# Article - International Estate Planning for U.S. Citizens: An Integrated Approach (Estate Planning, a Thomson Reuters publication)

by Michael W. Galligan

*This article advocates the creation of integrated international estate plans for U.S.citizens, particularly through the use of U.S.LLCs to hold the non-U.S. property of U.S.citizens.*

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For decades, if not for almost a century, it was widely assumed that any U.S. citizen who owned property outside the U.S. or who resided outside the U.S. should have a separate will for each jurisdiction in which the U.S. citizen resided or owned property. This assumption made sense in an era when each national legal system operated in apparent sovereign separation from other countries, with full discretion whether to enforce the judgments of other nations' courts and full liberty to decline to enforce other nations' tax laws.

But the landscape has changed, especially after the end of the Cold War in 1989 and after the terrorist attacks of 9/11/01. As the European Union ("EU") encompasses more and more countries, the respect generally granted to the judicial judgments and decisions of other countries, especially within Europe, continues to increase; [2] similar developments are afoot in Latin America. [3] Perhaps, even more importantly, countries seem increasingly willing to bind themselves to a mutual exchange of information and even assist in enforcing each other's tax laws as well as participate in multilateral security initiatives for which "tax evasion" ranks almost equally with money laundering and terrorism as an evil to be defeated. [4]

## Why a unified estate plan is necessary

Even before these recent changes in the international climate, there were—and are now—good practical reasons to organize an international estate plan to ensure that all property of a U.S. citizen could pass, directly or indirectly, under one comprehensive will or will substitute. To rely, without good reason, on multiple wills is to court disaster: one will may accidentally revoke another; the proper formalities for each relevant jurisdiction may not be followed; lack of clarity about the situs of particular properties may leave it unclear as to which will governs what property. Even practitioners who focus mainly on domestic planning advise their clients to hold property outside the state of their domicile through limited liability companies ("LLCs") or revocable trusts. This commonsense approach does not cease to apply when one crosses the borders of the United States!

But even more important reasons exist for seeking to integrate an international estate plan than the dangers of faulty drafting and duplicative estate proceedings.

***The need to be able to use trusts.*** The trust is the workhorse of U.S. estate planning. Most applicable exclusion, marital deduction, and charitable deduction planning is unthinkable without trusts. Lifetime planning transfers such as qualified personal residence trusts ("QPRTs"), grantor retained annuity trusts ("GRATs"), and grantor retained income trusts ("GRITs"), as well as sales to grantor trusts depend self-evidently on the law of trusts. But many of the most important countries in the world view trusts differently. For example, under German law, transfers to trusts under German wills violate public policy, while transfers to non-German trusts under non-German instruments incur gift and inheritance tax at the highest marginal tax rates. Switzerland recognizes trusts but looks through the trust to the underlying grantor or beneficiary for income tax purposes. The trust is not an institution fully incorporated in the internal law of any country in continental Europe, save Liechtenstein; in none of these countries can transfers to a trust be credited toward the share that a surviving spouse and children are required to inherit from their deceased spouse or parent.

Japan has trusts, but trusts still do not satisfy mandatory inheritance requirements for surviving spouses and children. England, the birthplace of modern trusts, does not have mandatory inheritance in the tradition of the civil law codes; nonetheless, the tax treatment of transfers to trusts under the Finance Act of 2006 does not accord with U.S. tax concepts. For instance, transfers of English property to a revocable trust may trigger an inheritance tax charge of 20%.

But the problems do not stop with the uncertain status of the trust throughout much of the world.

***Discordance between U. S. law and non-U.S. law.*** Most countries in the world (including many common law countries as well as most civil and Sharia law countries) think very differently from the United States about inter-generational wealth transfers, inheritance, family and creditor protection, and how wills are made and implemented. Here are some resulting areas of concern.

*Community property.* To prepare an estate plan, one must know the nature and extent of the property for which one is planning. Under the law of China, South Africa and Taiwan, as well as most countries in continental Europe and virtually all countries in Latin America, spouses own property "in community" unless they have expressly adopted another marital property regime such as separation of property. This means that a married U.S. citizen client may not have as much property to dispose of as the client thought!

Moreover, a married U.S. citizen from a non-community property U.S. state who purchases a residence or a business in a community property country might effectively be making a gift of one-half of the property to the non-purchasing spouse at the time of the acquisition. This could create significant U.S. gift and estate tax issues if the non-purchasing spouse is not a U.S. citizen. Conversely, there may also be significant planning opportunities when the purchasing spouse is neither a U.S. citizen nor a U.S. domiciliary.

*Mandatory inheritance.* Virtually every country in Latin America, continental Europe, the Middle East (except Israel), and important countries in Asia (including Japan, Korea and Taiwan) require that spouses, descendants, and sometimes parents inherit—or have a claim to—a portion of or interest in their decedent's property, regardless of what the decedent's will may provide. In countries where Sharia law applies, this requirement can even extend to siblings. These shares can apply to as much as three-fourths of a decedent's property. Furthermore, lifetime transfers must often be added back for purposes of determining the value of the putative "reserve" for division among mandatory heirs. [5] Sharia law, at least as applied in the United Arab Emirates, forbids a testator from leaving the "free" portion (one-third) of an estate to beneficiaries entitled to a share of the two-thirds mandatory portion. Although Indian inheritance law honors testamentary freedom, Sharia law restrictions are considered enforceable against estates of Indians of Moslem faith and certain restrictions on the disposition of "Hindu Undivided Property" also have legal sanction.

