permitted under Code § 72 as an amount attributable to the "investment in the contract." Complications can arise in this context when annuity payments are to be received by a non-resident alien. Annuities paid to a nonresident alien are subject to a 30 percent tax on the gross amount, and this taxation is to be enforced through withholding at source.²⁰ This rule does contemplate that tax basis should be fully recoverable by the foreign investor in the U.S. annuity since the gross amount subject to withholding must be "income."

²⁰ Code §§ 871(a)(1)(A) and 1441.

Complications can arise in this context when a taxpayer changes tax status during or after the time periodic payments are made into the annuity. A special rule has been included in the Jobs Tax Act to deal with the treatment of an annuitant (i) who was a nonresident alien at the time of the contribution into the annuity plan but (ii) who is a U.S. taxpayer as of the time the annuity payments are being received. New IRC §72(w) (replacing prior IRC§ 72(w), as enacted by Jobs Tax Act §906(a)), provides that “notwithstanding any other provision of this section” (i.e., Code § 72), for purposes of determining the portion of any distribution which is includible in gross income of a distributee who is a citizen or resident of the United States, the “investment in the contract” shall not include “any applicable nontaxable contributions or applicable nontaxable earnings.” The basic concept is that no tax basis (i.e., “investment in the contract”) is obtained for this purpose if (i) services have been performed by a nonresident alien, (ii) the services were performed outside the United States, and (iii) the income for those services was not subject to income tax (and would not have been subject to income tax if paid as cash compensation when the services were rendered) under the laws of the United States or any foreign country.²¹

²¹ The Joint Committee on Taxation’s “General Explanation of Tax Legislation Enacted in the 108th Congress,” JCS-5-05, May, 2005, states (at p. 510): “The Congress believed the rules which governed the calculation of basis provided an inflated basis in assets in retirement and similar arrangements for many individuals who became U.S. residents after accruing benefits under such arrangements. The Congress believed the ability of former nonresident aliens to receive tax-free distributions from such arrangements of amounts which had not been previously taxed was inconsistent with the taxation of benefits paid to individuals who both accrue and receive distributions of benefits from such arrangements as U.S. residents (i.e., basis generally includes only previously-taxed amounts). The Congress believed that the rule which allowed basis in contributions to such arrangements for individuals who became U.S. residents after they accrued

The objective of this provision is to preclude a nonresident alien from benefitting from non-taxable contributions to a retirement plan while in a foreign country, retiring to the United States where the retirement benefits are received, and asserting that tax basis existed in the retiree's plan account as of the time of the contributions into the plan account.²² This provision does not change the rules relating to the calculation of basis for contributions made while the alien was a resident of the United States.

Under this provision the U.S. Treasury Department is authorized to issue regulations to carry out the purposes of this provision. The Conference Report notes

benefits was inappropriate. While there was no comparable statutory provision providing basis for earnings, the Congress was aware that some taxpayers took the position that there was basis in the earnings on such contributions, even though such amounts had not been subject to tax. The Congress believed it was appropriate to provide more equitable taxation with respect to the distributions of both contributions and earnings from such arrangements.

²² This is a variant of the rule that an inbound alien becoming a U.S. resident does not obtain a "landed basis" for assets held when becoming a resident. Therefore, all accrued gain prior to becoming a U.S. resident is includible in the alien's income when selling the asset after having become a U.S. resident. This suggests that assets should often be sold before establishing U.S. resident status. If sold on an installment basis, applicability of the installment method of reporting should be negated in this context.

that the Treasury Department could provide in regulations that foreign income taxation that was merely nominal would not satisfy the “subject to income tax” requirement. Pending the issuance of regulations this question arises in the situation of an individual having a sizeable law basis account in a retirement plan account: Should the foreigner coming to the United States (1) Terminate his home country residence; (2) Establish an interim residence in a third country (e.g., in a tax haven jurisdiction in the Caribbean) where the retirement plan distribution is received (or deemed received through crediting to a bank account outside the country of original residence); and (3) then come to reside in the United States after the retirement plan benefits have been received, with the funds (outside any deferred compensation plan) then having a “stepped-up tax basis” for federal income tax purposes?

