

# Tax and Estate Planning Considerations for Foreign Persons Owning US Assets and Vice Versa

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# A ROAD MAP

- Why We Care: Introduction and Case Study
- U.S. Persons with Non-U.S. Activities
- Non-U.S. Persons with U.S. Activities
- Concluding Observations



# Why We Care: A Case Study

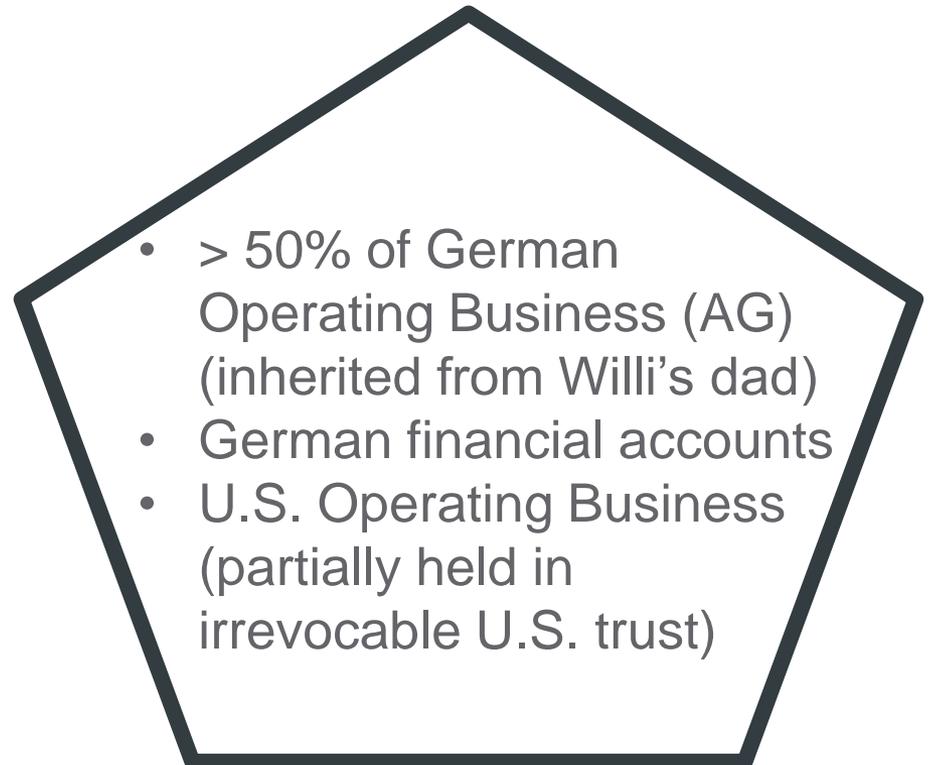
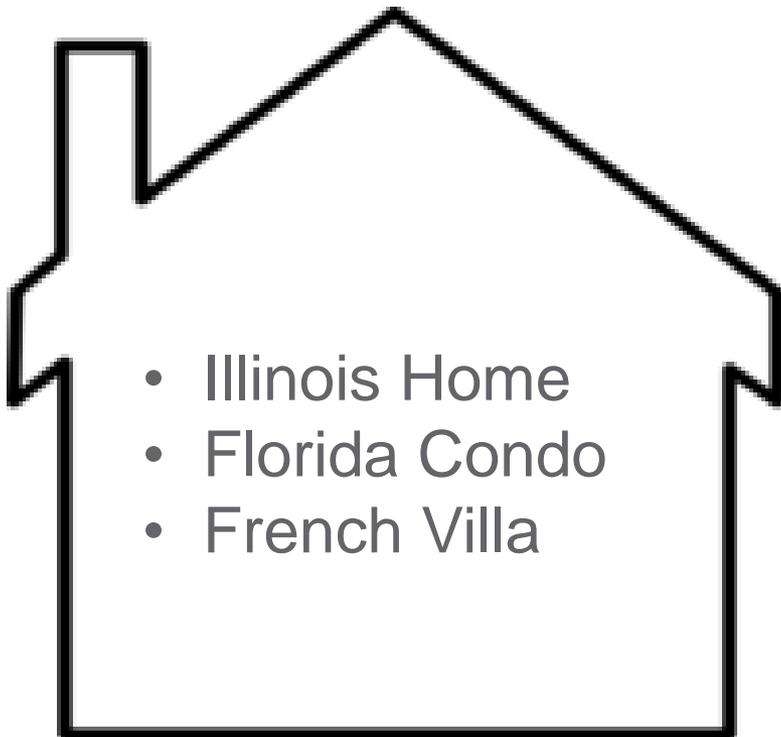
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# A CASE STUDY



