Foreign Affairs 101: Tax and Estate Planning Issues for U.S. Clients Who Own Foreign Property

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I. Introduction

A. When a U.S. citizen or resident client owns property in a foreign country, that client will face a number of U.S. and foreign legal and tax issues, and these issues sometimes are complicated or simplified by treaties between the United States and the foreign country involved.

B. The most obvious situation is when a U.S. client owns real property in another country. Numerous complex issues, however, can also arise when the client owns intangible property with a connection to another country, such as shares in a foreign corporation or an interest in a foreign partnership. While these items of property may not raise too many foreign succession law issues, these items of property can raise complex federal income tax issues for clients. In all cases, U.S. federal estate tax issues will also be lurking.

C. This outline describes some of the basic ground rules that U.S. estate planning advisers should follow when U.S. citizen and resident clients own foreign property, with a focus on succession law issues, federal income tax issues, and federal estate tax issues.

II. Some Basic Things You Should Know About Foreign Succession Law and Tax Law

A. *Not Every Country Works Like the United States*

1. Apart from Louisiana, all U.S. states have the common law legal system, which originated in England centuries ago. Louisiana has a mixed system of common law and civil law, which it inherited from the French. Puerto Rico also has a civil law legal system. Some of the U.S. states that were part of Mexico retain an important feature of the civil law - community property.

2. The United States shares the common law system with other jurisdictions that inherited their legal system from England, including the Canadian provinces and territories (other than Quebec), the Australian states and territories, Ireland, and New Zealand. While the language of common law countries is usually English and the legal systems in these jurisdictions are similar, the differences in substantive law among the jurisdictions means that a U.S. lawyer cannot assume that the law in England, for example, is the same as the law of Illinois.

3. The other major legal system that you are likely to encounter when you have clients with foreign property is the civil law system.

a. The civil law system derives from Roman law and the Corpus Juris Civilis of the Emperor Justinian. Most of the civil law countries have taken the path of enacting codes of law that reflect general legal principles. A few jurisdictions, however, such as Scotland, have implemented the Roman tradition without a code.

b. Those civil law countries that rely on codes enacted by legislatures were generally inspired by the Napoleonic Code that France implemented following the French revolution. The laws in Spain, Italy, the Netherlands, Portugal, and many Latin American countries were heavily influenced by the Napoleonic Code. The Napoleonic Code also influenced the development of the German Civil Code, although the German Civil Code is more precise and technical than the Napoleonic Code. Japan has adopted the German Civil Code. Switzerland also developed its own Civil Code in the early 1900s, and the Swiss Code, along with the French and German Codes, influenced the Brazilian, Peruvian, and Mexican codes. *See generally* Tetley, "Mixed Jurisdictions: Common Law vs. Civil Law (Codified and Uncodified)" at 6-7 (1999) (available online at www.unidroit.org/english/ publications/ review/articles/1999-3.htm).

c. The principal difference between a civil law system and a common law system is the role of courts. In a common law jurisdiction, judicial decisions are the principal source of law; statutes supplement the common law. Court decisions in common law jurisdictions have the force of law through the principle of stare decisis. On the other hand, in civil law countries the codes or the uncodified general principles of law are the principal source of the law. Court decisions that interpret the law do not have preferential effect. Although court decisions may be looked to by civil law lawyers as evidence of what the law is, the opinions of commentators sometimes are as important as court decisions in interpreting the law. *See generally* Hansman & Mattei, "The Functions of Trust Law: A Comparative Legal and Economic Analysis," 73 N.Y.U.L. Rev.

434, 439-442 (pointing out that "academic lawyers in the universities were the leading force in development of the law" and that "[t]he law itself was to be found not in a register of [civil] writs, but in the Justinian compilation....").

d. Civil law systems also differ considerably from common law legal systems in their substantive law, particularly in the area of succession law and property law, which is of great interest to estate planning advisers. The principal differences between the legal systems with respect to matters of succession law are discussed below. If you remember nothing else about a civil law system, however, remember that trusts are not a part of civil law legal systems.

4. Countries with a predominantly Islamic population are likely to follow the general traditions of Sharia law, the jurisprudence of which is based on the Koran and other important Islamic religious sources. There is considerable variety among the Islamic countries with respect to their substantive rules, making it hard to generalize about those rules. In general, however, the Sharia legal system shares more in common with civil law countries than with common law countries, particularly with respect to matters of succession law.

5. The legal systems in a number of jurisdictions have elements of both civil law and common law, including Scotland, South Africa, Quebec, Puerto Rico, the Philippines, and Louisiana.

B. *Succession Law Is Not The Same In The Rest Of The World*

1. A fundamental feature of any legal system is rules related to property ownership, and an important subset of these rules are the rules related to transfers and inheritance of property on death. This outline refers to these laws as "succession laws."

2. Common law jurisdictions generally allow an individual to give his or her property to whomever he or she wishes in the form that he or she wishes, including in trust. Spousal elective share laws and community property laws sometimes limit an individual's ability to freely dispose of all his or her property; these laws vary widely from jurisdiction to jurisdiction. State statutes in the United States generally allow after-born children to take their intestate share of a decedent's estate under pretermitted heir statutes.

3. Civil law countries, on the other hand, traditionally limit an individual's testamentary freedom through community property laws and forced heirship laws.

a. Many civil law countries follow a default system of community property for property acquired by a couple while married, which limits one spouse's ability to disinherit the other spouse. Lawyers in the United States should be familiar with the general principles of Spanish and French community property law given the influence of those laws on the U.S. community property states. Other civil law jurisdictions have different systems that tend to have similar results. German law, for example, has three kinds of marital property regimes. The default marital property regime is *Zugewinngemeinschaft* or "community of surplus." This regime is not a classic community property regime the way that U.S. lawyers understand community property. The other regimes are community property *(Gutergemeinschaft)* and separate property *(Gutertrennung).* If a couple who was married in Germany wanted one of the optional regimes to apply during their marriage they would have had to have a notary draw up a fairly simple agreement to that effect.

b. Civil law countries' "forced heirship" laws also limit an individual's ability to freely dispose of his or her separate property and his or her share of community property.

(i) Forced heirship laws either in actuality or in effect require a decedent to leave some proportion of his or her assets to his or her children at his or her death. Forced heirship laws also may give a surviving spouse a share of a decedent's estate in addition to the share to which a spouse may be entitled under the country's marital property laws.

(ii) For example, Italian forced heirship laws apply to a decedent's one-half share of community property and the decedent's separate property. If there is a surviving spouse and one child, the spouse's "compulsory share" or *riserva a favore dei legittimari* is one-third of the subject property; the child's compulsory share is also one-third of the subject property. If there is a surviving spouse and more than one child, the spouse's compulsory share is one-fourth. If there is no spouse and one child, the child's compulsory is one-half of the subject property. If there is more than one child, the children's collective compulsory share is two-thirds of the property. Children of deceased children succeed to the rights of their deceased parents.

(iii) German forced heirship laws take a slightly different approach than the Italian forced heirship laws. Germany's forced heirship laws give a disinherited heir a monetary claim against the persons who received the decedent's estate. Thus, a German individual can dispose of his or her estate as he wishes but the persons to whom he or she leaves his or her property may face a monetary claim from the disinherited children and the decedent's surviving spouse. The amount of a disinherited heir's claim *(Pflichtteil)* is equal to one-half of the value of the share that the heir would have received had the decedent died intestate. The intestate shares of descendants and a spouse vary under German law. Germany includes gifts made within 10 years of death in the pool of assets used to determine the value of a forced heirship claim.

(iv) Swiss law similarly treats forced heirship claims as monetary claims against the individuals or entities who receive a decedent's property. Like the laws in many other civil law countries, Swiss law pulls gifts within five years of death back into the estate for purposes of computing the basis on which a forced heirship claim could be made. Swiss law also pulls back a gift made more than five years before death if the purpose of the gift was to avoid forced heirship laws.

4. What are the implications of forced heirship laws for estate planning?

a. Forced heirship and community property laws leave very little of an estate for an individual to dispose of. As a result, individuals who live in civil law countries tend not to use wills to the same extent as individuals who live in common law countries do. When individuals in civil law countries use wills, those wills are often not as extensive or complicated as wills used in common law countries. Part of the reason for this is the absence of trusts as part of the law in most civil law countries.

b. Estate and inheritance tax systems in civil law countries often complement the country's forced heirship laws. Thus, gifts to close relatives, which forced heirship law requires, are taxed at a lower rate than gifts to more remote relatives. In some civil law countries, a gift or bequest to a trust is treated as a gift to an unrelated person that attracts inheritance tax at the highest rate.

c. While not necessarily tied to forced heirship laws, you should be aware that notaries, rather than lawyers, often draft wills and related documents in civil law countries. A notary in a civil law country is not like a notary public in a common law country. Rather, the civil law notary is a legal professional who drafts legal documents such as conveyancing, contracts, and wills. By contrast, a notary public in the United States simply has the power to take oaths from witnesses and acknowledge legal documents.

C. *Trusts Are Not Used Everywhere In The World*

1. The trust is among the most useful and flexible devices in the U.S. estate planner's play book. Trusts, however, are not found everywhere in the world. Believe it or not, much of the world manages to do estate planning without trusts. *See* Langbein, "The Contractarian Basis of the Law of Trusts," 105 Yale L.J. 625, 669 ("[W]hen we ask how the Europeans

function without the trust, we find that they achieve mostly by means of contract what Anglo-American systems do through trust."). Thus, it is important to understand that when you start thinking about a client's foreign property, you may not be able to use a trust.

2. Trusts are generally seen as a creation of English court of chancery, which later merged with the law courts in England. As England exported its law to other countries during its days of imperialism, many of those countries picked up the common law of trusts as part of the common. Trusts are now an established part of common law legal systems, including in many tax havens which have an English legal heritage.

3. Codes in civil law countries, on the other hand, do not normally contain trust laws. Civil law countries do have certain kinds of entities and relationships that resemble trusts, but these entities and relationships lack the bifurcation of ownership that is one of the essential elements of a trust. Some civil law countries such as Japan and South Africa do have trusts by statute, but they are isolated examples. Interestingly, at least one scholar's research suggests that the trusts do in fact have roots in the civil law. Lupoi, "The Civil Law Trust," 32 Vand. J. Transnat'l L. 967, 973 ("ample evidence exists that testamentary secret trusts were well known in Europe in the sixteenth and seventeenth century"). The French Revolution, however, ended the development of trust law in France and, therefore, throughout Europe and Latin America, given the influence of the Napoleonic Code on the law in those other jurisdictions.

4. Some civil law countries are signatories to the Hague Convention on the Law Applicable to Trusts and Their Recognition. This outline discusses the convention in more detail below. A country's accession or ratification of the convention, however, does not mean that the country adopts trust law as part of its domestic law. Rather, the convention simply requires a signatory to recognize a trust and certain features of a trust if the trust is valid under the law of a jurisdiction the domestic law of which provides for trusts.

5. Some civil law countries do recognize trusts as part of their domestic law. Colombia and Liechtenstein, for example, recognize and enforce trusts as part of their domestic law. Italy is also developing a domestic law of trusts based partly on the Hague Convention on the Law Applicable to Trusts and Their Recognition. *See* Lupoi, *supra,* at 985-988.

6. Civil law countries also have legal arrangements that achieve results similar to the result of a trust, though they are not identical to trusts. *See generally* Christensen, "Foreign Trusts and Alternative Vehicles," 12-16 (published by ALI-ABA in its International Trust and Estate Planning Course of Study Materials, August 2005).

a. For example, a usufruct *(usufruit)* is a right to use property for a period of time, which can be measured by a life or by a term of years. The holder of the usufructuary interest has the right to the income from the property and the use of the property. Another person, the remainderman, in English legal terminology, has a "naked interest" or *"nue propriete."* The principal difference between the usufruct and the trust is that there is no trustee.

b. Switzerland and Liechtenstein provide by statute for a foundation or "stiftung," which has some features similar to a trust, such as a person holding property for the benefit of another. Germany and Austria recognize foundations for charitable purposes. The uses of foundations, however, are more limited than the use of trusts in common law legal systems. Christensen, *supra,* at 13.

7. The lack of trust law in civil law countries, even in ones that have adopted the Hague Convention on the Law Applicable to Trusts and Their Recognition, has several implications for U.S. estate planning advisers.

a. The trust is not necessarily part of the estate planner's tool box for property in a civil law country, though, as discussed below, to some degree this turns on the country's choice of law rules.

b. Even if a civil law country's choice of law rules appear to permit the use of a trust to hold property in that country, there may be practical difficulties in doing so. For example, it may be difficult to register land in the name of a trust in a country that does not recognize trusts and the distinction between legal and equitable ownership.

c. If a client has property in a civil law country that he or she wants to pass to a trust, it may be advisable to hold the property through an intermediate entity, such as a corporation or other company, and have a trust in the United States or a tax haven own the shares or interests in the company.

d. Depending on the country's choice of law rules, a gift to a trust may give rise to claims by the donor's family members under forced heirship laws.

e. Because civil law countries do not have trusts, the tax treatment of trusts is often uncertain or rather onerous. As noted above, some countries treat gifts to trusts as gifts to unrelated persons, which triggers an inheritance tax at a higher rate. The income tax treatment of a trust in a civil law country can also be uncertain if the trust has income with a source in that country, such as rental income. A country may also want to ignore a trust for purposes of its wealth tax and treat the trust beneficiaries as if they own the trust property outright.

8. Even if your client has property in a common law jurisdiction, the trust

law and related tax laws in that jurisdiction are likely to differ somewhat from trust law commonly found in the United States, making it trickier to use trusts in those jurisdictions.

a. There are many differences between the English common and statutory law of trusts and the common and statutory trust law of the U.S. states. For example, England follows the common law rule against perpetuities but provides that a trust with a term of 80 years or less will not violate the rule. Contrast this provision with the lack of a rule against perpetuities in many of the U.S. states or the 90-year rule under the Uniform Statutory Rule Against Perpetuities. Another difference is that it is much easier for the beneficiaries and trustees to vary an irrevocable trust under English law than it is under U.S. law.

b. The other common law countries usually follow the English common law of trusts and give English court decisions much more weight than U.S. decisions, if they even consider those decisions. Thus, much of the common law of trusts and statutory law of trusts in British Commonwealth jurisdictions has more in common with English law than U.S. law. The Canadian provinces, however, tend to follow U.S. developments a little more closely than other common law jurisdictions. For example, the Canadian version of the prudent investor rule was inspired in part by the U.S. prudent investor rule. *See* Uniform Law Conference of Canada Report, "Investment by Trustees: The Prudent Investor Rule Revisited" (1996) (available online at www.law.ualberta.ca/alri/ulc/96pro/e96n.htm). Furthermore, and with the internet and the ease of obtaining court decisions, there seems to be a greater incidence of courts and legislatures looking to U.S. court decisions and legislation with respect to trust related issues. Despite this apparent trend, you should not assume that the laws of another common law jurisdiction are the same as they are in the United States

c. As discussed below in connection with U.K. inheritance tax treatment of gifts to trusts, the common law countries also may treat trusts considerably differently than the United States under those countries' wealth transfer tax laws.

d. The common law countries can also vary considerably in the way that their income taxes apply to trusts. In Canada, for example, the transfer of appreciated property to a trust, revocable or irrevocable is generally treated as a disposition of that property for Canadian federal capital gains tax purposes. There are certain exceptions to this deemed disposition rule for individuals over age 65 who transfer appreciated property to "alter ego" and "joint partner" trusts. Canada also deems a trust to have disposed of its property every 21 years for federal income tax purposes, which has an effect not unlike the U.S.

federal generation skipping transfer tax.

D. *Taxation of Wealth Transfers Varies Considerably Among Countries*

1. Because a client has foreign property, you might assume that you will have a foreign gift tax or estate tax issue because of that property. While you may be right in your basic assumption, you should not assume that another country taxes transfers of wealth in a manner similar to the United States federal gift, estate, and generation-skipping tax.

2. Some countries have no wealth transfer taxes, such as Australia, Canada, Sweden, Israel, Mexico, and China. These countries, however, may have other kinds of taxes or tax policies that affect gifts and inheritances of property. Canada, for example, deems the death of a person to be a disposition of appreciated property for income tax purposes. Australia, on the other hand, permits deferral of capital gains through a carry over basis scheme.

3. Some countries have estate taxes but not gift taxes. Although the United Kingdom has an inheritance tax, the inheritance tax does not apply to gifts made more than seven years before the decedent's date of death. If the donor dies during the seven-year period after he or she makes a gift, however, some or all of the gift may be subject to inheritance tax. Despite the lack of a gift tax, a U.K. donor's gift to a trust may attract an immediate inheritance tax and may not be a "potentially exempt transfer." In this way the United Kingdom in fact has a gift tax, but only on gifts to discretionary trusts. The "gift tax" applies to amounts exceeding £ 300,000 (about $ 600,000) (the "nil rate band"). The £ 300,000 nil rate band is in effect until April 6, 2008, when it will increase to £ 312,000 (£ 325,000 on April 6, 2009). The tax rate will initially be 20% on a transfer to a trust but could increase to 40% if the settlor dies within seven years of making the transfer. In addition to the immediate inheritance tax charge, the trust will be subject to a charge every 10 years - the "ten-yearly charge" of up to 6%. A charge may also apply on large distributions from the trust. Under certain circumstances a U.K. resident donor can create a lifetime "accumulation and maintenance" trust for children and grandchildren who are under age 18 without triggering an immediate inheritance tax charge. The trust must distribute its assets to the beneficiary when he or she reaches age 18 or convert to an interest in possession trust at that time to avoid becoming a tax-disfavored discretionary trust.

4. New Zealand has a gift tax but not an estate tax. If Congress lets the U.S. federal estate tax disappear in 2010 while retaining the gift tax, the United States will join New Zealand in this small club.

5. Civil law countries usually have "inheritance" taxes.

a. The civil law countries with wealth transfer taxes have either true inheritance tax systems or, as in some states of the United States, estate taxes that superficially resemble inheritance taxes.

b. A true inheritance tax is based on the citizenship or residency of the recipient of the transferred property; the donor's citizenship is irrelevant. Thus, in countries with a true inheritance tax, a resident or citizen beneficiary is taxed on all property he or she receives, regardless of its location and regardless of the donor's citizenship. Spain and Japan take this approach. Germany also takes this approach, though it also bases its taxation on a decedent's residency in Germany or a decedent's ownership of property in Germany.

c. Other civil law countries call their death taxes "inheritance taxes" because the rates and amounts of tax depend on the class of beneficiary receiving property. These countries, however, impose the tax based on the citizenship or residency of the decedent or on the location of the property, not of the recipient. To this extent, the tax is on transfers made by the decedent. A beneficiary is not taxed on the receipt of property from a nonresident or noncitizen decedent located in another country, except for property located in the taxing country. Countries that follow this approach include Belgium, Greece, Norway, and Germany. These taxes closely resemble U.S. state inheritance taxes.

d. In civil law countries an inheritance tax often complements the countries' community property and forced heirship laws; the more remote the beneficiary, the higher the tax rate. German gift and inheritance tax law, for example, bases its gift tax and inheritance tax rates on the relationship of the donor to the donee. A descendant is a Class I beneficiary; the top marginal rate for gifts or bequests to such a beneficiary is 30% (above [euro] 25,565,000 (about $ 36 million)). The general view in Germany is that trust is a Class III beneficiary regardless of the identity of the trust beneficiaries. The top marginal rate on a gift or bequest to a Class III beneficiary is 50% (above [euro] 25,565,000). Thus, a gift by a German resident to a trust for U.S. beneficiaries can trigger considerable German gift taxes.

E. The collective impact of all these differences between U.S. tax law and foreign tax law and succession law suggests one thing: strongly consider using foreign lawyers and tax advisers to help you when your clients have foreign property. Imagine a foreign lawyer trying to figure out how to dispose of property in one of the U.S. states, including attempting to understand the federal, state, and local tax consequences of the disposition. Do you want to try the same thing in a foreign country? You will sleep better if you seek foreign advice in one form or another during the estate planning process.

III. Should You Use a Situs Will?

A. The first question most lawyers and other advisers ask is whether a client should have a separate will for the client's foreign property. This part of the outline discusses that question and a client's options.

B. *What is a "Situs" Will?*

1. A "situs" will can take many forms, which can make such a will tricky to draft and to coordinate with the client's U.S. will.

2. One way to think of "situs" is to follow the common law tradition of distinguishing between immovable property and movable property. For example, an English situs will could dispose of only immovable property located in England, i.e. real property and improvements. The U.S. will would then dispose of all movable property whether located in England or in the United States. Such a will would be consistent with both U.S. and English choice of law rules.

3. A situs will could also define the property to which it applies based on the tax situs of the property. This might be appropriate where the client knows that the tax law of another country will apply to certain assets with a connection to that country. For example, a German situs will could cover German real estate and interests in German partnerships, both of which would be subject to German inheritance tax on a U.S. citizen's death under U.S. law and German law. Because Germany's inheritance tax applies in a manner very different from the U.S. federal estate tax, having a will that is designed to work effectively for German inheritance tax purposes may make sense. Of course, the client's estate will also owe U.S. federal estate tax on the property covered by the German will, which raises the possibility of the disposition in the German will doing more harm than good in the United States.

4. A situs will could also define its scope by reference to assets with a connection to the country without regard to whether those assets are movable or immovable. Such a will would be useful when a court or other official body in the other country would assert jurisdiction over assets with a connection to that country regardless of the domicile of the decedent. Professor Schoenblum points out that one risk of this kind of will is that the view of the other country as to the situs of the assets may differ from the client's view of the situs of the assets, leading to potential confusion. 1 Schoenblum, Multistate and Multinational Estate Planning, § 16.16[C] at 16-77 (3d. ed. 2006) ("Schoenblum").

C. *Advantages of Multiple Wills*

1. The main benefit of multiple wills is that they "eliminate the interrelationship of an estate's administration between jurisdictions." Lawrence, "Multinational Estate Planning Headaches and the Panacea Therefor," 1995 Inst. Est. Plan. ch. 18, § 1801.2 at 18-7 (1995).