B. Cross Border Compensation Planning

Although outside the more traditional elements of estate planning, many estate planners must regularly deal with the compensation benefits accrued as of death by the client. This is certainly true in the international estate planning context and, as noted from the annuity discussion above, considerable complexities can arise in this context. This paper does not discuss possible planning issues in this context. But, of particular importance in this cross border context can be (i) the income tax treatment of both contributions and distributions to “qualified plans,” (ii) the treatment of nonqualified deferred compensation (including the applicability of Code § 409A, as enacted in the Jobs Tax Act), and (iii) the income tax treatment of stock options. An amendment to Section 83 included in the Jobs Act, specifies: “For purposes of determining an individual’s basis in property transferred in connection with the performance of services, rules similar to the rules of section 72(w) shall apply.”²³ In many instances

²³ Code §83(c)(4). The Joint Committee on Taxation’s “General Explanation of Tax Legislation Enacted in the 108th Congress,” JCS-5-05, May, 2005, states (at p. 511): “The Act also changes the rules for determining basis in property received in connection with the performance of services in the case of an individual who was a nonresident alien at the time of the performance of services, if the property is treated as income from sources outside the United States. In that case, the individual’s basis in the property does not include any amount that was not subject to income tax (and would

third country trusts are used to frustrate income taxation in the foreign country where the services are being rendered.

C. U.S. Income Tax Treaty Applicability

Under the U.S. Model Income Tax Treaty and some U.S. income tax treaties, retirement plan distributions beneficially owned by a resident of a treaty country in consideration of past employment generally are taxable only by the individual recipient's country of residence. This exclusive residence based taxation rule is limited to the taxation of amounts that were not previously included in taxable income in the other country. For example, if a treaty country had imposed tax on a resident individual with respect to some portion of a retirement plan's earnings, subsequent distributions to that person while a resident of the United States would not be taxable in the United States to the extent the distributions were attributable to such previously taxed amounts. The treatment under each U.S. income tax treaty must be verified since under some treaties the taxation is shifted to the source country.

have been subject to income tax if paid as cash compensation when the services were performed) under the laws of the United States or any foreign country."

Gradually efforts are being made to assure, through the use of tax treaties, that qualified deferred compensation plans (and their equivalent under foreign country laws) are recognized as tax-exempt entities. This status would treat these plans as not subject to withholding taxes at source (e.g., on dividend income paid in a cross border context). See, e.g., the Swiss “MAP Agreement”, a mutual agreement procedure between Switzerland and the United States concerning the qualification of certain pensions for treaty benefits and on procedures for claiming benefits in each country.²⁴

VII. Beware of the U.S. Income Tax Withholding at Source Rules

A significant portion of the tax revenue collected through the efforts of the IRS international tax examiners comes from third parties who have failed to fulfill their responsibilities to withhold at source on payments of U.S. income being made to foreign investors and others. Of course, the purpose of a withholding tax at source is to recognize that the nonresident alien will want to remove funds from the United States and escape U.S. income taxation, since not having any incentive to thereafter voluntarily pay U.S. income tax when beyond the U.S. taxing jurisdiction. Except in extraordinary circumstances of a special treaty provisions being pertinent to enable assistance in the cross border enforcement of tax liabilities those taxes cannot then be collected.

²⁴ IRS Announcement 2005-3, 2005-2 IRB 270, and IRS News Release 2004-146.

Many parties making payments to nonresident aliens should be aware of their own withholding agent responsibilities in this context and act to assure adequate withholding at source from funds they are paying. Otherwise the liability for the tax can be on the payor. Of particular complexity in this context is verifying that an individual does qualify for reduced tax rates under an income tax treaty, as represented to the payor by the prospective recipient. The primary withholding form to be received in this context is the IRS Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding."²⁵

U.S. income tax withholding at source is also applicable in the real property disposition context. The "FIRPTA" rules provide (under Code § 1445) that a ten percent withholding tax is imposed on gross proceeds to be paid, to be transmitted by the payor directly to the U.S. Internal Revenue Service.²⁶ Real estate attorneys and title companies are familiar with these rules, but for the international estate planner the issues might involve explaining the withholding tax process to the client who is selling property and receiving an amount less than the contractual sales price,, applicable because of the withholding tax. Particular care must be taken when the property is sold on an installment basis, since this will often necessitate seeking a ruling in advance from the Service so as to enable a reduction to the amount to be withheld.

VIII. Choice of Tax Entity Planning - Outbound Investment

²⁵ This form includes a part to enable a claim of tax treaty benefits.

²⁶ See IRS Form 8288, "U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests."

A. The “Place of Management” Criterion

Unlike in the United States where the determination of tax status of an entity is based on where an entity is legally organized, in many foreign countries this determination is based on the “place of management” of the entity.²⁷ This enables U.S. tax planners to legally organize a foreign corporation (often a corporate subsidiary) in one foreign country although having its business situs and tax residence in another (often lower tax) jurisdiction. When outbound payments (such as dividends and royalties) are made from the United States the question might concern which U.S. income tax treaty will provide preferred tax relief from withholding at source, i.e., the tax treaty with (1) the country where the entity is organized or (2) the country where the entity has its primary place of management.

