

International Estate Planning

BARBARA R. HAUSER*

I. Qualified Domestic Trusts

A. BACKGROUND

Since 1988 the marital deduction has been denied when the surviving spouse is not a U.S. citizen unless the property is held in a Qualified Domestic Trust [QDOT]. The basic purpose of a QDOT is to ensure that the United States would retain jurisdiction over the eventual payment of the "deferred" tax. Thus, a QDOT has to have a U.S. taxpayer as trustee, as well as many other requirements.

B. AMENDMENTS

In the Taxpayer Relief Act of 1997 [1997 Act], a major concession was finally made to coordinate the U.S. trust requirement with the difficulty presented by civil law jurisdictions in which the trust is not a recognized legal concept. Section 1312 of the 1997 Act, entitled "Treatment Under Qualified Domestic Trust Rules of Forms of Ownership Which Are Not Trusts," permits the issuance of regulations to include "[other] arrangements [which] have substantially the same effect as a trust as 'trusts' for QDOT purposes."¹

Another helpful amendment in the 1997 Act is intended to provide some flexibility in the requirement that there be a U.S. trustee. Section 1314 allows the issuance of regulations that would make an exception to the requirement that a QDOT have a U.S. trustee.² This change was made because some countries do not allow a U.S. trustee to serve. The House Committee Report anticipates that "such regulations, if any, provide an alternative mechanism under which the U.S. would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent."³

*Barbara R. Hauser, of Carlson Holdings, Inc., in Minneapolis, Minnesota, is Chair of the International Private Client Planning Committee. She gratefully acknowledges the assistance of Julia Rau, a partner at Dorsey & Whitney LLP, in Minneapolis, Minnesota, in the preparation of this article.

1. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1312, 111 Stat. 788, 1044-45 (amending I.R.C. § 2056A(c) (1994)).

2. *Id.* § 1314 (amending I.R.C. § 2056A(a)(1)(A) (1994)).

3. H.R. REP. NO. 105-148, at 628 (1997).

C. EFFECTIVE DATE

The aforementioned portions of the 1997 Act become effective for estates of decedents dying after August 5, 1997.⁴ When the above QDOT provisions were added in 1988, the unlimited marital gift tax deduction was also eliminated for non-U.S. citizen recipients. To compensate somewhat, the annual gift exclusion was also increased to \$100,000 in those cases. The 1997 Act added a general inflation adjustment for the regular (\$10,000) annual exclusion.⁵ It is not clear whether the inflation adjustment will also apply to the \$100,000 exclusion.

II. Foreign Trusts

A. BACKGROUND

In 1995 the Clinton Administration stated that new rules were needed in the foreign trust area "to limit the avoidance and evasion of U.S. taxes."⁶ As a result, 1996 legislation⁷ included comprehensive and complex laws substantially revising U.S. tax rules and reporting requirements for foreign trusts with U.S. beneficiaries, U.S. transferors or U.S. settlors, and established new reporting requirements for gifts and bequests from foreign sources.

One of the benefits of the 1996 legislation in this area had been to define, finally, what a "foreign" trust is, for U.S. tax purposes.⁸ That definition required two conditions to avoid being a foreign trust: (1) a U.S. Court must be "able to exercise primary supervision over the administration of the trust,"⁹ and (2) "[one or more United States] fiduciaries have the authority to control all substantial decisions of the trust."¹⁰ The second requirement caused great concern because many former U.S. trusts were unable to meet it.

Extensive reporting requirements were also enacted in 1996 (with penalties of up to 35 percent of the reportable amount) but the deadlines for complying with the reporting requirements were initially deferred.¹¹

B. AMENDMENTS

The 1997 Act allows former U.S. trusts to elect to continue to be treated as U.S. trusts for a reasonable transitional period,¹² notwithstanding a failure to satisfy the two conditions referenced above. Some additional flexibility was allowed by changing the "control" entity from one or more "U.S. fiduciaries" to one or more "U.S. persons."¹³ Proposed Treasury regulations issued in June 1997 provide guidance with respect to the 1996 legislation and Code Section 7701.¹⁴

4. Taxpayer Relief Act §§ 1312(b), 1314(b).

5. *Id.* § 501(c) (amending I.R.C. § 2503(b) (1994)).

6. *Treasury Department Internal Explanation of Revenue Proposals in Clinton Administration's Fiscal Year 1996 Budget Request*, Feb. 6, 1995, reprinted in *DAILY TAX REP.* at L-6 (Feb. 7, 1995).

7. Foreign Trust Tax Compliance, Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1901-1907, 110 Stat. 1755, 1904-1917.

8. I.R.C. § 7701(a)(31)(B) (West Supp. 1998).

9. *Id.* § 7701(a)(30)(E)(i).

10. *Id.* § 7701(a)(30)(E)(ii).

11. See *infra* Part II. C. for current deadlines.

12. Taxpayer Relief Act § 1161.

13. *Id.* § 1601(i)(3). See also Prop. Treas. Reg. § 301.7701-7, 62 Fed. Reg. 30796 (1997).