2. With multiple wills, only one will needs to be presented for probate in the

situs jurisdiction. Without a situs will, the decedent's U.S. executor will need to obtain a certified copy of exemplified of the client's will and have the will admitted to probate or registered in the foreign country, which could be an expensive and time consuming process. It may be faster and simpler to walk into court in a common law country and present a will for probate without worrying about what is going on in the United States If the property is located in a country where English is not the official language, having the situs will in the local language can expedite the disposition of the client's property.

3. Another benefit of using multiple wills is that each will can be tailored to the substantive and conflicts rules for a particular jurisdiction. Schoenblum, § 16.16[C] at 16-75. These issues are discussed in greater detail below.

4. Multiple wills may also reduce fees and expenses in countries that compute fees based on worldwide assets. *Id.*

D. *Disadvantages of Multiple Wills*

1. Multiple wills are more expensive to prepare than a single will Preparing multiple wills will involve two lawyers, one in the United States to prepare the U.S. will and another in the other country to prepare the other will. Both wills, of course, have to be coordinated, so the U.S. lawyer must talk to the foreign lawyer and work out the details.

2. Multiple wills also greatly increase the complexity of the estate plan. The lawyers responsible for the wills must make sure that the wills complement each other and are consistent with one another. Everything from tax clauses to revocation clauses need to be coordinated. If the non-U.S. will involves concepts unique to the foreign law, such as a usufruct in a civil law country, the coordination becomes trickier.

3. Another problem that can sometimes arise is that the two wills do not cover all the client's assets. For example, assume a U.S. will covers U.S. property and an English will covers property located in England. What if the client has a bank account in the Isle of Man in his or her own name? That property would not be addressed by either will, resulting in an intestacy.

4. These issues and similar issues lead Professor Schoenblum to suggest that "multiple wills should rarely - if ever - be used." Schoenblum, § 16.16[C] at 16-77. He argues for the use of a revocable trust in lieu of multiple wills, which is discussed below. He acknowledges, however, that trusts will not always work, in which case "multiple wills, if constructed carefully, may offer certain benefits."

E. *How Do You Decide?*

1. While it is nice to know that there are advantages and disadvantages of having multiple wills, how do you advise a client on this subject?

2. These facts suggest using multiple wills:

a. When the client has substantial real property or other investments in privately owned companies in a foreign jurisdiction. The more substantial the property, the more permanent the client's investment is likely to be. In this case, the client's ownership of the foreign property will present legal and tax issues apart from succession law issues. In this case, it usually makes sense for the client to have a situs will.

b. Situations in which it is very difficult to conduct what U.S. lawyers think of as "ancillary" administration.

c. Where the country has not adopted the Hague Convention Relating to the Form of Testamentary Dispositions or the Washington Convention, thereby raising issues of proof of the formal validity of a U.S. will. In this case it may make more sense to execute a will in the local language and in compliance with the local formalities.

d. When you have no option but to probate the will or register the will in order to transfer title to property.

e. If you expect disputes about the disposition of property in the other country. In this case, you can have a will tailored to address some of the issues that will come up in the other jurisdiction.

f. If you want to do something complicated in the other country.

3. These facts suggest using a U.S. will to dispose of property located in a foreign country:

a. When the investment in the other country is not substantial or is not expected to be permanent. For example, a client may have inherited property located in a foreign country but expects to sell it.

b. When estate administration or registration of the property is fairly easy. In most common law countries, probate is not the onerous process that it is in the United States. Interestingly, in England and Wales, an estate normally must first file an inheritance tax return with Inland Revenue before obtaining a grant of probate.

c. Situations in which the disposition of the asset will be simple and in which issues of rules of substantive validity will not come into play.

d. The country has adopted the Hague Convention on Formal

Validity or the Washington Convention. In this situation the will should at least be formally valid, though, as discussed below, the provisions of the will may be substantively invalid in the other country.

e. When the property is located in a common law country, such as England. In this situation the basic principles of succession law in that country will be similar to the laws of the United States, including testamentary freedom and the use of trusts. On the other hand, because a common law country will use its own law in determining the substantive validity of the provisions of the U.S. will, a specific gift of the foreign property in a manner that comports with local law may be appropriate.

f. When it will not be necessary to probate or register a will to transfer title to the property in question. For example, it may not be necessary to probate a will to transfer title to shares of a closely held company. In lieu of a probate, the company may be willing to simply transfer the shares on the books of the company. If this is the case, it may be easiest to make a specific gift of the shares in the U.S. will.

F. *Issues in Drafting the Client's U.S. Will*

1. If you decide that a client needs a foreign situs will and a U.S. will, you will presumably have a lawyer or notary in the other country prepare the situs will. You, however, will be drafting the U.S. will and related estate planning documents. In doing so you will need to be attentive to a number of issues, given that the will you draft will not cover all of the client's worldwide property.

2. The U.S. will must clearly state its scope, i.e. that it applies to all of the decedent's assets other than those covered by the foreign will. You should make sure that the description of property covered in both wills is consistent.

3. Lawyers in the United States usually include a provision in a will that provides that the will revokes all prior wills and codicils. You do not want to include such a broad provision in the client's will because you do not want to revoke the client's situs will if he or she has already signed it. This will also be an issue for when you redo the client's U.S. will; you do not want to accidentally revoke the foreign will. The foreign will should have provisions that make it quite clear how to revoke the will so as to avoid any accidental revocation by a subsequent U.S. will or codicil to that will.

4. The drafting lawyer must also carefully consider the tax apportionment and payment clause in the U.S. will. If the client has foreign property, his or her estate may be responsible for foreign death taxes as well as federal estate tax. The drafting lawyer and the client should consider who should pay the foreign taxes and U.S. taxes on the property and coordinate tax

payment provisions in the U.S. will and the foreign will. Opting for full apportionment of all death taxes, foreign or U.S., in the decedent's U.S. will be appropriate when you cannot predict what those taxes will be. On the other hand, it may make sense to pay U.S. death taxes on the foreign property from the client's U.S. estate. You should be skeptical, however, of a clause in the U.S. will that requires the residue of the decedent's estate to pay all death taxes, foreign or U.S. You should also consider whether and how to apportion the benefit of any credit against the U.S. federal estate tax for any foreign death taxes that the estate may pay.

G. *Other Ways to Transfer Foreign Property*

1. A will is not the only way to dispose of property on death. In fact, U.S. lawyers are quite familiar with ways to transfer assets other than by will. Sometimes these well-known techniques will work for foreign property. In other situations there may be options that you would not necessarily think of.

2. One question to ask is whether your client needs a will to cover property physically located in a civil law country. In civil law countries, property vests in a decedent's heirs immediately on the decedent's death; there is no intervening change of title to an executor as there is in a common law country. If the client would leave the property in his or her will in the exact same manner as would occur under the succession laws of the civil law country, a will might not even be necessary. Simply allowing the property to vest in the decedent's heirs may make more sense, particularly if the heirs are likely to sell the property. This approach makes for a much cleaner record. In fact, a client's U.S. will in some of these countries might have limited applicability due to the country's community property and forced heirship rules, although the answer to this question depends on the country's choice of law rules. If you use this approach, you need to carefully draft the U.S. will to exclude the foreign property. This assumes that the country in question would apply its own intestacy rules on the death of the decedent. As discussed below, it is possible that the country might apply the law of the U.S. state of the decedent's domicile to determine the intestate takers under the will. This strategy would not be appropriate for a common law country.

3. If the client owns property in a common law jurisdiction, the client could put the title in joint names with other persons. Joint ownership with rights of survivorship is generally recognized in common law countries and it is just as easy in those countries to transfer title on death by survivorship as it is in the United States. Joint ownership between spouses is particularly useful in England because of the similarity of forms of title to the United States and the fact that as long as the domiciles of the husband and wife are the same, U.K. inheritance tax will not apply until the death of the surviving spouse.

4. On the other hand, a revocable trust is not usually a reliable way to make a transfer of property in another country, even a common law

country.

a. An attempt to transfer real property located in a civil law country presents obvious issues given the lack of trusts as part of the civil law. In this situation, it may be possible for the client to transfer the real property to a corporation or other vehicle and transfer the shares to a revocable trust. This combination of steps would permit an effective transfer of the property on the client's death without a probate or other registration issues. Such a strategy, however, usually raises tax issues in the other country, including stamp or real estate transfer tax or a deemed disposition for capital gain tax purposes. Furthermore, unless the client uses a foreign entity that is eligible for a check the box election, the corporation he or she uses will likely be a controlled foreign corporation for U.S. income tax purposes, which at a minimum trigger extra tax compliance obligations for the client.

b. Even in common law countries a revocable trust usually is not a desirable way to transfer property on the death of a nonresident of that country.

(i) The use of a revocable trust as a will substitute is much more common in the United States than in other common law countries. The use of revocable trusts and pour over wills is made possible by the testamentary additions to trusts acts in the U.S. states. Without such a statute, a pour-over gift in a will might not be valid under the incorporation by references rules in the common law of wills. For example, the provinces and territories of Canada other than the Yukon Territory do not have testamentary additions to trusts acts, making the effect of a pour-over from a will to a revocable trust uncertain. *See* Yukon Wills Act §§ 27 - 29 (R.S.Y. 2002, c. 230).

(ii) Even if you wanted to use a fully funded revocable trust as a probate avoidance device in a common law country, its use may raise income tax issues. In Australia, for example, the transfer of real estate to a revocable trust attracts real estate transfer tax and may be a deemed disposition of the property for capital gains tax purposes. Similarly, a U.S. citizen or resident's transfer of Canadian real property to a revocable trust will be deemed disposition of that property for Canadian income tax purposes. The "alter ego" trust and "joint partner" trust, the use of which can defer Canadian income tax until the death of the settlor or the settlor and the settlor's spouse, are limited to residents of Canada who are 65 years of age or older.

(iii) Even though tax havens often permit the use of revocable trusts, the transfer of local real estate to such a trust may attract a stamp duty or similar excise tax. Revocable trusts under the law of those jurisdictions are more useful for company shares and other intangibles that can easily be titled in the name of the trust.

5. It may be possible to transfer certain assets by beneficiary designation in various countries. For example, a death benefit payable under a life insurance policy issued by a U.K. life insurance company could pass by beneficiary designation. Similarly, a former Canadian resident who now lives in the United States can designate a beneficiary for an interest he or she may still have in a registered retirement savings plan or "RRSP."

IV. Is a Client's U.S. Will Formally Valid in Another Country?

A. *Introduction*

1. When you venture into advising your client about how to dispose of his or her foreign property on his or her death, the legal system of your state will encounter another legal system - the system of the jurisdiction in which the client owns property. That system may be a common law legal system, such as England or Canada, a civil law legal system, such as France or Japan, or a Sharia (Islamic) law system.

2. Private international law or, as U.S. lawyers refer to it, conflicts of law rules, will help navigate you through such a meeting of the legal systems. When the common law system in which you practice meets the other legal system, there may be a seamless transition or there may be a collision. Private international law should help you sort out the choice of law issues.

3. This section of the outline addresses the issues that are likely to arise when a U.S. client dies owning property in that country.

B. *Formal Validity*

1. The first issue to consider is whether another jurisdiction will consider your client's will to have been validly executed. This is an issue familiar to lawyers who practice in the United States because each state has similar, but not identical, requirements for the execution of a will and how to prove the due execution of the will in a probate proceeding.

2. If a will is formally invalid, a U.S. court will not allow the will to be probated. On the other hand, even if a will is formally valid does not mean that the will will be probated. For example, the testator may have revoked a properly executed will. In addition, the will might be invalid because it was procured by fraud or undue influence. Other substantive laws might make a will wholly or partially invalid. To this extent, formal validity involves a rather narrow inquiry.

3. In jurisdictions other than the United States a will must be formally valid before that jurisdiction's laws will give the will effect, all other things being equal. Thus, in order for any will to effectively dispose of property within the jurisdiction of a state or country other than the testator's state of

domicile, that will must be formally valid under that state or country's law.

4. Fortunately, difficult questions of private international law can often be avoided in this area because of two multilateral conventions: The Convention Providing a Uniform Law on the Form of an International Will and the Hague Convention Relating to the Form of Testamentary Dispositions.

C. *Convention Providing a Uniform Law on the Form of an International Will (the "Washington Convention")*

1. Introduction

a. For many years the formal validity of a will depended on choice of law rules in the country in which the will was sought to be given effect. Due to the difference in choice of law rules among countries, this approach led to uncertainty as to whether wills executed in one state or country were valid in another state or country.

b. To resolve this problem, a number of countries adopted the Washington Convention, which provides for the automatic recognition of the formal validity of an "international will." Unlike many multilateral treaties, the signatories to the Washington Convention agreed to adopt as domestic law a series of uniform laws related to the recognition of the formal validity of an international will. The signatories' intent was to make the recognition of the formal validity of an international will a matter of domestic substantive law rather than a matter of private international law.

c. The Washington Convention has entered into force in the following countries:

Belgium, Bosnia-Herzegovina, Canada, Cyprus, Ecuador, France, Italy, Libya, Niger, Portugal, Slovenia.

There are also a number of countries that have signed the treaty but in which the treaty has not been ratified or entered into force:

Holy See, Iran, Laos, Russian Federation, Sierra Leone, United Kingdom.

d. The United States is an original signatory of the Washington Convention. Because of the federal character of the United States, the states had to enact the uniform legislation one by one; many of them have adopted the Uniform International Wills Act, either as stand-alone legislation or as part of the Uniform Probate Code. *See generally* 8 Unif. Laws. Ann. at 243-253

(1998 and 2005 Supp.) (Alaska, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Maine, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Oregon, Pennsylvania, Utah, Virginia, Vermont). Many of the Canadian provinces and territories have also adopted legislation implementing the Washington Convention.

e. The benefit to a U.S. client of the Washington Convention is that when the client executes an international will, the client can be sure that the will is formally valid in a country that is a signatory to the convention. The assurance comes from the fact that the other state or country will have adopted as part of its domestic law a choice of law rule that recognizes the formal validity of an international will.

2. Requirements of an International Will

a. Requirements as to form (Annex to Convention, Articles 3- 7).

(i) The will must be in any form of writing, including typewritten and handwritten, and may be in any language.

(ii) 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.

(iii) The testator must sign the will in the presence of the witnesses and the authorized person or, if the testator has already signed it, acknowledge his signature to the witnesses and the authorized person.

(iv) The witnesses and the authorized person must "there and then" attest to the will by signing it in the presence of the testator.

(v) All signatures must be at the end of the will. If the will has more than one page, the testator must sign each page. Each page must be numbered.

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

b. Certificate

(i) The authorized person must attach a certificate to the end of the will that provides that the procedures for the execution of an international will have been complied with. Annex to Convention, Article 9.

(ii) The uniform legislation provides a sample form for the certificate. A copy of the American form is attached to this outline as Appendix 2.

(iii) In the absence of evidence to the contrary, the certificate serves as proof of due execution of the will and its formal validity. Annex to Convention, Article 12.

(iv) A self proving affidavit is not required. The use of the certificate to prove due execution derives from the practice in civil law countries of executing wills in front of a notary. The lack of a further requirement to prove due execution is also consistent with the rather simple approach to admitting a will to probate in most common law jurisdictions by the presentment of a will. By contrast, the U.S. states have much more rigorous procedures for probating a will, such as proof of the will's due execution by the witnesses. *See* Comment to § 5 of the Uniform International Wills Act, 8 Unif. Laws Ann. at 261 (1998).

c. Who is an authorized person?

(i) The enabling legislation for the Washington Convention requires an authorized person to be present at the execution of the will, to sign the will, and to complete the certificate.

(ii) Under the convention, an "authorized person" is an individual designated by the jurisdiction implementing the enabling domestic legislation. Convention, Article 11(1). The signatory countries have "complete discretion" to designate who is an authorized person.

(iii) In the U.S. version of the enabling legislation, only attorneys admitted to the practice of law are authorized persons. Uniform International Wills Act § 9, 8 Unif. Laws Ann. at 266 (1998).

(iv) The drafters' expectation was that civil law signatories would designate notaries as authorized persons because notaries already fulfill such a role in civil law countries. *See* Prefatory Note to Uniform International Wills Act, 8 Unif. Laws Ann. 243, 245 (1998).

3. Limits of the International Will

a. The Washington Convention does not address the revocation of wills, leaving the matter to domestic law. Thus, even if a person executes a valid international will, choice of law issues could possibly arise on revocation. Annex to Convention, Article 14.

b. The Washington Convention also has no effect on the substantive validity of an international will:

The Convention and the annexed uniform law deal only with the formal validity of wills. Thus, the proposal is entirely neutral in relation to local laws dealing with revocation of wills, or those defining the scope of testamentary power, or regulating the probate, interpretation, and construction of wills, and the administration of decedents' estates.

Prefatory Note to Uniform International Wills Act, 8 Unif. Laws Ann. 243, 244 (1998).

c. Finally, an international will is not necessarily formally valid in jurisdictions that have not signed the Washington Convention. The convention, however, is open-ended; a country can sign on to it at any time.

D. *Hague Convention Relating to the Form of Testamentary Dispositions*

1. The Hague Convention Relating to the Form of Testamentary Dispositions of 1961 (the "Hague Convention on Form") was a forerunner to the Washington Convention. In contrast to the Washington Convention, the Hague Convention approaches the question of formal validity through a uniform choice of law rule rather than a uniform law of formal validity.

2. In a country that has adopted the convention, a "testamentary disposition" will be formally valid if it complies with the internal law:

a. "Of the place where the testator made it, or

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

c. "Of 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. "Of the place in which the testator had his habitual residence either at the time when he made the disposition, or at the time of his death, or

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

Hague Convention on Form, Article 1.

3. As of October 1, 2007, the following countries were parties to the Hague Convention on Form:

Antigua and Barbuda, Armenia, Australia, Austria, Belgium, Bosnia-Herzegovina, Botswana, Brunei, China (Hong Kong only), Croatia, Denmark, Estonia, Fiji, Finland, France, Germany, Greece, Grenada, Ireland, Israel, Japan, Lesotho, Luxembourg, Macedonia, Mauritius, Netherlands, Norway, Poland, Portugal, Serbia and Montenegro, Slovenia, South Africa, Spain, Swaziland, Sweden, Switzerland, Tonga, Turkey, United Kingdom

4. Unlike the Washington Convention, the Hague Convention on Form's choice of law rules apply to matters of revocation as well as execution of testamentary dispositions. Hague Convention on Form, Article 2.

5. The Hague Convention permits a contracting state some flexibility in adopting the general choice of law rule in the convention.

a. A contracting state, for example, can refuse the application of a law "declared applicable" by the convention if that application would be "manifestly contrary to the 'ordre public.'" Hague Convention on Form, Article 7.

b. A contracting state can also reserve the right to not recognize certain forms of testamentary dispositions made abroad in the following situations:

(i) "the testamentary disposition is valid as to form by reason only of a law solely applicable because of the place where the testator made his disposition,

(ii) "the testator possessed the nationality of the state making the reservation,

(iii) "the testator was domiciled in the said state or had his habitual residence there, and

(iv) "the testator died in a state other than that in which he had made his disposition."

Hague Convention on Form, Article 11.

c. A state can reserve the right to exclude from the application of the convention any testamentary clauses which, under the law of the state, do not relate to matters of succession. Hague Convention on Form, Article 11.

d. All of these potential exceptions to the rule, which are not all of the exceptions, essentially require you to determine exactly how the contracting state applies the general choice of law rule in the convention. To this extent, the Hague Convention on Form is not as useful as the Washington Convention.

6. Although the United States is not a party to the Hague Convention on Form, some states have adopted the convention's choice of law rule with respect to the formal validity of wills.

a. Section 2-506 of the Revised Article II of the Uniform Probate Code, for example, includes this choice of law rule that is very similar to Article 1 of the Convention.

A written will is valid if executed in compliance with Section 2-502 or 2-503 or if its execution complies with the law at the time of execution of the place where the will is executed, or of the law of the place where at the time of execution or at the time of death the testator is domiciled, has a place of abode or is a national.

The prior version of section 2-506 is identical to the revised section.

b. Many states that have not adopted the Uniform Probate Code have similar provisions in their laws. *See, e.g.,* Cal. Prob. Code § 6113; 25 Pa. Stat. § 2504.1. Illinois, for example, provides that a will that qualifies as an international will under the Uniform International Wills Act will be treated as meeting the signing and attestation requirements for a will under Illinois law. 755 ILCS 5/4-3(b).

7. England implemented the Hague Convention by the enactment of the Wills Act 1963. Under Section 1 of the Act, a will made by a testator after 1963 will be treated as formally valid in England if the will was properly executed:

a. Under the law of the territory in which the will was executed;

b. Under the law of the territory where at the time of the testator's execution of the will or death the testator was domiciled or habitually resident; or

c. Under the law of the state of which the testator was a national.

This broad statute, which is like that in many U.S. states, should resolve most, if not all, choice of law questions related to formal validity for wills under English law. *See generally* Dicey & Morris on the Conflict of Laws P 27-030 (14th ed. 2006) ("Dicey & Morris"). Other common law jurisdictions follow rules similar to those in the Wills Act 1963. According to Dicey & Morris, legislation similar to that quoted above has been enacted in most of the Australian states and territories (Australia is a party to the Hague Convention on Form), some of the Canadian provinces and territories, the Isle of Man, Ireland (a party), and South Africa (a party). Dicey & Morris, P 27-029, n. 51.

E. *Choice of Law Rules on Formal Validity in Jurisdictions That Have Not Adopted Multilateral Conventions*

1. In countries that have not adopted the Washington Convention or the Hague Convention on Form, whether a will is formally valid raises a question of private international law: which law applies to determine whether the will is formally valid?

2. In common law countries that have not adopted the Hague Convention, the law is likely to be similar to English law related to the formal validity of wills. Because the law of the U.S. states is very similar to English law as to the validity of a will, a will executed in conformance with the laws of a U.S. state will likely be formally valid in another common law country under that country's domestic law without regard to its choice of law rules. In New Zealand, for example, the English Wills Act 1837 still is the fundamental law of wills. Under Section 9 of the Wills Act 1837, a will is formally valid if it is written and signed by the testator and the signature is made or acknowledged in the presence of two witnesses who in turn attest and sign the will or acknowledge their signatures in the presence of the testator. New Zealand retained the Wills Act 1837 despite an extensive study by the New Zealand Law Commission to update the Wills Act and to conform the New Zealand law of wills to the law of wills in the Australian states. Among other provisions, the Law Commission recommended that New Zealand adopt a provision similar to section 1 of the Wills Act 1963. *See* "Succession Law - A Succession (Wills) Act," New Zealand Law Commission Report 41, October 1997 available online at www.lawcom.govt.nz/uploadfiles/ publications). Alternatively, a common law country may have also followed England's lead and enacted a provision similar to section 1 of the Wills Act 1963 that effectively adopts the Hague Convention on Form's choice of law rules with respect for formal validity of a will.