## A CASE STUDY

- Willi and Barbara – U.S. residents (German citizens); have lived in United States > 20 years
- Jeremy – U.S. citizen son currently working in Germany
- Jill – U.S. citizen daughter studying in Paris
- Willi's mother, Helga, wants to buy U.S. real estate



# U.S. Persons with Non-U.S. Activities

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# GLOBAL WEALTHY IN THE CROSSHAIRS

1. Sensible U.S. efforts to combat money-laundering and terrorist financing has led to intergovernmental efforts to promote transparency and cooperation in exchange of information and revenue collection.
2. Trend toward public disclosure of beneficial owners of trusts and companies.
3. Real risk of sensitive family information falling into the wrong hands.
4. How to comply with bank and regulatory disclosure requirements while safeguarding family information?
5. What happens when you combine governmental incompetence with information sharing?

# ADOPTING AN “INTERNATIONAL” FRAME OF MIND

When planning for a U.S. client with cross-border issues:

1. Coordinate with foreign counsel. Be humble and ready to learn.
2. Consider how the client’s affairs are likely to evolve over the next 5, 10, 15 years.
3. Remember that U.S. planning techniques often do not “translate.”
4. Be skeptical of the use of trusts.
5. Learn as much as possible about the client’s intended beneficiaries and their respective plans.

# FUNDAMENTAL QUESTIONS TO BE ADDRESSED

1. What limitations, if any, does foreign law place on the client's ability to dispose of foreign assets? (Forced heirship).
2. What is the nature of the foreign property interest? Real property? Personal property? Tangible? Intangible?
3. What country's law applies to the disposition of the foreign asset?
4. What tools are available to dispose of the foreign asset?
5. What extra steps, if any, should the client take to "bulletproof" his disposition strategy?

# CHARACTERISTICS OF CIVIL LAW SYSTEMS

Most countries (apart from the Anglosphere) have civil law systems that do not allow complete testamentary freedom. For a U.S. client owning real estate in a civil law country, the implications are:

1. Local law may provide that the client's children have fixed rights to inherit a share of the client's property.
2. The size of the share to which the children (or other heirs) are entitled varies greatly among countries.
3. A simple bequest of real estate to a surviving spouse may be set aside, invalid, or subject to challenge.
4. Co-ownership of real estate by a surviving spouse and children (perhaps from a prior marriage) is often problematic.
5. U.S. estate tax may be incurred unexpectedly due to a share of the property passing directly to children.

# U.S. ESTATE TAX VERSUS TYPICAL EUROPEAN INHERITANCE TAX

European or other civil law inheritance tax systems impose a tax on the receipt of property. Some things to keep in mind in view of such a system:

1. In some systems, property received by surviving spouse is subject to tax.
2. Typically, the rate of tax is higher when the legatee is not directly descended from the decedent.
3. Often, the legatee will not pay tax on an exemption amount, but these personal exemptions are negligible compared to U.S. estate tax exemptions.
4. Assets passing to a trust for a child or grandchild may be taxed at the highest rate, e.g., as if an unrelated individual or distant relative had inherited the asset.

# EUROPEAN UNION SUCCESSION REGULATION: (EU) 650/2012 ("BRUSSELS IV")

Brussels IV enables a U.S. client to choose what law applies to the succession of his assets in most European countries. BEFORE Brussels IV, the law that would apply to different types of property varied by country:

1. In France, real estate passed in accordance with French law while law of the decedent's domicile at the time of death governed the transfer of movable property.
2. In Germany, Italy, and Spain, the decedent's nationality was paramount.
3. U.S. clients who sought to avoid forced heirship had to engage in special planning, such as owning French real estate through a company to convert it to moveable property.

