Ten Important Points to Remember About International Estate Planning for Persons with Connections to the United States

by Michael W. Galligan

INTRODUCTION

With the accelerating globalization of economic relations and the compression of travel and communications distances between countries, increasing numbers of U.S. citizens and residents find themselves holding property in many jurisdictions outside the United States and many foreign persons find themselves holding property in the United Sates. So pervasive have cross-border property interests at the individual and family level become that no U.S. trusts and estates advisor, whether lawyer, accountant, or financial consultant - no matter how strong the advisor's focus on U.S. domestic clients may be - can afford to be ignorant of the issues and potential problems that may confront a client with even the most tangential international connections.

For example, the conferral of a power of appointment over a trust or even the mere right to appoint successor trustees of a trust could cause a domestic trust to be treated as a foreign taxpayer for U.S. income tax purposes should that power ever fall into the hands of a person who is not a U.S. citizen or U.S. income tax resident. To take another example, perhaps more widely known, bequests of property to a spouse who is a U.S. permanent resident but not a U.S. citizen are no more eligible for the estate tax marital deduction (without the use of a qualified domestic trust) than a bequest to a foreign spouse who never set foot in the United States.

The purpose of this article, therefore, is to provide a basic outline of the major issues and challenges that every U.S. estate planner should be aware of whether advising clients who clearly have multinational families or multinational property holdings or advising clients who may find themselves unexpectedly confronting international estate issues simply by virtue of the growing internationalization of investments and finance and interpersonal relations themselves.

I. Gifts and bequests to non-U.S. citizen spouses that are subject to U.S. federal transfer taxation are not eligible for the U.S. federal gift and estate tax marital deductions.

The U.S. federal gift and estate taxes provide that all transfers to a spouse who is a citizen of the United States, whether during lifetime or at death, will be eligible for an unlimited marital deduction. As a result, all transfers to spouses who are U.S. citizens will not be subject to U.S. federal gift or estate taxes.

In addition, gifts and bequests to two types of trusts, so called power of appointment trusts and QTIP trusts, held for the benefit of a U.S. citizen spouse will also be eligible for the U.S. federal gift and estate tax marital deduction. A trust will qualify as a power of appointment trust if a U.S. citizen spouse is entitled to all the income from the trust and such spouse has a general power of appointment over the trust property. A trust will qualify as a QTIP (Qualified Terminable Interest Property) trust if (1) the spouse is entitled to all income from the trust for his or her lifetime; (2) during the spouse's lifetime, no distributions may be made from the trust to anyone other than the spouse; and (3) a timely "QTIP Election" is made by the donor (with respect to gifts to a QTIP trust) or the decedent's executor (with respect to bequests to a trust).

A. Explanation of Limitation of Marital Deduction for Non-U.S. Citizen Spouses

The U.S. federal gift and estate tax marital deductions do not exempt property from transfer taxes. Rather, these deductions defer estate tax on transfers to U.S. citizen spouses until the death of the surviving U.S. citizen spouse. However, to the extent a spouse transfers property to a U.S. citizen spouse (or a power of appointment trust or a QTIP trust for his or her benefit) and the donee spouse consumes such property during his or her lifetime such consumed property will not be subject to U.S. federal gift or estate taxes. Gifts and bequests to a spouse who is not a citizen of the United States, on the other hand, are not eligible for the unlimited deferral of estate taxes to the death of the surviving spouse that would otherwise flow as a consequence of the marital deduction. The reasoning for the disallowance of the marital deduction with respect to gifts and bequests to non-U.S. citizen spouses can be described as preservation of the tax base in the sense that property left to a non-U.S. citizen spouse may escape all U.S. estate taxation if the non-citizen spouse does not become a U.S. citizen after the death of the predeceased spouse and ceases to be (or never becomes) a U.S. domiciliary, while the unconsumed balance of the property left to a U.S. citizen surviving spouse will be presumably subject to estate tax on the death of the surviving spouse.

As a partial offset for the disallowance of the gift tax marital deduction for gifts to non-U.S. citizen souses, the annual exclusion for gifts to non-U.S. citizen spouses is increased to $117,000 (in 2005), adjusted for inflation. While this increased annual exclusion provides significant opportunities to transfer property to a non-U.S. citizen spouse free of gift tax, care must be taken when acquiring property in, or transferring property to, joint names with a non-U.S. citizen spouse. For example, in some states placing intangible or personal property in joint names is automatically treated as a gift of one-half (1/2) of that property and placing real property in joint names with a non-U.S. citizen spouse when the acquisition funds are supplied by a U.S. citizen spouse may give rise to a taxable gift upon the sale of the property at least when the proceeds must be or would be deemed to be shared with the non-U.S. citizen spouse. If more than $117,000 (in 2005), adjusted for inflation, in a calendar year is transferred between spouses, the excess would normally constitute a taxable gift, against which the donor spouse's U.S. federal gift tax credit would have to be applied.

B. Establishing Qualified Domestic Trusts To Qualify for the Marital Deduction

Generally speaking, all bequests made to a non-U.S. citizen spouse will be subject to U.S. federal estate tax unless the bequest is left to a qualified domestic trust (referred to as a QDOT) or is governed by an arrangement provided under the Treasury Regulations implementing Section 2056A of the Internal Revenue Code of 1986, as amended (referred to as "IRC"). A bequest to a QDOT or other approved arrangement will be eligible for the estate tax marital deduction because the QDOT or other arrangement will ensure that estate tax will be paid on the property transferred to the QDOT or other arrangement as the principal value of such property is distributed during the surviving spouse's lifetime and that the balance of the property will be subject to tax upon the surviving spouse's death. To be more precise, distributions of principal from a QDOT to the non-U.S. citizen spouse (other than for a hardship) are subject to U.S. estate tax due the year after the year of the distribution as an addition to the deceased spouse's estate tax. The undistributed balance of the QDOT is subject to estate tax upon the death of the surviving spouse as an addition to the estate tax of the predeceased spouse. Testamentary QDOTs are also subject to estate tax in the surviving spouse's estate, subject to a credit for the additional estate tax on the predeceased spouse's estate.