3. In civil law jurisdictions that have not adopted the Hague Convention on Form or the Washington Convention, the formal validity of a will will depend on internal law and the jurisdiction's choice of law rules for succession matters in that country. As discussed in detail below, many civil law jurisdictions follow a nationality principle in choice of law matters. Thus, if a U.S. citizen's will is valid under U.S. law, a civil law country that follows the nationality principle should consider the will formally valid in that country. One issue that will come up, however, is that there is no "national" law of formal validity under the U.S. federal system. If your client is dealing with a civil law country that is not a party to one of these multilateral conventions, local advice should probably be obtained.

V. Is the Client's U.S. Will Substantively Valid in Another Country?

A. *Introduction*

1. If you conclude that your client's U.S. will will be formally valid in another jurisdiction, the next step is to consider whether the will is likely to be substantively valid in that jurisdiction.

2. Whether a will is substantively valid raises two separate sets of questions.

a. The first set of questions relates to whether the will's execution was substantively valid. For example, a will's execution could be invalid if the will was procured by undue influence or if the testator lacked testamentary capacity to make a will. Questions of this kind are likely to come up in both common law jurisdictions and in civil law jurisdictions.

b. The second set of questions relates to whether particular provisions in a will are valid under applicable law. Questions of this kind can be quite varied, but include matters such as the effect of a purposed gift in fee tail, whether a gift violates a rule against perpetuities, or whether a will's provisions violate forced heirship laws. Questions of this kind are more likely to arise in civil law jurisdictions than in common law jurisdictions due to the forced heirship laws and lack of trusts in most civil law jurisdictions. Issues of substantive validity of this kind can also arise in common law jurisdictions because the substantive law of trusts and wills often differs among common law jurisdictions.

3. Analyzing these questions of substantive validity involves a preliminary question: What law should you apply to determine whether your U.S. client's will is substantively valid in the foreign jurisdiction? Answering this question requires an understanding of the choice of law rules that will apply in your state and in the foreign jurisdiction in question. When you know which law will apply, you can either answer the substantive validity questions yourself, if the law of your state applies, or refer the question to a lawyer in the other jurisdiction, if the law of that jurisdiction will apply. Would that it would be so easy, however; determining what the choice of law rules will be is in and of itself can be very difficult.

B. *Choice of Law Rules in the United States*

1. Introduction

a. In order to analyze choice of law questions, a U.S. lawyer must be familiar with U.S. choice of law rules in succession law matters.

b. This part of the outline describes the general U.S. choice of law rules for intestate succession and wills. The choice of law rules for trusts are similar to the choice of law rules for wills and can be found in Restatement (Second) of Conflicts of Law §§ 267-282.

2. Intestate Succession

a. In general, the law of the jurisdiction in which land is located will determine the intestate takers of the land. *See* Restatement (Second) of Conflicts of Law § 236. If a court in a jurisdiction other than the one in which the land was located had to determine the intestate takers of the land, that court would typically refer to the law of the jurisdiction in which the land is located. *See, e.g., Hinchee v. Security National Bank,* 624 P.2d 821 (Alaska 1981)(Alaska court applies Hawaii law to determine creditor's rights in Hawaiian real estate held by a married couple as tenants by the entirety).

b. On the other hand, the disposition of personal property when an individual dies intestate will be determined by the law of the state of the individual's domicile on his or her date of death. Restatement (Second) of Conflicts of Law § 260. *E.g., Estate of Sendonas,* 381 P.2d 752 (Wash. 1963) (applying Washington intestacy laws to estate of Greek national who was domiciled in Washington on the date of his death). Under this principle, a court in a U.S. state other than the state of the decedent's domicile would ordinarily refer to the laws of the jurisdiction of the decedent's domicile to determine the intestate takers of the decedent's personal property. Thus, in two cases involving U.S. property of intestate foreign domiciled decedents, the New York Court of Appeals decided that a decedent's property located in New York would escheat to a foreign country under New York choice of law rules. *Estate of Garwitt,* 393 N.Y.S.2d 702 (N.Y. 1977); *Estate of Utassi,* 261 N.Y.S.2d 4 (N.Y. 1965). The New York Legislature overruled the results of these two cases by providing that if property of a decedent located in New York would escheat to a foreign country, the property will instead escheat to New York. N.Y. Est. Powers & Trust L. § 4-1.5.

3. The choice of law rules that apply to wills differentiate between the validity of wills and construction of wills.

a. Issues of "validity" include capacity, validity of particular provisions of wills, the required form of the will, and the manner of the will's execution. *See* Comment (a) to Restatement (Second) of Conflicts of Law § 263.

b. Issues of "construction," on the other hand, involve the "meaning and effect of words used in the will." *See* Comment (a) to Restatement (Second) of Conflicts of Law § 264.

4. Choice of law rules for wills disposing of real property.

a. In general, the law of the jurisdiction in which the real estate is located will govern issues related to the validity and effect of the will as it relates to that real estate. Restatement (Second) of Conflicts of Law § 239. *E.g., Estate of Moore,* 223 P.2d 393 (Or. 1950) (Oregon law applies to the validity of a will giving land located in Oregon to the federal government); *Estate of Georg,* 298 F. Supp. 741 (D.V.I. 1969) (U.S. Virgin Islands law controls validity and effect of will of domiciliary of the Dominican Republic with respect to land located in the Virgin Islands; law of the Dominican Republic was not applicable to the disposition of the real estate).

b. With respect to issues of construction of a will disposing of land, a U.S. court will generally follow the law designated by the testator in the will.

(i) U.S. choice of law rules do not require that the law selected by the testator have a substantial connection to the testator or to the real estate itself. Restatement (Second) of Conflict of Laws § 240, comment (e).

(ii) In the absence of such a choice of law, a court would generally apply the laws of the jurisdiction in which the real estate is located.

5. Choice of law rules for wills that dispose of personal property.

a. U.S. choice of law rules generally provide that the laws of a decedent's domicile will control the validity and effect of a will to the extent the will disposes of the decedent's personal property. Restatement (Second) of Conflicts of Law § 263. *E.g., In the Matter of the Unanue,* 605 A.2d 279 (N.J. Superior Court 1991) *aff'd* 710 A.2d 1036 (N.J. App. 1998) (decedent was domiciled in New Jersey, not Puerto Rico, so Puerto Rican forced heirship laws did not apply to the decedent's estate); *Estate of Georg,* 298 F. Supp. 741 (D.V.I. 1969) (U.S. Virgin Islands court will respect will of a domiciliary of the Dominican Republic with respect to disposition of personal property located in the Virgin Islands even though the law of the Dominican Republic was different than the law of the Virgin Islands).

b. In a famous case, however, a New York court held that a New York choice of law provision in a will of a French domiciliary trumped French law that would have made the will invalid. In *In the Matter of Estate of Renard,* 437 N.Y.S.2d 860 (Surr. 1981) *aff'd.* 447 N.Y.S.2d 573 (App. Div. 1981) *aff'd.* 439 N.E.2d 341 (N.Y. 1982), the decedent was a U.S. citizen but was domiciled in France on the date of her death. The decedent's U.S. lawyers prepared a will that purported to dispose of all of the decedent's assets and that designated New York law as its governing law. The decedent's New York will left her assets in a manner inconsistent with French forced heirship laws. The decedent later executed a French will that governed her French real estate and tangible personal property located in France. The French will followed French forced heirship principles. The decedent's son, who was her only surviving heir, attempted to claim his right of forced heirship against the property disposed of by the New York will. The court did not recognize the son's claim against the property passing under the New York will because the decedent made a valid choice of New York law in that will and because New York law does not have forced heirship. The court took notice of the general rule that the law of a decedent's domicile should govern issues related to the validity and effect of the decedent's testamentary dispositions of personal property. The court, however, thought that the New York legislature intended to allow individuals to avoid the application of that rule through a New York choice of law. *Id.* at 865 ("Choice of law rules entail the balancing of divers policy considerations and where the Legislature has spoken, its decision should prevail."). The court went out of its way to defend its decision:

[T]raditional conflict of laws rules often fail to take cognizance of the policies of other jurisdictions, and of the interests which those jurisdictions have in the application of their laws. [Prior decisions] make it clear that the [New York] Court of Appeals has moved away from mechanical choice of law rules to a balancing approach which requires the identification of the underlying policies in the conflicting laws of the relevant jurisdictions, and the examination of the contacts of those jurisdictions to see which has a superior connection with the occurrence and thus a superior interest in having its policy of law followed. . . . The factor of decedent's domicile at death need not be decisive. *Id.* at 866 (citations omitted).

The court thought that the French forced heirship laws conflicted too much with New York's rule of testamentary freedom to give effect to those French laws when the decedent deliberately chose New York law:

France apparently applies its forced heirship law to personal property situated in that country, without regard to the fact that neither the testator nor the claiming child is domiciled there, so long as the child is a citizen of France. In this court's view the weight of the contacts with each jurisdiction must be considered. The French approach may reward a child's recent acquisition of French citizenship or residence with a windfall in the way of a forced share in the parent's estate. Our conflicts rules should not be extended to sanction such an approach, which might reward such changes made in contemplation of imminent death. *Id.* at 867 (citations omitted).

c. On matters of construction a court will generally follow the law designated by the testator in the will. Restatement (Second) of Conflicts of Law § 264(1).

(i) Choice of law rules in the United States do not require that the testator have a substantial connection to the jurisdiction the law of which he or she selects. Comment (e) to § 264.

(ii) If the testator did not make such a choice of law in his or her will, a court will generally apply the laws of the testator's domicile at his or her date of death in construing the will. Restatement (Second) of Conflicts of Law § 264(2). *E.g., Buresh v. First National Bank,* 500 P.2d 1063 (Or. App. 1972) (California law governs construction of will of California resident even though will prepared in Oregon).

C. *Choice of Law in Common Law Jurisdictions Other Than the United States*

1. Other common law jurisdictions' choice of law rules are very similar to the U.S. rules given the common source of those rules: English law. The primary impetus for the development of these rules in, English law was the commerce and movement of people and property between England and Scotland. *See generally* Dicey & Morris, P 1-018. The rules come in handy in analyzing conflicts between common law countries and conflicts between subdivisions of federal systems, such as the provinces and territories of Canada and the states and territories of Australia.

2. As is the case in the United States, the common law countries' choice of law rules usually provide that the law of the location of immovable property governs succession law matters related to that property. Dicey & Morris, PP 27-016, 27-053. *See, e.g., Re Collens* [1986] 1 Ch 505, [1986] 1 All ER 611 (English law applies to disposition of English real property by domiciliary of Trinidad and Tobago); *Re Bailey* [1985] 2 NZLR 656, 1984 NZLR LEXIS 737 (New Zealand court applies English law to determine a widow's right in real property in England); *In re Ogilvie* [1918] 1 Ch 492 (English court applies Paraguayan law to determine succession law issues related to an English-domiciled decedent's interest in Paraguayan real property). This means that when you have a U.S. client with real property located in a common law country, then that country will apply its own law in a matter related to the succession to that real property. A court in a U.S. state would almost certainly apply the law of the other country if the court had to resolve a succession law issue related to that property.

3. The common law countries generally base choice of law on succession matters related to movable property on the decedent's domicile at his or her date of death. Dicey & Morris, PP 27-011, 27-045. The U.S. states follow a similar rule absent a choice of law to the contrary by a decedent. In this way, the U.S. and common law country rules for choice of law on succession matters complement one another.

4. Just because the rules are complementary, does not mean that the provisions of your client's U.S. will will be valid in a common law country because the wills and trusts laws of the common law jurisdictions vary considerably. A recent English case illustrates the pitfalls a lawyer may encounter in this area. In *Tod v. Barton* [2002] WTLR 469, a Texas domiciliary made two last wills, one for his U.S. property and one for his other property. The latter will was an English will and provided that the will was to take effect under English law. The English will essentially created an annuity trust for the decedent's son with the remainder of the trust assets passing to charity. Pursuant to English law, the son and the charity agreed to vary the trust, resulting in the payment of a lump sum to the son and the acceleration of the charitable remainder. The decedent's widow objected, claiming that the testator would have wanted the son to receive an annuity, not a lump sum. According to the widow, Texas law, which was the law of the decedent's domicile, would not permit such a variation because the substantial purposes of the trust had not been accomplished (the *"Claflin"* rule). English law, on the other hand, would permit such a variation under the famous case of *Saunders v. Vautier.* The court held that despite the testator's Texas domicile, English law applied because the testator specified that his English will was to take effect under English law.

D. *Choice of Law In Civil Law Countries*

1. Many civil law countries base their choice of law rules in succession law matters on the decedent's citizenship *(lex patriae),* not the decedent's domicile.

2. For example, under German choice of law rules the disposition of the personal property of a German national is governed by German law even if he or she is domiciled in another country. German choice of law rules provide that the disposition of German real estate is also governed by the law the owner's nationality. Italy, Spain, and Sweden rely on similar choice of law rules in succession matters.

3. A case from the Phillipines illustrates how a citizenship-based choice of law rule will apply in a civil law country. In *Estate of Bellis,* 20 Philippine Supreme Court Reports Annotated 358 (1967), the decedent was a U.S. citizen who resided in Texas. The decedent had executed a will in the Philippines to govern his Philippines estate, and some of the provisions of the will violated Philippines forced heirship law. Following the decedent's death this will was probated in the Philippines. The Supreme Court of the Philippines refused to recognize the claims based on the Philippines forced heirship law, given the decedent's U.S. citizenship. Rather, the court held that Texas law applied. Because the parties admitted that Texas did not have any applicable forced heirship laws, the aggrieved children had no right to a share of the decedent's estate located in the Philippines.

4. The Scandinavian countries other than Finland rely on citizenship in choice of law matters involving succession law except with respect to choice of law among the countries themselves. As between the Scandinavian

countries other than Iceland, a 1934 multilateral treaty, the Nordic Convention on Succession, provides that domicile is the basis for choice of law with respect to choice of law issues between citizens of those countries. *See generally* 1 Schoenblum, § 9.05, 9-28.

5. Finland recently changed its conflicts of law rules in succession matters to emphasize domicile rather than citizen. Under Finnish choice of law rules, the law of a decedent's country of domicile applies to the disposition of property located in Finland as long as the decedent was a citizen of his or her country of domicile or had his or her permanent home in the country of domicile during the five years before death. If the law of the decedent's domicile does not apply pursuant to this rule, Finland will rely on citizenship for choice of law matters. These rules are described in a report by Urpo Kangas of the University of Helsinki for the Study on Conflict of Law of Succession in the European Union, which is available in English at http://europa.eu.int/comm/justice_home/doc_centre/civil/studies/doc/report_conflits_finland.pdf).

6. Although France is the source of much of the world's modern civil law, France actually relies on domicile in choice of law on succession law matters, as does Belgium. France and Belgium also follow the common law choice of law rule that the law of the location of immovable property governs succession law matters related to that property. To this extent, there should not be a conflict of choice of law rules between a U.S. state and France or Belgium. For example, if a U.S. citizen and resident decedent dies owning real property in France, a French court would apply French law to determine the rights of the decedent's heirs and legatees in the property. The application of French substantive law in this situation would be consistent with U.S. choice of law rules. In this situation, French forced heirship law could restrict the decedent's testamentary freedom with respect to the French real property. In addition, leaving French real property to a trust would not work because French law does not recognize trusts.

7. Switzerland generally relies on domicile as the basis for choice of law matters involving non-Swiss national individuals who are not domiciled in Switzerland. Thus, in the case of a U.S.-domiciled U.S.-national decedent who owned personal property located in Switzerland, a Swiss court would apply the succession law of the state of the decedent's domicile. If a U.S. citizen who was domiciled in the United States owned real property in Switzerland, however, a Swiss court could apply Swiss law to succession law matters related to the real property under either Swiss choice of law rules or the 1850 United States - Switzerland Treaty of Friendship, Reciprocal Establishments, Commerce, and Extraditions. If, however, a U.S. court asserted jurisdiction over Swiss real property in a succession law matter involving a U.S. citizen domiciled in the United States, a Swiss court would yield to the U.S. court's jurisdiction. Arpagus, "Estates Involving the United States and Switzerland," at 7 (2003)(available online at www.swissemb.org/legal/estate.pdf).

8. By way of reference, U.S. courts have shown a general lack of enthusiasm for recognizing forced heirship claims based on the laws of the decedent's country of citizenship. Courts that have considered questions of this kind usually have found an explicit or implicit choice of U.S. state law by the decedent that justifies the application of U.S. principles of testamentary freedom rather than foreign forced heirship laws. *See, e.g., In the Matter of Estate of Renard,* 437 N.Y.S.2d 860 (Surr. 1981) (applying New York law rather than French forced heirship law); *Wyatt v. Fulrath,* 211 N.E.2d 637 (N.Y. 1965) (applying New York law rather than Spanish community property law); *Neto v. Thorner,* 718 F. Supp. 1222 (S.D.N.Y. 1989) (applying New York law rather than Brazilian forced heirship law); *Sanchez v. Sanchez,* 547 So.2d 943 (Fla. App. 1989) (applying Florida law rather than Venezuelan forced heirship law).

E. *Renvoi*

1. A conflict between choice of law rules can occasionally arise for a U.S. domiciled client who owns real property located in a civil law country that follows a nationality principle in choice of law rules. For example, if an Illinois domiciled decedent owned real property in Spain, the Illinois choice of law rules would provide that Spanish law should apply to succession law matters related to that real property. Spanish conflicts law, however, generally provides that the law of a decedent's nationality controls all succession law matters. What happens with such a conflict?

2. Such a conflict triggers the potential application of the doctrine of *renvoi. Renvoi* arises when the conflicts rules of a U.S. state refers a matter to the "law" of another jurisdiction. Such a referral raises the question of whether the referral is to the substantive law of the other jurisdiction or to the substantive law and the choice of law rules of the other jurisdiction.

3. American courts generally interpret a reference to the "law" of another jurisdiction as a references to the substantive law of that jurisdiction and not the conflict of law rules of that jurisdiction. Restatement (Second) of Conflicts of Law § 8(1).

4. An exception to the general rule of no *renvoi* in U.S. courts, however, involves succession law matters related to foreign real property. Under the U.S. approach, a succession law matter related to foreign real property owned by a U.S. decedent is litigated in a U.S. court, that court is likely to apply what scholars refer to as "double *renvoi."*

a. In this situation, the U.S. court would attempt to decide the case in the same manner as a court in the other country, applying both the substantive law and the choice of law rules of that country. *See generally* Restatement (Second) of Conflicts of Law § 8(2).

b. Taking this approach requires proof of both the substantive law and the conflicts law of the foreign country. The court will first have to determine whether the foreign country will accept the "transmission" of the governing law from the U.S. state under that state's choice of law rule. If the court concludes that the foreign country will accept the transmission of choice of law, then the U.S. court would apply the substantive law of the foreign country with respect to succession law matters. If the U.S. court concludes that a court in the foreign country would not accept the transmission from the U.S. court, then the U.S. court will apply its substantive rules.

c. There are very few cases involving *renvoi* in this context in the United States. The leading U.S. case involving *renvoi* in succession law matters is *Accounting of Schneider,* 96 N.Y.S.2d 652 (Surr. 1950). In that case, the Surrogate's Court for New York County considered whether to apply Swiss or New York law with respect to a succession law matter involving the proceeds from the sale of a decedent's Swiss real property. The court took the position that it should decide the case in the same way that a Swiss court would decide the case. The court noted that Switzerland followed the nationality principle in succession law matters and would not accept the *renvoi* from New York. Accordingly, the court applied New York law to determine the parties' rights in the proceeds. The Delaware Court of Chancery in a 1954 case applied double *renvoi* to conclude that an Italian court would have applied the law of Mississippi to the estate of a non-Italian citizen domiciled in Italy. *Taormina v. Taormina Corporation,* 109 A.2d 400 (Del. Ch. 1954). The court's discussion of the choice of law matter, however, is dicta because the court had previously concluded that the decedent was in fact domiciled in Mississippi.

5. The English courts have generally followed the same double *renvoi* approach in cases concerning succession law matters related to foreign real property that are litigated in England. *See, e.g., In re Duke of Wellington* [1947] Ch 506 (English law applies to determine succession law matters related to Spanish real property owned by domiciliary of England). English courts have also applied double *renvoi* in cases involving movable property of British citizens who were domiciled in civil law countries that follow a nationality principle in choice of law matters. *E.g., In re Ross* [1930] 1 Ch 377 (English law applies to determine succession law matters related to Italian real property owned by a U.K. citizen who was domiciled in Italy).

6. Civil law countries that follow a nationality principle in succession law matters sometimes eschew *renvoi* because it could result in the non application of citizenship as the basis for choice of law depending on the nationality of the individual in question.

7. Germany, on the other hand, will accept *renvoi. See* 1 Schoenblum § 9.10 at 9-50, n. 274. Thus, if a U.S. citizen domiciled in Germany owns real property in Germany, German law would initially refer to U.S. law with

respect to succession law issues related to the property. A U.S. court, however, would refer to German law under U.S. choice of law rules. A German court should accept this reference and apply its substantive law with respect to the real property. Thus, a gift of German real estate would be subject to German forced heirship rules. Similarly, a gift of German real property to a trust might not be recognized because trusts are not a part of German law. Consistent with this general principle, an English court relied on German law in a case involving personal property of a German domiciled decedent that was physically located in England. *Estate of Fuld* [1968] P. 675.

F. *Multilateral Treaties on Substantive Succession Law Issues*

1. The Hague Convention Relating to the Form of Testamentary Dispositions and the Washington Convention, while useful in matters of formal validity, address only issues related to the formal validity of wills. The treaties do not address substantive legal issues that can arise in succession law matters, leaving those issues to private international law. As demonstrated by the above discussion, relying on private international law can lead to difficult analytical situations.