In Rev. Rul. 2004-76²⁸ Corporation A was incorporated under the laws of Country X but its “place of effective management” was situated in Country Y. Corporation had no fixed place of business in Country X. Under the laws of Country X, before the application of any income tax treaty, Corporation A is liable to tax as a resident. Under the laws of Country Y, before the application of any income tax treaty, Corporation A is also liable to tax as a resident, thereby presenting the possible

²⁷ See, however, Joint Committee on Taxation, “Options To Improve Tax Compliance and Reform Tax Expenditures,” JCS-02-05 (January 27, 2005), p. 180, where a legislative proposal is recommended that a publicly traded foreign corporation be treated as resident in the United States if it managed and controlled in the United States. Thus, the residency status of the foreign corporation would be based on its primary location of management and control. This proposal differs from the system of many foreign countries using the “management and control” test to determine residency status. Those countries apply this test on the basis of where the board of directors may meet. This JCT staff report notes that the actual management and control test would be more difficult to manipulate than the board of directors meeting location test.

²⁸ 2004-31 I.R.B. 111.

dilemma of double economic taxation. Corporation A receives U.S. source income during the taxable year and seeks benefits under a U.S. income tax treaty, either with Country X or with Country Y. The relevant articles of the U.S.-Country X treaty and the U.S.-Country Y treaty each provide that “the term ‘resident of a contracting state’ means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.” However, the treaty between Country X and Country Y provides that “the term ‘resident of a contracting state’ means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management, or any other criterion of a similar nature.”

After applying this article of the Country X-Country Y tax treaty, Corporation A is treated as a resident of Country Y, and not a resident of Country X because its “place of effective management” is in Country Y. Therefore, under the U.S.-Country Y treaty, Corporation A is treated as a resident of Country Y also regarding the treatment of its U.S. source income (assuming that it satisfies the requirements of the applicable “limitation on benefits” article). Corporation A is not a resident of Country X under the U.S.-Country X treaty and is not entitled to claim any benefits under this treaty as a resident of Country X.

This ruling is of particular importance to U.S. parties making certain outbound payments to foreign recipients of passive income who will be subject to obligations for withholding at source. The foreign recipient will want to assert that the owner of this income is a resident in that jurisdiction having the lowest applicable U.S. tax treaty rate on the particular item of income. That recipient will be required to provide an IRS Form W-8BEN, “Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding,” identifying that the recipient is a resident of a particular country “within the meaning of the income tax treaty between the United States and that country.” The withholding agent can ordinarily rely on that representation as to residency status. The withholding agent will not want to be in the position of making the determination that, because of facts similar to those described in Rev. Rul. 2004-76, the recipient is a resident of one of several countries. Therefore, indirectly this ruling is really an admonition to the foreign payee to correctly identify the country of residence on the withholding certificate. The U.S. payor should ordinarily be entitled to rely on that representation in the Form W-8BEN unless knowing that it is clearly erroneous.

B. The Service Partnership with U.S. Activities

In Rev. Rul. 2004-3,²⁹ the Service concluded that a nonresident partner in a service partnership with a U.S. fixed base is subject to U.S. tax on the partnership's U.S. income under the U.S.-Germany income tax treaty and all other similar income tax treaties. The Service identified a situation where a German service partnership with both a German resident partner and a U.S. resident partner has offices in the United States and in Germany. The U.S. office is a "fixed base" under Article 14 of the U.S.-Germany income tax treaty. The partners perform services solely in the offices of their respective countries of residence, although they agree to divide the partnership's profits equally. The Service noted that the German resident partner is treated as having a regularly available U.S. fixed base. The Service concluded that the partner is, therefore, subject to U.S. tax on that partnership income allocable to the U.S. regardless of where he actually performs his services. Article 14 of the treaty provides that "[i]ncome derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities." As supporting authority the Service noted *Unger v. Commissioner*,³⁰ where the court concluded that the office or permanent establishment of a partnership is, as a matter of law, the office of each of the partners—whether general or limited.

This ruling is consistent with the *Unger* case and earlier decisions, and the question then arises as to what motivated the Service to issue this ruling. This tax position does often come as a surprise to the foreign partner who has no activities in the United States. This is often solved by making a guaranteed payment to the in-country partner, thereby avoiding (or reducing) the proportionate allocation, or through some other special allocation, assuming no Code § 704(b) impediment in determining that this allocation does have "substantial economic effect."³¹

²⁹ 2004-7 I.R.B. 486.

³⁰ 936 F.2d 1316 (D.C. Cir. 1991),

³¹ For an extensive discussion of this issue see May, "Wrongs and Remedies: The U.S. Tax Treatment of

Note that, to avoid confusion in the tax treaty context between these rules in Article 14 and the definition in Article 5 of a “Permanent Establishment”, Article 14 has been eliminated in the Model Tax Treaty promulgated by the Organization for Economic Cooperation and Development (OECD). The OECD Commentary on former OECD Tax Treaty Article 14 specifies: “Article 14 was deleted from the Model Tax Convention on 29 April 2000 on the basis of the [identified] report.... That decision reflected the fact that there were no intended differences between the concepts of permanent establishment .. and fixed base .. or between how profits were computed and tax was calculated. In addition, it was not always clear which activities fell within [either Article]. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits.”