Mandatory or "forced" heirship rules perhaps have the greatest potential for playing havoc with a U.S. estate plan. Few circumstances can deal a more devastating blow to a typical plan for a U.S. married couple to defer estate taxes until the death of the surviving spouse than a provision of a non-U.S. jurisdiction that requires a non-U.S. citizen spouse or child (whether a U.S. citizen or not) to inherit large amounts of property outright upon the death of the first spouse to die.

At the same time, most of the major common law countries, such as England (only in the case of English domiciliaries), Ireland, Canada, Australia and New Zealand, allow a will to be reformed after a decedent's death to provide for the support of family members and care providers who can establish need for postmortem support or an equitable share in a decedent's property, while China provides that family members who were supported by the decedent should share in the estate. While not as likely to ruin a proper U.S. estate plan as mandatory inheritance rules of "civilian" countries, the risks are still there. [6]

*Unlimited liability.* Under the law of Japan, Korea and Taiwan, as well as many countries in Europe and Latin America, heirs are deemed to inherit property from a deceased person immediately upon death, without a common law estate administration (thus the distinction between common law "probate" and civil law "succession"), but the corollary is that heirs assume liability to creditors of their decedent even if the liabilities exceed the value of the inherited property. Usually, an election can be made to limit this liability to the value of the assets actually inherited, which then gives rise to something akin to a common law estate administration. But the time limits for making this election are often very short (one month in Switzerland, three months in Japan, Korea and Taiwan), and failure to make a timely decision is not easily repaired. [7]

*Conflicts of laws.* Wrapped around all these issues is the challenge of knowing with reasonable certainty the law that will apply to a U.S. client's testamentary plan in the first place. The main options are nationality with regard to all property (e.g., Austria, Germany, Italy, Japan, Poland, Spain, Sweden, Taiwan); residence with regard to all property (e.g., Argentina, Brazil, Denmark, Finland, Switzerland); domicile with regard to all property (e.g., Chile, United Arab Emirates [8]); situs for immoveable property and domicile/residence for moveables (e.g., Belgium, Canada, Costa Rica, France, Israel, Russia, South Africa); situs for real property and domicile for personal property (e.g., Australia, Canada, Ireland, New Zealand, and the United Kingdom); situs for real property and shares of companies and domicile for other moveables (e.g., China and Ukraine); and situs for real property and nationality for everything else (e.g., Monaco).

The diverse ways in which non-U.S. courts apply "foreign law" is a great source of uncertainty. Do they apply only the "substantive law" or the "whole law?" If the whole law, do they accept a referral back ("remission") to their own laws or a referral ("transmission") to the laws of a third country? To what extent will they entertain a "foreign court" or "double remission" approach? The next worse thing to the derailment of a U.S. estate plan by discordant non-U.S. property and inheritance rules is the derailment of the plan by a failure to correctly identify the proper law of the country that will apply to estate property or an unforeseeable change in the "private international law" of the country that has to make that decision.

*Inheritance taxes.* Many countries have inheritance taxes, sometimes with rates of tax that approach, and in certain cases even exceed, U.S. rates: Belgium, Chile, Dominican Republic, Finland, France, Germany, Greece, Ireland, Italy, Japan, Korea, Netherlands, Norway, Poland, South Africa, Taiwan, Ukraine, United Kingdom, and Venezuela. Canada and Peru each have income taxes that serve as an inheritance tax substitute. Some Brazilian states and Swiss cantons also impose inheritance tax.

In most cases, these taxes would be applied on a worldwide basis if a U.S. citizen died a domiciliary or resident of the relevant jurisdiction. Interesting exceptions are Chile, which taxes non-Chilean property of a U.S. citizen resident in Chile if the non-Chilean property was acquired with Chilean source funds, and Taiwan, which taxes the non-Taiwanese property of a Taiwanese national. While having no Mexican inheritance tax, Mexican states have transfer taxes that would apply to transfers of real property by reason of death.

The estate tax credit for "foreign death taxes" under IRC Section 2014 covers "foreign" inheritance taxes imposed on "foreign" property. The rules for determining if property is "foreign" for credit purposes generally follow the IRC Section 2105 rules for determining if U.S. property owned by a non-U.S. person is exempt from U.S. estate tax because it is deemed located outside the United States. But reliance on the credit is not always satisfactory because the United States credits only taxes paid to the United States on the property taxed abroad, while the country abroad may tax property eligible for the U.S. marital or charitable deductions. Moreover, the Section 2014 credit does not apply to "foreign" taxes on property located in the U.S.

Some relief for U.S. citizens or beneficiaries in this situation is provided by "modern" U.S. estate tax treaties with such countries as France, Germany, Netherlands and the United Kingdom and by the U.S. income tax treaty with Canada. The "older" estate tax treaties with Finland, Greece, Ireland, Italy, Japan, South Africa, and Switzerland may also afford protection depending on the circumstances. But there is no such treaty protection for U.S. citizens who reside in such countries with significant worldwide inheritance taxes as Belgium, Chile, Korea, Philippines, Poland, Turkey, Ukraine, and Venezuela.