2. The members of the Hague Convention addressed choice of law issues related to substantive succession law matters in the 1989 Hague Convention on the Law Applicable to Succession to the Estates of Deceased Persons (the "Hague Convention on Succession").

a. The Hague Convention on Succession attempted to come up with a uniform set of choice of law rules for substantive succession law matters. The main principles of the convention are:

(i) The location of property and a decedent's domicile are irrelevant to choice of law questions.

(ii) Choice of law in succession law matters must be based on the law of the country of which a decedent was a citizen provided he or she was habitually resident in that country. If the decedent was habitually resident in a country other than his or her country of citizenship, the law of the country of habitual residence will apply as long as the decedent had been so resident in that country for five or more years before his or her death. If the decedent was not a citizen of the country in which he or she was habitually resident for less than five years preceding his or her death, the law of his or her country of citizenship applies to succession law matters. Hague Convention on Succession, Article 3.

(iii) A decedent can choose the law governing the disposition of his or her estate, but the law must either be the law of the country of which he or she is a national or of the country of which he or she is habitually resident. *Id.* Article 5(1). A testator cannot choose the law of more than one country.

(iv) The Hague Convention on Succession has no real significance in international succession law matters at this point. Only Argentina, Holland, Switzerland, and Luxembourg have signed the convention. Of these four countries, only Holland has ratified the convention. Holland also has implemented the choice of law provisions in the convention into its domestic law, so its choice of law rules on succession matters mirror those in the convention. As discussed above on page 33, Finland recently changed its choice of law rules to reflect the provisions of the convention, although Finland is not a signatory to the convention.

3. The 1985 Hague Convention on the Law Applicable to Trusts and on Their Recognition (the "Hague Convention on Trusts") may make it possible to use trusts to hold property with a connection to a jurisdiction that does not recognize trusts as part of its domestic law.

a. Like the Hague Convention on Succession matters, the Hague Convention on Trusts is an attempt to harmonize choice of law rules so that one country will recognize a trust that is valid in another country. The convention does not require a party to adopt a domestic law of trusts. In addition, a signatory does not have to recognize a trust if its "significant elements" other than its choice of law, its place of administration, and the habitual residence of the trustee, "are more closely connected" to a state that does not recognize the trust as part of its domestic law.

b. The following countries have ratified the Hague Convention on Trusts:

Australia, Canada (subject to certain reservations and the nonapplication of the convention in Quebec), China (for the Hong Kong special administrative region only), Italy, Luxembourg, Malta, Netherlands, Switzerland, United Kingdom (including many of its territories, including Bermuda, Gibraltar, and the Isle of Man).

The convention entered into force in 2006 in Liechtenstein and San Marino and will enter into force in Monaco in 2008. The United States, Cyprus, and France each signed the convention, but none of these countries has ratified it. The convention entered into force in Switzerland in 2007. According to a press release from the Swiss Federal Office of Justice issued before ratification:

A large volume of assets belonging to trusts or managed in the name of trusts [are] held in Switzerland. More and more banks have their own trust departments, while increasing numbers of Swiss-domiciled companies specialize in their management. Fiduciary companies and law firms are other players which are becoming increasingly involved in trust planning and administration.

Although trusts are already broadly recognized under current Swiss law, the present legal situation is still encumbered with considerable uncertainty. The recognition of trusts is thus to be given a firm foundation, with more legal certainty created for all concerned. Both the parties involved in trusts and the relevant authorities have a vested interest in a system that sets out with the greatest degree of certainty the legal provisions which apply to trusts in individual cases. There is also a significant economic interest in greater legal certainty, as a sound legal basis improves conditions for the establishment and management of trusts and thereby boosts the appeal of Switzerland as a business location.

For the reasons given above, Switzerland is planning to ratify the Hague Convention on the Law Applicable to Trusts and on their Recognition in the near future.

Press Release, "Ratification of the Hague Trust Convention," June 2005, Swiss Office of Federal Justice (available online at www.finweb.admin.ch/pdf_neue_neue_version/pdf_e/FS_HaagerTrust_BJ_e.pdf).

c. Under Article 11 of the convention, a party must recognize a trust if that trust was created in accordance with the law of a country that recognizes trusts:

A trust created in accordance with the law specified by the preceding [provisions of the convention] shall be recognized as a trust. Such recognition shall imply, as a minimum, that the trust property constitutes a separate fund, that the trustee may sue and be sued in his capacity as trustee, and that he may appear or act in this capacity before a notary or any person acting in an official capacity.

d. In particular, Article 11 provides that a party must recognize these features of trusts to the extent that the law governing the trust so provides:

In so far as the law applicable to the trust requires or provides, such recognition shall imply, in particular -

(i) That personal creditors of the trustee shall have no recourse against the trust assets;

(ii) that the trust assets shall not form part of the trustee's estate upon his insolvency or bankruptcy;

(iii) that the trust assets shall not form part of the matrimonial property of the trustee or his spouse nor part of the trustee's estate upon his death;

(iv) that the trust assets may be recovered when the trustee, in breach of trust, has mingled trust assets with his own property or has alienated trust assets. However, the rights and obligations of any third party holder of the assets shall remain subject to the law determined by the choice of law rules of the forum.

e. The convention also provides that a country must permit a trustee to register title to movable and immovable assets in the trustee's fiduciary capacity "in so far as this is not prohibited by or inconsistent with the law of the State where registration is sought." Hague Convention on Trusts, Article 12. In making such a registration, the country's government may require the disclosure of evidence that discloses the trust's existence. In other words, the trustee must register the property with some reference to the fact that he or she owns the property as trustee and not individually.

f. If a party to the convention must resolve an issue related to the trust, it will apply the law chosen by the settlor of the trust. If the settlor did not make a choice of law or chose the law of a jurisdiction that does not recognize trusts, the court will apply the law of the jurisdiction with which the trust is most closely connected. *Id.* Article 7. The facts that will determine that jurisdiction are:

In ascertaining the law with which a trust is most closely connected reference shall be made in particular to:

(i) the place of administration of the trust designated by the settlor;

(ii) the situs of the assets of the trust;

(iii) the place of residence or business of the trustee;

(iv) the objects of the trust and the places where they are to be fulfilled.

g. Article 13 of the convention contains an "escape clause" that allows judges to decide that despite the convention a trust should not be recognized:

No state shall be bound to recognize a trust the significant elements of which, except for the choice of the applicable law, the place of administration and the habitual residence of the trustee, are more closely connected with states which do not have the institution of the trust or the category of trust involved.

According to the Explanatory Report on the convention by Alfred von Overbeck ("von Overbeck Report"):

This clause will be used above all by judges who think that the situation has been improperly removed from under the application of their own laws. But it might also be utilized by the judge of one State which does not have trusts as a matter of solidarity with another State, which also does not have them and to which the situation is objectively connected.

It will also be noted that this provision allows a judge of a State which does not have trusts to refuse recognition to the trust because he thinks that the situation involved is internal to his State. In contrast this possibility does not exist for those States which have trusts, but those States do not seem to feel the need for it.

Von Overbeck Report at 387 (available online at http://hcch.e-vision/nl/upload/exp130.pdf).

h. The convention has a few other "escape clauses" that will allow a signatory to avoid recognizing a trust.

(i) Article 15 in effect provides that the convention will not alter the domestic choice of law rules of a country on succession law issues other than issues related to the recognition of trusts. For example, the convention does not change a country's choice of law rules with respect to the "protection of minors" and "the personal and proprietary effects of marriage." The convention also does not apply to "succession rights, testate and intestate, especially the indefeasible shares of spouses and relatives." Hague Convention on Trusts, Article 15(c).

(ii) Article 16 provides that certain domestic laws related to "international situations" are not affected by the convention. The purpose of this provision was to allow a country to apply its really important domestic laws that generally override the country's choice of law rules in certain international situations:

Among the laws which fall in this category, mention may be made of those which are intended to protect the cultural heritage of a country, public health, certain vital economic interests, the protection of employees or of the weaker party to another contract.

Von Overbeck Report at 44.

i. Even though the United States has not ratified the convention, a U.S. person can receive the benefit of the convention in the countries that have adopted the convention. Christensen, *supra,* at 7.

4. The European Commission has also recently begun to study the potential for harmonizing the conflict of law rules related to succession across the European Union, though the Commission recognizes the difficulty of this undertaking. *See* Green Paper - Succession and Wills (Commission of the European Community - March 1, 2005)[SEC (2005) 270]. On November 16, 2006, the European Parliament adopted a resolution with recommendations to the European Commission directing the Commission to submit legislative proposals to harmonize choice of law rules for succession matters in the European Union during 2007. In a precursor to the Commission Study, a 2002 study by the International Institute for the Unification of Private Law ("UNIDROIT") pointed out that it was not possible nor desirable to attempt to harmonize the substantive succession laws within the member countries of the European Union. About the best that can be hoped for is uniformity in the choice of law rules.

VI. How Should a Client Dispose of Foreign Assets in U.S. Estate Planning Documents?

A. You may conclude that because of choice of law rules or because of substantive law rules in the other country that the provisions of the U.S. will are valid in that country. You should not, however, therefore assume that leaving the property in the manner contemplated by the client's U.S. estate planning documents is necessarily the best idea for that property.

B. From a nontax law perspective, simplicity is often best, particularly when the property is located in a civil law country.

1. A U.S. lawyer's instinct may be to leave a decedent's estate in one or more trusts of various kinds. A gift to a trust will be given effect in a common law country such as England. A gift to a trust may also be given effect in a civil law country if its choice of law rules or its domestic law would recognize a gift to a trust. Just because such a gift is possible, however, does not mean that it is advisable.

2. If a civil law country has adopted the Hague Convention on Trusts, it may be possible to register the property in the name of the trustee. The Hague Convention on Trusts directs signatory states to permit such registrations, but it allows a country to not do so if doing so is "prohibited by or inconsistent with the law of the State where registration is sought." Hague Convention on Trusts, Art. 12.

3. In a civil law country that has not adopted the Hague Convention on

Trusts, registering real property in the name of a trustee may be difficult to do even though as a matter of succession law the gift of the property to the trust was permissible. For example, the registration may disclose only the name of the trustee and not reflect the fact that the property is owned by a trust. The Chancery Court in *In re Duke of Wellington* [1947] Ch 506, addressed this issue:

> It appears from the expert evidence that, so far as immovable property in Spain is concerned, there is a system of compulsory registration, and that in order to perfect title to immovable property or to any interest therein, such as a usufruct, it is necessary to obtain registration. The experts agree that Spanish law does not recognize the doctrine of trusts as understood in English law, and that it is not possible in Spanish law to obtain registration of a trust. They are also agreed, however that the mere presence in a document of title, including a will, of the word "trust" would not, of itself, be fatal to registration, and that, assuming English law to be applicable in the case in questions, the registrar and, if necessary, the Spanish court would seek competent English opinion as to the effect of the document in question.

4. A particular problem may arise in a common law country when the U.S. client uses a pour-over will and real property located in the country is covered by the pour-over provision, rather than a specific gift. For example, it is unclear in Canada whether a gift by a will to a revocable trust that has been amended since the execution of the will is valid. Such a gift raises issues under the incorporation by reference doctrine that is part of the common law of wills, which the U.S. states have addresses through testamentary additions to trust legislation.

5. These kind of issues suggest favoring simplicity, such as using outright specific gifts to individuals when you can. Gifts of this kind are easy to understand, easy to translate into a foreign language, and do not introduce U.S. legal concepts and principles into a foreign situation.

C. Many U.S. estate planning conventions and devices can lead to infelicitous foreign tax consequences.

1. For example, although many civil law countries follow the nationality principle in choice of succession law matters, estate and inheritance taxes in those countries may be based on the location of property.

a. As noted above, civil law countries often have inheritance taxes that impose a higher rate of tax on gifts to more remote relatives than on gifts to close relatives. If such a country relies on nationality in its choice of law rules related to succession, a bequest by a U.S. citizen to a friend or remote relative should not violate the country's forced heirship laws. On the other hand, because the devisee is not closely related to the decedent, the country may apply a higher rate of tax to the bequest. Thus, while the gift may be substantively valid, the price for making it is higher.

b. As discussed above, under Swiss choice of law rules a Swiss court is likely to apply U.S. succession law to the estate of a U.S. citizen. Thus, a U.S. citizen who owned real property in Switzerland could technically leave that property to a trust. If the canton in which the property is located, however, has an inheritance tax, the canton may treat the bequest to the trust as a bequest to a nonfamily member, triggering inheritance tax at the highest rate. More dramatically, some of the Swiss cantons do not impose an inheritance tax on a transfer of property to descendants. A gift to a trust for the benefit of descendants, however, may be treated as a gift to an unrelated person, thereby attracting inheritance tax when it would not otherwise be payable. In this situation, the benefit of being able to use a trust is outweighed by the tax consequences. With respect to this last point, some cantons may permit a gift to a trust solely for the benefit of descendants to be treated as a gift to a descendant, but an advance ruling will be necessary to secure this favorable treatment.

2. Making gifts of foreign property to U.S.-style trusts may also cause foreign estate and inheritance tax problems.

a. For countries that still have estate taxes and gift taxes, gifts and bequests to trusts for the benefit of U.S. beneficiaries may trigger wealth transfer taxes in the donor's country of residence. While the imposition of foreign wealth transfer taxes in and of itself may not be surprising, how other countries apply those taxes may be surprising. Note that the Hague Convention on Trusts does not apply to fiscal matters, so a party to the convention is free to tax trusts as it wishes.

b. German gift and inheritance tax law, for example, bases its gift tax and inheritance tax rates on the relationship of the donor to the donee. A client, for example, may own an interest in a German partnership that is subject to German gift tax. A descendant is a Class I beneficiary; the top marginal rate for gifts or bequests to such a beneficiary is 30% (above [euro] 25,565,000 (about $ 36 million)). The general view in Germany is that a trust is a Class III beneficiary regardless of the identity of the trust beneficiaries. The top marginal rate on a gift or bequest to a Class III beneficiary is 50% (above [euro] 25,565,000). Thus, a gift to a trust can trigger a higher German gift tax than would a gift to an individual.

c. Giving English real property to a U.S.-style trust seems like it should be simple because the law of England recognizes trusts. A bequest of English real property to a trust, however, may result in the trust paying a U.K. inheritance tax every 10 years - the "ten- yearly charge" of up to 6%. A charge may also apply on large distributions from the trust.

d. Often the safest way to proceed is to prepare U.S.-style documents that mirror the optimal tax consequences in the taxing countries. Avoiding the use of trusts, while anathema to U.S. estate planning lawyers, may often be necessary to avoid unfortunate foreign tax results as long as the tax laws of the other country apply.

3. Even in countries without estate taxes, such as Canada, U.S.-style gifts to trusts, rather than outright gifts, may cause income tax issues. For example, a U.S. citizen who resides in the United States is generally subject to Canadian capital gains tax when he or she transfers appreciated Canadian real estate to a trust. Furthermore, the trust will be deemed to have disposed of the property for Canadian capital gains tax purposes every 21 years, absent some intervening taxable event with respect to the property.

4. In this situation, a lawyer generally should consult with lawyers and tax advisers in the other country to determine the most appropriate way to prepare the client's estate planning documents during this interim period until the U.S. tax system alone applies to the decedent's estate.

VII. U.S. Gift and Estate Tax Issues

A. *Introduction*

1. A U.S. citizen's worldwide estate is subject to U.S. estate tax on his or her death. If the decedent's estate includes property located in or connected to a foreign country, the decedent's estate tax return will include that property and the estate will pay tax on the property.

2. This simple rule of inclusion raises a considerable number of U.S. estate tax issues. While the most obvious might seem to be double taxation, there are a number of other tricky issues with which to contend.

3. This section of the outline discusses some of the important federal estate tax issues that may come up for clients who own foreign property.

B. *Identification and Description of Foreign Property*

1. All descriptions of property on a federal estate tax return, of course, must be in English. Thus, the executor must obtain translations of relevant documents that will be included with the federal estate tax return. This may present issues when attempting to translate legal descriptions of real property located in another country.

2. All values reported on a federal estate tax return must be in U.S. currency, even for foreign financial assets. The exchange rate to use is the "commercial (or retail) exchange rate, stated in United States dollars, established by the United States financial centers on the valuation date." P.L.R. 8927038 (involving valuation of bank accounts, time deposits, retirement accounts, and other financial accounts in Canada). The "buy" rate is not an appropriate rate to use in these computations. If the decedent died on a weekend day, the executor must use a weighted average of commercial exchange rates based on the principles of Treas. Reg. § 20.2031-2(b)(2).

3. A decrease in the U.S. dollar against the relevant foreign currency between the date of death and the alternate valuation date may make an alternate valuation date election available even if the foreign assets have not been reduced in value using the local currency as a measurement.

C. *Valuation of Foreign Property*

1. Neither the Code nor the Treasury Regulations have any special rules for valuing foreign property. Accordingly, the general fair market value standard of value applies for all of a decedent's foreign property. *See generally* Treas. Reg. § 20.2031-1(b).

2. If a decedent owned real estate located in a foreign country, the decedent's executor should obtain an appraisal of the real estate by an appraiser or other expert in that country, and the appraiser or other expert should use U.S. principles in determining fair market value. *See, e.g., Estate of Proios v. Commissioner,* T.C. Memo. 1994-442, 68 T.C.M. 645 (1994)(Greek real estate valued by an expert who had particular experience with the real estate market in Piraeus).

3. If a decedent owned shares traded on a foreign stock exchange, the executor should follow the general principles in Treas. Reg. § 20.2031-3 in determining the value of the shares. The internet and its multitude of web sites devoted to financial matters have made this task considerably easier than it used to be.

4. If the decedent owned an interest in a closely held foreign company, the executor will have to determine the fair market value of the interest in a manner consistent with Treas. Reg. § 20.2031-3 and Rev. Rul. 59-60, 1959-1 C.B. 237. Absent actual sales of similar interests in the same company, an appraisal will be necessary. The appraiser or other expert should use market data from the foreign country to determine the fair market value of the company interests. The Tax Court's memorandum decision in *Estate of Schneider-Paas v. Commissioner,* T.C. Memo. 1969-21, 28 T.C.M. 81 (1969), demonstrates the complexities of valuing a decedent's shares in a foreign corporation, in that case a German corporation. The court took 40 pages to describe the complicated evidence of valuation, which included testimony of experts who were familiar with the German

securities. The court acknowledged that deciding the case was difficult because not only did it involve the valuation of a closely-held company, it was a German company at that: "In addition to the problems that must be considered in valuing the shares of a closely held American corporation, consideration in this case must be given to the fact that the shares to be valued are of a German company." 28 T.C.M. at 85.

5. One issue that used to regularly come up in estate tax cases was the valuation of foreign currency that was subject to exchange controls, such as currency located in occupied European countries during the Second World War. In such a case, the estate tax value of the currency must reflect restrictions imposed by exchange controls and similar rules. In spite of exchange controls, there is usually a commercial market for restricted currency; the rate used in that market controls. *See, e.g., Estate of Fokker v. Commissioner,* 10 T.C. 1225 (1948)(involving Dutch guilders); *Landau v. Commissioner,* 7 T.C. 12 (1946)(involving South African pounds). Courts have applied similar rules to valuing blocked securities. *E.g., Estate of Nienhuys v. Commissioner,* 17 T.C. 1149 (1952)(property located in the Netherlands during the Second World War); *Estate of Fry v. Commissioner,* 9 T.C. 503 (1947)(shares in a British corporation that could not be transferred outside of the United Kingdom). These issues still come up today because some countries still have exchange controls, including South Africa and Brazil.

D. *Avoiding Double Taxation of Foreign Wealth Transfer Taxes*

1. Introduction

a. The estate of a U.S. citizen or resident decedent may face double death taxes on account of the decedent's ownership of property in a foreign country. In some situations, however, either a tax treaty or the IRC § 2014 credit for foreign death taxes may alleviate double taxation.

b. The United States has estate tax treaties with the following countries: Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Sweden, Switzerland, and the United Kingdom. The newer U.S. estate tax treaties (Austria, Denmark, France, Germany, the Netherlands, Sweden, and the United Kingdom) (the "OECD Treaties") are based more or less on the OECD Model Estate Tax Treaty. All but one of the older treaties (Australia, Finland, Greece, Ireland, Italy, Japan, Norway, South Africa) on the other hand, emphasize the situs of property. The two kinds of treaties are considerably different in how they apply to estates of U.S. citizen decedents. The Switzerland treaty does not fit within either category.

2. OECD Treaties

a. The OECD treaties generally provide that the country in which the decedent is not domiciled (determined under the treaty rules) can tax only certain items of property with a connection to that country. *See* 1982 OECD Model Estate, Inheritance, and Gift Tax Convention, Articles 5 and 6. The OECD treaties allow the country of domicile to tax all the other items of property passing on the decedent's death. If the country of domicile also taxes the property located in the other country, the country of domicile must generally provide a credit against that country's tax for the situs country's tax. *Id.* Article 7. The United States, for example, generally reserves the right to tax estates of its citizens as if the treaty was not in force. *E.g.,* Convention Between the United States of America and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of fiscal Evasion with Respect to Taxes on Estates, Inheritances, Gifts, and Generation-Skipping Transfers, TIAS 10570, Article 9(1). If a country can tax on the basis of situs under the treaty and the United States can tax on the basis of citizenship, the United States must allow a credit for the foreign death taxes. *E.g., id.,* Article 9(2).

b. The OECD treaties generally provide that the nondomiciliary country has primary taxing authority over the following items of property of a decedent's estate:

(i) Real property located in the nondomiciliary country; and

(ii) Business property of a permanent establishment located in the nondomiciliary country.

c. Some of the OECD treaties give the nondomiciliary country primary taxing authority over other items of property with a connection to that country.

(i) The Germany treaty allows the nondomiciliary country to tax the decedent's interests in partnerships that do business in that country. Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with respect to Taxes on Estates, Inheritances, and Gifts, TIAS 11082, Article 8.

