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Estate Taxes

Lee A. Wendel and James S. Tsang of Squire Patton Boggs, in the second of two articles on estate planning for couples residing outside the U.S. in which one spouse is a U.S. citizen but the other isn't, examine U.S.-focused estate planning for the possibility that the noncitizen spouse will predecease the U.S. citizen spouse, and planning for their children following the survivor's death. The first article, published June 25, considered U.S.-focused estate planning for the possibility that the U.S. citizen spouse will predecease the noncitizen spouse.

Estate Planning for the U.S. Citizen With a Noncitizen Spouse, Resident Abroad

BY LEE A. WENDEL AND JAMES S. TSANG

Recently we have had opportunities to do estate planning for couples residing outside the United States in which one spouse is a U.S. citizen but the other is not.

A previous installment of this article discussed planning for the possibility that the U.S. citizen spouse will predecease the noncitizen spouse (122 DTR J-1, 6/25/14)). This second installment discusses U.S.-focused estate planning for the possibility that the noncitizen spouse will predecease the U.S. citizen spouse, and planning for their children following the survivor's death.

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Representative Family

Here again is the planning case discussed in both installments of this article:

- Mark is 42 years old and is a citizen of the U.S. Mark was born in New York but moved abroad following college and has made his career (and built his wealth) outside the U.S. Mark has had a successful career as an investment banker. Currently his net worth is approximately $12 million.

- Wendy is 39 years old. Wendy isn't a citizen of the U.S. nor is she resident in the U.S. Like Mark, Wendy has had a successful career as an investment banker. Wendy's net worth currently is approximately $4 million. She also anticipates that she may inherit approximately $10 million from her parents.

- Mark and Wendy have two children. Debby is 9 years old and Sam is 6 years old. Both Debby and Sam are U.S. citizens due to Mark's U.S. citizenship. Debby and Sam also are citizens of their country of residence.

- Mark's mother is a U.S. citizen and resides in California. His father is deceased. Mark also has two siblings. His brother resides in Florida and his sister resides in London. Both are U.S. citizens.

■ Wendy's parents are both still living. Neither is a citizen or resident of the U.S. Wendy also has one sister, who is neither a citizen nor a resident of the U.S.

Planning for Mark If Wendy Dies First

Since Mark is a U.S. citizen, Wendy can claim a marital deduction for U.S. estate tax purposes for any of her property that is includible in Wendy's gross estate for U.S. federal estate tax purposes, if she leaves the property to Mark (either outright or in trust) in marital-deduction-qualifying form.

However, Wendy is a nonresident noncitizen for purposes of the U.S. estate tax. On the one hand, that means Wendy's estate will only be able to exempt a very modest amount of other property from her gross estate in determining the U.S. estate tax payable by reason of her death—$60,000 if her death occurred during 2014.[1] On the other hand, Wendy's estate only will be subject to U.S. estate tax to the extent it consists of property that is sitused in the U.S. under the rules contained in Internal Revenue Code Sections 2104 and 2105 and the Treasury regulations that implement those sections. With careful planning Wendy (and her parents, for her inheritance) can minimize the amount of her property that is subject to U.S. estate tax at the time of her death.

Long-term trusts can be designed to shelter property from U.S. estate taxes, gift taxes and generation-skipping transfer taxes for multiple generations.

For Wendy's property that isn't sitused in the U.S. for U.S. estate tax purposes, rather than leaving that property to Mark as outright owner, the estate plan for Wendy can provide long-term trusts for Debby and Sam and their respective descendants. These long-term trusts can be designed to shelter property from U.S. estate taxes, gift taxes and generation-skipping transfer taxes for multiple generations. These long-term trusts can be designed so that:

■ Mark can receive distributions of net income or principal during his lifetime to the extent he has need. Mark also can be granted a power of appointment to redirect distribution of the trust property among Debby, Sam and their respective descendants, or other beneficiaries, either during his lifetime or upon his death. Mark also can be a trustee of the trusts during his lifetime.