In order for a trust to qualify as a QDOT, a testamentary QDOT must not only qualify for the marital deduction under IRC Section 2056(b)(5), 2056(b)(7) or 2056(b)(8) (this requirement is typically satisfied by the trust meeting all the requirements of a QTIP trust under IRC Section 2056(b)(7)) but IRS regulations also require the trust to have additional characteristics. All QDOTs must (1) be maintained under the laws of a state of the United States or the District of Columbia, and the administration of the trust must be by the laws of a particular state or the District of Columbia, (2) require that at least one trustee be an individual citizen of the United States or a corporation that is created or organized under the laws of the United States, any state of the United States or the District of Columbia (such individual or corporation being referred to as a "U.S. Trustee"), (3) provide that no distribution (other than a distribution of income) may be made from the trust unless a U.S. Trustee has the right to withhold from such distribution the additional estate tax (imposed by IRC Section 2056A(b)), (4) recite or incorporate the provisions of the Treasury Regulations that are designed to secure the collection of that tax, and (5) the executor of the decedent's estate must make a timely QDOT election on an estate tax return, which can be filed up to one year after the due date for filing the decedent's estate tax return, including extensions (i.e., twenty-seven months after the date of death assuming an extension is timely filed or twenty-one months after the date of death if an extension is not timely filed).**[1]**

As mentioned above, Treasury Regulations require all QDOTs to recite or incorporate the security requirements for QDOTs set forth in the Treasury Regulations. For QDOTs with assets with a fair market value of more than $2 million (irrespective of debts) as of the date of the decedent's death (or the alternate valuation date), these security requirements provide that at all times during the term of the QDOT (1) at least one U.S. Trustee must be a bank as defined in IRC Section 581, (2) the U.S. Trustee must furnish a bond in favor of the Internal Revenue Service in an amount equal to 65% of the fair market value of trust assets (irrespective of debts) as of the date of the decedent's death (or the alternate valuation date), or (3) the U.S. Trustee must furnish an irrevocable letter of credit issued by a bank as defined in IRC Section 581 equal to 65% of the fair market value of trust assets (irrespective of debts) as of the date of the decedent's death (or the alternate valuation date). For QDOTs with assets with a fair market value of less than or equal to $2 million (irrespective of debts) as of the date of the decedent's death (or the alternate valuation date) these security requirements include the requirement that the trust instrument provide that either (1) no more than 35% of the fair market value of trust assets determined annually on the last day of the taxable year will consist of real property located outside of the United States or (2) the trust will meet the U.S. bank, bond or letter of credit requirements set forth in the previous sentence with respect to QDOTs with assets worth more than $2 million. Solely for purposes of determining whether the $2 million threshold has been exceeded, the executor of the estate can elect to exclude up to $600,000 in value attributable to real property (and related furnishings), whether situated within or without the United States, owned by the QDOT that is used by or held for the use of the surviving spouse as a personal residence.

If the Last Will and Testament of a predeceased spouse does not provide for a QDOT, a surviving non-U.S. citizen spouse can transfer property he or she inherits from the predeceased spouse to a QDOT created by the non-citizen spouse. This form of QDOT, often referred to as a "post-mortem QDOT," is available to secure the marital deduction for outright bequests to a surviving non-U.S. citizen spouse as well as the passing of property to a surviving non-U.S. citizen spouse by operation of law. Interestingly, the terms of the post-mortem QDOT need not meet the requirements for the U.S. federal estate tax marital deduction. However, because the surviving spouse is the transferor to the post-mortem QDOT of property that passed to the surviving spouse from the predeceased spouse, for estate tax purposes, the property in the QDOT will be subject to the same additional estate tax provisions as a testamentary QDOT. In most cases, it will also constitute property subject to tax in the surviving spouse's estate because, in most cases, the surviving spouse will have retained an interest or a power designed to avoid a taxable gift upon the trust's inception that will make the trust property part of the surviving spouse's estate under the rules of IRC Sections 2035-2038.

A non-U.S. citizen surviving spouse can also transfer proceeds of life insurance and assign individual retirement account or qualified plan assets of which he or she is designated as beneficiary to the post-mortem QDOT to alleviate the estate tax burden attributable to those assets. In addition, non-assignable annuities and other arrangements passing to a non-U.S. citizen surviving spouse that are not transferred to a QDOT may be treated as passing to a QDOT and therefore eligible for the marital deduction if the spouse agrees in writing to pay the estate tax due on the corpus portion of the annuity or arrangement and the decedent's executor files an information statement and the spouse's written agreement with the decedent's estate tax return. Transfers of property to post-mortem QDOTs are typically structured as incomplete gifts for gift tax purposes (e.g., as revocable trusts) to avoid triggering a gift tax on the creation of the trust.

If a non-U.S. citizen surviving spouse who is the beneficiary of a QDOT becomes a citizen of the United States, the QDOT can terminate and principal can be distributed to the surviving spouse free of estate tax as long as the surviving spouse was continuously a U.S. resident from the date of the predeceased spouse's death until the date of attaining citizenship or no taxable distributions were made from the QDOT. Even a non-citizen spouse who becomes a U.S. citizen after the first spouse's death but who was not so continuously resident but who received a taxable distribution from the QDOT may receive the remaining principal of the QDOT free of estate tax subject to the spouse agreeing to certain offsets to the spouse's adjusted taxable gifts and unified credit for such taxable distributions.

C. Planning Considerations for Non-U.S. Citizen Spouses

Estate plans for large estates and non-U.S. citizen spouses would typically include a credit shelter (or by-pass) trust and a QDOT to allow maximum estate tax deferral, especially if the non-U.S. citizen spouse does not intend to apply for U.S. citizenship. Estate plans for smaller estates may wish to provide for (1) a disclaimer to a trust that could qualify as a QDOT or (2) leaving all property outright to a surviving spouse subject to the surviving spouse's election to establish a post-mortem QDOT.

Estate planners face various practical issues when planning with QDOTs. Planners should consider recommending that the U.S. citizen spouse establish a life insurance trust for the benefit of the surviving spouse to provide liquidity for non-U.S. citizen surviving spouse. This technique can avoid the need to make distributions to the spouse from the QDOT that will be subject to the additional estate tax in respect of the decedent spouse. Additionally, estate planners should consider whether foreign property may be used to fund a QDOT. There may be difficulties placing real property located in certain countries whose legal systems do not recognize trusts into a QDOT and the election to defer the estate tax on the property left to or contributed to the QDOT may result in the loss of certain valuable tax credits on taxes imposed by the jurisdiction where the property is located due to the fact that the foreign tax on the QDOT property and the additional U.S. federal estate tax payments do not properly coincide. Finally, it may be advisable to run some projections about the likely taxes on the death of the surviving spouse to ensure that anomalies do not result from possible changes in the domicile of the surviving spouse or other factors that could cause more than one state death tax to apply to the same QDOT property.

II. Direct contributions by individuals to foreign charities are generally eligible for the U.S. federal gift and estate tax charitable deductions but are not eligible for the U.S. federal income tax charitable deduction.

IRC Section 2055(a)(2) provides that contributions by individuals to "corporations organized and operated exclusively for religious, charitable, scientific, literary or educational purposes" are eligible for the U.S. federal gift and estate tax charitable deductions. Because there is no limitation in this provision to corporations organized in the United States, this provision has been interpreted to allow U.S. federal gift and estate tax charitable deductions for contributions to

both U.S. and foreign charitable corporations. IRC Section 2522(a)(2) is similarly non-exclusive with regard to the gift tax charitable deduction. IRC Section 2055(a)(2) permits the charitable deduction for trusts with the only condition that the contributed funds (but not the entire trust) be used for exclusively charitable purposes; this provision established the foundation for several Court decisions that have now established that the estate tax charitable deduction is available for contributions to foreign governments as long as the contribution is expressly required to be used exclusively for charitable purposes. The U.S. federal gift tax charitable deduction for contributions to charitable trusts is conditioned on any such trust being organized exclusively for charitable purposes but the trust does not have to be a U.S. trust. One exception to these liberal provisions as to foreign charities has to do with charitable remainder trusts: any charitable remainder beneficiary of a charitable remainder trust must be a U.S. charitable entity.