## How to create a unified estate plan

This article focuses on a strategy of converting a client's non-U.S. property into U.S. property by using a U.S. entity—particularly a U.S. LLC—to hold all non-U.S. property owned by a U.S. citizen domiciled in the United States and, in some instances, all U.S. as well as non-U.S. property owned by a U.S. person domiciled abroad. The purpose is to unify a U.S. citizen's estate plan so that U.S. planning documents will govern all non-U.S. property and minimize as much as possible the ability of discordant non-U.S. property and tax rules to undermine the integrity of the U.S. estate plan. As discussed below, the first step in international planning for U.S. citizens should be to consider this "holding company" approach and then to supplement it with other measures to the extent that it cannot stand on its own.

***Characteristics of the limited liability company.*** An LLC has great legal and tax flexibility under U.S. law. From a tax perspective, a single-owner LLC is completely disregarded for U.S. tax purposes (absent an election to be treated as a corporation) and, if there are two or more owners, is treated as a partnership (in the absence of an election to be treated as a corporation). Thus, one can avoid the two-tiered system of taxation associated with C corporations and also the exclusion of the underlying assets from cost basis "step-up" at a shareholder's death, which, absent careful planning, may preclude underlying assets of an S corporation as well as assets of a C corporation from this important benefit. In the case of a multi-member LLC, the ability to make a basis step-up election under IRC Section 754 also allows persons who inherit membership interests a measure of tax savings with respect to sales of LLC assets after a decedent's death.

## Effect of a unified plan: Results from international estate planning survey

In preparation for this article, a survey was conducted among leading non-U.S. succession and tax law counsel in many countries where U.S. citizens own property or live, including Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Costa Rica, Denmark, Finland, France, Germany, Hong Kong, India, Ireland, Israel, Italy, Japan, Korea, Mexico, Monaco, Netherlands, New Zealand, Panama, Philippines, Poland, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Ukraine, the United Arab Emirates, and the United Kingdom. [9] On the basis of this survey, it appears that effectively converting the non-U.S. assets of a U.S. citizen to U.S. assets by interposing a U.S. LLC between the U.S. citizen and the non-U.S. assets often reduces or even eliminates the applicability of non-U.S. property, succession and tax law principles that would otherwise interfere with the smooth application of the U.S. citizen's estate plan.

When the use of a U.S. holding company does not afford complete protection from discordant non-U.S. property and tax rules, the U.S. estate plan can still be protected by assuring that favorable non-U.S. choice of law principles are fully exploited, using pre-mortem and postmortem renunciations in the non-U.S. jurisdictions, having all heirs join in an inheritance or succession agreement enforceable in the United States, and/or carefully drafting the dispositions under the U.S. planning documents to encourage maximum cooperation by the heirs with the U.S. citizen's estate plan.

***Permissibility of transfers of non-U. S. assets to U.S. LLC.*** Of the jurisdictions surveyed, Australia, Belgium, Brazil, Canada, Chile, Costa Rica, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Korea, Mexico, Monaco, Netherlands, New Zealand, Panama, Russia, Spain, Sweden, the United Kingdom, Ukraine, and the United Arab Emirates generally permit a home owned by a U.S. citizen to be transferred to a U.S. LLC. Transfers of a home in Australia require the approval of the Treasurer (easily granted). Transfers of real property in areas near the borders of Argentina and Brazil require administrative approval. Neither individuals nor non-Chilean entities can own real property near Chilean borders. In Costa Rica, the LLC would need to appoint a legal representative to act for and represent the LLC before the Costa Rican public registry, and all other Costa Rican legislation related to real property must be duly followed. Administrative approval is also required for transfers of real property near Mexican borders or the Mexican coast, which must generally be held in the first instance by a Mexican trust or, if for commercial purposes, by a Mexican entity whose corporate parent can be a U.S. LLC.

Transfers of homes in Austria require provincial approval, which are reviewed more intensively in the Alpine regions. Denmark imposes some restrictions on transfers of homes to non-EU entities. Transfers of homes in Korea require a report to a government bureau. In Poland, an official permit would be required, with evidence of the LLC's owner's ties to Poland. A U.S. LLC, like any other non-Philippine person, may effectively hold only an interest in a condominium, as long as Philippine persons own at least 60% of the property. To own real property in South Africa, a U.S. LLC must interpose a South African company.

A U.S. LLC cannot generally own a home in China without establishing a representative office in China, a relatively easy hurdle to overcome; interposition of a Hong Kong or a Singapore company could also be considered. As to Singapore, the approval of the Minister of Law is required other than for apartments in buildings governed by specific Planning Act schemes. For Taiwan, the ability of a U.S. citizen to own non-agricultural real property—and, thus the ability to transfer it to a U.S. LLC—depends on whether the U.S. citizen's home state permits Taiwan citizens to own property in that state (apparently the case in 43 states). Transfers of homes in Switzerland and India to a U.S. LLC are currently more difficult because of general limitations on foreign ownership of real estate.

All the surveyed countries permit transfers of tangible property owned by a U.S. citizen to a U.S. LLC, on the condition that works of art are not "national patrimony" (Italy), "of historical significance" (Poland), or subject to a state option to purchase unique works of art (Denmark). A U.S. LLC may own works of "cultural value" located in Russia or Ukraine but may not be able to move the works permanently outside either country.