# EUROPEAN UNION SUCCESSION REGULATION: (EU) 650/2012 (“BRUSSELS IV”) – CONTINUED

Brussels IV seeks to create a uniform law of succession for Member States. U.S. citizens or residents who own property in a Member State also benefit.

1. Generally, the “law applicable to the succession as a whole shall be the law of the State in which the deceased has his habitual residence at the time of death.” The default rule will not apply when:
  - a. “[I]t is clear from all the circumstances . . . that, at the time of death, the deceased was manifestly more closely connected with” another country; or
  - b. The decedent has chosen the law of his nationality to govern his succession.
2. A U.S. citizen (even one with multiple nationalities) may choose the law of a particular State to govern his entire succession.

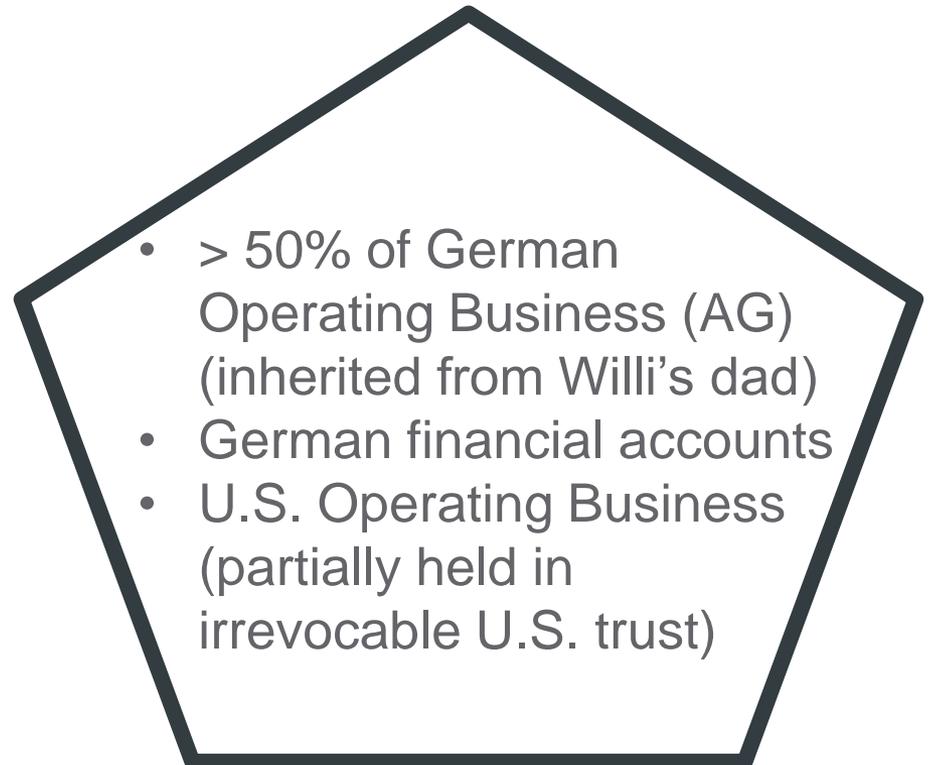
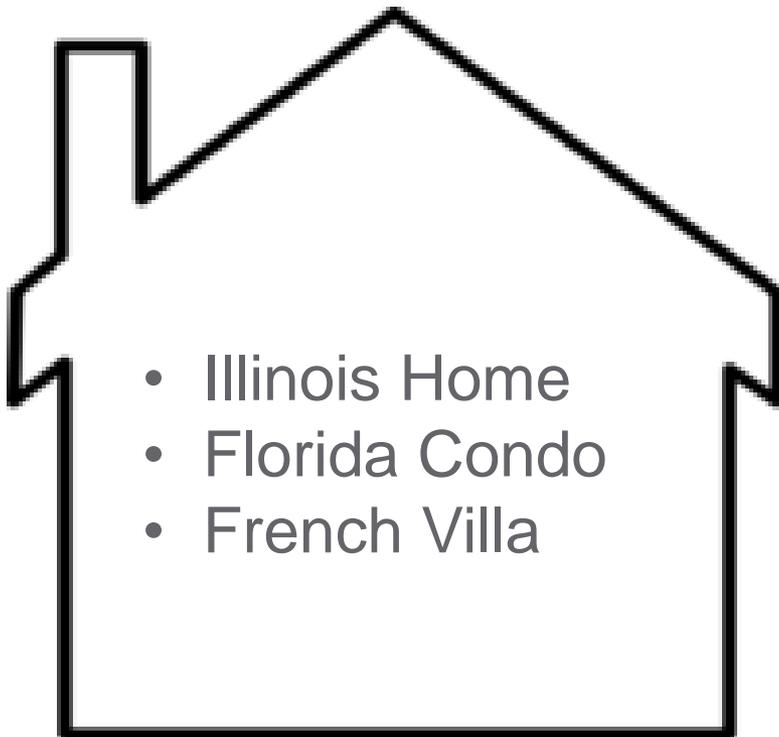
# SAMPLE LANGUAGE CHOOSING ILLINOIS LAW TO GOVERN SUCCESSION UNDER EU SUCCESSION REGULATION