The scope of the income tax charitable deduction with respect to contributions by individuals is more limited. IRC 170(c)(2)(A) effectively provides that an income tax deduction will only be allowed for contributions to corporations, trusts or community chests, funds or foundations "created or organized in the United States or in any possession thereof, or under the laws of the United States, any State, the District of Columbia, or any possession of the United States." As a result, the income tax charitable deduction is only available for contributions to domestic charitable corporations. However, the Internal Revenue Service will allow an income tax charitable deduction for contributions to U.S. charitable organizations that conduct charitable activities abroad or support the work of foreign charitable organizations as long as the U.S. organization retains independent discretion over the disbursement of the funds to the foreign charitable organizations. Often U.S. organizations created primarily to support the charitable endeavors of a foreign charitable entity with contributions that qualify for the U.S. income tax charitable deduction are referred to as "friends of" organizations. Under IRC Section 642(c), the income tax deduction is granted more liberally to cover contributions by trusts to foreign charities â€“ even trusts that are not exclusively devoted to charitable purposes and do not qualify as charitable remainder trusts - as long as they are permitted by their governing instruments to make contributions for charitable purposes.

Occasionally tax treaties with other countries provide that contributions to charitable organizations formed in a foreign country may be eligible for the income tax charitable deduction in the same manner as charitable organizations organized in the U.S. For example, the U.S.-Canada Income Tax Treaty allows certain limited income tax deductions for contributions made by U.S. citizens or residents to charitable organizations located in Canada (based on the amounts of source income in Canada and U.S. deduction limitations), and for contributions made by Canadian residents to charitable organizations located in the United States.**[2]**

III. Trusts can very easily become foreign trusts for U.S. federal income tax purposes, with substantial disadvantages for U.S. grantors and beneficiaries.

The United States has given a great deal of attention to the tax treatment of foreign trusts, especially when U.S. persons establish foreign trusts or when U.S. persons have beneficial interests in foreign trusts. Prior to 1996, it was relatively difficult for a trust with significant ties to U.S. persons to be a foreign trust unless it was administered from abroad and held substantial foreign assets. That was all changed by legislation enacted in 1996 that set up a set of bright-line tests for determining whether a trust was domestic and defined all trusts that do not meet these tests as foreign trusts. Because the tests are fairly exacting in the U.S. connections they require a trust to qualify as a domestic trust, they make it very easy for trusts that to the untutored eye look very domestic to be treated as foreign trusts.
The 1996 legislation imposed, two basic set of tests for determining whether a trust is a domestic trust. Failure to satisfy either set of tests causes the trust to fail to be a domestic trust and to qualify as a foreign trust: (i) a U.S. court must be able to exercise primary supervision over the trust (the "Court Test"); and (ii) one or more U.S. persons must have the authority to control all substantial decisions of the trust (the "Control Test").

A. The Court Test

A United States court must be able to exercise primary supervision over the trust. This means that a United States court must have the authority to determine substantially all issues about the administration of the trust. The "court test" means that a trust governed by an agreement that attempts to give a foreign court exclusive jurisdiction over the trust will ordinarily not qualify as a U.S. trust, even if U.S. citizens control all the major decisions of the trust.**[3]** The final regulations provide for three special situations in which a trust would be deemed to have satisfied the "court test": (i) when a trust is registered by an authorized fiduciary or fiduciaries within the United States pursuant to a state statute similar to Article VII of the Uniform Probate Code; (ii) when a trust created under a will is admitted to probate within the United States, if all trust fiduciaries have been qualified as trustees by a U.S. court; and (iii) when fiduciaries or beneficiaries of a trust take steps to cause the administration of the trust to be subject to the primary supervision of a U.S. court.

B. The Control Test

United States persons must exercise control over all substantial decisions affecting the trust. United States citizens and United States residents qualify as United States persons for purpose of this requirement; a U.S. citizen trustee need not reside in the United States to qualify. Domestic corporations and partnerships may also qualify as U.S. trustees. Substantial decisions include all types of decisions that trustees are required to make under the trust agreement or under applicable law that are not ministerial. Thus, U.S. persons must be able to control all discretionary decisions as to distributions, investment of the trust, allocation between income and principal, and so forth. Delegation of investment decisions by a trustee to a foreign investment advisor would not cause the trust to fail the "control test" as long as a U.S. person can terminate the investment advisor's power to make investment decisions at will.

C. Analysis

It is especially important to be clear about a trust's U.S. tax status when advising clients who are considering establishing foreign trusts or, perhaps most significantly, may be the beneficiaries of foreign trusts. Since 1979, the United States has sought to dissuade U.S. persons from establishing foreign trusts with two different methods: U.S. persons who establish foreign trusts for the benefit of U.S. beneficiaries are treated as owners of the foreign trust property for U.S. income tax purposes and substantial penalties fall on any U.S. person who declines to disclose that he or she has established a foreign trust of this kind and to report fully the income and realized gains of the trust and pay the corresponding taxes. Although U.S. persons who establish foreign trusts that do not have any U.S. beneficiaries are not required to report and pay tax on the income and gains derived from the trust property as if they still owned it, they must pay a capital gains tax on the built-in gain on all appreciated assets transferred to the trust as if the transfer to the foreign trust constituted a sale of the assets.

The United States has been concerned for many years with the possibility that U.S. beneficiaries of foreign trusts that do not qualify as "grantor trusts" for U.S. income tax purposes (i.e., trusts where the person who funded the trust is deemed to still own the trust property) would be able to defer taxes on the income from foreign trusts and have an unfair advantage over the beneficiaries of many domestic trusts. In an effort essentially to compel these foreign trusts to distribute income to U.S. beneficiaries on a current basis so that the beneficiaries would have to report this income as part of their receipt of distributable net income, U.S. beneficiaries who receive distributions of accumulated income are required to pay a tax that is supposed to roughly mimic the tax the beneficiaries would have paid if they had received the income currently.

That might not be so bad in and of itself but there are two additional factors. First, undistributed capital gains are treated as ordinary income, so that distributions that effectively pass out the proceeds of sales of trust property are also subject to U.S. income tax in the hands of the beneficiaries at ordinary income tax rates. Second, there is an interest charge on the payment of taxes on distributions of accumulated income and gains which, since 1996, is computed on a compounded basis, using the prevailing Treasury rates for underpayment of taxes. The effect of this treatment of distributions from foreign trusts, especially when they are deemed to carry out many years of accumulated income and gains, is to cause the beneficiaries to essentially forfeit virtually all of their trust distributions except for the receipt of the original principal contributed to the trust and any current income and gains.[4]

IV. U.S. persons living abroad or owning property abroad must often contend with heirship regimes and property regimes that may be inconsistent with their estate planning goals.