(ii) The France treaty allows the nondomiciliary country to tax the decedent's interests in tangible movable property other than currency located in that country. Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Estates, Inheritances, and Gifts, TIAS 9812, Article 7(1). The situs country, however, cannot tax tangible movable property "used for... normal personal use" of a decedent or his or her family; only the domiciliary country may tax that property. *Id.,* Article 7(2).

(iii) The 2004 protocol to the France treaty gives the United States and France primary taxing rights over partnerships and other pass through entities that own business assets in their respective countries. The protocol also adopted a special rule that treats shares of stock in companies that own French real estate as French situs assets under some circumstances. *See generally* Protocol Amending the Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Estates, Inheritances, and Gifts, Signed at Washington on November 24, 1978. The protocol entered into effect on December 21, 2006.

d. The OECD treaties use two principal mechanisms to avoid double taxation.

(i) The first mechanism is an exemption from tax.

(a) Under the OECD treaties, all items of a decedent's property other than those specifically "allocated" to the nondomiciliary country are subject to wealth transfer tax *only in the decedent's country of domicile.*

(b) This rule can provide a substantial exclusion from foreign death taxes on foreign assets owned by U.S. citizens and residents that would otherwise be subject to inheritance tax or estate tax in the foreign country.

(c) For example, a U.S. citizen who resides in the United States will be subject to U.K. inheritance tax only on his or her U.K. real estate and some business assets, but not his or her shares in U.K. companies or debts of U.K. persons, including nonqualified deferred compensation promises from U.K. companies. *See* Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Estates of Deceased Persons and on Gifts, TIAS 9580, Articles 5-7.

(ii) The other principal mechanism used by the OECD treaties to avoid double taxation is a credit against tax.

(a) Under the OECD treaties, the decedent's country of domicile must give the decedent's estate a credit against its tax for the foreign estate or inheritance tax paid by the decedent on property located in the other country that that country is permitted to tax under the treaty.

(b) Continuing the above example, when a U.S. citizen and resident owns U.K. real property, the United Kingdom may impose its inheritance tax on that property. *Id.,* Articles 5(1)(a), 6(1). The United States may also impose its federal estate tax on the value of the property by virtue of the decedent's U.S. citizenship. The IRS, however, must give the estate a credit against the federal estate tax for the U.K. inheritance tax. *Id.,* Article 9(1)(a). Thus, the estate will pay the higher of the two taxes, which at this point is the U.S. federal estate tax, taking the relative exemptions from the federal estate tax and the U.K. inheritance tax into account.

(c) Some OECD treaties, however, effectively incorporate the second limitation of the IRC § 2014 credit for foreign death taxes, which means that the credit against the U.S. tax cannot exceed the ratio that the French property bears to the gross estate less the charitable deduction and the marital deduction. For example, the Technical Explanation of the 2004 Protocol to the United States - France Estate Tax Treaty in its discussion of the credit allowable against federal estate tax for French inheritance tax describes how this limitation works:

Under paragraph 2(b)(iii), notwithstanding the provisions of paragraph 2(b)(i) and (ii), the total amount of all credits allowed by the United States pursuant to Article 12 or pursuant to its own laws or other conventions with respect to all property in respect of which a foreign tax credit is allowable under paragraph 2(b)(i) and (ii) (French property) is not to exceed that part of the United States tax which is attributable to such property. The part of the tax deemed to be so attributable is to be determined in accordance with the principles of section 2014(b)(2) of the Code and section 20.2014-3 of the Estate Tax Regulations.

3. Situs Treaty Countries

a. The "situs" treaties (Australia, Finland, Greece, Ireland, Italy, Japan, Norway, and South Africa) generally provide that the following items will have a situs in a foreign country:

(i) Real property located in the foreign country

(ii) Tangible personal property located in the foreign country with an "in transit" exception. Ships and aircraft generally have a situs in the country of registration.

(iii) Shares of stock in corporations organized in the relevant foreign country.

b. The treaties vary with respect to the situs rules for:

(i) Debts of foreign obligors.

(ii) Deposits in bank accounts in treaty countries

c. Even if property has a foreign situs under the treaty, the foreign country may not tax the property under its domestic law. If so, the treaty provision that gives the country the right to tax the property is irrelevant.

d. The situs treaties' principal mechanism for the avoidance of double taxation is a credit against the U.S. federal estate tax for death taxes paid to the situs country on property deemed located in the situs country under the treaty. A credit against the federal estate tax arises when the other country taxes an asset based on its situs and the U.S. taxes the asset based on the decedent's citizenship. In effect the decedent's estate will pay the higher of the two taxes on the property in question. In contrast to the OECD treaties, the situs treaties do not offer blanket exemptions from tax for certain classes of property.

4. Special Treaty Issues

a. Australia

(i) The United States and Australia entered into a situs style estate tax treaty in 1953. Convention Between the Government of the United States of America and the Government of the Commonwealth of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on the Estates of Deceased Persons, TIAS 2903. Australia, however, repealed its estate tax in 1979. The treaty is not important to U.S. citizens who own Australian property because Australia does not have an estate tax.

(ii) The United States - Australia estate tax treaty, however, remains in force. *See* Treaties in Force - - January 1, 2005 (U.S. Department of State) (noting that the Australia Treaty is in force).

(iii) The Australia treaty has situs rules similar to the other situs treaties, except that the treaty does not have a situs rule for corporate shares. The situs rules in the Australia treaty are quite similar to the rules under the Internal Revenue Code, so the treaty rules do not really change the property of an Australian resident decedent's estate that the United States can tax compared to U.S. domestic law. The primary benefit of the Australia treaty for estates of Australian-domiciled decedents is the pro rata credit against U.S. federal estate tax.

b. Sweden

(i) The United States and Sweden entered into an OECD-style estate tax treaty in 1983. Convention Between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Estates, Inheritances, and Gifts, TIAS 10826. Sweden, however, repealed its inheritance tax effective January 1, 2005.

(ii) The Sweden treaty is still in force. Article 15 of the Sweden treaty provides that either country may terminate the treaty with six months' notice to the other party through normal diplomatic channels. As of the date of this outline, neither country has given notice that it wishes to terminate the treaty. A review of the Department of State's "Treaties in Force - January 1, 2005" posted on the Department's web site shows the Sweden treaty is in force.

c. Switzerland

(i) While the United States has an estate tax treaty with Switzerland, that treaty - alone among the U.S. estate tax treaties -- does not have any rules governing the situs of property for estate tax purposes. *See generally* Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Estates and Inheritances, TIAS 2316. The treaty takes this approach because inheritance taxes differ among the Swiss cantons. Thus, a comprehensive treaty was not practicable.

(ii) Under the treaty, the rules of the Internal Revenue Code apply to determine which assets of a Swiss-domiciled decedent's gross estate are situated in the United States Conversely, the situs rules of the various Swiss cantons determine what items of property of a U.S. decedent's estate will be subject to cantonal inheritance tax. To the extent that a Swiss canton imposes an inheritance tax on the estate of a U.S. decedent, the United States must allow a credit against the federal estate tax for the cantonal tax.

d. Canada

(i) The United States and Canada entered into an estate tax treaty in 1961. Convention Between the Government of the United States of America and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on the Estates of Deceased Persons, TIAS 4995 (the "1961 Treaty"). Canada, however, repealed its estate tax in 1972.

(ii) The 1961 Treaty, however, remained in force until December 31, 1984, when Canada and the U.S. agreed to terminate the treaty. *See* Convention Between The United States of America and Canada with respect to Taxes on Income and on Capital (1980) (the "1980 Treaty"), TIAS 11087, Article 30(8) (terminating the 1961 Treaty). The reason that the 1961 Treaty continued to apply was that neither Canada nor the U.S. acted to terminate the 1961 Treaty in accordance with its provisions.

(iii) Following the termination of the 1961 Treaty, the IRS and the courts took the position that the Canadian capital gains tax at death did not qualify as a "foreign death tax" for purposes of the IRC § 2014 foreign death tax credit. *E.g., Estate of Ballard v. Commission,* 85 T.C. 300 (1985); Rev. Rul. 82-82, 1982-1 C.B. 127. Thus, the estate of a U.S. decedent could pay federal estate tax and Canadian capital gains tax on certain appreciated Canadian assets.

(iv) In 1995 Canada and the United States adopted a protocol to the 1980 Treaty that attempted to solve the double taxation problem. *See generally* Protocol Amending the Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, as Amended by the Protocols signed on June 14, 1983 and March 28, 1984 (the "Protocol").

(v) The Protocol, in connection with other parts of the treaty, offers some important benefits for estates of U.S. citizens and residents who own property subject to Canadian income tax. For example, some deemed dispositions at death that would be taxed under Canadian domestic federal tax law are not taxable to U.S. taxpayers under the treaty. Under Section 115(1)(b) of the Canadian Income Tax Act gains from the sales or deemed dispositions of the following types of property by a nonresident of Canada are subject to Canadian income tax:

(a) Canadian real property;

(b) Stock in a non-publicly traded Canadian corporation;

(c) Stock in a Canadian publicly traded corporation more than 25 percent of which is owned by the taxpayer, or persons with whom the taxpayer did not deal at arm's length; and

(d) Interests in a partnership 50 percent or more of the value of which is attributable to certain property, primarily Canadian natural resources, timber, and real property.

Under Article 13 of the 1980 treaty, U.S. residents are generally exempt from Canadian capital gain tax on most forms of Canadian property other than real estate held directly by the resident or indirectly, such as through a Canadian corporation, partnership, trust, or estate. Thus, the treaty limits the items of property of a U.S. resident decedent to which the deemed disposition tax will apply on his or her death.

(vi) The estate of a U.S. citizen or resident decedent also may take a credit against the U.S. federal estate tax for any Canadian federal or provincial income taxes imposed at the decedent's death with respect to property situated in Canada. Protocol, Art 19(7). The amount of the credit is subject to the limitations established for the foreign death tax credit of IRC § 2014. Protocol, Art 19(7)(b).

(vii) The Protocol also may allow the estate of a U.S. citizen to defer capital gains tax until the death of the decedent's surviving spouse or common-law partner.

(a) Canadian income tax law allows a Canadian resident surviving spouse or common-law partner and certain Canadian resident testamentary trusts to defer the capital gains tax at death through a roll over. Income Tax Act § 70(6).

(b) The Protocol provides that a United States citizen and his or her spouse may be treated as Canadian residents for purposes of the spousal rollover from Canadian income tax. Protocol, Art 19(5). Accordingly, a U.S. resident's transfer of Canadian property at death to his or her non-Canadian resident surviving spouse is eligible for a rollover.

(c) Spousal rollover treatment is also available for a U.S. resident's transfer of Canadian property to a qualifying testamentary marital trust under Income Tax Act § 70(6)(b) for a non-Canadian resident surviving spouse. Protocol, Art 19(5). Income Tax Act § 70(6)(b) provides that a trust will be "qualified" for a rollover if:

(1) the trust was created by the taxpayer's will;

(2) the taxpayer's spouse or common law partner is entitled to receive all the income of the trust that arises before the spouse's or common law partner's death; and

(3) no person other than the spouse may, before the spouse's or common law partner's death, may receive or otherwise obtain the use of any of the income or capital of the trust.

Income Tax Act § 70(6)(b) also provides that the qualifying testamentary trust must be a resident of Canada "immediately after the time the property vested indefeasibly in the trust." The Protocol, however, deems a U.S. resident trust to be a Canadian resident trust for purposes of Article 19(5). The purpose of this provision is to allow transfers of Canadian property by U.S. residents (citizens and noncitizens) to qualified domestic trusts and other trusts that qualify for the federal estate tax marital deduction as transfers to qualifying spousal rollover trusts. The exemption for a U.S. resident trust, however, will be allowed only if the Canadian authorities treat the trust as a Canadian resident trust. The Protocol, however, provides no standards for the Canadian authorities to apply when considering whether a U.S. resident trust should be treated as a Canadian resident trust. As a result, it is unclear when a U.S. trust may be deemed a Canadian resident trust for purposes of this rule. One commentator suggested that Canada might agree to treat the trust as a Canadian resident trust if the trustee posts adequate security for the payment of Canadian tax when due. Wolfe D. Goodman, "Cross-Border Estate Planning: The Canada-United States Income Tax Convention," Probate & Property, 45, 48 (July/August, 1996).

5. IRC § 2014 Credit

a. IRC § 2014 allows the estate of a U.S. citizen or resident to claim a credit against federal estate tax for foreign death taxes actually paid to another country with respect to property located in that country. The credit specifically applies to death taxes substantially equivalent to an estate, inheritance, legacy, or succession tax. Rev Rul 82-82, 1982-1 CB 127. In other words, the credit is available for those taxes imposed on the value of property transferred from a decedent to a beneficiary.

b. No credit is allowed under IRC § 2014 if the property in question subject to death tax in another country is located outside of that country under the principles of IRC § 2104 and § 2105. Thus, if a U.S. citizen's estate includes money on deposit in a Spanish bank, Spanish inheritance tax on the money would be eligible for the IRC § 2014 credit because the money would be deemed to have a situs in Spain under IRC § 2104. *Estate of Schwartz v. Commissioner,* 83 T.C. 943 (1984), *acq.* 1986-2 C.B. 1. *See also Riccio v. United States,* 71-2 U.S.T.C. P 12,801 (D.P.R. 1971). *But see Borne v. United States,* 83-2 U.S.T.C. P 13,536 (N.D. Ind. 1983)(reaching a conclusion opposite the conclusion in *Estate of Schwartz* with respect to a credit against federal estate tax for Ontario death taxes on money on deposit in a Canadian bank included in the estate of a U.S. citizen decedent who resided in Canada).

c. The IRC § 2014 credit for foreign death taxes is subject to two limitations.

(i) The tax credit is limited to the product of (a) the foreign death tax paid and (b) the ratio of foreign property included in the gross estate to the value of all foreign property subject to tax. This limitation has the effect of limiting the credit to the foreign tax attributable to property that is subject to both foreign and U.S. tax. For purposes of this calculation, the estate must use U.S. dollars based on the exchange rate at the time of the tax payment. Treas. Reg. § 20.2014-2(a); Rev. Rul. 75-439, 1975-2 C.B. 359.

(ii) The second limitation is the product of (a) the federal estate tax less the applicable credit and (b) the ratio of the value of foreign property subject to tax and included in the decedent's gross estate to the adjusted value of the decedent's entire gross estate. This calculation uses federal estate tax values of the foreign property.

d. An estate may choose to utilize a treaty credit or the foreign death tax credit, whichever produces a better result for the estate (usually the treaty). If the estate elects to proceed under a treaty, it must disclose its reliance on the treaty to the IRS on the federal estate tax return by filing an IRS Form 8833, which discloses information to the IRS about the treaty-based position taken by the estate. IRC § 6114; Treas. Reg. § 301.6114-1(d)(1). Failure to disclose the position may result in a $ 1,000 fine.

e. An estate must file an IRS Form 706-CE with the IRS to claim an IRC § 2014 foreign tax credit or a foreign tax credit under an estate tax treaty. The instructions to the form direct the executor to ask that a foreign tax official certify the form. If a foreign official will not certify the form, the executor must explain why the foreign government did not certify the form.

VIII. U.S. Income Tax Issues for Clients Who Own Foreign Property

A. *Introduction*

1. If a U.S. citizen or resident client knows that he or she will receive a gift or bequest from a nonresident alien, careful advance planning can permit tremendous U.S. tax savings.

2. A nonresident alien of the United States is subject to limited federal gift and estate taxation. In particular, a nonresident alien is not subject to gift tax on gifts of intangible property. Thus, a nonresident alien can often theoretically make gifts to long term or perpetual trusts for the benefit of U.S. citizens and residents with the imposition of little or no U.S. gift or estate tax. Furthermore, to the extent that a nonresident alien makes a gift

or bequest to a trust that is not subject to U.S. gift tax or estate tax, then the trust will be GST exempt. The end result is a long term or perpetual GST exempt trust for the benefit of U.S. beneficiaries. U.S. citizens and residents no longer can create these kinds of trusts but nonresident aliens can. In the right circumstances, this presents a blockbuster estate planning opportunity.

3. The inheritance of property from overseas may involve a lot of wealth transfer tax savings, but it may generate numerous income tax issues for U.S. citizen and resident recipients. The tax issues have two dimensions. One dimension is the substantive income tax rules; there are many basic and complicated income tax rules for U.S. taxpayers who own foreign property. The other dimension is compliance; U.S. taxpayers who own foreign property, whether it generates income or not, often have greater compliance burdens than U.S. taxpayers who own only U.S. property.

4. The substantive income tax rules and compliance rules for U.S. clients who own foreign property can often be more complicated and more onerous than the rules and compliance obligations related to domestic investments. Clients may or may not be aware of all of their obligations. The client's professional advisers can be of great assistance in making sure that the client understands his or her tax and reporting obligations and that the client follows the rules.

B. *Reporting Worldwide Income*

1. A basic principle of U.S. income tax law is that a U.S. citizen or resident is subject to U.S. federal income tax on his or her worldwide income. Such a citizen or resident must report all of his or her income on his or her U.S. individual income tax return

2. A basic assumption of this outline is that your client tells you that he or she has foreign property. One of the first questions to ask in response is whether the client reports the income, if any, and whether the clients are filing the proper informational returns with the IRS.

3. Clients vary in their response to the question of whether they are reporting their foreign source income to the IRS. Clients usually instinctively know that they must pay U.S. income tax on their worldwide income. Sometimes, however, clients fool themselves into thinking that because the property is overseas, they do not need to pay tax on its income, particularly if the income is not brought in to the United States. Other clients may be outright tax cheats. Still other clients have heard that it is possible to avoid U.S. income taxes through the use of foreign corporations and foreign trusts and figure that they should be able to do so too. The opportunities to defer or eliminate U.S. income tax on foreign source income, however, are few and far between.

4. It can be helpful for a U.S. tax adviser to raise the tax and compliance issues with the client from the start. If the client has been taking a *laissez*

faire attitude towards U.S. tax payments, the situation will probably not improve for the client. Furthermore, the lawyer or other tax adviser will be able to quickly judge the quality of the client based on his or responses to questions about U.S. tax compliance.

C. *Disclosing Signature Authority Over Foreign Financial Accounts*

1. Federal law requires each U.S. citizen or resident to keep records of transactions and relationships with foreign financial agencies. 31 U.S.C. 5314(a). The purpose of this legislation is to give the government information that it can use "in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism." 31 U.S.C. 5311.

2. A U.S. taxpayer must report financial accounts maintained in a foreign country in which he or she has an interest or over which he or she has signature authority on TD Form 90.22-1 if the value of the assets in all such financial accounts exceeds $ 10,000. The form must be filed for a calendar year by June 30 of the succeeding calendar year. For purposes of the form, financial accounts in Guam, Puerto Rico, and the U.S. Virgin Islands are not considered to be foreign.

3. The Instructions to Form 90.22-1 describe "financial accounts" quite broadly:

> [A]ny bank, securities, securities derivatives or other financial instruments accounts. Such accounts generally also encompass any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund. The term also means any savings, demand, checking, deposit, time deposit, or any other account maintained with a financial institution or other person engaged in the business of a financial institution.

4. A U.S. taxpayer must file Form 90.22-1 if he or she has signature authority over or an interest of the following kinds in a foreign financial account:

a. An account that he or she maintained for his or her own benefit or for the benefit of another person.

b. An account of which he or she was a joint owner.

c. An account that another person maintains as an agent, attorney, nominee, or a similar capacity for a U.S. taxpayer

d. An account maintained by a corporation if the U.S. person owns more than 50% of the stock by value.

e. An account maintained by a partnership in which the U.S. person owns more than 50% of the profits, which the instructions refer to as the "distributive share of the income."

f. An account maintained by a trust if the U.S. taxpayer has a present beneficial interest in more than 50% of the assets or receives more than 50% of the income from the trust. The Instructions to Form 90.22-1, not surprisingly, misapprehend the nature of a trust. A trust is a relationship and cannot hold legal title. The trustee of the trust holds legal title. But we know what the government means.

5. The Instructions to Form 90.22-1 provide that a failure to file results in penalties pursuant to 31 U.S.C. 5322(a), (b), and 18 U.S.C. 1001. Section 1001 is a statute that generally criminalizes fraud in connections with statements to the U.S. government. Section 5322(a) states that a person who "willfully violates" any part of Title 31 or a regulation promulgated under Section 5322 "shall be fined for not more than $ 250,000, or imprisoned for not more than five years, or both." Section 5322(b) simply steps up the penalty when the statute is willfully violated "while violating another law of the United States or as a part of a pattern of any illegal activity..." *Id.* In addition, 31 U.S.C. 5321 indicates that a person may face civil penalties for failing to file Form 90.22-1, including a penalty of up to $ 10,000 without regard to whether the failure to file was willful. The government can waive the penalty if the person who failed to file the form reported the income from the foreign account or his or her income tax return and demonstrates reasonable cause for failure to file. *See* 31 USC 5321(a)(5).

D. *Ownership of Shares in Foreign Corporations*

1. Clients who own shares in publicly traded foreign operating companies usually do not have significant U.S. federal income tax issues.

a. If the corporation pays dividends, the country of residence is likely to collect an income tax on the dividends through withholding at the source. If the United States has an income tax treaty with the country that withheld the tax, the rate of withholding may be less than it would otherwise be under the domestic tax law of that country. The client should be able to take a tax credit against his or her federal income tax for the withheld foreign taxes.

b. If the foreign corporation is a "qualified foreign corporation" dividends paid by the corporation to a U.S. shareholder will qualify for the 15% federal income tax rate on dividends. A corporation will be a qualified foreign corporation if its shares are readily tradable on an established U.S. securities market. IRC § 1(h)(11)(C)(ii). A corporation will qualify if ADRs in its shares or the shares themselves are readily tradable. The markets that qualify are the Nasdaq, NYSE, AMEX, Boston Stock Exchange, Chicago Stock Exchange, Philadelphia Stock Exchange, Cincinnati Stock Exchange, and the Pacific Exchange, Inc. IRS Notice 2003-71, 2003- 43 I.R.B. 922. The IRS stated in Notice 2003-71 that the OTC Bulletin Board and the pink sheets did not meet the definition of an established U.S. securities market, although the IRS said it would consider expanding the definition of such a market in the future.

c. If an income tax treaty applies, the client will probably not have to pay capital gains tax, if any, in the country of incorporation when the client sells the shares, although the client will have to pay capital gains tax in the United States.