C. Exploiting the Check the Box/Entity Characterization Rules

For “Subpart F” purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. Thus, in many cases, a U.S.-party owning a multi-tiered foreign corporate structure may trigger a current U.S. tax under Subpart F as it moves its foreign earnings among its CFCs by means of such payments.³² However, this result often can be avoided as a practical matter by using a ‘hybrid branch arrangement’ (e.g., making an interest payment through an entity that is treated as a corporation under foreign law but as a branch of a CFC under U.S. law).³³ Some have argued that there is nothing objectionable about moving active, non-subpart-F earnings from one CFC to another, and, therefore, that dividends, interest, rents, and royalties received by one controlled foreign corporation from a related controlled foreign corporation should not be treated as foreign personal holding company income to the extent attributable to non-subpart-F earnings of the payor. According to this view, certain frictions that exist under present law in allocating foreign earnings among different foreign uses should be eliminated. Others argue that the proposal would significantly enhance the benefit of deferral, further deterring the repatriation of foreign earnings and increasing the overall attractiveness of foreign investment relative to domestic investment.”

³² See “The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad”, Joint Committee on Taxation, [Joint Committee Print; JCX-68-03, July 14, 2003, segment entitled: “IV. Recent Competitiveness and Simplification Proposals, B. Proposals Relating to the Subpart F Anti-Deferral Rules.”

³³ See Notice 98-11, 1998-6 I.R.B. 18; Notice 98-35, 1998-27 I.R.B. 35.

In this context the Staff of the Joint Committee on Taxation has a proposal to modify the tax entity characterization rules to “reduce opportunities for tax avoidance.”³⁴ Under this proposal an entity would be treated as a corporation for federal tax purposes if the organization (1) is a separate business entity organized under foreign law, and (2) has only a single member. This rule would override any contrary entity classification rule. If a branch, local office or other organization would not rise to the level of a separate business entity (e.g., it is not established as a separate legal entity under local law) then the branch, office or organization would not be subject to this rule and would not be treated as a corporation for federal tax purposes.

D. Rethinking Subpart F Applicability

Serious tax policy analysts on Capitol Hill are regularly debating the appropriate configuration of the taxation of income derived from offshore investments. The fundamental question is whether the United States should tax income of a U.S. taxpayer on a worldwide basis or on a territorial basis (i.e., taxation being limited to income derived within the United States). In the 2004 Jobs Act the Congress provided a limited territorial approach for a limited period with respect to the receipt of dividends from controlled foreign corporations.³⁵ A further proposal has been made by the Staff of the Joint Committee on Taxation to adopt a dividend exemption system for foreign derived business income.³⁶ Passive income earned abroad by a foreign subsidiary of a U.S. parent corporation would be taxed

³⁴ See Joint Committee on Taxation, “Options To Improve Tax Compliance and Reform Tax Expenditures,” JCS-02-05 (January 27, 2005), p. 182.

³⁵ See Code § 965 providing for a temporary dividends received deduction to United States corporate shareholders.

³⁶ See Joint Committee on Taxation, “Options To Improve Tax Compliance and Reform Tax Expenditures,” JCS-02-05 (January 27, 2005), p. 186.

immediately under the Subpart F rules. However, active income (that not subject to the Subpart F rules) would be exempt from U.S. tax and could be repatriated on a tax-free basis. The current income tax imposition at the time of repatriation of foreign corporate profits would be repealed. An additional impact would be that the importance of the foreign tax credit would be significantly reduced.

IX. Finding the Existence After Death of the Foreign Bank Account Held by the U.S. Citizen/Resident

In January 2003 the Service initiated a compliance initiative to get taxpayers to identify their offshore bank accounts and to settle up their federal income tax responsibilities with the Service.³⁷ Taxpayers had a deadline of April 15, 2003 in which to comply. The goal of the program was to identify taxpayers engaged in abusive offshore activities by examining four areas: who introduced the taxpayer to the offshore scheme; how the assets are sent offshore; how assets are controlled; and how assets are repatriated.³⁸ The Service received 1,300 applications under this “Offshore Voluntary Compliance Initiative” (out of 2 million offshore bank accounts

³⁷ See Rev. Proc. 2003-11, 2003-1 C.B. 311.