A. Forced Heirship

Foreign property and inheritance regimes can be very different from those we are accustomed to in the United States. Perhaps the best known difference is that, while most states in the United States give parents virtually complete freedom over whether to bequeath property to their descendants at death, most civil law countries require that parents leave a considerable portion of their estates to their descendants ("forced heirship").
Take Switzerland, for example: the rules that guarantee children a portion of an estate are based on the Swiss rules about intestate distribution. If there is no will and the decedent is survived by a spouse and issue, the surviving spouse is entitled to one-half of the estate and the issue share the other one-half of the estate. If there is a will, the spouse is entitled to one-half of her intestate share or one-quarter of the estate and the children are entitled to three-fourths of their intestate share, or three-eighths of the estate, all regardless of any inconsistent provisions of the will.

In France, to take another example, if there is only one child, the child or that child's issue are entitled to one-half of the estate; if there are two children those children or issue are entitled to two-thirds of the estate and if there are three or more children, the children or issue have a right to three-quarters of the estate. The decedent may direct that the surviving spouse receive either the entire portion of the estate that is not required to go to issue, or one-quarter of the estate and the balance in usufruct (a form of interest very close to a common law life estate) during the surviving spouse's lifetime, or the entire estate in usufruct. In the case of a decedent who dies leaving no issue and no spouse but both parents, one-half of the estate must go to the parents, and if a decedents leaves only once parent one-quarter of the estate must go to the parent, again, regardless of what the will may provide.

Finally, in Brazil, the decedent may dispose of only one-half of the decedent's estate freely, if there are any issue or parents surviving.

B. Other Differences

Another important legal difference is that many countries have a system of community property (like the states of the United States that were influenced by Spanish or French law), with the result that property acquired in one of these countries during a marriage may be automatically considered to be owned equally by each spouse, regardless of who actually paid the consideration for the property or took title to it.[5]

In addition to major differences in property law, the formalities and procedures for executing a valid will can be very different from those we are accustomed to in the United States and the procedures for seeking the recognition of a will, administering property, and seeing to the ultimate distribution of the property can be equally different. In many civil law countries, for example, legal officers with the title of "notary," essentially special purpose lawyers for the administration of property, play a major role in the making of wills and in their implementation. Executors are often not appointed and, where used, their power is more restricted than that of their American counterparts.

The idea that an estate constitutes a separate legal or tax entity is especially foreign to most civil law jurisdictions. For example, a civil law executor could not undertake a refunding obligation without being personally responsible for the obligation. In another important variation, beneficiaries of non-U.S. estates can find themselves sharing responsibility for their decedent's liabilities, without limitation to the property inherited from the deceased, unless special steps are taken to avoid this result within specified time periods after the decedent's death.

Finally, certain common law countries such as England and Australia have laws that grant individuals with a close personal relationship to a decedent, who are not necessarily related to the decedent by blood (e.g., individuals who were dependant upon the decedent, surviving members of same sex couples and so forth) the right to petition for what is essentially a judicial amendment of a will or other testamentary instrument to provide for their maintenance and support. For example, in England, the Inheritance (Provision for Family and Dependants) Act of 1975 allows unrelated persons who are dependent on the decedent to apply to a court for a discretionary maintenance provision from the decedent's estate. Australia's Family Provision Act grants certain people the right to apply to a court to request provision from an estate based on the argument that a decedent did not adequately provide for their proper maintenance, education and advancement in life. For these purposes is has been suggested that the individuals with rights to apply for provisions from the estate should be defined as "those who, in the normal course of human affairs, might be expected to have had such a close personal relationship with the deceased as to possibly leave the latter, at the time of his death, under some moral obligation to make provision for their maintenance, education or advancement in life, irrespective of whether or not a blood tie exists."

C. Choice of Law

Obviously, before attempting to determine the tax aspects and consequences of a client's situation, it is necessary to understand the nature of the client's property interests in the various countries where those interests are located, the identity of the persons who will be the donees or beneficiaries of the client's property under the rules of the respective countries, and the legal characteristics of entities in different countries used by the client to hold these interests.

But to understand these matters, it is important to ensure something else that might seem so obvious as to be overlooked: that the planner is looking to the proper law that will govern these rights, claims and legal consequences. Choice of law in international estate planning is a fascinating but difficult topic. In order not to break the general progress of the discussion in this article, an outline of some of the most important considerations is contained in Appendix A. Briefly, many countries do not make the distinction most common law jurisdictions make between the law of situs for real property and the law of domicile for personal property. In addition, a not insignificant

number of countries consider the law of a decedent's nationality rather than domicile or residence to be controlling. In the end, the moral of the story is that it is never wise to make a judgment on a question of governing law or on the ultimate impact of foreign inheritance or estate law without seeking competent legal advice in the country that concerns you.

V. All citizens of the United States are subject to U.S. federal transfer taxes on their worldwide assets: Estate tax, gift tax, generation-skipping transfer tax.

A. General Principle

The United States is one of the few countries in the world to have a worldwide transfer tax system as well as a worldwide income tax system. The rules for determining who is subject to the worldwide transfer tax system and who is subject to the worldwide income tax system, while often overlapping in their practical effect, are not the same except for one category, U.S. citizens. A U.S. citizen is subject to U.S. federal income tax on the citizen's worldwide income and subject to the U.S. federal gift, estate and generation-skipping transfer taxes with regard to all of the citizen's property transfers, regardless of the location of the property, whether during life or at death.**[6]**

When dealing with citizens of other countries who own assets in the United States or whose situations somehow impact on planning for U.S. persons, one should not assume that they are subject to worldwide taxation on the same basis as they would be if they were U.S. citizens. Most other countries tax on the basis of residence not nationality. Thus, if one of their nationals has habitually resided in the United States for a substantial number of years, that person may well be subject to the foreign country's income and transfer taxes only with respect to income earned and property located in that country.

The fact that the United States does impose its transfer taxes on a worldwide basis means that the estate planner to a U.S. citizen who lives abroad or who owns property abroad has a very complicated task. The planner must take into account the way foreign property and inheritance laws may affect the disposition of the client's property and, in the case of U.S. citizens living abroad, how foreign property and inheritance laws may even affect the disposition of the client's U.S. property. In addition, the planner must also carefully consider the impact of United States transfer taxes on gifts and bequests of foreign property as well as the impact of whatever transfer taxes the relevant foreign jurisdictions may impose on those properties. In the case of a U.S. citizen living abroad, the planner must also consider the possibility that, under the tax rules of the U.S. citizen's country of residence, that country may also claim the right to tax the U.S. citizen's property located in the United States. If so, the planner must address how the client's property can be organized to avoid being fully taxed both by the foreign country and the United States.