1.01 **Governing Law.** The internal laws of the State of Illinois govern the validity and interpretation of this will and the administration of my domiciliary probate estate.

1.02 **European Union Reference.** I choose the laws of the State of Illinois (without regard to its choice of law rules) to govern the succession to my assets, rights and obligations as a whole, including any not disposed of by this will, and I declare that my will and all matters arising under or relating to my will, shall be governed by and construed according to the laws of the State of Illinois (without regard to its choice of law rules) and that all matters relating to the devolution and administration of my assets shall be governed by the said laws of the State of Illinois (without regard to its choice of law rules) and such choice and such declarations are made pursuant to, inter alia, Article 22 of Regulation (EU) No. 650/2012. I am a United States citizen who is most closely connected with the jurisdiction of the State of Illinois.

## A CASE STUDY

- Willi and Barbara – U.S. residents (German citizens); have lived in United States > 20 years
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# Non-U.S. Persons with U.S. Activities

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# INCOME TAX FRAMEWORK

## U.S. Citizens and U.S. Residents

U.S. citizens and U.S. residents (including U.S. trusts and estates) generally are subject to U.S. income tax on worldwide income.

## Non-Residents

Non-citizens not resident in the U.S. (including foreign trusts and estates) only are subject to U.S. income tax on their “U.S. source income.”

# CATEGORIES OF INCOME FOR U.S. INCOME TAX PURPOSES

## Not Taxed

- Foreign source income

## Preferentially Taxed

- Fixed, determinable and periodic (“FDAP”) income
- Examples include U.S. interest, dividends, rents, and royalties
- Exceptions include portfolio interest and treaty benefits

## Fully Taxed

- Income effectively connected with a U.S. trade or business (“ECI”)
- Gains from sale of U.S. real estate

# U.S. SOURCE INCOME

Type of Income	General U.S. Tax Treatment (Subject to Treaty Modification)
<b>Capital Gains</b>	<ul style="list-style-type: none"><li>• Generally excluded from U.S. tax.</li><li>• If the NRA was in the U.S. for 183 days or more during the tax year, the net gain from sales or exchanges of capital assets is taxed at 30%.</li><li>• Capital gains are taxed also if they are effectively connected with a trade or business in the U.S. during the tax year.</li></ul>
<b>Capital Gains from the Sale of Real Estate</b>	<ul style="list-style-type: none"><li>• Under FIRPTA, capital gains are taxed on a net basis.</li><li>• However, 15% withholding is on the gross sale price, unless seller applies for reduced certification.</li><li>• See Forms 8288 and 8288-A.</li></ul>
<b>Capital Gains from the Sale of a Partnership Interest</b>	<ul style="list-style-type: none"><li>• Gain or loss on the sale or exchange of all (or any portion of) a partnership interest will be taxed to the extent that the NRA partner would have had ECI if the partnership had sold all of its assets on the date of the sale and allocated the gain to partners.</li><li>• The buyer of the partnership interest is required to deduct and withhold tax equal to 10% of the amount realized on the sale of the partnership interest.</li><li>• If the buyer fails to withhold, the partnership itself must withhold the 10% tax.</li></ul>