The great majority of the surveyed jurisdictions permit transfers of business interests owned by a U.S. citizen to a U.S. LLC. In Argentina, Brazil, Japan, Korea and Ukraine, a U.S. LLC owning a local company would have to register the

U.S. ownership with local authorities, and a government permit is often required in the case of Poland. If a U.S. citizen resides in South Africa, transfers of South African business interests would be subject to approval by the foreign exchange authority ("ExCon"). Transfers of shares of certain commercial and professional Monaco companies require government consent. While there are no express provisions of Russian law prohibiting non-Russian ownership of Russian business entities, the September 1999 legislation on foreign investment must be followed. Taiwan permits the transfer of Taiwanese companies upon approval of a business plan by Taiwan's Investment Commission.

***Impact on non-U.S. community property.*** Of the surveyed countries, Belgium, Brazil, Chile, China, Costa Rica, Denmark, France, Italy, Mexico, Netherlands, Philippines, Russia, South Africa, Spain, Sweden, Switzerland, and Ukraine have some form of community property as the default regime for regulating property ownership by spouses. [10] However, in some countries such as Belgium, Sweden and Switzerland, local community property rules generally apply only when at least the U.S. citizen spouse and sometimes both spouses resided in the country at the time of marriage or when the property was acquired. In the Philippines, the rules do not apply if both spouses are non-Philippine citizens even if they are Philippine residents.

In a number of countries, including Chile (real estate only), Italy, Russia, South Africa, Sweden (real estate only) and Taiwan, the consent of both spouses appears to be required to effect the transfer of community property to an LLC. Even with such consent, the community property regime may simply adhere to the U.S. LLC interests for which the non-U.S. property was exchanged, at least in community property states like California, New Mexico or Texas and states such as New York that have adopted the Uniform Disposition of Community Property Rights at Death Act.

***Impact on non-U.S. inheritance regimes.*** Of the surveyed countries, all but Israel and South Africa (save for an exception for spousal maintenance) have at least some rules regarding inheritance that are inconsistent with U.S. inheritance rules. Here, one must carefully consider whether the U.S. citizen will be considered by a U.S. jurisdiction to be its domiciliary and whether any non-U.S. jurisdiction might consider the U.S. citizen to be its domiciliary or resident. One must also consider whether the non-U.S. property was first acquired by the U.S. citizen personally or by the LLC.

*Effectiveness of transfers to U.S. LLC.* A transfer to a U.S. LLC of property with a situs in a non-U.S. jurisdiction owned by a U.S. citizen considered by that same jurisdiction to be domiciled or resident in the United States appears to afford protection from the application of discordant inheritance rules in the following jurisdictions: Australia, Belgium, Brazil, China (excepting real property and business interests), Costa Rica, Denmark, France, Germany, Ireland (possibly excepting real property), England and Wales, Mexico, Monaco, Netherlands, Panama, Poland (as long as the transfer is a sale and not a gift), Russia, Switzerland (except for real property), Taiwan, and the United Arab Emirates. [11]

In addition to the protection afforded by all the countries just mentioned above, protection appears to be afforded as well in the following jurisdictions when the property is first acquired by the LLC rather than by the U.S. citizen: Canada, Finland, Ireland (for real property as well), Italy, Japan, Philippines, Poland and Sweden. As a practical matter, transfers of property with a situs in other jurisdictions that have mandatory inheritance rules to a U.S. LLC may still afford protection in these jurisdictions because judicial proceedings, which are not common in the administration of a succession, may be required to enforce these rules on property not owned in the decedent's own name.

In the case of a U.S. citizen domiciled or resident in a non-U.S. jurisdiction, the protection afforded by a U.S. LLC is often less, especially if the situs country applies the law of domicile or residence to the inheritance of intangible assets, because the inheritance of the U.S. citizen's LLC interest would then be governed by the law of the non-U.S. country where the U.S. citizen is considered most likely domiciled or resident. But here, local "private international law" may help: Switzerland allows a non-Swiss national, even if a Swiss resident, to elect to have national law apply to Swiss as well as non-Swiss property. [12]

Each of Poland, Spain and Sweden applies nationality law to its residents but does not necessarily apply its own law even when nationality law would defer to the law of residency (technically, "accept remission" or "renvoi"), so that U.S. law could still apply to all property of a Spanish or Swedish national, even with respect to Spanish or Swedish real property. [13]In the case of Italy, which follows the nationality principle but accepts remission, a U.S. citizen may be able to achieve the same result by directing in his or her will that remission should not apply. [14] Transfer of Brazilian property owned by a U.S. citizen residing in Brazil to a U.S. LLC would cause Brazilian rules not to apply to it.

*Supplemental measures.* In cases where a transfer of local assets to a U.S. LLC does not completely exempt the property from local inheritance rules, the transfer may still help accomplish the desired result. In some jurisdictions, transfers of "reserve" property to a U.S. LLC would be voidable but not void. In many jurisdictions, an heir who claims to be disadvantaged by a pre-mortem transfer must take affirmative steps to assert claims against transferred property in the courts of that jurisdiction.

In Argentina, for example, a court may consider such circumstances as whether the transfer to the LLC was for adequate and full consideration. When the assets were directly acquired by the LLC, an Argentine court is less likely to set aside the transfer. In some jurisdictions, a court may also take into account the degree to which, as a practical matter, the disposition of the assets of the LLC according to a U.S. citizen's testamentary plan would be as generous to an heir as the satisfaction of a mandatory heirship share.