B. Enforceability

As to a U.S. citizen living abroad, one may ask how the United States can effectively enforce its claim to tax the transfers of the U.S. citizen's property located abroad. If the U.S. citizen has no property in the United States and none of the U.S. citizen's heirs are U.S. citizens or residents, the United States may well have difficulty enforcing its taxes. However, the general reluctance of countries to enforce other countries' tax laws is gradually being weakened by international efforts, especially in Europe, not only to fight money-laundering and fraudulent transfers of funds but also to promote tax harmonization and the flight of funds to tax havens. In any event, many U.S. citizens who live abroad own property in the United States and wish to give or leave their property to persons who are U.S. citizens or residents. The United States can seek payment of any unpaid taxes from any beneficiary or donee of such property who lives in the United States or over whom the United States has jurisdiction.

For example, the United States will have an estate tax lien against the U.S. property of a U.S. citizen living abroad, which can be seized to satisfy U.S. transfer tax obligations related to the foreign property as well as the U.S. property. If the property in the United States is subject to administration, the person appointed to administer the property will have to take into account the U.S. tax liabilities before distributing the property, or else risk personal liability for the unpaid taxes. Thus, in virtually all cases involving U.S. citizens living abroad, the consequences of the U.S. transfer tax system must be taken into account from a practical as well as a legal point of view.

VI. A U.S. citizen domiciled in a foreign country with estate or inheritance taxes may be subject to double transfer taxation unless that person lives in or owns property in a jurisdiction with a favorable U.S. transfer tax treaty.

There is no U.S. federal gift tax credit for gift taxes paid to a foreign country. There is a U.S. federal estate tax credit for "death" taxes paid to a foreign country, but there are two significant limitations on this credit, which effectively limit the scope of the credit to some or all of the death taxes paid to a foreign country only on property located in that country. The first limitation is generally designed to ensure that no greater percentage of foreign inheritance taxes paid will be allowed as a credit against U.S. taxes than that percentage of the total foreign inheritance taxes that is imposed on the foreign property that is also being taxed by the United States.**[7]** The second limitation is designed to ensure that no greater percentage of the total U.S. tax paid will be allowed as a credit than that percentage of the total U.S. taxes imposed on the decedent's foreign property.**[8]** The amount of the foreign death tax credit is the lower of the amount of foreign death tax calculated under the first limitation and the amount of U.S. tax calculated under the second limitation.

The result of these limitations is that the statutory foreign death tax credit can, under certain circumstances, present very little relief for U.S. citizens or domiciliaries who reside in, or for some other reason are subject to death taxes in, a foreign country on a substantial part or all of their worldwide estates. Take, for example, a U.S. citizen who maintains ninety percent of the citizen's worldwide assets in the United States but who resides in a foreign country that imposes inheritance taxes on a worldwide basis on its residents. Under the first limitation (which would apply here because the credit is limited to the lower of the two limitations), only ten percent of the foreign tax would be eligible for the credit. Assuming the foreign tax rate is the same or lower than the U.S. rate, ninety percent of the estate would be effectively subject to two death duties, with no mitigation of one against the other. Only if the rate of the foreign tax exceeded the U.S. rate would there be a possibility that some portion (and a very small portion at that) of the available credit would shelter any portion of the U.S. tax on the other ninety percent.

A U.S. citizen or domiciliary will possibly be entitled to more generous relief from double transfer taxation only if that person is fortunate to be a resident of a country with which the United States has entered into an estate tax treaty. The United States has entered into estate tax treaties that are currently in force with Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, The Netherlands, Norway, South Africa, Sweden, Switzerland and the United Kingdom. The treaties with Australia, Austria, Denmark, France, Germany, Sweden and the United Kingdom also cover gift taxes. The treaties with Australia and Italy are of very little current use, since these countries have effectively eliminated inheritance taxes. The United States has also entered into a Protocol to the U.S.-Canada Income Tax Treaty, which contains some partial amelioration of double death-time taxes that can result from the Canadian tax on a decedent's deemed or unrealized capital gains.

A. Situs Treaties

The U.S. estate tax treaties negotiated in the decade after World War II used a combination of situs and credit rules. In broad terms, under a situs treaty, assets belonging to a national or domiciliary of one state party that are deemed located in the other state party are permitted to be taxed by the other state party, subject to (i) an allocation against the other state's tax of a proportionate share of any exemption offered by the other state party and (ii) a prohibition on considering property in the national or domiciliary state in calculating the rate or amount of tax. The state of nationality or domicile is usually permitted to tax the same property, but is required to give a credit against its tax for the tax paid to the situs state. In the case where both countries tax because of domicile or citizenship connections, a credit is usually available equal to the lower of the two countries' taxes, with each country being required to give a credit against the other country's taxes based on its share of the total taxes that would be due if no foreign death tax credits were available.

B. Fiscal Domicile Treaties

The U.S. estate tax treaties negotiated in the seventies and eighties are predicated on a determination, for treaty purposes, of the "fiscal domicile" of the donor or decedent. If a person is considered by each country to be a domiciliary of that country, each of these treaties contains a set of "tie breaker" rules designed to produce a determination of "fiscal domicile" for treaty purposes. Like the "situs" treaties, but on a more restricted basis, a state party that is not the fiscal domicile is permitted to tax certain forms of property located in that country, and the domiciliary country is required to give a credit for the tax paid to the situs country. In cases where both countries are permitted to impose their tax on an unrestricted basis (assets located outside the country as well as within), the country of domicile is deemed to be the primary taxing authority, and the country of nationality is generally required to give a credit against its taxes for the taxes paid to the country of domicile.

The moral of the story with regard to a U.S. citizen or domiciliary living abroad is that choosing the right country of residence abroad with a favorable approach to estate taxes or with a favorable estate treaty can be as crucial to the maintenance of a family's wealth as choosing the country with a favorable approach to income taxes or a favorable

income tax treaty. Of course, most advisors' are only consulted by a family long after decisions about residence have been made for many other reasons. Still, if the country where the client resides does have an estate tax treaty with the United States, it may be possible to organize a client's assets in a way that will make the client's family eligible for the best treatment under the treaty. It is crucial to run calculations on what the client's foreign inheritance or death tax filing and payments would look like as well as the client's U.S. tax filings, to be sure that inconsistent treatment of certain assets or interests the client may have will not cause the treaty protections against double transfer taxes to be ineffective.**[9]**

VII. A U.S. citizen owning assets outside the United States should consider using tax efficient entities to hold foreign assets in order to eliminate or at least minimize the application of foreign heirship and foreign property regimes, complicated choice of law rules, and in some cases foreign taxes.

In planning the estate of a U.S. person who owns property or has other interests in many different countries, as indicated in Part IV above and Appendix A, one can become embroiled in foreign substantive and choice of law rules that are not always complementary or consistent to say nothing of the parallel tax rules and their ramifications. Therefore, one of the main goals of estate planning for a U.S. client who lives abroad or who has property abroad is to organize the client's property interests in a way that will insulate the properties from the application of local inheritance and property regimes and from the necessity of employing local forms of wills and local procedures for the distribution of inherited property.

The ideal way to accomplish this goal is to organize one or more asset-holding entities in a jurisdiction whose rules best permit the client to accomplish the client's goals or which will at least complement the rules of the jurisdiction you expect to govern the client's inheritance. The entities will generally be organized so that they will survive the client's death, with the result that the jurisdictions where the underlying properties are located will have no reason to take account of the client's death. That will be the result and this is often the most important factor if the jurisdictions where the underlying properties are located will recognize the entities as the legal and equitable owners of the property and will not "look through" them and impose any legal rights or obligations on the client as the owner of the entities.