14. See *id.*

C. ISSUANCE OF REPORTING RULES

In 1997, IRS Notices 97-34¹⁵ and 97-42¹⁶ were issued which provide, in part, that taxpayers with reportable transactions must file 1996 and 1997 forms 3520-A and 3520¹⁷ no later than April 15, 1998 (plus applicable extensions of time to file 1997 tax returns), provided that with respect to 1996 transactions with a foreign trust, the taxpayer's 1996 income tax return (or amended return) reflects any income attributable to post-August 20, 1996 transactions.

Notice 97-34 addresses the treatment of loans by foreign trusts to U.S. grantors and U.S. beneficiaries and describes limited circumstances under which loans can avoid being treated as indirect distributions. Notice 97-34 also addresses the treatment of an accumulation distribution to a U.S. beneficiary and methods to avoid this treatment.

D. "REPEAL" OF EXCISE TAX ON TRANSFERS TO FOREIGN TRUSTS

Internal Revenue Code (I.R.C.) § 1491, subjecting transfers (by U.S. persons) to foreign trusts to a 35 percent excise tax, was eliminated in the 1997 Act, but any gain must now be recognized (unless the U.S. transferor is treated as the owner under the U.S. grantor trust rules).¹⁸

E. GRANTOR TRUST RULES

Proposed regulations were issued in 1997 consistent with changes to the grantor trust rules under the Small Business Job Protection Act of 1996 (generally classifying foreign trusts as non-grantor trusts for U.S. income tax purposes in many cases where grantor trust status previously would have applied). Subject to several exceptions, the proposed regulations first apply the basic grantor trust rules to determine a "worldwide amount" and a "U.S. amount," and then provide that any worldwide amount in excess of the U.S. amount is to be treated as owned by a foreign person.¹⁹ Comments have been requested with respect to these proposed regulations.

III. Investments Exempt From U.S. Estate Tax

A. BACKGROUND

Certain bank deposits and portfolio debt obligations have been exempt from U.S. income tax and U.S. estate tax when owned by non-resident aliens in an effort to encourage those investments (with assets that would otherwise be deemed to be located in the U.S., as are securities of U.S. corporations). Since 1988, however, there has been a seemingly inadvertent gap with respect to otherwise qualified debt obligations that generated short-term original issue discount income. These were exempt from income tax but not from estate tax.

B. AMENDMENT

The 1997 Act provides that short-term U.S. debt obligations held by a non-resident non-citizen that produce original issue discount income will be treated as property located outside

15. I.R.S. Notice 97-34, 1997-25 I.R.B. 22.

16. I.R.S. Notice 97-42, 1997-29 I.R.B. 12.

17. The IRS issued revised Form 3520 on November 5, 1997. A new form 3520-A may be released in the first quarter of 1998.

18. Taxpayer Relief Act § 1131(a) (repealing I.R.C. §§ 1491-1494) (1994); *Id.* § 1131(b) (adding I.R.C. § 684 (West Supp. 1998)).

19. Prop. Treas. Reg. § 1.672(f), 62 Fed. Reg. 30785 (1997).

the U.S. for purposes of the U.S. estate tax.²⁰ State and local bonds were not included in the Amendment.

C. EFFECTIVE DATE

The amendment discussed above is effective for estates of decedents dying after August 5, 1997.²¹

IV. Expatriation

A. BACKGROUND

In 1996 there was a flurry of proposals to tax those who give up U.S. citizenship. None of those passed. Instead, extensive new reporting requirements were added (and a small change in the Immigration laws allowed the denial of reentry into the United States of those who had relinquished U.S. citizenship).

B. AMENDMENTS

In March 1997 there was another attempt to tax those who relinquish U.S. citizenship. The "Immigration Fairness Act of 1997" was introduced in the House.²² It was assigned to the House Ways and Means Committee, which did not issue a report. It did not pass.

Minor changes were made to I.R.C. § 877(d)(2), clarifying the inception of the ten-year period as beginning the date the individual loses U.S. citizenship and requiring the recognition of gain for all exchanges during the five-year period before expatriation.²³

Note, however, that under existing expatriation provisions, an expatriate must recognize gain on property transactions that otherwise would receive non-recognition treatment if the property is sold during the ten-year expatriation period. This means, for example, that an expatriate would not qualify for the new provisions excluding gain on the sale of a principal residence under § 312(a) of the 1997 Act (amending I.R.C. § 121).

V. Reporting of Foreign Gifts

IRS Notice 97-34 liberalizes reporting rules (enacted in the 1996 legislation) for recipients of foreign gifts by raising the reporting threshold from \$10,000 to \$100,000 per year for gifts from non-resident aliens and foreign estates (the prior \$10,000 level for gifts from foreign corporations or foreign partnerships has been retained).²⁴ Form 3520 instructions now clarify that a gift to a U.S. person does not include any amount paid for qualified tuition or medical payments.²⁵

20. Taxpayer Relief Act § 1304(a) (adding I.R.C. § 2105(b)(4) (West Supp. 1998)).

21. *Id.* § 1604(b).

22. H.R. 1015, 105th Cong. (1997).

23. Taxpayer Relief Act § 1602(g).

24. I.R.S. Notice 97-34, 1997-25 I.R.B. 22.

25. Instructions for Form 3520, (Treas. Dept. 1996) Part IV.