When a transfer of non-U.S. assets to a U.S. LLC does not afford unquestionable protection from local inheritance rules, a second and even a third "line of defense" should be applied, such as an agreement by the beneficiaries of the U.S. estate, as a condition to their inheriting under the U.S. plan, not to challenge any of the transfers to the U.S. LLC nor to require that the transfers be added back in any local "reserve" calculation and to sign any local instruments of renunciation that may be necessary to fulfill this purpose. [15] Most countries surveyed have provisions for postmortem renunciation of statutory shares, and several countries—Austria, Denmark, Finland, Germany, Poland, Sweden, Switzerland, and Taiwan—even allow pre-mortem renunciations of forced or mandatory inheritance shares. [16]

An even stronger line of defense would be to include an in terrorem clause in the U.S. will that would disinherit any beneficiary who chose to try to enforce rights under non-U.S. law that violate the estate plan. An alternative, especially in states that disfavor in terrorem clauses, would be to condition legacies under a U.S. will, whether outright or in trust, on cooperation in the postmortem implementation of the U.S. plan. Such conditions should be enforceable in any U.S. jurisdiction (except possibly Louisiana) on the basis that a beneficiary would have no legal right to compel a legacy from the decedent and therefore the decedent can impose any condition that does not violate public policy. Conditional bequests are not generally contrary to public policy in the United States, and it is to U.S. courts that estate fiduciaries as well as beneficiaries of a U.S. citizen would look to enforce the terms of a U.S. will or will substitute.

***Impact on unlimited liability.*** Of the surveyed countries, the following provide that persons who inherit property from a decedent generally inherit unlimited personal liability for their decedent's unsatisfied debts: Argentina, Austria, Belgium, Chile, France, Germany, Italy, Japan, Korea, Netherlands, Poland, Spain, Switzerland, and Taiwan. Some countries—including Belgium, Germany, Italy, Spain, Switzerland, and Taiwan—do not apply this principle if, under their choice of law rules, their own law does not apply to a decedent's succession. Thus, the efficacy of a transfer of assets in any of these jurisdictions to a U.S. LLC would depend on the extent to which such a transfer would protect the assets from the reach of the inheritance rules of that jurisdiction.

***Impact on inheritance taxes.*** Of the surveyed countries, the following impose meaningful inheritance or inheritance-related taxes: Belgium (regional), Brazil (state level), Canada, (deemed capital gains tax), Chile, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Korea, Monaco (not on transfers to spouses, descendants and ascendants), Netherlands, Philippines ("estate tax"), Poland, South Africa, Spain, Switzerland (cantonal with total exemption for spouses and exemptions or low rates for descendants), Taiwan, Ukraine, and the United Kingdom.

*U.S. citizen `domiciled' or `resident' in the United States.* It appears that transfers by a U.S. citizen of assets located in the following jurisdictions to a U.S. LLC should cause the assets not to be subject to that jurisdiction's inheritance taxes, at least if the U.S. citizen is not considered by that jurisdiction to be its domiciliary or resident (or, in the case of Taiwan, a national): Belgium, Brazil (unless an heir is a Brazilian resident or the transferred assets are mainly real estate), Canada, Chile, Denmark, Finland (unless an heir is a Finnish resident or an asset is Finnish real estate or a Finnish real estate company interest), France (only for moveable assets), Germany (as long as the LLC qualifies as a corporation for German tax purposes and an heir is not a German resident), Ireland (as long as an heir is not an Irish resident), Italy (if interests in the LLC are not solely owned by the decedent), Japan (unless an heir is a Japanese resident), Korea (but subject to a "clawback" for some transfers made within the previous five years), Monaco, Netherlands (as long as the assets of the LLC do not consist principally of Netherlands real property), Philippines, Poland, South Africa, Spain (in certain cases for immoveable assets only as long as an heir is not a Spanish resident), Taiwan, Ukraine (as long as an heir is not a Ukrainian resident), and the United Kingdom. The same exclusion appears to apply to local real property transfer taxes on the inheritance of Mexican real property.

One must keep in mind that the U.S. estate tax credit under IRC Section 2014 may be useless if there is no U.S. tax against which to apply the non-U.S. tax payment and when there is a U.S. tax, the effective non-U.S. tax rate on the non-U.S. property may be higher than the effective U.S. rate. Therefore, by removing the property from taxation in the non-U.S. country, one may be able to avoid any non-creditable non-U.S. tax entirely.

*U.S. citizen residing abroad.* The estate of a U.S. citizen residing in one of the above-mentioned countries could be subject to that country's inheritance tax on all property, including U.S. property. A beneficiary of that U.S. citizen who resides in one of these countries other than Brazil could be subject to inheritance tax on inherited U.S. property as well as inherited property located in that country.

The Section 2014 credit does not cover non-U.S. taxes on U.S. property and the United States does not have estate tax treaties with many countries, including, of the surveyed countries that tax inheritances, Belgium, Chile, Denmark, Korea, Philippines, and Ukraine. Denmark, Chile, Korea, and the Philippines have their own foreign death tax credits, each of which appears to effectively provide a credit against local tax for the U.S. estate tax on U.S. property; Belgium gives a credit for non-Belgian taxes on non-Belgian real property. For countries like the Ukraine, to claim the benefit of the Section 2014 credit for non-U.S inheritance/estate taxes on U.S. property, one may have to consider placing the U.S. assets in a special holding company organized under the laws of the country where a U.S. citizen resides in order to convert the U.S. assets into non-U.S. assets eligible for the credit. [17] The special holding company could still be owned by the U.S. LLC, at least as long as the U.S. citizen is the only member of the LLC, thus preserving the unity of the estate plan and the jurisdiction of a U.S. court over the administration of all estate assets.