There are three principal candidates from which to select entities that can be used to organize and hold a U.S. client's interests abroad:**[10]**   trusts; corporations; and limited liability companies.

A. Trusts

The institution of the trust, with its separation of right to title and rights to beneficial enjoyment, is deeply woven into the fabric of U.S. estate planning. It provides flexibility in providing for beneficiaries, especially for those to whom it would be unwise to transmit property directly, whether because of issues of capacity, financial responsibility, future need, or protection from creditors. It also provides the mechanism by which a wide variety of tax credits, exemptions and deductions can be preserved. From the income tax side, trusts can often be easily structured as grantor trusts, so that the client's income tax planning need not be upset by steps that are designed exclusively for estate planning purposes.

The institution of the trust, of course, is well known in many common law countries, and a number of off-shore jurisdictions have adopted it. However, it is still not widely recognized in most civil law jurisdictions. The fact that many jurisdictions do not have the institution of the trust means that non-trust jurisdictions often have difficulty in dealing with trusts that seek to hold property or do business. There is often the risk that the property held by the trust will be treated as the personal property of the trustee, subject to the personal creditors of the trustee and possibly even treated as part of the trustee's personal estate at death. It is often unclear how far a foreign court will go in recognizing the judgments of a court in the trust's home jurisdiction about the rights of beneficiaries that require extra-territorial effect.

The Hague Convention on the Law Applicable to and the Recognition of Trusts was proposed to avoid many of these problems by, among other matters, conferring legal recognition by civil law countries for trusts established in common law countries. Unfortunately, to date, only Italy and The Netherlands, among the civil law countries, have ratified the Convention. The fact that a trust cannot freely act across national boundaries therefore often makes it less than ideal as a vehicle for holding foreign assets of a U.S. client.**[11]**

B. Corporations

Corporations are well known as entities primarily designed to enable individuals to pursue commercial objectives, collect and organize capital, and insulate individual owners from liabilities of corporations when those liabilities exceed the capacity of corporations to satisfy them. Unlike a trust, however, corporations (with the possible exception of certain "family companies" under Swiss or Liechtenstein law) cannot operate as a direct mechanism for transmitting property at death. The directors of a corporation have a duty to the shareholders to operate the business of the corporation for the benefit of the shareholders, but they cannot decide to whom ownership of the corporation will pass upon a shareholder's death. That must be determined by the will or other testamentary instrument of the owner of the corporate shares.

Corporations organized in the United States can also pose certain income tax complications. A "C" corporation is a separate taxpayer with responsibility to file income tax returns (regardless of the level of income) and to pay income tax at the corporate level, while shareholders are taxed again on dividends and other forms of income distributions and also on the gains realized upon certain stock redemptions and the partial or complete liquidation of the corporation. While shares of a corporation that pass upon the death of an owner are entitled to a step-up in cost basis, there is no step-up in the cost-basis of the underlying assets.

In general, adoption of "S" status effectively removes the double taxation at the corporate and shareholder level because the corporation acts essentially like a conduit or pass-through entity, with the stockholders being liable for their allocable shares of the corporation's items of income and deduction. It does not change the fact that, while the shares of an owner will be entitled to a step-up in cost basis, there is no corresponding step-up in the cost-basis of the underlying assets. Moreover, there are a number of restrictions and limitations on the use of "S" corporations. These include a disqualification of any person who is not a U.S. citizen or U.S. resident from being a shareholder, a limitation on the number of shareholders to one hundred, and rather rigid rules as to what conditions must obtain for a trust to be a shareholder.

C. Limited Liability Companies

Limited liability companies generally offer an optimum combination of organizational and tax advantages. Like shareholders of a corporation, members of a limited liability company enjoy protection from liability for the company's liabilities as along as the company is properly organized and capitalized and company formalities are respected in the operation of the company's business. At the same time, a limited liability company will be treated for income tax purposes like a partnership, as a pass-through entity, with the members picking up their allocable share of the company's taxable income and deductions as part of their own income and deductions. Consequently, the problem of double taxation inherent in a "C" corporation is avoided without having to fit within the restrictive limitations of an "S" corporation. Of particular note is the ability of a limited liability company, like a partnership, to obtain a step-up in basis with respect to the member's pro-rata share of the assets held by the company at the death of a member and, of course, upon the purchase of a membership interest. In addition, all of the flexibility that a partnership has with regard to the gifting of limited partnership interests is available to membership units in a limited liability company.

VIII. Non-U.S. citizens who are domiciled in the United States are subject to U.S. worldwide transfer taxation while non-U.S. citizens who are not domiciled in the United States may be subject to no U.S. transfer taxes or only some U.S. transfer taxes.

All issues discussed in Parts V, VI and VII with respect to U.S. citizens also apply equally to non-U.S. citizens who are domiciled in the United States. For these purposes, domiciled means living in the United States with no definite present intention of later removing therefrom.

A. Different Treatment

When dealing with U.S. persons who are not U.S. citizens, it is important to remember that the rules for determining the scope of U.S. taxation are not identical for income tax purposes and for transfer tax purposes.

Take a legal immigrant, i.e., a person who is a U.S. permanent resident or "green card holder." To obtain a green card, one, must have an intent to take up permanent residence in the United States. However, there is no requirement that a person intend to live in the United States for the rest of that person's life. Thus, holding a green card may be very persuasive evidence of having the intent to make the United States one's domicile, but that inference can be rebutted by showing the close connections of the person to another country and the intention of the person to return or move there in the future. The same may be also true of a person who is subject to worldwide U.S. income taxation because the person established a tax residence here simply by spending a substantial number of

days here over a period of time. Such persons may include people who may stay in the United States in a legal non-immigrant status, such as investors who reside in the United States under E-2 status and other persons who have lived for many years in the United States with a succession of temporary visas such as an F (student) visa, an H (specialty worker) visa, or an L (intra company transferee) visa. It could also include people who have lived in the United States for many years without legal immigration status.

B. Consequences

If a U.S. permanent resident or a U.S. tax resident does not establish a U.S. domicile, that person will be treated for transfer tax purposes virtually the same as a person who is neither a U.S. citizen nor a U.S. resident ("nonresident alien"). The only gifts that will be subject to U.S. federal gift tax will be gifts of tangible property and real property located in the United States. All other gifts, including gifts of financial assets, will be completely free of U.S. federal gift tax. At death, that person's U.S. financial assets as well as tangible personal and real property located in the United States will be subject to U.S. federal estate tax but the United States will not be entitled to tax any of that person's non-U.S. property.

For estate tax purposes, one difference between the treatment of U.S. permanent residents and tax residents, on the one hand, and nonresident aliens, on the other should be noted: nonresident alien decedents do not generally pay U.S. federal estate tax on U.S. bank deposits and accounts nor on most U.S. debt instruments issued after July 1984, due to a legislative dictate that these assets, when owned by nonresident aliens, are treated as having a situs outside the United States.