2. Ownership of shares in nonpublicly traded operating corporations can present more complicated issues.

a. U.S. shareholders of nonpublicly traded operating companies that pay dividends will pay foreign taxes through withholding if the country of residence has an income tax. The client should be able to take a foreign tax credit under an income tax treaty or IRC § 901 for the withheld dividends.

b. A corporation will be a "qualified foreign corporation" if the corporation is eligible for the benefits of a comprehensive income tax treaty with the United States. IRC § 1(h)(11)(C)(i)(II). The treaty must also have an information exchange provision. The IRS listed the U.S. income tax treaties that are "comprehensive" for purposes of IRC § 1(h)(11)(C) in Notice 2003-69, 2003-42 I.R.B. 851. Even if the corporation is incorporated within one of these countries, it must still qualify for benefits under the treaty, which is a separate inquiry.

c. Gains from the sale of the shares may or may not be taxed in the country of incorporation; that depends on local law and U.S. income tax treaty provisions, if any. The client will, of course, have to pay U.S. federal income tax on the gain.

d. Under some circumstances a U.S. taxpayer who acquires shares of a foreign corporation or owns a certain percentage of shares in a foreign corporation must file an IRS Form 5471.

(i) A U.S. taxpayer who "controls" a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the corporation must file an IRS Form 5471. *See* IRC § 6038(a)(1); Treas. Reg. § 1.6038-2(a)(2). Such a person is a "Category 4" filer for Form 5471 purposes.

(a) "Control" for IRC § 6038 purposes means ownership of stock that possesses more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the value of shares of all classes of stock in the corporation. IRC § 6038(e)(2); Treas. Reg. § 1.6038-2(b). Note that the corporation in question does not need to be a controlled foreign corporation or "CFC" for U.S. tax purposes. A foreign corporation in which a U.S. taxpayer meets the "control" test of IRC § 6038(e)(2) will be a CFC only if there are one or more U.S. shareholders who control 10% or more of the vote of the corporation. *See* IRC § 951(b). Under IRC § 6038(e)(2), it is possible that a U.S. taxpayer could be deemed to "control" a foreign corporation by owning more than 50% of the value of the shares of the corporation. Unless another U.S. person controls 10% or more of the vote, however, the corporation will not be a CFC.

(b) In determining whether a U.S. taxpayer "controls" a corporation for IRC § 6038 purposes, the constructive ownership rules of IRC § 318(a) apply. Treas. Reg. § 1.6038-2(c).

(c) A putative Category 4 filer is not required to file an IRS Form 5471 if the person is deemed to control a foreign corporation only because he or she is deemed to constructively own shares owned by a nonresident alien. This exception does not apply if the U.S. shareholder directly or indirectly owns any shares of the foreign corporation. Treas. Reg. § 1.6038-2(1).

(d) In addition, a putative Category 4 filer does not have to file Form 5471 if all the following apply:

(1) The U.S. taxpayer does not directly own any shares in the foreign corporation.

(2) The filing requirement arises solely because the U.S. taxpayer constructively owns shares owned by another U.S. taxpayer.

(3) The U.S. person through whom the putative Category 4 filer owns shares files an IRS Form 5471 with all of the required information.

See Treas. Reg. § 1.6038-2(j)(2).

(ii) Under IRC § 6046(a)(1)(B), a U.S. taxpayer must report the acquisition of shares in a foreign corporation to the IRS in these two situations:

(a) When the taxpayer acquires shares in a foreign corporation which, when added to the shares the taxpayer already owns, results in the taxpayer owning 10% or more of the total combined voting power of all classes of stock of the corporation entitled to vote or 10% or more of the total value of the corporation. IRC §§ 6046(a)(1)(B)(i), 6046(a)(2).

(b) When the taxpayer acquires shares in a foreign corporation which, without regard to the shares the taxpayer already owns, results in the taxpayer owning 10% or more of the total combined voting power of all classes of stock of the corporation entitled to vote or 10% or more of the total value of the corporation. IRC §§ 6046(a)(1)(B)(ii), 6046(a)(2).

(iii) The reporting requirement of IRC § 6046(a) applies if the U.S. taxpayer owns stock directly or indirectly. Under IRC § 6046(c), an individual will be deemed to indirectly own shares owned by members of his or her family. "Family" for this purpose means "only brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants." IRC § 6046(c). This family attribution rule does not apply to treat a U.S. person as indirectly owning shares deemed to be indirectly owned by another U.S. member of that person's family. Treas. Reg. § 1.6046-1(i)(2).

(iv) The reporting requirements apparently do not apply if a U.S. person becomes a beneficiary of a foreign trust or foreign estate that owns shares in a foreign corporation. Any reporting requirements related to the acquisition of shares will be postponed until the U.S. taxpayer receives a distribution of shares from such a trust or estate. *See* Treas. Reg. § 1.6046-1(i)(1)(only shares owned by a corporation or partnership will be deemed to be indirectly owned by shareholders or partners; no reference to estates or trusts).

(v) A U.S. taxpayer subject to the reporting requirements is a "Category" 3 filer for IRS Form 5471 purposes. The Instructions to Form 5471 provide that a putative Category 3 filer does not have to file Form 5471 if all the following apply:

(a) The U.S. taxpayer does not directly own any shares in the foreign corporation.

(b) The filing requirement arises solely because the U.S. taxpayer constructively owns shares owned by another U.S. taxpayer.

(c) The U.S. person through whom the putative Category 3 filer owns shares files an IRS Form 5471 with all of the required information.

See Treas. Reg. § 1.6046-1(e)(4)(iii).

3. Clients who own shares in controlled foreign corporations present

additional issues.

a. If a U.S. taxpayer owns shares in a controlled foreign corporation or "CFC," the taxpayer will have special compliance obligations and substantive tax issues as a result of the ownership of those shares. These tax issues may arise when U.S. taxpayer who is the beneficiary of a foreign estate or a foreign trust that owns shares in a foreign corporation.

b. A foreign corporation is a CFC if on any day during its tax year one or more United States shareholders directly, indirectly, or constructively own more than 50% of the total combined voting power of all classes of the foreign corporation's voting stock or more than 50% of the total value of the foreign corporation's stock. IRC § 957(a); Treas. Reg. § 1.957-1(a). For purposes of the CFC rules, a United States shareholder is a "United States person" who "owns . . . or is considered as owning" 10% or more of the total combined voting power of all classes of stock entitled to vote. IRC § 951(b).

c. For a foreign corporation to be a CFC, the following facts must be present:

(i) One or more U.S. taxpayers own 10% or more of the total combined voting power of all classes of stock entitled to vote. IRC § 951(b).

(ii) The 10% U.S. shareholders collectively own more than 50% of the total combined voting power of the corporation's outstanding stock or more than 50% of the total value of the stock of the corporation. IRC § 957(a).

If the answer to both questions is yes, the corporation is a CFC. If the answer is no to either question, the corporation is not a CFC.

d. If the corporation is a CFC, the next step is to determine the extent to which the CFC's U.S. shareholders are currently subject to U.S. income tax on the CFC's Subpart F income. Each 10% U.S. shareholder of a CFC is subject to U.S. income tax on the shareholder's proportionate share of the CFC's "Subpart F" income, which, broadly speaking, is income from the CFC's non-operating or passive assets. IRC § 951(a). *See generally* IRC § 952(a). For this purpose, the shareholder's "proportionate share" of the CFC includes not only the shareholder's voting shares but also the shareholder's nonvoting shares. A U.S. shareholder who owns less than 10% of the voting power of a CFC is not subject to tax on his or her pro rata share of the CFC's Subpart F income even if the shareholder owns more than 10% of the value of the CFC's shares due to his or her ownership of nonvoting shares.

See IRC §§ 951(a), 951(b).

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

(i) Direct ownership by an individual is when the individual owns shares in his or her individual name. IRC § 958(a)(1).

(ii) If a U.S. taxpayer has an interest in a foreign corporation, foreign partnership, foreign estate, or foreign trust that own shares in a foreign corporation, the taxpayer will be deemed to "indirectly" own a proportionate share of the foreign entity's shares in the foreign corporation. IRC § 958(a)(2).

(iii) A U.S. taxpayer will also be deemed to constructively own shares owned by other persons under the constructive ownership rules of IRC § 318(a). IRC § 958(b).

f. The indirect and constructive ownership rules can result in a U.S. beneficiary of a foreign estate or foreign trust being deemed to own shares of a foreign corporation owned by that foreign estate or foreign trust. If so, the U.S. beneficiary may have extra compliance obligations and possibly extra tax obligations.

(i) Under the indirect ownership rule of IRC § 958(a)(2), the determination of a beneficiary's "proportionate interest" in a foreign estate or foreign trust depends on the facts and circumstances of the situation. Treas. Reg. § 1.958-1(c)(2).

(ii) The CFC indirect ownership regulations have one example that addresses beneficiaries of a foreign estate:

Example 4. Among the assets of foreign estate W are Blackacre and a block of stock, consisting of 75 percent of the one class of stock of foreign corporation T. Under the terms of the will governing estate W, Blackacre is left to G, a nonresident alien, for life, remainder to H, a nonresident alien, and the block of stock is left to United States person K. By the application of this section, K is considered to own the 75 percent of the stock of T Corporation, and G and H are not considered to own any of such stock.

Treas. Reg. § 1.958-1(d), Example 4.

(iii) Applying these principles to determine the indirect ownership of a foreign estate's U.S. beneficiaries in shares of a foreign corporation should be relatively straightforward because the facts and circumstances of an estate and its beneficiaries are usually fairly simple. On the death of a decedent, the beneficiaries' interests in the decedent's estate will vest, which would appear to permit the easy application of the indirect ownership test. Thus, if a beneficiary receives a specific gift of CFC shares, he or she should be treated as indirectly owning those shares until the estate distributes the shares to him or her. *See* Treas. Reg. § 1.958-1(d), Example 4. The beneficiaries of the residue of the decedent's estate should similarly be deemed to own the estate's shares in a foreign corporation based on their proportionate interests in the residue. *Id.* Unlike trusts, estates do not raise difficult issues related to apportionment of trust property between income and remainder beneficiaries and the quantification of beneficiaries' rights in discretionary trusts.

(iv) Attributing ownership of a foreign estate's CFC shares to an estate's beneficiaries will be more difficult when the beneficiaries are entitled to a formula pecuniary gift or a fractional share of the estate. Unlike a specific gift of CFC shares or a fixed portion of the residue of an estate, the proportion of an estate attributable to a beneficiary of pecuniary gift or fractional gift may not be determinable until well into the administration of the estate. A pecuniary gift, for example, might abate or might be subject to the payment of estate taxes. Similarly, a gift of a fraction of the residue of an estate may be subject to the payment of specific gifts, pecuniary gifts, and some taxes and expenses. The uncertainties as to amounts, and uncertainties as to funding, at first glance appear to make the application of the indirect ownership rule to a foreign estate a problematic task. In this case, an analogy to the separate share rule of IRC § 663(c) may be the best way to proceed.

(v) In the case of a foreign trust with mandatory income interests, the IRS considers the income beneficiaries as the indirect owners of the foreign trust's stock. *See* Treas. Reg. § 1.958-(d), Example (3). That example, however, ignores the question of whether the income beneficiaries have any control or influence over the shares that the trust owns, casting doubt on the applicability of the example. There are no clear guidelines on when a U.S. beneficiary of a foreign discretionary trust will be deemed to own a proportionate share of such a trust's shares in a foreign corporation.

(vi) Under the constructive ownership rules of IRC § 958(b), stock owned by a foreign trust will be considered to be owned by its beneficiaries in proportion to the beneficiaries' actuarial interests in the trust. IRC § 318(a)(2)(B)(i). If the foreign trust provides for mandatory distributions of income, these rules are easy enough to apply. The constructive ownership rules, however, appear to have little application in the case of beneficial interests in discretionary trusts.

g. Income tax consequences of CFC share ownership

(i) Any U.S. citizen or resident who is a 10% shareholder of a CFC must include a pro-rata share of the CFC's Subpart F income in his or her income whether or not the CFC distributed that income. A U.S. citizen or resident who is an indirect 10% shareholder of a CFC through a foreign estate or trust must also include his or her pro rata share of the CFC's Subpart F income in his or her income whether or not the CFC makes a distribution to the foreign estate or foreign trust and whether or not the estate or trust makes a distribution to the indirect shareholder. Subpart F income is analogous to passive income, such as dividends and interest. *See generally* IRC § 952. When a U.S. taxpayer includes Subpart F income on his or her individual income tax return, the income is effectively taxed as a dividend income that does not qualify for the special 15% federal rate on dividends. This characterization applies regardless of the source of the Subpart F income. A U.S. taxpayer will have Subpart F income only if the corporation has earnings and profits in the relevant calendar year, computed using U.S. tax principles.

(ii) When a CFC has non-Subpart F income, that income is not taxed to a shareholder until it is distributed to a shareholder. The shareholder will pay tax on that distributed income under normal U.S. principles. Most importantly, the distribution will be taxed as a dividend to the shareholder if the corporation has earnings and profits in the year of distribution, but taking any previously taxed Subpart F Income into account. Such a distribution is eligible for the 15% rate on dividends provided that the corporation is a "qualified foreign corporation" under IRC § 1(h)(11)(C). IRS Notice 2004-70, 2004-44 I.R.B. 724, 726.

(iii) If a U.S. shareholder of a CFC sells his or her shares, the gain on the sale will be treated as ordinary income to the extent of the CFC's earnings and profits over the shareholder's holding period. *See generally* IRC § 1248. Recall that in this context, a "U.S. shareholder" is a person who owns 10% or more of the shares of the company either directly or indirectly. *See* IRC § 1248(a)(2)(referring to the direct and indirect ownership rules of IRC § 958(a)). The previous allocation of Subpart F income to the shareholder, however, will have increased his or her basis in the shares, resulting only in the taxation of earnings and profits only once. Furthermore, amounts treated as dividends under IRC § 1248(a) are eligible for the 15% rate on dividends, assuming that the CFC is a "qualified foreign corporation" under IRC § 1(h)(11)(C). *See* IRS Notice 2004-70, 2004-44 I.R.B. 724, 726. The special tax treatment of sales proceeds under IRC § 1248 does not apply to a redemption of shares taxed under IRC § 303. IRC § 1248(g)(1).

h. A U.S. taxpayer who owns more than 10% of the total combined voting power of a CFC must file a Form 5471 if he or she owned that 10% or more of the shares for an uninterrupted period of more than 30 days during the tax year of the CFC or owned that 10% or more of the shares on the last day of the CFC's tax year. *See* IRC § 6038(a)(4)(giving the IRS authority to require a 10% shareholder to file an informational return).

(i) The IRS used the authority given to it by Congress to require a 10% shareholder to file a Form 5471 simply by instructing a shareholder to do so on Form 5471. The IRS did not promulgate regulations requiring such a filing. A 10% shareholder of a CFC is a Category 5 filer.

(ii) A U.S. taxpayer is required to file a Form 5471 as a Category 5 filer if he or she directly, indirectly, or constructively owns 10% or more of the total combined voting power of all classes of stock of a CFC entitled to vote. *See* IRC § 951(b)(defining a "U.S." shareholder for purposes of Subpart F). If, however, the U.S. person does not directly or indirectly own any shares of the CFC, but only constructively owns shares through a nonresident alien, that U.S. person is not required to file a Form 5471.

(iii) Just because a U.S. taxpayer must file a Form 5471 does not mean that he or she will be taxable on a share of the CFC's Subpart F income. If the U.S. person does not own any shares directly or indirectly, but only constructively, he or she will not be liable for a pro rata share of the CFC's Subpart F income. *See* Instructions to IRS Form 5471 at 3. *See also* Treas. Reg. § 1.6038-2(1)(similar rule for a Category 4 filer). *See generally* IRC § 951.

4. Clients who own shares in passive foreign investment companies also have issues.

a. A foreign corporation with a lot of passive investments and income may be passive foreign investment company or "PFIC", which means a special tax regime will apply when distributions to the shareholder are made from the company. Unlike the CFC rules, there are no minimum ownership requirements for the PFIC tax regime to apply.

b. What is a PFIC?

(i) A PFIC is a foreign corporation that meets one of these tests:

(a) 75% or more of the gross income of the corporation is "passive" income. IRC § 1297(a)(1).

(b) The average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50%. IRC § 1297(a)(2).

(ii) Subject to certain limited exceptions, "passive income" is foreign personal holding company income within the meaning of IRC § 954(c). *See generally* IRC § 1297(b).

(iii) In determining whether a foreign corporation is a PFIC, if a foreign corporation owns at least 25% of the stock of another corporation, then the first corporation will be deemed to own a pro-rata share of the assets of the other corporation and directly received a pro-rata share of the other corporation's income. IRC § 1297(c). This rule effectively permits the use of holding company to own a foreign operating business without that holding company being classified as a PFIC.

(iv) The PFIC regime does not apply to a U.S. taxpayer who is 10% shareholder of a controlled foreign corporation. IRC § 1297(e). Because such a shareholder is currently taxable on her share of the CFC's Subpart F income, it is unnecessary to subject him or her to the PFIC tax regime; the CFC rules accomplish Congress's anti-deferral objectives.

c. Taxation of distributions from a PFIC.

(i) A special tax regime applies when a U.S. shareholder receives a distribution from a PFIC. Unlike the normal rules of U.S. federal corporate income taxation, a PFIC's earnings and profits are often not relevant to the taxation of a PFIC distribution. Rather, the taxation of a PFIC distribution depends on the relative size of the distribution as compared to the PFIC's distributions in prior years, including the years before the corporation became a PFIC.

(ii) Distributions from a PFIC fall into two categories, "excess" and "nonexcess" distributions. An excess distribution is the portion of a distribution from a PFIC that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the three preceding years included in the shareholder's holding period or, if the shareholder's holding period is less than three years, the holding period. IRC § 1291(b)(2)(A). A nonexcess distribution is the part of a distribution that is not an excess distribution.

(iii) The portion of a PFIC distribution that is a nonexcess distribution is taxed to the shareholder based on the general rules of U.S. corporate income taxation, which will usually result in dividend treatment. Prop. Treas. Reg. § 1.1291-2(e)(1). The nonexcess distribution from a PFIC will not qualify for the 15%

rate on qualified foreign dividends because a PFIC by definition is not a "qualified foreign corporation." IRC § 1(h)(11)(C)(iii).

(iv) The portion of a PFIC distribution that is an excess distribution is subject to a special tax regime. The taxpayer must first allocate the distribution pro rata to each day in the shareholder's holding period for the shares. IRC § 1291(a)(1)(A). Whether the PFIC had earnings and profits in those years is irrelevant. The portion of the excess distribution allocated to the current year and the pre-PFIC years is included in the taxpayer's income for the year of receipt as ordinary income. IRC § 1291(a)(1)(B)(i), (ii). Those amounts of the excess distribution are not qualified dividends for federal income tax purposes. *See* IRC § 1(h)(11)(C)(iii) (a foreign corporation that is a PFIC is not a "qualified foreign corporation").

(v) The portion of the excess distribution allocated to other years in the taxpayer's holding period (the "PFIC years") is not included in the shareholder's income. Rather, this portion is subject to a special "deferred tax" that the taxpayer must add to her tax that is otherwise due. *See* IRC § 1291(c). To compute the deferred tax the shareholder must first multiply the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year. IRC § 1291(c)(1). The shareholder then aggregates all the "unpaid" tax amounts for the PFIC years. IRC § 1291(c)(2). The shareholder must then compute interest on those increased tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate. IRC § 1291(c)(3). The taxpayer includes the deferred tax and interest as separate line items on his or her individual income tax return. *See* IRC § 1291(a)(1)(C). The effect of the deferred tax and the interest charge is similar to the throwback rule that applies to accumulation distributions from foreign trusts.

(vi) Tax law treats the sale of PFIC shares as an excess distribution to the extent the proceeds of sale exceed the seller's basis in the PFIC shares. IRC § 1291(a)(2). The effect of these rules is to treat the gain as ordinary income realized ratably over the seller's holding period with deferred tax and interest on the amounts allocated to prior years.

d. Alternate tax regimes for U.S. taxpayers who own interests in PFICs.

(i) Instead of subjecting himself or herself to the excess distribution regime, a U.S. shareholder of a PFIC may make a "qualified electing fund" or "QEF" election for his or her shares. If the shareholder makes this election, he or she must include in his or her gross income a pro rata share of the PFIC's ordinary income and net capital gain for a taxable year. *See generally* IRC § 1293(a). Thus, instead of waiting until the PFIC makes a distribution, the shareholder elects to be taxed currently on the PFIC's earnings and profits. If a shareholder makes this election, however, he or she must have access to the PFIC's books and records so that he or she can determine how to compute their allocable share of the PFIC's income and gains.

(ii) If a U.S. taxpayer acquires shares in a PFIC which are "marketable," the shareholder may make a "mark to market" election for the shares. *See generally* IRC 1296. A PFIC's shares are marketable when the shares are regularly traded as defined in Treas. Reg. § 1.1296-2(b)) on:

(a) A national securities exchange that is registered with the Securities and Exchange Commission (SEC);

(b) The national market system established under section 11A of the Securities and Exchange Act of 1934; or

(c) A foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and has the characteristics described in Regulations section 1.1296-2(c)(1)(ii).

Instructions to IRS Form 8621 (Rev. December 2004) at 2. Under the mark to market regime, the shareholder includes the excess of fair market value of the PFIC shares over his or her adjusted basis in the shares in gross income on an annual basis. The shareholder may adjust his or her basis in the shares for the amount of income subject to inclusion under the mark to market regime.

e. Issues with the application of the excess distribution regime to foreign estate and foreign trusts that own PFIC shares.

(i) The income tax rules related to PFICs are fairly easy to apply to individual U.S. taxpayers. The rules, however, are much more difficult to apply to estates, trusts and their beneficiaries because the concepts used by Congress in the PFIC rules conflict with many of the principles of Subchapter J.