■ Debby and Sam can be provided similar interests, powers and rights during their lifetimes, so long as they continue to be U.S. citizens.

■ To the extent that property passing at Wendy's death isn't included in her gross estate for U.S. estate tax purposes, that excluded property need not be sheltered by her available GST exemption amount (nor limited by that available GST exemption amount) in order to remain in trust for U.S. beneficiaries for multiple generations without incurring U.S. generation-skipping transfer taxes. If the transferor of property to a trust is neither a citizen of the U.S. nor a resident of the U.S. for U.S. federal estate tax purposes, the U.S. generation-skipping transfer tax only applies to a transfer of that property to or from the trust if and to the extent that the transferor's transfer to the trust was subject to U.S. federal estate (or gift) tax.[2]

Since (and for so long as) Mark, Debby and Sam are U.S. citizens, they can be given such powers of appointment and powers as trustee, without causing the trusts to be classified as ''foreign trusts'' for U.S. income tax purposes and information reporting purposes. However, a co-trustee resident in the U.S. may be advisable, during any time that Mark, Debby or Sam (as the case may be) resides outside the U.S.

As discussed in the first installment of this article, in order to avoid a trust created for Mark, Debby or Sam being classified as a foreign trust, the trust must satisfy both of the following requirements:

■ a court within the U.S. must be able to exercise primary supervision over the administration of the trust (the ''Court Test''), and

■ one or more U.S. persons must have the authority to control all substantial decisions of the trust (the ''Control Test'').[3]

Treasury regulations detail the requirements, and certain safe harbor provisions, to satisfy the Court Test and the Control Test.[4] A detailed discussion of these requirements and safe harbors is beyond the scope of this article. But to review the subject briefly, for a family situation like Mark's and Wendy's the key requirements include the following:

■ In order to satisfy the Court Test, each trust probably needs to have at least one trustee who or which is resident in the U.S., and that trustee should have authority (or at least jointly exercisable authority) over all substantial decisions relating to the administration of the trust.[5] The applicable Treasury regulation authorizes certain actions to be taken to subject the trust to the jurisdiction of a U.S. court without regard (necessarily) to the residence of the trustee,[6] but we haven't had occasion to examine and rely on these provisions for a trustee resident outside the U.S.

■ In order to satisfy the Control Test, the following ''substantial decisions'' must be controlled by one or more U.S. persons: whether and when to distribute in-

[1] See Internal Revenue Code Section 2102(b), which provides a credit against U.S. estate tax in the amount of $13,000 that shelters the first U.S. $60,000 of nondeductible property from tax under the rate schedule in Section 2001(c). All section references are to the Internal Revenue Code of 1986, as amended, or to Department of Treasury regulations issued to implement its provisions.

[2] See Treas. Reg. Section 26.2663-2.
[3] See I.R.C. Sections 7701(a)(31); 7701(a)(30)(E).
[4] See Treas. Reg. Section 301.7701-7.
[5] See Treas. Reg. Section 301.7701-7(c)(3).
[6] See Treas. Reg. Section 301.7701-7(c)(4)(i)(A)-(C).

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come or corpus; the amount of any distributions; the selection of a beneficiary; whether a receipt is allocable to income or principal; whether to terminate the trust; whether to compromise, arbitrate or abandon claims of the trust; whether to sue on behalf of the trust or to defend suits against the trust; whether to remove, add or replace a trustee; whether to appoint a successor trustee to succeed a trustee who has died, resigned or otherwise ceased to act as a trustee, even if the power to make such decision isn't accompanied by an unrestricted power to remove a trustee, unless the power to make such decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and investment decisions, unless a U.S. person hired the investment adviser and can terminate the investment adviser's power to make investment decisions at will.[7]

Planning for Debby and Sam At Survivor's Death

Planning for Debby and Sam, for the wealth that they will inherit when both Mark and Wendy are deceased, can be approached much the same way as if the entire family resided in the U.S., subject to the following special planning considerations:

■ As covered earlier, property that Wendy leaves for Debby and Sam can be allocated to long-term, flexibly structured trusts that may avoid U.S. estate taxes, gift taxes and generation-skipping transfer taxes for multiple generations, except as limited by forced-share rights if Mark and Wendy reside in a civil law jurisdiction.