## Income tax issues

A decision to adopt a strategy of organizing all non-U.S. assets of a U.S. citizen to a U.S. LLC can be made only after taking into account all U.S. as well as non-U.S. tax consequences of the transfers and the tax treatment of the U.S. LLC once the transfers have been completed. From a U.S. tax point of view, the U.S. LLC would be disregarded as long as the U.S. citizen is the sole owner or treated as a partnership if there are two or more owners, absent a check-the-box election to the contrary.

Among the surveyed countries, the LLC would or could be treated as a pass-through entity in France and Switzerland, much as in the United States. Germany looks to several different factors to determine if an entity should be taxed as a corporation or as a partnership: The limited liability feature of the LLC makes it more likely to be treated as a corporation but placing a limit on the duration of the LLC might help avoid that result. [18] Similar considerations may apply for Austria and Korea.

***When applicable tax treaty addresses treatment of LLC with U. S. owners.*** The Fifth Protocol to the United States-Canada Income Tax Treaty—not yet in force—provides for LLCs to be treated by Canada as pass-through entities rather than as corporations. The Canadian Protocol evidences a significant recent policy trend of the U.S. Treasury to expand the number of jurisdictions that confer treaty benefits for the owners of U.S. pass-through entities so that non-U.S. jurisdictions will treat U.S. partners, members or shareholders of such entities, for treaty purposes, in a manner consistent with their treatment under U.S. tax law. Thus, if an income tax treaty between the United States and Country X provides an exception from gains tax on the sale of property located in Country X that belongs to a U.S. resident, that exemption should be available to the U.S. tax resident even if the property is not directly owned by the U.S. tax resident but owned through a pass-through entity of which a U.S. tax resident is a family member or beneficiary.

This principle of consistency is now enshrined in the 2001 U.K. Treaty, [19] the most recent Protocols to the French, Japanese and Swedish Treaties, and recent Competent Authority Agreements under the Mexican, Spanish and New Zealand Treaties. This principle would seem to dictate, in instances where Country X is permitted to impose a gains tax on transfers of real property in Country X, that any transfer of real property in Country X to or from an entity considered by Country X to be a separate entity but considered by the United States to be a pass-through should be disregarded as to any U.S. owner of the pass-through and therefore be exempt from Country X's gains tax to the extent of such U.S. ownership. If this argument is valid and this principle continues to be incorporated in upcoming U.S. income tax treaties and related agreements, one of the most important tax obstacles to the planning for which this article advocates may be removed.

***When LLC is treated as corporation under non-U.S. tax rules.*** In the following countries to which no treaty protection for the pass-through characteristics of U.S. LLCs currently applies, it appears the LLC would be taxed as (or like) a permanent establishment at corporate tax rates: Argentina (for income from Argentine real estate), Australia, Austria (for income from Austrian real estate), Belgium, Brazil, Costa Rica, Denmark, Germany, Netherlands, Ireland, Israel, Russia, South Africa (with respect to South African business interests), Spain (depending on nature of activities in Spain), Sweden, and Ukraine.

In the case of a solely-owned LLC classified as a corporation by the non-U.S. jurisdiction, the United States disregards the foreign characterization of the LLC as much as it does its U.S. status as a separate legal entity. As a result, the taxes paid by the LLC to the non-U.S. jurisdictions should be treated as paid by the U.S. citizen owner and therefore fully creditable against the U.S. citizen's taxes on the same income. If the LLC had more than one member, the non-U.S. taxes should be similarly allocated to the LLC members for credit purposes. [20]However, other issues need to be considered. For example, if a country taxes the U.S. LLC at a higher rate of taxation than that to which a U.S. citizen or the members of an LLC are subject, there could be an additional cost. Corporate rates of tax in most of the surveyed countries do not exceed 35% but withholding or similar taxes on dividends and distributions imposed by jurisdictions such as Germany, South Africa and Spain could push the effective tax rate above U.S. rates, unless, as is the case with Chile, the corporate tax is credited against the withholding tax. Excess foreign tax will generally not be creditable against U.S. income tax unless the U.S. citizen has other non-U.S. source income that is taxed at a lower rate than the U.S. tax in the same year or in an eligible carryover year. [21] The imposition of a value-added tax ("VAT tax") by a jurisdiction such as the Ukraine could also push the effective tax rate above 35% and, in any event, VAT tax is not generally creditable for U.S. income tax purposes.

***Coping with possible non-U.S. capital gains taxes.*** Some countries may impose a capital gains tax on the transfer to a U.S. LLC of real property that the U.S. citizen acquired in his or her own name before transferring the assets to the LLC. These countries include Argentina (nominal rate of 1.5%), Australia (but not if U.S. citizen is only shareholder), Canada (if the LLC is treated as a corporation), China, Denmark (except for a home), Finland, France, Germany, Ireland, Japan, Philippines, Poland, Russia, South Africa, Spain, Sweden, Switzerland (cantonal), and Taiwan. [22]

A transfer of real property in Italy or Monaco would incur various registration or transfer taxes and duties but no gains tax. A transfer of Spanish real property would be subject to transfer and stamp duties of 7%. A transfer of Brazilian real property would incur a transfer tax of 2% to 6% but no capital gains tax as long as the property transferred to the LLC is capitalized at cost rather than market value. Netherlands imposes 6% transfer tax and Singapore and Hong Kong impose stamp duties of up to 3% and 3.75% respectively. It cannot be emphasized too much that in virtually all these instances no such capital gains or transfer taxes would be imposed if the non-U.S. real property were purchased directly by the LLC.