## U.S. SOURCE INCOME (CONTINUED)

Type of Income	General U.S. Tax Treatment (Subject to Treaty Modification)
<b>Rental Income</b>	<ul style="list-style-type: none"><li>• Income generated by the use of U.S. real estate is subject to 30% withholding.</li><li>• However, a special election may be made to treat U.S. real property income as ECI so tax may be paid on only the net income (income less deductions attributable to rental income).</li><li>• Timely U.S. tax returns must be filed to receive the benefit of this election.</li></ul>
<b>Dividends</b>	<ul style="list-style-type: none"><li>• Generally included as U.S.-source taxable income subject to 30% withholding.</li></ul>
<b>Interest from Bank Accounts</b>	<ul style="list-style-type: none"><li>• Excluded from NRA withholding tax.</li></ul>
<b>Interest from Bonds or Other Debt Obligations</b>	<ul style="list-style-type: none"><li>• Taxable and subject to 30% withholding unless the portfolio interest exemption applies.</li></ul>

## THE PORTFOLIO INTEREST EXEMPTION

Excludes interest paid to NRAs on bonds and other debt obligations held for investment if:

1. The obligation identifies the payer (*i.e.*, is in registered form);
2. The payee is a foreign individual or entity and is the beneficial owner of income; and
3. The foreign individual or entity provides a Form W-8 to the payer.

## THE PORTFOLIO INTEREST EXEMPTION (CONTINUED)

The portfolio interest exemption does not apply if:

1. The foreign investor owns 10% or more of the U.S. corporation or partnership that issued the obligation;
2. The interest payments are tied to the issuer's receipts, sales, cash flow, income, etc.; or
3. The registered debt is convertible to bearer form.

**The portfolio interest exemption does not mitigate FATCA withholding.**

# U.S. GIFT, ESTATE, AND GENERATION-SKIPPING TRANSFER TAX

*Citizenship and domicile are determinative of many aspects of U.S. gift, estate, and generation-skipping transfer taxation.*

## **U.S Citizens and Residents:**

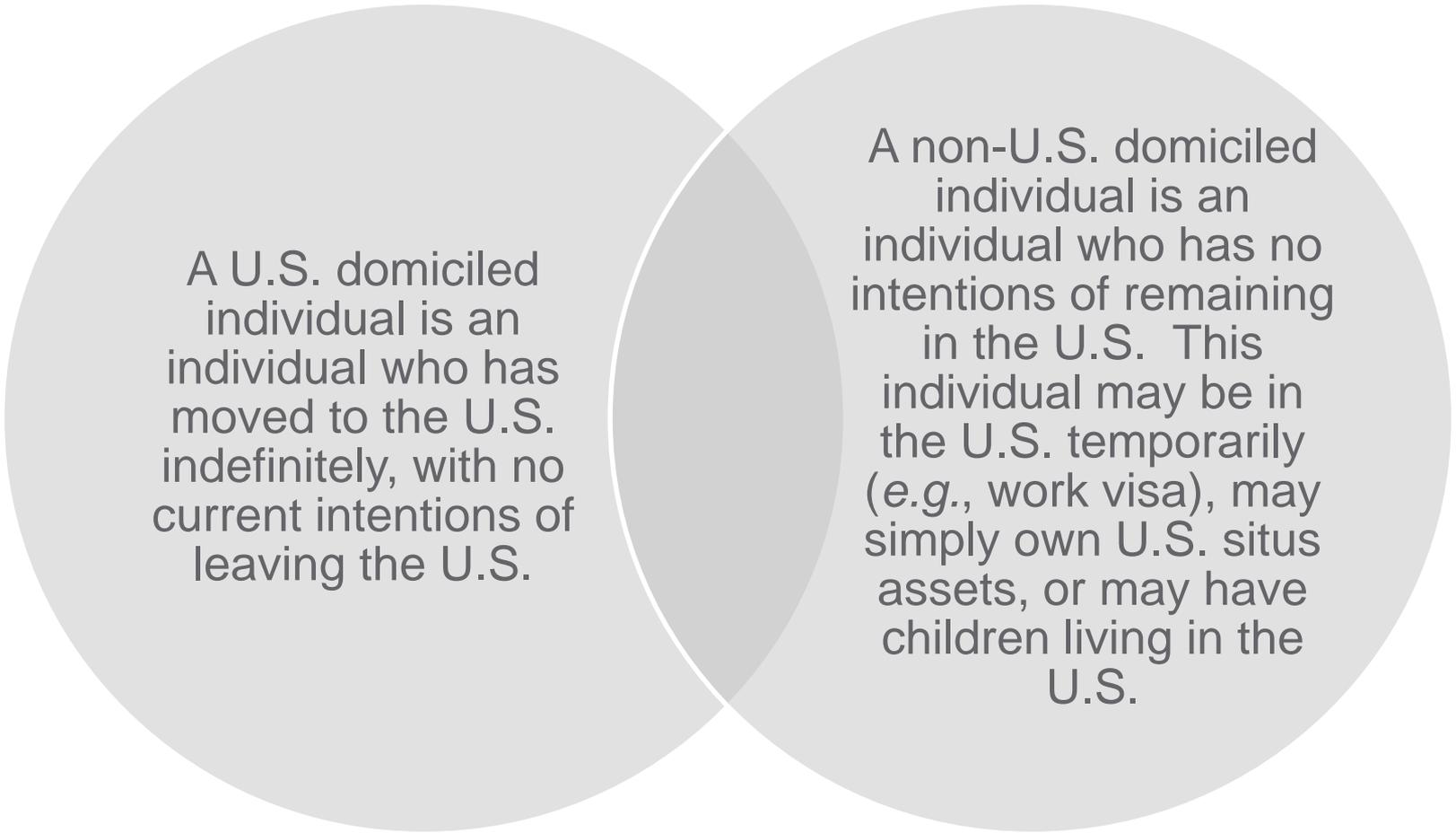
U.S. citizens (wherever they live) and U.S. “residents” (regardless of their citizenship) are subject to U.S. gift, estate, and generation-skipping transfer taxes on their worldwide assets.