IX. Non-U.S. domiciliaries who are not U.S. citizens may make unlimited gifts of U.S. financial assets (other than cash) completely free of U.S. federal gift and generation-skipping transfer taxes.

Foreign persons, that is, persons who are not U.S. citizens or domiciliaries, have the benefit of what is perhaps the biggest authorized "tax loophole" in the U.S. transfer tax system. Specifically, gifts by such foreign persons of all U.S. assets other than real property located in the United States and tangible property located in the United States are completely free of U.S. federal gift tax. Some care should be taken when a foreign person makes gifts of cash intended to be used to purchase real property located in the United States. In such cases, the Internal Revenue Service may argue that the gift is really a gift of real property subject to U.S. federal gift tax.

The benefit of the essential exemption from U.S. gift tax on transfers of all intangible assets by foreign persons is not only that a foreign person may make gifts of U.S. assets to family and friends but that it is a powerful planning tool in two particular categories. First, for a foreign person with substantial U.S. assets, it makes it possible to organize the foreign person's property to avoid U.S. estate tax upon the death of the foreign person with virtually none of the tax costs that must often be incurred to effect a proper estate plan for a U.S. citizen or domiciliary. Second, for a foreign person with substantial U.S. or foreign assets who has family and friends in the United States whom such person wishes to benefit, property can be organized for the benefit of those U.S. beneficiaries in a way that will preserve the assets from U.S. transfer tax for many generations. The principal vehicle for this benefit is a long-term family or "dynasty" trust that is funded with intangible U.S. or foreign assets. An indirect benefit of there being no gift tax on transfers by foreign persons into U.S. domestic trusts of foreign assets and U.S. intangible assets is that these transfers are also completely exempt from U.S. federal generation-skipping transfer tax. If the property was given directly to the present generation of U.S. beneficiaries, the property would be subject to U.S. federal estate tax and possible U.S. federal generation-skipping transfer tax as long as these taxes continue to exist. By placing the property in trust for the benefit of the U.S. beneficiaries but without their holding title to the property, the property can be available to members of the U.S. family but be completely insulated from the U.S. transfer tax system.

Prior to changes in the law enacted in 1996, it was possible for foreign persons who established irrevocable foreign trusts to confer a special income tax benefit on U.S. beneficiaries by ensuring that trusts they established qualified as "foreign grantor trusts" for purposes of U.S. U.S. federal income tax. In this way, a foreign trust could make distributions to U.S. beneficiaries and the receipt of the distributions would not cause the U.S. beneficiaries to have U.S. taxable income. Under current law, the only irrevocable trust that would qualify for this treatment would be a trust for the benefit of a U.S. spouse of a foreign person. The same benefit can still be realized if the foreign trust making distributions to U.S. beneficiaries is fully revocable by the person who established the trust. For some foreign persons who would like to benefit U.S. persons, particularly if these foreign persons live in jurisdictions that do not have income taxes, using a revocable trust structure may merit consideration.

X. Estates of Non-U.S. domiciliaries who are not U.S. citizens are subject to federal estate and gift tax on U.S. property owned directly by them.

As noted in the discussion in Part VIII, persons who are neither U.S. citizens nor U.S. domiciliaries who die owning U.S. assets are subject to U.S. estate tax on these assets. They also have a greatly diminished estate tax unified credit that translates into an estate tax exemption of only Sixty Thousand Dollars.**[12]** However, as also mentioned above, persons who are neither U.S. citizens nor domiciliaries and who are considered nonresident aliens for U.S. income tax purposes enjoy an exemption on virtually all U.S. bank deposits and accounts and on virtually all U.S. debt instruments issued since July 1984. U.S. life insurance policies on the life of a foreign decedent are also not taxed as part of such a person's estate.

While foreign persons are not eligible for as large an authorized tax loophole in the estate tax area as they are in the gift tax area, they have the next best thing: an almost breathtakingly simple way of protecting all of their assets from U.S. federal estate taxation. If an entity that the United States recognizes as a foreign corporation owns U.S. assets, the United States does not look through the foreign corporation to determine whether the underlying assets are U.S. assets. This is as true of real and tangible property located in the United States as it is of intangible property. A trust does not function in this way because, under long-established statutory rules, a trust in which the grantor has retained an interest or certain forms of control cannot serve as an intermediary entity to shelter the underlying assets from tax. Whether a partnership can be used for this purpose has been uncertain for many years. Moreover, since limited liability companies are usually treated for tax purposes as partnerships, it is also uncertain whether they would insulate their underlying assets from U.S. tax unless a check the box election is made to treat the company as a corporation.

Sound estate planning for foreign persons therefore generally requires the use of an offshore corporate entities. In the ideal situation, U.S. assets would be acquired in the name of the corporation. Transfers of U.S. assets owned by a foreign client to an offshore corporation are the next best thing. In the case of intangible or personal assets with a U.S. situs, transfers to a foreign corporation in exchange for stock of the corporation are exempt from U.S. capital gains tax just like any other sale of a U.S. capital asset that a foreign person owned. Transfers of real property to foreign corporations pose much more difficult problems because gifts of US real property are subject to gift tax and sales of U.S. real property interests are subject to U.S. capital gains tax and require compliance with FIRPTA.

It should be noted that, with proper planning, it may also be possible to obtain income and capital gains tax savings for foreign clients who contemplate acquiring U.S. property or making gifts of property to U.S. persons or entities.

CONCLUSION

In conclusion, it is hoped that the discussion in this article has highlighted some of the novel and complex issues that must be confronted in dealing with cross-border estate planning. The article does not purport to prescribe answers to all of these issues, but hopefully it will enable readers to identify those unexpected circumstances and superficially domestic scenarios that can easily harbor international estate planning issues and challenges.

APPENDIX A

Basic Choice of Law Concepts for International Estate Planning

A. Choice of Law Based on a Distinction Between Real Property and Personal Property. Virtually every jurisdiction within the United States uses a relatively simple rule to determine the law that governs the property that is part of a decedent's estate. That rule says that the law of the situs of real property governs all legal issues concerning any such real property, including the land that makes up the property and the physical building and other structures that cannot be easily removed from the land. The rule also says that the law of the domicile of the decedent governs all other forms of the decedent's property, which is generally referred to as "personal property" and includes tangible property other than real property as well as all financial assets, claims and legal rights, often referred to as "intangible property."**[13]**

An example will help to make clear how important the distinction between real property and personal property can be in determining governing law: Take a New York domiciliary decedent who acquired a vacation home in Arizona during his second marriage. The decedent's will leaves the Arizona home to his only child from his first marriage. But the surviving spouse's rights with respect to the Arizona real property would most likely be governed by Arizona law. Because Arizona is a community property state and the home in Arizona was acquired during the second marriage the surviving spouse may well be able to claim a one-half undivided share in the Arizona home on the basis that the real property was property of the marital community, regardless of the provisions of the decedent's will. In that case Arizona community property law may be applied to defeat the testamentary interest of the decedent's child in the wife's one-half interest in the Arizona home because the home is real property located in Arizona.