■ Decisions regarding suitable legal guardians for Debby and Sam, if either is still under age 18, must take into account legal requirements and restrictions in the jurisdiction in which the family resides. The planning must take into account both legal requirements prescribed by that jurisdiction's laws to become a legal guardian, and legal requirements and procedures to remove the minor child from that jurisdiction if Mark and Wendy plan for the child to reside with a relative in a different country. Further discussion of legal guardianship requirements and constraints for minor children is beyond the scope of this article.

■ Decisions regarding appropriate trustees for Debby's and Sam's trusts must take into account the rules for classifying trusts as foreign trusts for U.S. income tax purposes and information reporting purposes. In particular, a family member who is neither a citizen nor a resident of the U.S. likely won't be a suitable candidate to act as the trustee nor to hold a power to change the trustee.

■ Both Debby and Sam currently are U.S. citizens. However, to date they have lived abroad and one or both of them may never reside in the U.S. nor desire (for business or personal reasons) to travel regularly to the U.S. Debby or Sam may conclude at a later date to expatriate from the U.S. Mark's and Debby's estate plan can be structured to accommodate such a decision.

■ Some jurisdictions, such as Germany or Canada, treat trusts less favorably than individual owners of property for gift and inheritance tax purposes or for income tax purposes, or both. If the family resides in one of these jurisdictions, and the children can be expected to make their lives in that jurisdiction, these non-U.S. tax disadvantages for Debby and Sam may detract from or even outweigh the long-term U.S. estate tax benefits anticipated from creating long-term trusts for them.

Special Considerations For the Next Generation

■ Property can be allocated to long-term, flexibly structured trusts that may avoid U.S. estate taxes, gift taxes and generation-skipping transfer taxes for multiple generations.

■ Decisions regarding appropriate trustees must take into account the rules for classifying trusts as foreign trusts for U.S. income tax purposes and information reporting purposes. In particular, a family member who is neither a citizen nor a resident of the U.S. likely won't be a suitable candidate to act as the trustee nor to hold a power to change the trustee.

■ Children who are U.S. citizens may decide later to expatriate, and the parents' estate plan can be structured to accommodate such a decision.

Planning to Avoid Treatment as Foreign Trust

Since both Debby and Sam are U.S. citizens, it ordinarily will be advisable to avoid characterization of their trusts as foreign trusts for U.S. income tax purposes and information reporting purposes. To that end:

■ Family members who are neither citizens nor residents of the U.S. shouldn't be designated as trustees, nor given authority to remove a trustee or appoint a successor trustee. In Mark's and Wendy's case, these constraints rule out naming either of Wendy's parents or Wendy's sister to have these roles or powers.

■ Mark's mother, his brother and his sister all are U.S. citizens and so could be allocated these roles and powers. However, Mark's sister doesn't reside in the U.S., so it is possible that naming her as sole trustee of the children's trusts would cause the trusts not to satisfy the Court Test. Prudent planning dictates that Mark's sister also have a co-trustee who (or which) resides in the U.S. and has a sufficiently substantial role in the administration of the trust to support the position that a U.S. court can exercise primary supervision over the administration of the trust. Mark's mother could act as trustee without causing foreign trust treatment. But Mark's mother resides in California. Making her the trustee may subject income and capital gains accumulated in the trust to California income tax, even if neither Debby nor Sam resides in California nor has any

[7] Treas. Reg. Section 301.7701-7(d)(1)(ii). The concern with granting a power of appointment to a non-U.S. person is that the non-U.S. person could exercise the power of appointment to select a beneficiary or to determine the timing or amount of distributions from the trust.

other connection to California.[8] By default, Mark's brother may be the most suitable trustee, if he is otherwise capable and willing to act in that role.