(ii) The IRS did not give any guidance on how to apply to those rules. In sections of the proposed regulations where the IRS intended to address trusts and their beneficiaries, the IRS simply wrote "reserved." Prop. Treas. Reg. §§ 1.1291-2(f)(2)(i), 1.1291-2(f)(ii)(B), 1.1291-3(e)(5)(ii). In light of the lack of any rules on the subject, the preamble to the proposed regulations simply directs the "shareholder" - which could be the estate, trust or beneficiary - to apply the PFIC rules and Subchapter J in a reasonable manner that triggers or preserves the interest charge.

f. Indirect ownership of PFIC shares through foreign estates and foreign trusts.

(i) The PFIC tax regime applies to U.S. taxpayers who directly or indirectly own shares of a PFIC. The direct and indirect ownership rules work together to "find" the first U.S. taxpayer in the ownership chain and subject him or her to the PFIC tax regime on excess distributions. *See* IRC § 1298(a)(3). If a U.S. citizen or resident directly owns shares in a PFIC, he or she will be directly subject to the PFIC tax regime.

(ii) Indirect ownership rules apply when a foreign estate or trust owns PFIC shares. *See* IRC § 1298(a)(3) (shares in a PFIC owned by an estate or trust will be considered as owned "proportionately" by its beneficiaries). In 1992 the IRS issued proposed regulations under what was then IRC § 1297(a)(3). Those regulations, which are still in proposed form, generally provide that a trust beneficiary will be deemed to own a proportionate amount of the stock owned by the trust. Prop. Treas. Reg. § 1.1291-1(b)(8)(iii)(C). The proposed regulations provide that indirect ownership depends on the facts and circumstances in each case, with the substance rather than the form of ownership controlling, taking the purposes of the PFIC rules into account. Prop. Treas. Reg. § 1.1291-1(b)(8)(i) Unlike the CFC rules, the PFIC rules do not rely on the constructive ownership principles of IRC § 318(a) to attribute ownership of PFIC shares from one person to another.

(iii) The proposed regulations did not address how to apply the proportionate ownership rule to estates and trusts and their beneficiaries. In the preamble to the proposed regulations the IRS solicited comments as to "whether different attribution rules, such as the indirect ownership rules in section 25.2701-6 (relating to special valuation rules for purposes of estate and gift taxes), should be adopted for purposes of determining whether a beneficiary of a trust or estate is an indirect shareholder of a PFIC." 1992-1 C.B. 1124, 1125. At least one law firm submitted comments on the attribution rules in the proposed regulations. The IRS, however, has not taken any action to finalize these now 15-year old proposed regulations. Furthermore, the IRS has not issued any public or private rulings on this subject.

(iv) Application of the indirect ownership rules to foreign estates should be fairly straightforward.

(a) There are no proposed regulations under IRC § 1298(a)(3) with respect to foreign estates with U.S. beneficiaries. The CFC indirect ownership rules are probably the closest in spirit to the PFIC rules because both sets of rules seek to discourage and punish U.S. investors' deferral of U.S. income tax by investing in foreign corporations. In fact, the IRS referred to the CFC rules in the proposed PFIC regulations in connection with the facts and circumstances test of indirect ownership. Prop. Treas. Reg. § 1.1291-1(b)(8)(i) ("In applying this paragraph (b)(8), the determination of a person's indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purpose of section 1291. *Cf. section 1.958-1(c)(2)")* (emphasis added). For this reason, the facts and circumstances on which the government relies to apply the CFC indirect ownership rules under IRC § 958(a)(2) are the most useful ones to look to in predicting how the IRS would interpret IRC § 1298(a)(3).

(b) The application of the CFC indirect ownership rules to estates is discussed above on pages 66 and 67. You could take the approach used in the CFC indirect ownership rules with respect to the indirect ownership of PFIC shares of a foreign estate.

(v) Application of the indirect ownership rules to foreign trusts, however, may be more difficult.

(a) Because there are no proposed regulations under the PFIC indirect ownership rules with respect to trusts and their beneficiaries, again the logical place to look for inspiration is the CFC indirect ownership rules for trusts and their beneficiaries.

(b) As discussed above, the CFC trust-beneficiary indirect ownership rules are fairly easy to apply to trusts with mandatory income interests rules are fairly easy to apply. *See* Treas. Reg. § 1.958-(d), Example (3). In a recent technical advice memorandum, TAM 200733024, the IRS stated that it would take the approach described in Example (3) in applying the PFIC indirect ownership rules to foreign trusts with U.S. beneficiaries.

(c) The CFC rules, however, have no clear guidelines on when a U.S. beneficiary of a foreign discretionary trust will be deemed to own a proportionate share of such a trust's shares in a foreign corporation. The logical approach to take in the PFIC area is to focus on the distributions in a year in which the trust received an excess distribution. *See generally* F.S.A. 199952014 (Sept. 23, 1999) (rejecting the use of actuarial values to determine a trust's beneficiary's proportionate ownership of shares owned by a trust). Such an approach should dovetail with the general Subchapter J rules. Under those rules, the current portion of an excess distribution would be included in DNI and carried out to the income beneficiaries. The portion of the excess distribution allocated to previous years, however, cannot by definition be DNI because the portion is not taxable income. That portion will be accounting income, so to the extent that accounting income is distributed to U.S. beneficiaries, those beneficiaries will receive some of that portion of the excess distribution under the character rule. Thus, it makes sense to treat those beneficiaries as picking up a pro rata share of the noncurrent portion of the excess distribution. One difficulty may be if the total distributions do not exceed DNI. In that case you could argue that the distributions to the U.S. beneficiaries are already "full" of the trust's DNI, leaving no portion of the distribution to which to allocate the noncurrent portion of the excess distribution. A recharacterization of the distributions to deem them to include a portion of the noncurrent portion of the excess distribution would address this problem but could also create UNI.

(d) The analogy to the CFC trust indirect ownership rules, however, breaks down when a foreign trust sells PFIC shares. The PFIC tax rules treat a sale of PFIC shares as excess distributions. For trust accounting purposes, however, the gain will be principal. If the trust's income beneficiaries are the indirect owners of the PFIC shares, requiring those beneficiaries to bear the tax on a receipt that they will never receive would be unfair. Furthermore, you have to determine how to compute the beneficiary's deemed holding period for purposes of computing the deferred tax and interest charge. Using the trust's holding period might be a way to do this, but that does not take account of the fact that the trust may never have made distributions to the beneficiary in previous years. By contrast, if a U.S. taxpayer indirectly owned PFIC shares through a foreign partnership or foreign corporation, her holding period would be relatively easy to determine. On the other hand, if foreign trust distributes an excess distribution to a U.S. beneficiary, then the U.S. beneficiary has essentially received the benefit of the deferral of U.S. income tax over the trust's holding period. In TAM 200733024, the IRS took the position that U.S. beneficiaries of a foreign discretionary trust should be deemed to have received an excess distribution when a foreign trust disposed of PFIC shares even though the trust did not make any distributions to those U.S. beneficiaries. The matter involved in the TAM is in IRS Appeals at the moment; a court may have to resolve the matter.

g. Compliance issues for owners of shares in PFICs.

(i) A direct or indirect U.S. shareholder in a PFIC who has not made a QEF election must file an IRS Form 8621 for a year in which the taxpayer receives a distribution from a PFIC or recognizes gain on the disposition of PFIC shares. If a shareholder does not receive a distribution from a PFIC in a given year, the shareholder is not required to file Form 8621 for the year. A shareholder must file a separate Form 8621 for each PFIC.

(ii) A U.S. shareholder of a PFIC who has made a QEF election or mark to market election must file a Form 8621 for each year in which the election is in place.

E. Ownership of Interests in Controlled Foreign Partnerships

1. Extra compliance rules apply to U.S. citizens and residents who "control" foreign partnerships. A U.S. person will be deemed to "control" a foreign partnership if he or she directly or indirectly owns more than a 50% interest in the partnership. Code § 6038(e)(3)(B) describes a 50% interest as either an interest equal to 50% of the capital of the partnership, an interest in 50% of the partnership's profits, or, as provided in regulations, an interest to which 50% of the partnership's deductions or losses are allocated.

2. Even if a U.S. person does not "control" a foreign partnership, he or she may be subject to extra compliance obligations if he or she holds a 10% or greater interest in a foreign partnership that is controlled by U.S. persons who own 10% of greater interests. *See* IRC § 6038(a)(5)(giving the IRS authority to require 10% partners to file an informational return); Treas. Reg. § 1.6038-3(a)(2)(implementing reporting requirements). For purposes of this reporting requirement, "control" by 10% partners means that the 10% partners together own more than a 50% interest in the partnership. *See* IRC § 6038(e)(3)(C)(referring to IRC § 6038(e)(3)(B)); Treas. Reg. § 1.6038-3(b)(1).

3. For purposes of the 10% reporting rules, a 10% interest is an interest equal to 10% of the capital interest in the partnership, an interest equal to 10% of the profits of the partnership, or an interest to which 10% of the partnership's deductions and losses are allocated. Treas. Reg. § 1.6038-3(b)(3).

4. Unlike the CFC and PFIC rules, the controlled foreign partnership reporting rules are not substantive tax rules; they are only compliance rules. Under the general principles of Subchapter K, a U.S. citizen or resident owner of an interest in a foreign partnership must already include his or her share of the foreign partnership's income, gain, loss, and deductions in his or her income.

5. The constructive ownership rules of IRC § 267(c), other than IRC § 267(c)(3), apply to determine when U.S. citizens and residents are deemed to own interests in partnerships for purposes of the IRC § 6038 reporting requirements. Treas. Reg. § 1.6038-3(b)(4).

a. The effect of the constructive ownership rules means that an individual will be deemed to own interests in a foreign partnership owned by members of his or her "family." IRC §

267(c)(2). A member of an individual's "family" for purposes of IRC § 267(c)(2) is the individual's spouse, siblings, ancestors, and descendants. IRC § 267(c)(4).

b. The regulations, however, provide that an interest of a nonresident alien in a foreign partnership will not be attributed to a U.S. member of that alien's family unless that U.S. family member directly or indirectly owns an interest in that partnership. Treas. Reg. § 1.6038-3(b)(4). In other words, a U.S. taxpayer will not be subject to the reporting requirements simply because a nonresident alien member of the taxpayer's family owns an interest in a foreign partnership.

c. A U.S. beneficiary of a foreign trust or foreign estate may be deemed to own a proportionate share of the trust's or estate's interest in a foreign partnership.

(i) Under IRC § 267(c)(1), an interest owned by an estate or trust will be considered as owned proportionately by its beneficiaries. The IRS, however, has not issued any regulations under IRC § 267(c)(1) that explain how to apply the proportionate ownership rule.

(ii) Applying the proportionate ownership rule to an estate should be fairly straightforward as it is in the CFC and PFIC indirect ownership rules, i.e. based on the beneficiaries' proportionate interests in the decedent's estate.

(iii) Applying the proportionate ownership rule to trusts, however, is more difficult due to a lack of guidance from the courts and the IRS. In PLR 9015055, for instance, the IRS ruled that an individual and her children, who were beneficiaries of a trust that owned shares, were deemed to own the shares under IRC § 267(c)(1). The IRS, however, did not discuss how to apportion the shares among the trust beneficiaries. *See also Liflans Corp. v. United States,* 390 F.2d 695 (Ct. Claims 1968) (court concludes that beneficiaries of a trust deemed to own trust's shares under IRC § 267(c) without any discussion of the basis on which the proportionate ownership rules were to be applied); PLR 8128073. About the most we can tell from the cases and rulings is that even contingent interests do count for purposes of IRC § 267(c) but we do not know how to count them. *E.g., Wyly v. United States,* 662 F.2d 397 (5th Cir. 1981); *Widener Trust No. 5 v. Commissioner,* 80 T.C. 304 (1983).

(iv) In *Hickman v. Commissioner,* T.C. Memo. 72-208, 31 T.C.M. 1030 (1972), the Tax Court held that actuarial values cannot be used to apply the proportionate ownership rules for trust beneficiaries under IRC § 267(c)(1). In *Hickman,* the taxpayer challenged the IRS's method of computing proportionate ownership, but failed to convince the court that the IRS was incorrect. The taxpayers first suggested that actuarial values should be used to determine their proportionate interests in the trust's shares, but the court found no support for this approach in the legislation and its history. The court also rejected the taxpayers' suggestion that the value of their interests in the shares owned by the trust was zero because they could not assign their interests in the trust. The court, however, did not describe how the IRS applied the proportionate ownership test other than referring to an IRS conclusion that the taxpayers owned more than 50% of the value of the shares because the taxpayers were the only present beneficiaries of the trust and because the trust had no specifically named remainder beneficiaries.

6. Other reporting requirements related to a U.S. taxpayer's ownership of an interest in a foreign partnership may apply under IRC § 6046A.

a. Under IRC § 6046A a U.S. taxpayer must file an informational return when:

(i) The U.S. person acquires or disposes of an interest in a foreign partnership if the U.S. person either directly or indirectly owns at least a 10% interest in the partnership either before or after the acquisition or disposition. IRC §§ 6046A(a)(1), 6046A(a)(2).

(ii) The U.S. person's proportionate interest in a foreign partnership changes "substantially." This reporting requirement applies only if a change is equivalent to at least a 10% interest in the partnership. IRC § 6046A(a)(3). Under the regulations, a partner's proportional interest in a foreign partnership may change for a number of reasons:

[F]or example, the change may be caused by changes in other partners' interests resulting from a partner withdrawing from the partnership. A proportional change may also occur by operation of the partnership agreement, for example, if the partnership agreement provides that a partner's interest in profits will change on a set date or when the partnership has earned a specified amount of profits and one of those events occurs.

Treas. Reg. § 1.6046A-1(b)(3).

b. Section 6046A relies on the definition of a 10% partnership interest used in IRC § 6038(e)(3)(C).

c. Under IRC § 6046A, reporting of an event is required only when it changes a direct interest that the U.S. taxpayer has in a foreign partnership. The IRC § 6046A reporting requirements do not apply to transactions that involve interests in partnerships that the U.S. person might indirectly own under the principles of IRC § 6038(e)(3)(C). *See* Treas. Reg. § 1.6046A-1(b)(1); Treas. Reg. § 1.6046A-1(b)(7), Example 1.

7. Compliance obligations for owners of interests in controlled foreign partnerships.

a. A U.S. citizen or resident who is required to report information about a controlled foreign partnership does so on IRS Form 8865.

b. A U.S. taxpayer who "controls" a foreign partnership under the 50% test is a Category 1 filer for Form 8865 purposes. A U.S. taxpayer who owns a 10% interest in a controlled foreign partnership is a Category 2 filer. A Category 3 filer is a U.S. person who made a capital contribution to a foreign partnership in a particular year with the result that he or she owned directly or constructively at least a 10% interest in the partnership immediately after the contribution. Category 3 also includes U.S. taxpayers who contributed property with a value of more than $ 100,000 in a 12-month period, without regard to that taxpayer's proportionate ownership. Finally, a Category 4 filer is a U.S. taxpayer who had an event with respect to the partnership that must be reported under IRC § 6046A.

c. In general, any U.S. citizen or resident who owns more than a 10% "controlling" interest in a foreign partnership must file an IRS Form 8865. If, however, the foreign partnership has a U.S. citizen or resident who is a 50% controlling partner, then the 10% partners are not required to file Form 8865. Instead, the government will rely on the Form 8865 filed by the 50% partner to collect the information the government needs.

d. A Category 1 or 2 filer is not required to file a Form 8865 if the partnership itself files an IRS Form 1065 or 1065-B for its tax year. Instead, the Category 1 or 2 filer can use a copy of the partnership's return in lieu of the Form 8865.

F. *Reporting the Receipt of Lifetime Gifts from Nonresident Aliens*

1. A U.S. citizen or resident who receives a gift from a nonresident alien donor is generally not subject to federal income tax on the gift. *See* IRC § 102 (excluding gifts from gross income).

2. A U.S. citizen or income tax resident, however, must report the receipt of a gift from a nonresident alien to the IRS on an IRS Form 3520. *See generally* IRC § 6039F (reporting required for gifts received from a person "other than a United States person" (referring to IRC § 7701(a)(30)). Filing a Form 3520 in and of itself does not give rise to any tax obligations on the

donee.

3. Section 6039F requires a U.S. person to report gifts from nonresident aliens if the aggregate amount of gifts received in a given calendar year exceeds $ 10,000. The IRS, however, increased the minimum reportable amount for aggregate gifts from nonresident alien individuals to $ 100,000 in Notice 97-34, 1997-1 C.B. 422. The IRS left the $ 10,000 minimum amount for gifts from foreign corporations and partnerships, although the $ 10,000 threshold will be adjusted for inflation. In computing the amount of aggregate gifts received from a nonresident alien donor, a U.S. person must aggregate gifts from that donor and persons related to that donor for the calendar year in question.

G. *Taxation of Distributions from a Foreign Estate to a U.S. Beneficiary*

1. Introduction

a. The simplest situation you may run into is when a client is the beneficiary of the estate of a nonresident alien, either by will or by intestate succession.

b. The client's receipt of a bequest or devise of property from a nonresident alien should not be subject to tax by reason of IRC § 102. It is also likely that distributions from the estate will not carry out any DNI to your client if the estate does not have any U.S. source income.

c. In certain situations, a revocable trust used by a deceased nonresident alien as a will substitute may be classified as a foreign estate, thereby bringing the benefits of a foreign estate to a foreign trust, at least for two years.

2. Classifying an Estate as Foreign or Domestic

a. If your client is the beneficiary of an estate administered in a country other than the U.S., that estate will be a foreign estate for U.S. income tax purposes. *See* IRC § 7701(a)(31)(A). It is possible, however, that an estate of a foreign decedent administered in the United States may also be a foreign estate for U.S. federal income tax purposes. If this is the case, the income tax consequences to a beneficiary of the estate are considerably different than if the estate was a domestic estate. Thus, this section of the outline goes through some of the definitional rules related to foreign estates for U.S. federal income tax purposes so you can identify whether your clients may be in this situation.

b. Although IRC § 7701(a)(31)(A) looks like it will define a foreign estate, it does not. Instead, it simply says that a foreign estate is an estate the U.S. source income of which is not effectively connected with a U.S. trade or business is not includable in the estate's gross income under Subtitle A. Congress, in a great demonstration of drafting skill, provided in IRC § 7701(a)(30)(E) that a domestic estate is any estate that is not a foreign estate as defined in IRC § 7701(a)(31). *See generally* Schoenblum, § 22.05[B] at 22-64 (IRC § 7701(a)(31)(A) is "a largely useless definition that begs the question ... In short, the Code has a built in circularity.").

c. The IRS has not promulgated any regulations on the definition of a foreign estate. As a result, the rules for classifying an estate as foreign or domestic have been developed in court decisions and revenue rulings. *See generally id.*

d. The IRS described the important facts and circumstances in the classification of an estate as domestic or foreign in Technical Advice Memorandum 9413005:

(i) the country under whose law the estate was created;

(ii) the residence or citizenship of the decedent;

(iii) the residence or citizenship of the beneficiaries;

(iv) the location of the estate assets;

(v) the residence of the executor; and

(vi) location of the administration of the assets.

The IRS cited *B. W. Jones Trust v. Commissioner,* 46 B.T.A. 531 (1942), *aff'd* 132 F.2d 914 (4th Cir. 1943), as the source of these factors.

e. Among these factors, one of the most important is the decedent's residence. *E.g.,* Rev. Rul. 81-112, 1981- C.B. 598 (estate of U.S. citizen who resided in a foreign country for 20 years before his death was a foreign estate); Rev. Rul. 64-307, 1964-2 C.B. 163 (estate of a U.S. citizen and resident that was administered in a foreign country was not a foreign estate). Thus, you can usually assume that your client is a beneficiary of a foreign estate if the decedent was resident in a country other than the United States.

f. It is possible, however, that the IRS could classify a foreign estate as a foreign trust if the estate has been under administration for a long time and more closely resembles a trust rather than an estate. *See, e.g.,* PLR 9010046 (involving a German estate).

3. U.S. Federal Income Taxation of Distributions from Foreign Estates

a. A foreign estate is a nonresident alien for federal income tax purposes. Thus, it will be subject to U.S. income tax on income with a U.S. source or income effectively connected with a U.S. trade or business. *See, e.g.,* Rev. Rul. 68-621, 1968-2 C.B. 286; Rev. Rul. 62-154, 1962-2 C.B. 148; PLR 8317020.

b. More important, however, is how the principles of Subchapter J apply to distributions from foreign estates to U.S. beneficiaries.

(i) As is the case with a domestic estate, a U.S. beneficiary of a foreign estate must include a pro rata share of the estate's DNI in his or her income when the estate makes a distribution to him or her. *See generally* IRC § 662.

(ii) A foreign estate's distributable net income or "DNI," however, does not include its non-U.S. source income. Section 643(a) generally provides that the DNI or an estate or trust is the trust's taxable income computed with certain modifications. A foreign estate's taxable income for U.S. purposes is only its U.S. source income. Foreign source income, including gains realized on the sale of U.S. intangible assets, would not be part of a foreign estate's taxable income. *E.g.,* PLR 8317020. *See generally* IRC § 872(a). Although IRC § 643(a)(6) provides that a foreign *trust's* gross income includes non-U.S. source income and capital gains, the modification of that section does not apply to foreign estates. Accordingly, a foreign estate's DNI does not include foreign source income, including gains realized from the sale of U.S. intangible assets.

(iii) Because a foreign estate's DNI does not include its foreign source income, a distribution from the estate to a U.S. beneficiary will not carry out any foreign source income to the beneficiary. *See* IRC § 662(a). Thus, the U.S. beneficiary will have taxable income on account of receiving the distribution from the foreign estate only if the estate's DNI includes U.S. source income. *See* Zaritsky, "U.S. Taxation of Foreign Estates, Trusts and Beneficiaries (T.M. Memo. 854) at A-129 ("while there are no cases or rulings on point, a clear reading of the Code and regulations compel this result").

(iv) The accumulation distribution tax or "throwback tax" does not apply to distributions from estates. *See* IRC § 665(b) (defining an accumulation distribution by references to trusts). Thus, a distribution from a foreign estate to a U.S. beneficiary will not attract the throwback tax, even if the foreign estate has accumulated income for a significant time period. It is possible, however, that the IRS may treat a long-term foreign estate as a foreign trust.

c. Certain revocable trusts can elect to be treated as foreign estates under IRC § 645.