The transfer of business assets of some countries to a U.S. LLC may also incur gains or transfer taxes, including business interests in Canada, Denmark, Philippines, and Sweden. Contribution of retail or industrial real property in Mexico, even if no capital gain taxes were incurred by virtue of the United States-Mexico Competent Authority Agreement, may still give rise to a 15% value added tax, which, with proper planning, may be eligible for a subsequent Mexican credit or refund. Again, initial acquisition of such non-U.S. business interests by the U.S. LLC would avoid these taxes.

If one is dealing with a jurisdiction with which the United States does not have an income tax treaty or the relevant treaty does not adequately address the tax treatment of pass-through entities owned by U.S. persons, any transfer of non-U.S. assets to a U.S. LLC by a U.S. citizen that triggers a non-U.S. gains tax will not be a recognition event for U.S. income tax purposes and, therefore, no U.S. income tax credit for the foreign tax would be currently available.

In that event, one could consider having the U.S. LLC form a wholly-owned subsidiary in the non-U.S. country. Since the LLC is a disregarded or pass-through entity, the contribution of the non-U.S. assets to the non-U.S. subsidiary would trigger U.S. capital gains tax against which the capital gains tax paid to the non-U.S. country could be claimed as an income tax credit. The cost basis for gains tax purposes would presumably be "stepped up" in both countries to the value on the date of the transfer. Once the transfer was complete, the U.S. citizen or LLC could make an election to have the subsidiary treated for U.S. income tax purposes as a partnership, and any subsequent sale of the property could then be taxed in both countries at the same time with a parallel increase in basis and a U.S. credit for the tax paid to the other country. [23]

## Alternative holding entities

If it is determined that using a wholly-owned U.S. LLC as a holding entity would have adverse capital gains or other tax consequences, serious inquiry should be made about the utility of a partnership, including a limited partnership, as a holding entity to accomplish the unitary estate planning objectives that this article advocates. The use of a partnership to accomplish this result appears to have some promise in Austria, Ireland and the United Kingdom and may, with appropriate adjustments, work in other jurisdictions as well.

For property located in a common law jurisdiction, a trust may be another alternative, but, at least in the United Kingdom, there may be a mismatch between U.S. and U.K. tax rules even more serious than with an LLC. The status of trusts in China, Japan, and Korea deserves monitoring. A U.S. trust might be able to act as an owner of property in civil law jurisdictions that have ratified or are expected to ratify the Hague Convention on the Recognition of Trusts (Italy, Luxemburg, Monaco, Netherlands, and Switzerland) as well as countries such as Austria, Belgium and France, which, in their internal law, now recognize trusts organized in common law countries as having legal status.

## Final word—When more than one will must be used

In some cases, organizing the disposition of all the non-U.S. assets of a U.S. citizen under one will or as part of a U.S. holding entity may not be feasible. Take real property in Italy: heirs of Italian real property are exempt from Italian capital gains tax on the sale of the property. [24] If the heirs are U.S. persons, there will be no U.S. gains tax on pre-mortem appreciation. Transferring the Italian real property to a U.S. LLC might jeopardize the Italian gains tax exclusion. In this case, the U.S. will could still direct the disposition of the Italian property, even if Italian court proceedings would be required to enforce the will. As already noted, Italy is one of the few "civilian" countries that have ratified the Hague Convention on the Recognition of Trusts; transfer of Italian real property to a testamentary trust under a U.S. will may be feasible if the U.S. will directs that U.S. law should apply and that Italy should not "accept remission." [25]

If recognition of a U.S. will in a non-U.S. jurisdiction would be difficult or a non-U.S. jurisdiction would apply its own law and thereby endanger the dispositions under the U.S. will, the measures identified above as "second lines of defense" such as inheritance agreements, non-U.S. inheritance renunciations, in terrorem clauses, and conditional bequests must play a primary role, even if resort to a non-U.S. will must still be had.

Great care must be taken to ensure that any non-U.S. will is properly coordinated with the U.S. will. U.S. clients need to understand clearly that U.S. counsel must be consulted when any property is acquired abroad and when any non-U.S. testamentary instruments are executed. As emphasized above, the effectiveness of a U.S. holding company strategy is often greater when the U.S. entity has made the initial acquisition of non-U.S. property and, in such cases, resort to a non-U.S. will should not be necessary. But, whatever the circumstances, any acquisition of non-U.S. property and any execution of a non-U.S. will must always invite review of the U.S. will as well as revision and re-execution of the U.S. estate planning documents after the non-U.S. transactions are complete.

**PRACTICE NOTES**

The first step in international planning for U.S. citizens should be to consider a `holding company' approach and then to supplement it with other measures to the extent that it cannot stand on its own.

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[2] Commonly referred to as the "Brussels Regime," all members of the European Union are now subject to the Brussels I Regulation (officially the Council Regulation (EC) No. 44/2001 of 12/22/00) on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters. The Brussels I Regulation follows and incorporates the provisions of the 1968 Brussels Convention and the 1988 Lugano Convention dealing with the same issues.