## **Non-Citizen Non-Domiciled:**

Non-U.S. citizens not domiciled in the U.S. are subject to U.S. gift, estate, and generation-skipping transfer tax on their U.S. situs assets.

**Treaties:** Additionally, the United States has estate and gift tax treaties with various countries.

# WHO IS A U.S. DOMICILED INDIVIDUAL?



A U.S. domiciled individual is an individual who has moved to the U.S. indefinitely, with no current intentions of leaving the U.S.

A non-U.S. domiciled individual is an individual who has no intentions of remaining in the U.S. This individual may be in the U.S. temporarily (e.g., work visa), may simply own U.S. situs assets, or may have children living in the U.S.

## DOES A NON-U.S. DOMICILED INDIVIDUAL OWE U.S. ESTATE TAX?

- Yes.
- U.S. estate tax on his or her U.S. taxable estate at death.
- See Subchapter B Code Sections 2101-2108.
  - 2101 – Tax imposed on taxable estate of non-citizen, non-resident decedent.
  - 2102 – Estate tax credit for gift taxes paid, plus \$13,000 unified credit.
  - 2103 – Definition of gross estate.
  - 2104 – Property within the United States.
  - 2105 – Property without the United States.

# WHAT IS INCLUDED IN A NON-DOMICILED DECEDENT'S ESTATE?

- The value of the gross estate of every non-domiciled decedent “shall be that part of his gross estate which at the time of his death is situated in the United States.”



## WHAT IS NOT INCLUDED IN THE ESTATE?

- The value of the gross estate does not include certain property, even though physically located in the United States.