■ As U.S. citizens, Debby and Sam can be granted powers of appointment over the trust, and powers to remove a trustee and appoint a successor trustee, either currently or upon attaining specified ages, without failing the Control Test. However, it is possible that the trust would fail the Court Test if either Debby or Sam becomes the sole trustee while residing outside the United States, unless the trust also has a co-trustee resident in the United States. Prudent drafting could include a requirement that Debby or Sam must serve alongside a co-trustee resident in the United States, or an authorization for Debby or Sam to appoint such a co-trustee.

Planning for Expatriation

The trust also can be drafted flexibly to accommodate the possibility that Debby or Sam may expatriate from the U.S. at a future date. To this end:

■ The trust can include provisions that expressly authorize Debby or Sam to disclaim or release a power of appointment, a right to remove a trustee or appoint a successor trustee, or a right to become a trustee upon attaining a specified age, in each case to avoid conversion of the trust from a U.S. domestic trust to a foreign trust by reason of the expatriation.

■ The trust can be drafted with discretionary distribution standards, and without unrestricted rights to receive or withdraw net income or principal from the trust, for reasons discussed below.

If a U.S. domestic trust becomes a foreign trust, the trust is treated for U.S. income tax purposes as if it had sold all of its assets for fair market value,[9] and for information reporting purposes as if it had transferred those assets to a foreign trust.[10] If the trust property has appreciated in value, the U.S. income tax cost may be substantial.

Even if the trust itself remains a U.S. domestic trust, the value of Debby's or Sam's interests as a beneficiary of the trust may be taken into account in determining whether Debby or Sam is a ''covered expatriate,'' for purposes of the departure tax imposed by Section 877A. Debby or Sam may be classified as a covered expatriate for this purpose if, at the time Debby or Sam expatriates, he or she meets any of the following tests:

■ the expatriate's average annual net income tax for the period of five taxable years ending before the date of loss of U.S. citizenship is greater than an inflation-adjusted amount that is $157,000 for calendar year 2014[11]; or

■ the expatriate's net worth is U.S. $2 million or more; or

■ the expatriate fails to certify under penalty of perjury that the expatriate has met all U.S. federal income tax filing requirements and information return requirements for the five preceding taxable years or fails to submit evidence of such compliance.[12]

For purposes of determining whether or not the expatriate's net worth is $2 million or more (the ''net worth test''), the expatriate's interests as a beneficiary of any trust are taken into account at a value determined (with certain modifications) as if the expatriate was making a gift of those interests.[13] If the trust confers on Debby or Sam rights to receive the net income from the trust property, or rights to withdraw trust property, or a general power of appointment by will, even if only when Debby or Sam attains one or more specified ages, such current or future entitlements may increase the value attributed to Debby's or Sam's interests in the trust for purposes of applying this net worth test.

Further, if Debby or Sam is classified as a covered expatriate, the trust property may be subjected to U.S. income tax either at the time of expatriation (if and to the extent the trust is a grantor trust) or when Debby or Sam later receives distributions (if and to the extent the trust isn't a grantor trust).

For purposes of determining whether or not the expatriate's net worth is $2 million or more, the expatriate's interests as a beneficiary of any trust are taken into account at a value determined as if the expatriate was making a gift of those interests.

For purposes of determining the ''mark-to-market'' income tax imposed by Section 877A(a) at the time Debby or Sam expatriates, the covered expatriate will be treated as owning (and the tax may be imposed on) not only property the covered expatriate owns individually. The covered expatriate also will be treated as owning any trust property that the covered expatriate would be treated as owning for U.S. federal income tax purposes, and would be included in the covered expatriate's gross estate for U.S. federal estate tax purposes if the covered expatriate had died a citizen or resident of the U.S., on the day before the expatriation date.[14] A currently exercisable right to withdraw trust property

[8] See Cal. Rev. & Tax Code Section 17742(a), which classifies a trust as resident in California for California income tax purposes if the trustee is a resident of California, regardless of the place of residence of the settlor or the beneficiaries of the trust.