³⁸ See Bennett, “IRS Offshore Compliance Initiative Collects \$170 Million, Tax Notes,” February 9, 2004, p. 713.

held by U.S. taxpayers?).³⁹ The Service collected \$200 million under this program.⁴⁰ The Service indicated that a wide variety of financial arrangements were used to

³⁹ IR-2003-95, 2003 IRB Lexis 337. In the "Highway Bill" (S. 1230, Highway Reauthorization and Excise Tax Simplification Act of 2005) currently under consideration in the Congress a Senate amendment would double the total amount of civil penalties, fines, and interest applicable to taxpayers who were eligible to participate in, but did not participate in, the OVCI and did not otherwise voluntarily disclose their underpayment of U.S. income tax through the use of such offshore financial arrangements. See Summary Description of the "Highway Reauthorization and Excise Tax Simplification Act of 2005," Title V of H.R. 3, as Passed by the Senate on May 17, 2005, June 13, 2005, [Joint Committee Print]; H.R. 3; JCX-41-05.

⁴⁰ See "Senate Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript," 2004 TNT 145-30, the unofficial transcript of a July 21 Finance Committee hearing on the country's estimated \$ 311 billion tax gap. Testimony indicated that, in response to the Offshore Voluntary Compliance Initiative, 861 taxpayers (of 2 million?) paid \$200 million to the U.S. Treasury.

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avoid U.S. taxes, including foreign entities, foreign bank accounts, foreign trusts, and credit cards. What is the next step in this process?⁴¹

⁴¹ Some believe this program may not have been particularly effective. See Sullivan, "Economic Analysis: U.S. Citizens Hide Hundreds of Billions in Cayman Accounts," 2004 TNT 102-4, May 24, 2004.

The estate planning client may have had ownership of funds deposited in a foreign bank account. If that account was generating investment income (e.g., interest), particularly in a tax haven jurisdiction, the client may not have reported that income for federal income tax purposes. Numerous U.S. individuals have apparently considered the offshore bank account to be one of the self-help mechanisms to reduce their own effective U.S. income tax rate.⁴² Hopefully, the U.S. advisor is unaware of this account, discovering its existence only after the client's death, rather than being a participant in its establishment (and, particularly, associated evasion of U.S. income tax on the investment income).⁴³

The foreign financial institution assisting in establishing this account may have insisted on implementing some designation of the succession to ownership of this account upon the death of the account holder. These funds may be held through a trust arrangement, but the holding may be through bearer shares of a wholly owned company. Establishing successor ownership and dealing with previously accrued U.S. income tax liabilities can be a challenge for both the estate fiduciary and legal counsel.

X. Bilateral U.S. Tax Treaty Considerations

A. Objectives of U.S. Bilateral Tax Treaties

The U. S. has both bilateral income tax treaties and estate and gift tax treaties with various jurisdictions. The fundamental objectives of bilateral tax treaties are:

- To provides rules for establishing primary tax jurisdiction.
- To allocate taxing jurisdiction between the source (or location) country and

⁴² See the article by Cynthia Blum, "Sharing Bank Deposit Information With Other Countries: Should Tax Compliance Or Privacy Claims Prevail?" 6 Florida Tax Review 579 , describing the pervasive use of offshore bank accounts and the argument about the protection of bank account privacy to limit access by the Service to information about such accounts. See, further, Sheppard, "Offshore Investments: Don't Ask, Don't Tell," Tax Notes, July 11, 2005, p. 171.

⁴³ The offshore bank accounts of U.S. taxpayers are asserted to approximate 2 million in number. Certainly many of these accounts are for quite legitimate purposes, and the income is currently reflected on the owner's federal income tax return, but for many individuals this is not the situation.

the residence country, so as to avoid “economic double taxation.”

- To create mechanisms for the several taxing authorities to exchange information and to have facilities to resolve disputes.

To become effective, these treaties need the ratification of the U.S. Senate, exercising its “advice and consent” function. The primary jurisdiction within the U.S. Senate for the review of tax treaties resides in the Senate Foreign Relations Committee, not the Senate Finance Committee. This jurisdictional distinction can produce some differing perspectives about U.S. international tax policy.

B. U.S. Estate Tax Treaties

The United States has entered into both estate and gift tax treaties with various foreign countries. These treaties are with the following countries: Australia, Austria, Canada,⁴⁴ Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, Republic of South Africa, Sweden, Switzerland, and United Kingdom. Some are estate and gift tax treaties, some are only gift tax treaties, some include reference to generation skipping transfer tax provisions. In its Instructions to the IRS Form 706-NA, consistent with the current perspective of the Bush Administration, these are all called “death tax treaties” (although not so designated in the particular treaty).

The usual objectives in these transfer tax treaties is to (i) identify where tax residence is treated as located, (ii) allowing situs based taxation for business property and real estate, and (iii) allowing the residence jurisdiction to have exclusive taxing jurisdiction over the remaining property. Many variations arise, however, in individual treaties.