(i) If a nonresident alien decedent held property in a revocable trust at his or her death, the trust may be able to make an IRC § 645 election to be treated as part of the nonresident alien's estate for federal income tax purposes. The final regulations under IRC § 645 do not limit the election to domestic trusts and estates. In fact, the IRS acknowledged in the preamble to the final regulations that a foreign trust could make the election as long as the trust was a "qualified revocable trust" or "QRT" within the meaning of IRC § 645(b)(1):

The proposed regulations also provide that a QRT must be a domestic trust under section 7701(a)(30)(E) and that a section 645 election for a QRT must result in a domestic estate under section 7701(a)(30)(D). Several commentators suggested that the section 645 election should also be available in situations in which either the QRT or the related estate, or both, are foreign. According to the commentators, U.S. citizens living abroad frequently use revocable trusts to avoid jurisdictional disputes concerning the decedent's assets, as well as the cumbersome probate and forced heirship rules of several foreign countries. Many of the trusts will be foreign trusts upon the grantor's death and, if a section 645 election is permitted to be made, will become part of a foreign estate. The commentators questioned the authority for the domestic restriction provided in the proposed regulations given that the statute and the legislative history do not explicitly limit the applicability of a section 645 election to domestic trusts and domestic estates. Upon consideration of these comments, the requirements that a QRT be a domestic trust and that the election result in a domestic estate are removed from the final regulations. The IRS and the Treasury Department note, however, that a trust for which a section 645 election is made is treated as an estate for purposes of Subtitle A of the Code, but not for purposes of Subtitle F. Accordingly, information reporting under section 6048 will continue to apply with respect to a foreign trust even though a section 645 election has been made to allow the foreign trust to be taxed as part of an estate for purposes of Subtitle A of the Code.

T.D. 9032, 2003-7 I.R.B. 471. Consistent with this rule, IRS Form 8855, by which the IRC § 645 election is made, allows a foreign estate or foreign trust to make the election.

(ii) To make the election, a revocable trust established by a nonresident alien must have been treated as the owner of the assets of the trust for income tax purposes during his or her lifetime under IRC § 676 by reason of the decedent's retention of a power to revoke the trust. IRC § 645(b)(1). Under IRC § 672(f), however, many revocable trusts settled by nonresident aliens cannot claim grantor trust treatment for U.S. federal income tax purposes. Section 672(f) applies only when one of the other provisions of the Subpart E rules would make a trust a grantor trust. If a nonresident alien establishes a revocable trust that complies with IRC § 676 (without regard to IRC § 672(e)) and also meets the requirements for grantor trust treatment under IRC § 672(f)(2)(A)(i), then the trust should be a qualified revocable trust for IRC § 645 purposes because IRC § 676 applied to treat the trust as a grantor trust; the effect of the trust's compliance with IRC § 672(f)(2)(A)(i) was that IRC § 676 would in fact apply to the trust.

(iii) The benefit of an IRC § 645 election for a revocable trust settled by a nonresident alien is that the trust's non-U.S. source income would not be included in its DNI for the effective period of the election. Thus, when the trust makes distributions to U.S. beneficiaries during that period, the distributions will not carry out any foreign source income to those beneficiaries. Furthermore, because the foreign source income is not includable in the trust's DNI, that income cannot become undistributable net income ("UNI"), which could give rise to a throwback tax if the trustee later makes an accumulation distribution.

(iv) To make the IRC § 645 election, the executor of the decedent's estate, if any, otherwise the trustee of the revocable trust, must file the appropriate forms with the IRS. *See generally* Treas. Reg. § 1.645-1(c). A foreign executor or trustee may be reluctant to file the necessary forms with the IRS if the trust will not have any U.S. source income.

(v) The length of the election will be two years after the date of the decedent's death unless the decedent's estate files an IRS Form 706, in which case the election will continue until six months after the final determination of the federal estate tax in the decedent's estate. If the six-month period concludes sooner than two years after the decedent's date of death, the two-year period applies. *See generally* Treas. Reg. § 1.645-1(f).

4. Compliance Obligations for U.S. Beneficiaries of Foreign Estates.

a. A U.S. citizen or income tax resident who receives a distribution from a foreign estate must report the receipt of a distribution to the IRS on an IRS Form 3520. *See generally* IRC § 6039F (reporting required for bequests received from a person "other than a United States person" (referring to IRC § 7701(a)(30)). Thus, a U.S. beneficiary who receives a bequest from a foreign decedent must report the receipt of the bequest, assuming that the beneficiary treats the distribution as a bequest under IRC § 102.

b. Section 6039F requires a U.S. person to report bequests from nonresident aliens if the aggregate amount of bequests received in a given calendar year exceeds $ 10,000. The IRS, however, increased the minimum reportable amount for aggregate gifts from nonresident alien individuals to gifts that exceed $ 100,000 in IRS Notice 97-34 1997-1 C.B. 422, § VI(B)(1).

c. The penalty for not reporting the receipt of a reportable bequest is 5% of the amount of the bequest for each month that the failure to report continues, subject to a limit of 25% of the total amount of the bequest. IRC § 6039F(c)(1). The IRS may waive the penalty for reasonable cause. IRC § 6039F(c)(2).

d. Section 6039F(b) applies to amounts received from a foreign person that the U.S. recipient treats as a gift or a bequest, which presumably is a reference to IRC § 102. If a foreign estate has no U.S. source income, a distribution from that estate to a U.S. person should be treated as a nontaxable bequest so IRC § 6039F generally requires the beneficiary to report the receipt of the bequest. If, however, the foreign estate had U.S. source income that would be taxable to the beneficiary under IRC § 662(a), the distribution is not technically a bequest from a foreign person to the U.S. person within the meaning of IRC § 102. This raises a question of whether the receipt of such a distribution is reportable under IRC § 6039F. The reporting requirements of IRC § 6048(c) apply only to distributions from foreign trusts.

e. In Notice 97-34 the IRS took the position that IRC § 6039F covered the receipt of a bequest from a foreign person to a U.S. person without addressing whether some or all of the bequest might be taxable under IRC § 662(a). The Instructions to IRS Form 3520 do not address how to report, if at all, a distribution from a foreign estate that the recipient does not treat as a bequest because of the presence of U.S. source income. If, however, a foreign trust that has made an IRC § 645 election makes a distribution to a U.S. person, the IRS takes the position that the distribution is reportable. *See* T.D. 9032, 2003-7 I.R.B. 471 (preamble to final IRC § 645 regulations).

H. *Introduction to Foreign Trust Issues*

1. The Anti-Deferral Regime for Distributions from Foreign Nongrantor Trusts

a. Distributions from foreign trusts to U.S. citizens and U.S.

residents trigger potentially harsh U.S. income tax consequences irritating reporting requirements for the beneficiaries.

b. U.S. tax law generally treats distributions from foreign nongrantor trusts to U.S. beneficiaries in the same way it treats distributions from domestic nongrantor trusts to U.S. beneficiaries. The law takes this approach even though the trust in question is a nonresident alien and may not be subject to the U.S. taxing jurisdiction. To this extent, the rules of Subchapter J are deemed to apply to the foreign trust, rather than to actually apply.

c. Accordingly, applying general principles of Subchapter J, if a distribution from a foreign nongrantor trust would have carried out the trust's DNI to the U.S. beneficiary, then the U.S. beneficiary must include some or all of the trust's income in his or her individual income.

d. There is, however, a practical difficulty in applying this rule: the fiduciary of a foreign trust may not be subject to U.S. tax reporting rules or may not be familiar with those rules. As a result, the U.S. beneficiary may not know the nature and character of the amount she or she received from the trust.

e. In light of this practical difficulty, Congress and the IRS decided to treat all distributions from foreign trusts to U.S. beneficiaries as distributions from nongrantor trusts unless the beneficiary can demonstrate that the distribution was from a grantor trust. *See* IRC § 6048(c)(2).

f. In addition, Congress and the IRS presume that distributions from foreign trusts to U.S. persons are "accumulation distributions" that carry with them not only current income tax but also accumulated income, which could generate a penalty "throwback" tax. IRC § 6048(c)(2). Again, the burden is on the U.S. beneficiary to establish a more favorable tax treatment of the distribution.

g. To implement these rules, Congress and the IRS have imposed numerous reporting requirements for U.S. taxpayers who receive distributions from foreign trusts. The outline discusses those requirements in detail below.

2. Classifying Trusts as Foreign or Domestic

a. A threshold question is whether a trust is a foreign trust or a domestic trust. It is fairly easy for a trust to be a foreign trust. Under IRC § 7701(a)(31), a trust is a foreign trust if it is not a domestic trust. A trust is a domestic trust if (a) a court within the U.S. is able to exercise primary supervision over the administration of the trust and (b) if U.S. persons have the authority to control all substantial decisions of the trust. IRC § 7701(a)(30)(E). *See also* Treas. Reg. § 301.7701-7. Thus, to be classified as a foreign trust, a U.S. court must not be able to exercise primary supervision over the administration of the trust or a non-U.S. person must have authority to control at least one substantial decision related to the trust. If the trust with which you are concerned has a foreign trustee and is administered in a foreign country, that trust is likely to be a foreign trust.

b. The classification of a trust as foreign or domestic does not in and of itself determine the substantive tax rules that apply to the trust, its grantor, and its beneficiaries. Rather, a number of special rules within Subchapter J apply to foreign trusts, so you have to know how to classify the trust in order to determine whether those special rules apply. The classification of a trust as foreign or domestic also determines the compliance rules that apply to the trust, its grantor, and its beneficiaries; the compliance rules that apply to a foreign trust are much more onerous than the rules that apply to a domestic trust.

I. *Taxation of Distributions from Foreign Nongrantor Trusts*

1. A U.S. beneficiary must treat the receipt of any distribution from a foreign trust as a distribution from a nongrantor trust unless the beneficiary can establish that the distribution was from a grantor trust. *See* IRC § 6048(c)(2).

2. A distribution from a foreign nongrantor trust may or may not be taxable to the beneficiary. If the distribution would not carry out DNI to the beneficiary under general principles of IRC § 663(a)(1), then the beneficiary should not incur any taxable income as a result of receiving the distribution. If, however, the distribution does not qualify for the IRC § 663(a)(1) exception, the distribution may trigger income tax for the U.S. beneficiary.

3. If the distribution does not exceed the foreign trust's DNI for the year in question, computed according to the principles of IRC § 643, then the beneficiary will simply include the DNI deemed distributed to him or her on his or her U.S. individual income tax return.

a. Unlike a domestic trust however, a foreign trust's DNI includes the trust's realized capital gains. IRC § 643(a)(6)(c). As a nonresident alien, a foreign nongrantor trust is not subject to U.S. income tax on its capital gains from the sale of U.S. assets, other than U.S. real property interests. The inclusion of the trust's realized capital gains in its DNI, however, will effectively make the trust's capital gains subject to U.S. income tax to the extent the trustee makes a distribution to a U.S. beneficiary.

b. Again, these rules will not have any practical effect on a foreign trust with no U.S. source income or no U.S. taxable income because the trust is a nonresident alien. Rather, Congress placed the tax and the reporting burden on the U.S. beneficiary.

c. Under a special rule, if the trust's fiduciary accounting income exceeds the trust's DNI and the trustee distributes an amount greater than its DNI but less than the trust's accounting income, the beneficiary can treat the excess as a nontaxable distribution. *See* IRC § 665(b); Treas. Reg. § 1.665(b)-1A(c)(2). Recall, however, that the definition of DNI of a foreign trust includes its realized capital gains, so under general fiduciary accounting principles it is unlikely that a distribution of accounting income will exceed a foreign trust's DNI for a year absent a lot of deductible expenses charged to principal.

4. If the distribution from the foreign trust exceeds the trust's DNI or accounting income for the year of distribution, the distribution may be an "accumulation distribution" for U.S. income tax purposes, which triggers the "throwback tax." IRC § 665(b).

a. Although Congress repealed the throwback tax on accumulation distributions from domestic trusts in 1997, the tax still applies to accumulation distributions to U.S. citizens and residents from foreign nongrantor trusts. *See* IRC § 665(c). The purpose of the throwback tax as applied to distributions from foreign nongrantor trusts is to capture the U.S. tax that would have been paid had the trust distributed the accumulated DNI to the U.S. beneficiary on a current basis.

b. An accumulation distribution will occur if a trust has undistributed net income ("UNI"). If a foreign trust has DNI in a given year and the distributions, if any, from the trust do not fully carry out that DNI, the undistributed DNI becomes UNI. As noted above, a foreign trust's DNI includes its realized gains. As a result, a foreign trust that buys and sells investments could have substantial amounts of UNI, which means a later accumulation distribution could be quite large.

c. If a distribution is an accumulation distribution, the U.S. beneficiary must allocate or "throw back" the average amount of UNI for the preceding years in which the trust had UNI to three of the five preceding taxable years. The beneficiary must then compute the average increase in his or her taxes for those three years to which the average amount was thrown back. Finally, the beneficiary multiplies the average increase in tax by the number of preceding years in which the trust had UNI. The product is the throwback tax. Thus, under the accumulation distribution rules, the receipt of an accumulation distribution in effect triggers an income tax for previous years even though the beneficiary may never have received anything from the trust in those prior years.

d. Because the purpose of the throwback tax is to capture unpaid income tax on accumulated income that should have been distributed when it was earned income, the tax bears interest. *See generally* IRC § 668. Before January 1, 1996, the throwback tax bore simple interest at a rate of 6%. In 1996, however, Congress imposed an interest charge on the throwback tax based on the interest rate imposed on underpayments of federal income tax under IRC § 6621(a)(2), which is compounded daily. The law includes a complicated formula to determine the period for which interest is charged using the federal underpayment rate. IRC § 668(a).

e. Many features of the throwback tax enhance its onerous nature when applied to foreign nongrantor trusts.

(i) The throwback tax is computed without regard to whether the UNI was capital gain or ordinary income, which effectively eliminates the benefit of the lower capital gains tax rates for the U.S. beneficiary. *See* IRC § 667(b)(1)(D).

(ii) The throwback tax will apply without regard to how long the beneficiary has been a U.S. taxpayer. Thus, if a Canadian resident moves to the U.S. and obtains a green card, distributions from a foreign trust to the beneficiary will trigger a throwback to prior years in which the trust had UNI even if those years were before the beneficiary moved to the United States. In computing the throwback tax, however, the beneficiary's nonresident alien status will come in to play in the computation of taxes already paid on the UNI and will also affect the interest charge.

f. When a U.S. beneficiary receives a distribution from a foreign trust, the IRS presumes that the distribution is an accumulation distribution and, therefore, is subject to the throwback tax and interest. IRC § 6048(c)(2).

(i) The beneficiary can avoid accumulation distribution treatment by demonstrating to the IRS that the distribution was not an accumulation distribution.

(ii) If the trustee provides the beneficiary with a "Foreign Grantor Trust Beneficiary Statement" the beneficiary can treat the distribution as a gift for U.S. income tax purposes, which is not subject to income tax. IRS Notice 97-34, 1997-1 C.B. 422, § V(B).

(iii) If the beneficiary receives a "Foreign Nongrantor Trust

Beneficiary Statement" that indicates the exact composition of the distribution, then the beneficiary need not rely on the default rule to compute the throwback tax on an accumulation distribution. IRS Notice 97-34, 1997-1, C.B. 422, § V(B). The statement, for instance, may indicate that the distribution did not exceed the trust's DNI or accounting income for the year in question. As noted above, the penalty tax does not apply to a distribution that does not exceed the greater of the trust's DNI or accounting income.

g. If the beneficiary did not receive a Foreign Grantor Trust Statement or a Foreign Nongrantor Trust Statement that indicates that the distribution was not an accumulation distribution, the beneficiary must determine how to compute the throwback tax. The beneficiary, however, may not receive sufficient information from the trustee of the foreign trust to make the computations required under the accumulation distribution rules. In this situation, the government has established a "default" method of computing the throwback tax. The default method generally allocates a distribution in a given year to the current year and the three preceding years, taking prior distributions into account. *See* 2004 Instructions to IRS Form 3520 at pp. 7-8.

h. The U.S. beneficiary will receive a credit for any foreign taxes or U.S. taxes paid on items deemed to be included in an accumulation distribution. *See* IRC §§ 665(a), 665(d). This is consistent with the purpose of the accumulation distribution rule to penalize the distribution of previously untaxed income. If the income in question has been subject to tax, whether foreign or U.S., it would not further the purpose of the accumulation distribution rule to apply the penalty tax to the distribution without taking account of those tax payments.

J. *Foreign Grantor Trust Issues*

1. A foreign trust that is a grantor trust as to a U.S. person must file an annual report of the trust's activities and operations for a calendar year with the IRS. IRC § 6048(b)(1)(A).

2. To comply with the annual reporting requirements, the trust must file an IRS Form 3520-A each calendar year and attach a "Foreign Grantor Trust Statement." The trustee must send a copy of the statement to the U.S. taxpayer owner of the trust and to each beneficiary who received a distribution from the trust in the year in question. The U.S. owner of the trust is responsible for "ensuring" that the trust files the Form 3520-A. IRS Notice 97-34, 1997-1 C.B. 422 § IV(A).

3. The deadline for filing Form 3520-A is the 15th day of the third month following the end of the trust's taxable year. This means that the Form

3520-A must be filed by March 15 of each year, rather than April 15. The trustee must on the same date furnish copies of the Foreign Grantor Trust Statement to the U.S. owner of the trust and the trust beneficiaries who received a distribution from the trust. The March 15 filing date is unfortunate because the logical filing date for a Form 3520-A is the 15th day of the fourth month following the end of the taxable year - April 15.

4. The government can impose a penalty for failing to file Form 3520-A of 5% of the gross value of the trust's assets. IRC § 6677(a).

5. The Instructions to IRS Form 3520 also direct a U.S. owner of the income, gain, and loss of a foreign grantor trust to file an IRS Form 3520 for each year in which the trust is a grantor trust.

a. This filing requirement is in addition to the requirement that the trust file a Form 3520-A for each calendar year. Neither the Code nor Notice 97-34 contemplates this filing requirement, so the IRS appears to have developed this requirement on its own.

b. The requirement that a U.S. owner of a foreign trust file an additional report recognizes the fact that the IRS may not be able to compel the trustee of a foreign trust to file an IRS Form 3520-A. By requiring that a person subject to U.S. jurisdiction file the report, the government is simply covering its bases.

c. The U.S. taxpayer must file the Form 3520 at the same time he or she files his or her individual tax return.

K. *Compliance Issues for Beneficiaries of Foreign Trusts*

1. A beneficiary who receives a distribution from a foreign trust must report the receipt of the distribution to the IRS on Form 3520 in the year of distribution. IRC §§ 6048(c). There is no reporting threshold for distributions from foreign trusts. The beneficiary must file the Form 3520 at the same time he or she files his or her individual income tax return.

2. The reporting requirements apply equally to distributions from foreign grantor trusts and foreign nongrantor trusts. This is true even though a distribution from a grantor trust will be treated as a gift for U.S. income tax purposes and will not carry out DNI or UNI to the trust beneficiary from the foreign trust. IRS Notice 97-34, 1997-1 C.B. 422, § VI(A).

3. As discussed in detail above, a distribution from a foreign trust will be treated as an accumulation distribution unless the beneficiary can demonstrate otherwise.

a. If the trustee provides the beneficiary with a "Foreign Grantor Trust Beneficiary Statement," the beneficiary can treat the distribution as a gift for U.S. income tax purposes, which is not subject to income tax.

b. If the beneficiary receives a "Foreign Nongrantor Trust Beneficiary Statement" that indicates the exact composition of the distribution, then the beneficiary need not rely on the default rule to compute the penalty tax on the accumulation distribution. The statement, for instance, may indicate that the distribution did not exceed the trust's DNI or accounting income for the year in question. As noted above, the penalty tax does not apply to a distribution that does not exceed the trust's DNI or accumulated income.

APPENDIX 1

Ten Important Things to Know About U.S. Clients With Foreign Property

1. U.S. citizens and residents must pay U.S. income tax on worldwide income.

2. U.S. owners of interests in foreign business entities face a lot of complicated federal income tax issues.

3. U.S. citizens and residents must tell the IRS about gifts from nonresident aliens and distributions from foreign trusts.

4. Foreign taxation of wealth transfers is not as common as you might think.

5. Succession laws vary considerably throughout the world.

6. Most of the rest of the world is not as dependent on trusts as the U.S.

7. A U.S. citizen and resident client's American estate plan is likely to be valid in another country, with some exceptions.

8. An American-style estate plan, however, may not be the best idea for a client's foreign property.

9. Multiple wills may be a good idea - or may not be a good idea.

10. The client is usually better off getting foreign tax and legal advice than having you attempt it on your own.

APPENDIX 2

FORM OF CERTIFICATE FOR AN INTERNATIONAL WILL UNDER THE WASHINGTON CONVENTION

CERTIFICATE

(Convention of October 26, 1973)

1. I, ... (name, address and capacity), a person authorized to act in connection with

international wills

2. Certify that on . . . . (date) at . . . . (place)

3. (testator) . . . . (name, address, date and place of birth) in my presence and that of the witnesses

4. *(a)* . . . . (name, address, date and place of birth)
(b) . . . . (name, address, date and place of birth)
has declared that the attached document is his will and that he knows the contents thereof.

5. I furthermore certify that:

6. *(a)* in my presence and in that of the witnesses

> (1) the testator has signed the will or has acknowledged his signature previously affixed.
>
> *(2) following a declaration of the testator stating that he was unable to sign his will for the following reason . . . ., I have mentioned this declaration on the will
> * and the signature has been affixed by . . . . (name, address)

7. *(b)* the witnesses and I have signed the will;

8. * *(c)* each page of the will has been signed by . . . . and numbered;

9. *(d)* I have satisfied myself as to the identity of the testator and of the witnesses as designated above;

10. *(e)* the witnesses met the conditions requisite to act as such according to the law under which I am acting;

11. * *(f)* the testator has requested me to include the following statement concerning the safekeeping of his will: . . . .

12. PLACE OF EXECUTION

13. DATE

14. SIGNATURE and, if necessary, SEAL