[9] See I.R.C. Section 684(c).

[10] See Treas. Reg. Section 1.684-1(c).

[11] See Rev. Proc. 2013-35, I.R.B. 2013-47, at Section 3.29.

[12] I.R.C. Sections 877A(g)(1)(A); 877(a)(2). On the facts we have posited in this article, Debby or Sam may be able to avoid the first two tests—but not the third tax-filings test—under either of two statutory exceptions if the one expatriating doesn't reside in the U.S. for more than 10 years before expatriating. See I.R.C. Section 877A(g)(1)(B). Discussion of these special exceptions is beyond the scope of this article.

[13] See Notice 2009-85, 2009-45 I.R.B., at Section 2.B, referencing Notice 97-19, 1997-1 C.B. 394, at Section III.

[14] See Notice 2009-85, 2009-45 I.R.B., at Section 3.A.

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may subject that trust property to immediate, mark-to-market income tax if Debby or Sam expatriates.[15]

For these reasons, and for additional reasons noted below, it may be preferable to structure Debby's and Sam's interests in the trust as discretionary interests, with a third-party trustee:

- If Debby or Sam expatriates and is a covered expatriate, thereafter the trustee is required to withhold 30 percent of any amount distributed from the trust to the covered expatriate that consists of ordinary income or (if treated as distributed to the covered expatriate for U.S. income tax purposes) realized capital gains. If instead the trustee makes in-kind distributions to the covered expatriate of appreciated assets, the trust will recognize the untaxed gain amount for U.S. income tax purposes.[16] By comparison, if some or all of the trust property can be distributed to the covered expatriate prior to expatriation, the covered expatriate may be able to shelter some or all of the appreciated value of that property from the mark-to-market departure tax, by application of the exclusion amount provided by Section 877A(a)(3). Up to $680,000 of total built-in gains may be excluded from the mark-to-market departure tax by an individual who expatriates during 2014.[17] Thereafter subsequent appreciation in value of that property in the hands of the covered expatriate may never be subjected to U.S. income tax. This exclusion amount can't be applied to shelter trust-level gains from the 30 percent withholding tax that otherwise may be imposed later when trust distributions are made.
- Even if Debby or Sam doesn't expatriate, she or he may determine to move to a country that subjects trusts or trust distributions to unfavorable income tax, inheritance tax or gift tax treatment. Proactive planning may favor preemptive distribution of substantial amounts from Debby's or Sam's trust, or even all of Debby's or Sam's trust, to Debby or Sam prior to that relocation, so that subsequent income and gains from the property instead are taxed based on that country's rules for individuals.

A trustee equipped with broad discretionary distribution authority will have flexibility to engage in proactive tax planning as appropriate to reduce Debby's or Sam's overall tax costs.

Conclusion

Planning for a client couple like Mark and Wendy can be interesting and challenging. Such planning requires consideration, and coordination, of applicable income tax, gift tax and estate tax rules and treaties both in the U.S. and in the jurisdiction(s) in which the client couple and their family members reside.

[15] See I.R.C. Sections 678 and 2041. This income tax consequence may occur in any event under Section 684, if the right to withdraw trust property will continue and, under the Control Test, cause the trust to become a foreign trust following the expatriation. See I.R.C. Section 684(c).

[16] See I.R.C. Section 877A(f). Both of these rules apply if and to the extent the covered expatriate wasn't considered the owner of the trust property for U.S. income tax purposes immediately prior to expatriating.

[17] See Rev. Proc. 2013-35, I.R.B. 2013-47, at Section 3.30.