The negotiation by the U.S. Department of the Treasury of additional or revised estate tax treaties has been dormant for a considerable period. Perhaps modernization of the estate tax treaty system is being revived because on December 8, 2004 a Protocol was signed with France to amend and expand the 1978 estate and gift tax

⁴⁴ Article XXIX B of the U. S. - Canada Income Tax Treaty.

treaty.⁴⁵ The explanation of this protocol is quite succinct, indicating that the equivalent of real property holding companies will be treated as “real property” for treaty purposes (rather than shares) to assure that estate taxation occurs at the location. Various other provisions were included in the estate tax Protocol, however, including, (i) a “savings clause”, (ii) a partnership provision allocating a partnership interest to a partner as a “permanent establishment” or “fixed base”, (iii) an expanded charitable contributions provision, and (iv) a marital deduction and community property provision.

C. U.S. Income Tax Treaties

In the last several years the U. S. Department of the Treasury has been actively negotiating bilateral income tax treaties. A revised anticipated U.S. Model Income Tax Treaty is anticipated during 2005. This will provide the perspective of the current Treasury Department concerning its income tax treaty policy.

D. Tax Reporting When the Tax Treaty Provides a Benefit

IRC § 6114 provides that if certain items are reported on a tax return based on the provision of a U.S. bilateral tax treaty a statement may be required to be attached to the return disclosing the return position that is treaty based. The regulations provide various exceptions from this reporting when the treaty provisions are clear, e.g., a reduced rate on withholding taxes.

E. Treaty Shopping by Foreign Investors into the U.S.

In the income tax context one of the important issues has been limiting the use

⁴⁵ See electronic citation: 2004 TNT 237-4. Another explanation might be that a Protocol to the France-United States Income Tax Treaty was negotiated at the same time, and the estate tax Protocol “tagged along” with other adjustments concerning the FIRPTA tax legislation in the United States.

of “treaty shopping”, i.e., trying to locate a foreign jurisdiction where a corporate entity can be formed which will be the direct investor into the United States. The idea would be for that entity to be the beneficiary of favorable income tax treaty provisions to enable clearing income out of the United States on very favorable tax terms, while avoiding tax in the jurisdiction where the corporate entity is formed, thereby enabling its eventual distribution into the hands of the economic owners (in a third country) with only limited tax impact.

F. A Specific Example - Lottery Winnings

For the domestic winner of a lottery prize U.S. income tax will apply and the payor will be obligated to withhold U.S. income tax when making payments to the winner. Some lotteries allow the lottery winner to receive payments over some extended period, rather than in a lump sum, thereby benefitting from the time value of money (interest) component which will increase the nominal total of the payments. These extended payments are also subject to withholding when periodically paid since the receipt has been delayed and no “constructive receipt” concept applies to cause earlier realization. When the Texas (or other state) lottery is won by a nonresident alien gross income inclusion will also be required, under Section 871(a)(1)(A), being an item or fixed or determinable annual or periodic income. Similarly, U.S. income tax withholding at source will be required of the payor (ordinarily a government agency).

An applicable income tax treaty will not ordinarily enable any rate reduction for lottery winnings but the question arises whether some other categorization may enable a reduced tax rate (which, in turn, would enable a reduced withholding rate at source). In *Abeid v. Commissioner*⁴⁶ a nonresident alien resident in Israel became entitled to 20 annual payments of \$772,000 each through the purchase of a \$1 ticket that won a California based lottery. The taxpayer asserted that the payments constituted “annuities” under the Israel-U.S. income Tax Treaty, Article 20(5), and, consequently, the outbound payments were exempt from U.S. income tax under the provisions of that treaty. This treaty provides that annuities are taxable only in the jurisdiction in which the recipient resides. The court determined that the payments were not

⁴⁶ 122 T.C. 404 (2004).

annuities (within the meaning of this treaty) since not paid “under an obligation to make payments in return for adequate and full consideration” as provided in the treaty and therefore were subject to 30 percent withholding tax imposed at source.

Although the results appears to be technically correct, the court could perhaps have been influenced by the tax treatment of the taxpayer in Israel. The court noted that the taxpayer apparently successfully claimed that, for Israeli income tax purposes, the payments were lottery winnings and, under applicable domestic Israel law (unlike U.S. tax rules), were exempt from income taxation. Therefore, the taxpayer was not successful in obtaining total income tax immunity on these winnings. Finding better tax treatment under an applicable income tax treaty for lottery winnings is unlikely, but this suggests a regular challenge to the tax advisor to explore the many available approaches to decrease the tax burden on cross border payments.