Anyone advising U.S. clients who own property abroad must be aware that most countries abroad (with the exception of some countries in the common law tradition, like England and provinces of Canada other than Quebec) do not follow the rule based on the distinction between real and personal property. First, for those countries that do make some distinction between what Americans would consider real and personal property, the distinction is made between "immoveable" and "moveable" property. The distinction is similar to the differences between real and personal property, but not the same. Generally, immovable property consists not only of land and permanent structures connected to it but also leaseholds, mortgages and other claims or rights that are closely related to real estate. Moveable property generally consists of all other forms of property including financial assets other than those closely tied to real property. Take a U.S. citizen client domiciled in New York who owns a mortgage on real property located in France. We will assume that this person is not a dual U.S. French citizen. What law will govern the inheritance of the mortgage? France applies French law to immoveable property located in France owned by a person who is not a French citizen and applies domiciliary law to that person's moveable property. Because the mortgage is considered under French law to be immoveable property, French law would govern.

B. Choice of Law Based on a Unitary Approach to Property. The biggest differences between the way we in the United States are accustomed to determining governing law and the way governing law is determined in many other countries is (1) they do not make any distinction between types of property at all, and (2) they determine governing law in the estate context on the basis of nationality. Where the country of nationality has a federal system, the governing law would be determined on the basis of the "habitual residence" of the decedent. This appears to be a much simpler and straightforward approach. Thus, for example, a United States citizen who has lived in New York for many years and who owns real property in Germany could assume that German officials would apply New York law to the inheritance of the property because of the owner's U.S. nationality and New York residence.

Unfortunately the issue has become more complicated over recent years because many countries, including Germany, have adopted a more complicated approach to applying the law of nationality. The principle of nationality remains unchanged but now the reference to the law of nationality is not only to the property and inheritance laws of the country of nationality but also to the "choice of law" rules of that country as well. So, in our example, a German court would look first to the choice of law rules of New York before looking to the substantive New York rules. Since, under New York law, the law that applies to real property is the law of the situs or location of the property, a German court would most likely apply German law to the inheritance of German real property owned by a New York decedent. Practice in this regard among the major civil law countries in Europe is not consistent, which underscores the need for obtaining competent local counsel in dealing with most international estate planning and administration issues.

NOTE:
An earlier version of this Article appeared in the Spring 2003 edition of the New York State Bar Association's International Law Practicum. The author wishes to thank Jeffrey B. Kolodny, an attorney in the Trusts and Estates Department of Phillips Nizer LLP, for his assistance with the revisions incorporated in this Article. This Article is written for academic purposes and does not constitute tax advice. It is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the IRC or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

[1] Private Letter Ruling 9843030 (October 23, 1998).

[2] For a full analysis of U.S. charitable giving rules as they apply in the international context, please see Galligan, "International Charitable Giving and Planning Under U.S. Tax Law," Tax Management Estates, Gifts and Trusts Journal, May-June 2004 at 151.

[3] The U.S. Treasury's final regulations provide a "safe harbor" for compliance with the "court test." Thus, a trust will be deemed to satisfy the "court test" if (1) the trust instrument does not direct that the trust be administered outside the United States, (2) the trust is administered exclusively in the United States, and (3) the trust is not subject to an automatic migration provision. The requirement that the trust be administered in the United States means all steps necessary to carry out the terms of the trust and applicable law (including maintaining the records of the trust, filing tax returns, managing and investing trust assets, defending the trust from suits by creditors, and determining the amount and timing of distributions) must be performed in the United States.

[4] For a fuller discussion of many of these issues, please see Galligan, "Foreign Trusts and U.S. Estate Planning:: A Client-Centered Analysis," published in the Journal of Asset Protection (July/August 1999).

[5] Keep in mind that all three countries mentioned in the previous discussion in Part IV A. about forced heirship operate under the systems of community property.

[6] At one time, the United States did not attempt to impose its transfer taxes on a U.S. citizen's transfers of real property, but that exclusion was abolished in 1978. Predictions about the long-term future of the U.S. federal estate tax, now slated for a one-year suspension in 2010, are almost as numerous as the predictors. Given the vagaries of U.S. politics and the re-emergence of the federal deficit, it seems imprudent to assume that the current tax structure will be totally disassembled. At the time this Article went to press the House of Representatives had passed a bill to repeal the U.S. federal estate tax but passage of that bill in the Senate was far from clear and it appeared that some sort of compromise reform bill might be more likely.

[7] Thus, the amount of foreign tax paid must be multiplied by a fraction, the numerator of which is the value of the property in the foreign country subject to that country's tax that is also taxed by the United States, and the denominator of which is the value of all property subject to foreign tax by that country. Take an estate of a U.S. citizen living in a foreign country that consists fifty percent of real property in the foreign country and fifty percent of a trust that the foreign country taxes but the United States does not. Only fifty percent of the tax paid to the foreign country on the real property would be available for credit against the United States tax.

[8] Thus, the amount of U.S. tax paid must be multiplied by a fraction, the numerator of which is the value of the property subject to tax in the foreign country, and the denominator of which is the total property subject to U.S. tax. For this purpose, the value of the foreign property in the numerator of the ratio must be reduced by deductions to the extent they would cause the property to be effectively excluded from U.S. tax, including the charitable and marital deductions and the special deduction allowed for taxes paid to a foreign country on charitable contributions. Similarly, the value of the entire estate subject to U.S. tax in the denominator is reduced by the marital and charitable deductions allowed on the entire estate.

[9] For a fuller discussion of some important fiscal domicile treaties, please see Galligan, "Making Sense of Four Transatlantic Estate Tax Treaties: US-Netherlands, US-Germany, US-France and US-UK," New York State Bar Association International Law Practicum (Spring 2004).

[10] Care must be taken to ensure that transfers to those entities do not result in adverse income tax consequence to the client under the tax laws of the country in which the property is located or, if the client lives abroad, the country of the client's residence. In most cases, these transfers should be able to be effected without adverse U.S. income tax consequences.

[11] Readers may wish to consult the author's report on the possible impact on U.S. trust law of the Hague Convention on the Law Applicable to Trusts and their Recognition that appeared in the Fall 2000 issue of the NYSBA Trusts and Estates Section Newsletter.

[12] The revamping of the federal transfer tax system in 2001 provided partial estate tax relief to U.S. citizens and domiciliaries by gradually raising the estate tax exemption from $1 million to the current exemption of $1.5 million and eventually to $3.5 million in 2009. No such relief was afforded to the estates of persons who are neither U.S. citizens

nor U.S. domiciliaries, for whom the exemption remains at the current Sixty Thousand Dollar level.

[13] Thus, interests in leaseholds, mortgages or even stock in cooperative housing corporations, since they are not direct interests in real property, are considered personal property and would be governed by the law of the domicile of the decedent rather than the law of the location of the real property to which they are related.