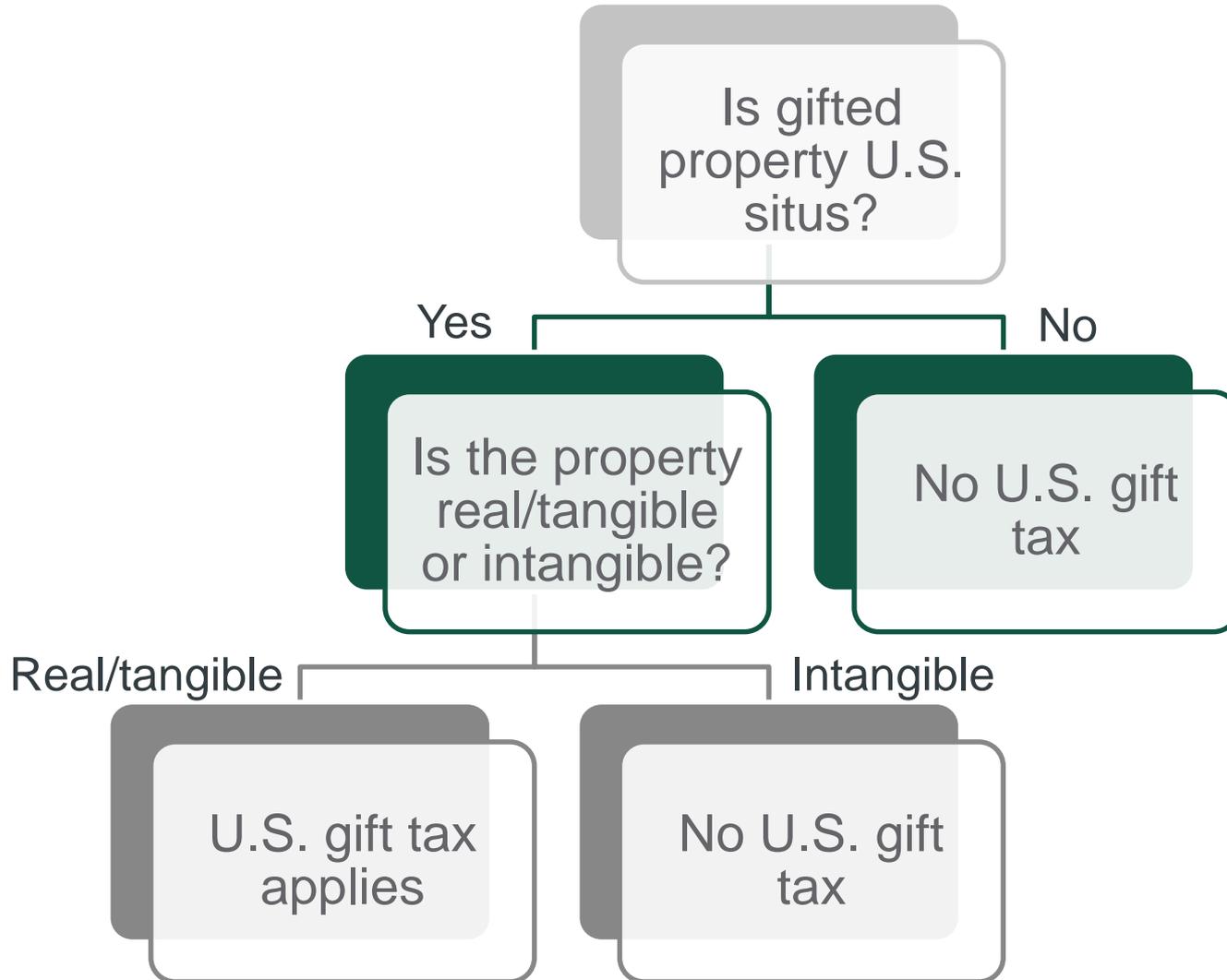


# U.S. ESTATE TAX EXCLUSION AND DEDUCTIONS

*The estate tax calculation for a non-domiciled decedent varies from the regular estate tax calculation in a few important ways.*

- Deductions for expenses, losses, debts, and taxes are pro-rated using a ratio of U.S. to worldwide assets.
- Charitable deduction is allowed, but only for bequests to U.S. charities.
- Marital deduction only is allowed if surviving spouse is a U.S. citizen or if property passes to a qualified domestic trust (“QDOT”).
- Reduced exclusion amount of \$60,000 generates a credit of only \$13,000.
- Foreign death tax credit only allowed for the estates of U.S. citizens and U.S. resident decedents.