G. The Impending U.S. Treasury Department Study

The American Jobs Creation Act of 2004, §806(b), mandates the Secretary of the Treasury to conduct a study of United States income tax treaties “to identify any inappropriate reductions in United States withholding tax that provide opportunities for shifting income out of the United States, and to evaluate whether existing anti-abuse mechanisms are operating properly.” This study is to include specific recommendations to address all inappropriate uses of tax treaties. This report is to be submitted to the U.S. Congress by June 30, 2005. The objective of this requirement is to identify any remaining “tax haven” arrangements available through U.S. tax treaties which can enable preferential tax treatment to foreign enterprises expatriating profits from the United States.

XI. Foreign Investors Can Have a Significantly Different Attitude About Payment of Taxes

Reluctantly many U.S. taxpayers recognize their U.S. tax responsibilities and comply with making tax payments to the Internal Revenue Service (although at the edges they may implement tax shelter investments and other devices to significantly

mitigate U.S. income tax liabilities).⁴⁷ Many foreigners (except for northern Europeans) have a quite different attitude about tax compliance, believing this is merely an ever continuing “cat and mouse” game with the tax collector. If they can extract their proceeds of a deal from the United States free of tax the investment return can be considerably enhanced.

The withholding at source rules (discussed above) facilitate much of the U.S. tax enforcement in this context. Many devices exist in this context to extract earnings from the United States, including transfer pricing and high interest amounts on debt. Specific limitations exist on many of these arrangements. The planning dilemma arising in this context is often to limit the risk exposure of the U.S. advisor.

XII. Special U.S. Tax Jurisdiction Rules Apply to “Tax Expatriates”

Special federal tax rules apply to “tax expatriates.” These are individuals who terminate their U.S. citizenship for purposes of the avoidance of federal income, estate, gift and generation skipping transfer taxes. This is an arcane area of cross border tax planning and is more often discussed than actually implemented. One reason is that (particularly after the enactment of the Patriot Act) immigration into the United States by a foreign national (including an expatriate) has become much more difficult.

⁴⁷ Perhaps this statement is too generous to some taxpayers, i.e., those who contribute to the \$300 billion plus “tax gap.”

Various tax rules apply to impose certain “long arm” provisions so that some income and assets are included in the U.S. tax base if transferred within ten years after expatriation.⁴⁸ Similar rules are included in the income tax, the gift tax and the estate tax provisions.⁴⁹ Above a specified income or asset level a presumption applies that the expatriation is for tax motivated purposes and the expanded tax jurisdiction then applies for the ten year period.

⁴⁸ See Streng, “Emigration and Expatriation,” Chapter 10, p. 377, in Schoenblum, “A Guide to International Estate Planning - Drafting, Compliance, and Administration Strategies,” ABA Section of Real Property, Probate and Trust Law, 2000.

⁴⁹ See Code §§ 877, 2197 and 2501(a)(3).

These rules were considerably strengthened in the 2004 Jobs Act. Subjective tax-avoidance provisions of prior law were repealed and replaced with mechanical test that apply solely on the basis of the individual's net worth and prior annual income tax liability. Whether or not an expatriating individual is actually subject to these new rules, as specified in Code §7701(n) that person will continue to be classified as a U.S. citizen or resident for U.S. tax purposes until he (1) gives a notice of expatriation or termination of residence to the U.S. State Department or the Department of Homeland Security and (2) files a detailed statement with the Service detailing his income, assets and liabilities and other personal information.⁵⁰ IRS Form 8854 is to be used for this purpose, as revised in March 2005. The objective of this filing requirement is to preclude individuals from successfully taking a position that they had lost their U.S. citizenship much earlier (e.g., as a result of some event causing citizenship loss under federal citizenship rules) and then asserting that all or much of the ten year "long-arm" provision for extended continuing federal tax jurisdiction has already expired.

These rules have been evolving for a considerable period of time. The appropriate treatment in this situation would seem to impose an "exit tax" when an individual expatriates. Under such an approach the expatriating individual would be required to "mark to market" all appreciated assets as of the time of expatriation for U.S. tax gain recognition.⁵¹

A special rule adopted in the 2004 Jobs Act in this context is Code § 877(g) which mandates the reclassification of a tax expatriate as a resident for all U.S. tax purposes (i.e., for federal income tax, federal estate tax and federal gift tax purposes) for any calendar year during the 10-year period following expatriation in which the individual is physically present in the United States for more than 30 days. This period can be extended by up to 30 more days if the individual meets certain tests and visits the United States on business trips for a qualifying employer.⁵² Several

⁵⁰ 2004 Jobs Act, P.L. 108-357, § 804(b).

⁵¹ In an earlier report on the expatriation tax dilemma the exist tax was examined in detail but in that report the statement is made that the report "does not take a position" on the exit tax proposal. Joint Committee on Taxation, "Review Of The Present-Law Tax And Immigration Treatment Of Relinquishment Of Citizenship And Termination Of Long-Term Residency," JCS-2-03 (2/12/2003).