[3] Major initiatives include the Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards (Montevideo, 1979) and the Inter-American Convention on Jurisdiction in the International Sphere for the Extraterritorial Validity of Foreign Judgments (La Paz, 1984), and, in addition with respect to the Mercosur countries (Argentina, Brazil, Paraguay and Uruguay), the Protocol of Cooperation and Jurisdictional Assistance on Civil, Commercial, Labor and Administrative Matters (Las Leñas, 1992).

[4] The "Forty Recommendations" of the Financial Action Task Force (established by the G-7 Summit in Paris in 1989) include "Measures to Be Taken by Financial Institutions and Non-Financial Businesses and Professions to Prevent Money Laundering and Terrorist Financing" and "Institutional and Other Measures Necessary in Systems for Combating Money Laundering and Terrorist Financing."

[5] In Switzerland, for example, transfers made in the five years prior to death and transfers made with an intent to deprive an heir of a reserve portion must be added back. Other countries have no necessary limit on the duration of the "look-back" period.

[6] That this article looks for ways to protect a U.S. citizen's estate plan from being defeated by mandatory inheritance rules or other pre-emptive inheritance provisions does not in any way imply that these inheritance rules are wrong as a matter of policy. Avoidance of the application of these rules, however, is generally required in order to construct an estate plan consistent with current U.S. property and tax concepts. Wise estate planning, in the author's view, often requires a judicious blend of outright dispositions with dispositions in trust.

[7] China limits the liability of heirs to the assets of the succession but any renunciation of an inheritance governed by Chinese law—whether for U.S. tax planning or other reasons—must be exercised within only two months of the decedent's death.

[8] In the United Arab Emirates, inheritance matters are subject to the jurisdiction of the religious (Sharia) courts, for whom civil and common law choice-of-law concepts are relatively novel, and which therefore, in practice, generally apply Sharia law across the board.

[9] Copies of the survey, responses, and related correspondence are on file at the offices of Phillips Nizer LLP, the author's law firm.

[10] In Costa Rica, community property rules become effective only upon the dissolution of a marriage or civil union.

[11] Jurisdiction over inheritance, in the UAE, is lodged in the Sharia courts, and these courts may be more easily persuaded to ignore the formal rules of UAE "secular" law.

[12] Belgium has a similar rule as long as the law of nationality cannot deprive an heir of a reserved portion.

[13] For a helpful discussion of the relevant Spanish case law, see Hayton, *European Succession Law*, at pp. 456-457 (London).

[14] See, Article 13, Law of May 31, 1995, No. 218, discussed by Hayton, *supra* note 13, at 331-332. This should be the case where the relevant U.S. jurisdiction would not accept remission ("renvoi") or would otherwise honor such a provision.

[15] A renunciation of forced heirship rights generally serves a different purpose from a "qualified disclaimer" under U.S. tax concepts. Presumably, in most instances, the consideration for renouncing a forced heirship right—usually asset protection and the discharge of moral as well as legal obligations to family members—will satisfy the IRC requirement of "full and adequate consideration" to avoid any U.S. gift tax liability.

[16] Russia also allows renunciation but only of property inherited through the non-compulsory or "free" share, and beneficiaries of a renunciation must generally be those eligible for mandatory shares from the renouncing party.

[17] Under Article 25 of the U.S.-Ukraine Income Tax Treaty, which governs *all* types of taxes, Ukraine should not impose higher inheritance taxes on a U.S. person holding Ukrainian property than it does on a Ukrainian person.

[18] To avoid the application of Germany's forced heirship rules, however, it is advisable for the LLC to be treated as a corporation.

[19] See DT 19851A—United States of America: Scope: fiscally transparent persons from 2003 at www.hmrc.gov.uk/manuals/dtmanual/DT19851A.htm.

[20] See Prop. Reg. 1.901-2(f)(3)(ii).

[21] Some countries, such as Belgium, Germany, Ireland and the United Kingdom (when the owner is a U.K. resident) may tax rent-free use of a home owned by a U.S. LLC that is treated as a corporation on an imputed income basis.

[22] The mention of France and Italy in this sentence prescinds from the argument suggested above in the section "Income tax issues—When applicable tax treaty addresses treatment of LLC with U.S. owners" (especially material to which footnote 19 is attached) that, under such agreements as the recent Protocol to the United States-France Income Tax Treaty and the recent United States-Spain Competent Authority Agreement, taxing a transfer by a U.S. resident of an interest in French or Spanish real property to a U.S. LLC should not give rise to French or Spanish capital gains tax because such a tax would be inconsistent with the "pass-through" nature of the U.S. LLC under U.S. tax law.

[23] I wish to acknowledge the contribution of my partner, Tiberio ("Tibi") Schwartz, to the thinking reflected in this paragraph. In some cases, payment of the non-U.S. gains tax when no U.S. credit is available may still be tax-efficient where a non-U.S. country has no special exemption for U.S. capital gains tax on real property passing at death and no step-up in cost basis. The U.S. citizen would be effectively pre-paying the non-U.S. gains tax that heirs would have to pay upon a sale of the property after the U.S. citizen's death, with funds that would otherwise be subject to U.S. estate tax on the U.S. citizen's death.

[24] Israel has a similar exemption for the sale of inherited Israeli real property interests used as a residence.

25 See note 14 and the accompanying text above.