⁵² Code § 877(g)(2).

important elements of this provision need identification:

- 1) Unlike the prior tax expatriate rules, this provision would tax an expatriate's foreign source income or foreign situs assets. This treatment would apply for the entire year.
- 2) If this rule applies the reclassification of the expatriate as a U.S. resident for federal income tax, federal estate tax and federal gift tax purposes would appear to override pre-existing tax treaty provisions that classify an individual as a resident of the treaty country if that individual has a "permanent home" there or has more economic and personal contacts with that country than with the United States.

This latter question of "treaty override" is most important in international tax relationships. Certainly the U.S. Congress does have the capability of overriding a tax treaty with subsequent legislation. Code § 7852(d)(1) recognizes that, under the "later-in-time" rule, the Congressional enactment of legislation conflicting with a pre-existing treaty can effectively override inconsistent provisions of the treaty. Code §877(g) does appear to override all existing tax treaties. When (if ever) the Service finds the occasion to seek to apply this provision some very interesting tax litigation will occur, perhaps with the intervention of the foreign treaty country on behalf of the taxpayer.

XIII. The Relevance and Applicability of Foreign Law Concepts

A. Conflict of Laws Difficulties

Estate planners often confront conflict of laws issues, seeking to determine which law controls the resolution of a particular issue, whether from state to state in the United States, or on a cross-border international basis. This can necessitate obtaining an opinion from legal counsel in another jurisdiction (including a foreign country) which may be both a time consuming and an expensive process. For this reason trust and similar entity mechanisms are often suggested to U.S. clients having foreign based properties, so as to enable greater ease of property transfer at death.

These arrangements may have many variations under foreign law, and will not necessarily be denominated as a "trust," particularly since civil law countries do not recognize the trust concept. The important element which the professional advisor

must recognize in this context is that many local country (or third country) variations are available to facilitate foreign based asset management under circumstances where applicable rules can enable reasonably predictable results. This might include trusts (with additions such as a “trust protector”) and business entities (such as limited liability companies where the U.S. tax status can be elective, including possible corporate, partnership or disregarded entity status).

B. Reference to Foreign Law for Resolving Controversies

Because many taxation issues are similar in other jurisdictions a question sometimes arises concerning whether decisions in foreign courts have relevance for purposes of deciding U.S. tax issues (and other issues). The U.S. Tax Court regularly cites foreign court decisions in examining cross-border taxation issues. Reference is periodically made to international materials such as the OECD Model Income Tax Treaty and, particularly, the Commentary to that treaty which provides significant explanation of the many provisions. This Commentary has only been issued after thorough and comprehensive input from many sources, including representatives of the United States Government.

Those judges citing this foreign authority often specify that this authority is noted only for its persuasive elements, but even this is “over the top” for some strict construction “purists.” This controversy arises in other more volatile areas (capital punishments, gay rights), but commercial (including tax) disputes are not immune from this issue. This controversy has been evidenced by two recent events:

- During the 108th Congress H.R. 3799 and S. 2082, the “Constitution Restoration Act” were introduced by Rep. Aderholt (R-Ala) and Sen. Shelby (R-Ala). This legislation would “prohibit a U.S. court from relying upon any law, policy, or other action of a foreign state or international organization in interpreting and applying the U.S. Constitution.” This legislation will probably be reintroduced into the 109th Congress. Although prospects for its enactment might be limited, a “chilling effect” on court opinion writing (including in the Tax Court) might be observed.

- On January 13, 2005 a forum at American University Law School entitled “Foreign Courts and U.S. Constitutional Law” occurred at which U.S. Supreme Court

Justices Scalia and Brewer debated this precise issue. Justice Brewer stated that reference to foreign law was appropriate, noting “I may learn something” and “[foreign law doesn’t determine the result, but it shows what other people have done.” But, Justice Scalia indicated that it is “arrogant” to rely on foreign law to determine issues in the United States, noting that “if we don’t want [foreign law] to be authoritative, then what is the criteria for using it?”⁵³

For estate planners this controversy has potential relevance in (1) the interpretation of wills and trust distribution provisions (are U.K., Irish, Australian and New Zealand cases of no relevance?); (2) the determination of mental competency and eligibility under both wills and intestacy provisions; and, (3) both income tax and transfer tax provisions.

XIV. Concluding Observations

The discussion above suggests that the area of international estate planning has many very different applications and is exceptionally dynamic. For the domestic tax advisor representing these taxpayers the exposure to serious professional risks must be examined when a transaction has any cross border aspects. Further, many of the international developments described above have important parallels in the domestic tax planning context (often being the precursor for subsequent domestic tax developments). Consequently, many of the cross-border U.S. tax rules described above can provide guidance for thinking about other common domestic-based transactions.

⁵³ See BNA Daily Report for Executives, January 14, 2005, p. A-32.