# DOES A NON-U.S. DOMICILED INDIVIDUAL OWE U.S. GIFT TAX?



# U.S. GIFT TAX EXCLUSION AND DEDUCTIONS

*The gift tax calculation for a non-domiciled individual varies from the regular gift tax calculation in a few important ways.*

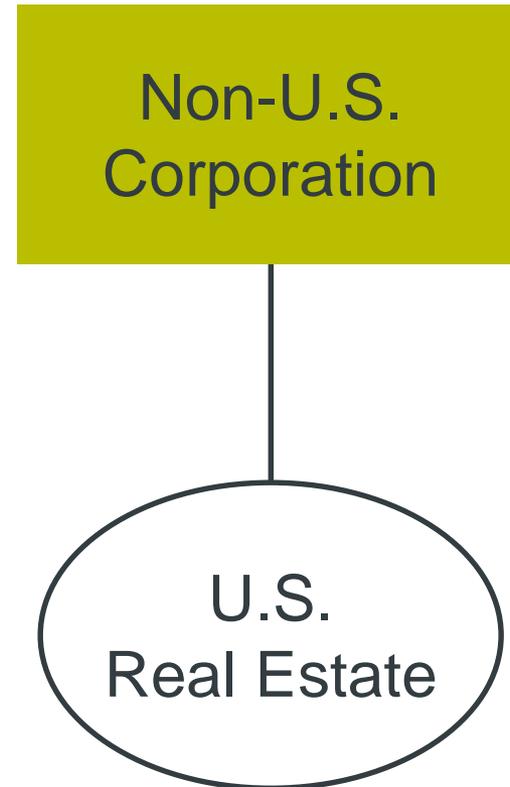
- There is no applicable or basic exclusion for lifetime gifts, although the annual exclusion (\$15,000 in 2018) does apply.
  - For purposes of the annual exclusion, a married foreign donor may not take advantage of the gift-splitting election available to U.S. persons.
- There is no unlimited gift tax marital deduction from a U.S. spouse to a non-U.S. citizen spouse.
- A U.S. or non-U.S. spouse can gift up to \$152,000 in 2018 annually to a non-U.S. citizen spouse, as the annual exclusion amount is increased for non-U.S. citizen spouses.

# ESTATE AND GIFT TAX – A COMPARISON TO U.S. CITIZENS

	<b>Non-U.S. Citizen and Non-U.S. Domiciled</b>	<b>U.S. Citizen or U.S. Domiciled</b>
<b>U.S. Estate Tax</b>	<ul style="list-style-type: none"> <li>Taxed on U.S. situs assets (real, tangible, intangible).</li> </ul>	<ul style="list-style-type: none"> <li>Taxed on worldwide assets.</li> </ul>
<b>Estate Tax Applicable Exclusion Amount</b>	<ul style="list-style-type: none"> <li>\$60,000, subject to treaty modified pro-rata rules.</li> <li>Only available for estate tax purposes, not available for lifetime gifts.</li> </ul>	<ul style="list-style-type: none"> <li>\$11.18 million in 2018.</li> <li>Available for estate, gift, and generation-skipping transfer tax purposes.</li> </ul>
<b>U.S. Gift Tax</b>	<ul style="list-style-type: none"> <li>Taxed on gratuitous transfers of U.S. situs assets (real, tangible).</li> </ul>	<ul style="list-style-type: none"> <li>Taxed on all gratuitous transfers.</li> </ul>
<b>Annual Gift Tax Exclusion</b>	<ul style="list-style-type: none"> <li>\$15,000 in 2018.</li> <li>Gift splitting with spouse not allowed.</li> </ul>	<ul style="list-style-type: none"> <li>\$15,000 in 2018.</li> <li>Gift splitting with U.S. citizen/resident spouse allowed.</li> </ul>
<b>Transfers to a Non-U.S. Citizen Spouse</b>	<ul style="list-style-type: none"> <li>Estate tax marital deduction for transfers to U.S. citizen spouse or QDOT.</li> <li>No unlimited marital deduction for transfers to non-U.S. citizen spouse.</li> <li>Annual exclusion amount for gifts to non-U.S. citizen spouse is \$152,000 in 2018.</li> </ul>	

# TRANSFER TAX PLANNING FOR U.S. REAL PROPERTY

- Consider acquiring U.S. situs assets in a non-U.S. entity.
- If a non-U.S. domiciled individual already owns a U.S. situs asset, a subsequent transfer to a non-U.S. entity must be carefully executed (*e.g.*, three year clawback rule in Code Section 2104(b)).



# THE DISCLOSURE LANDSCAPE

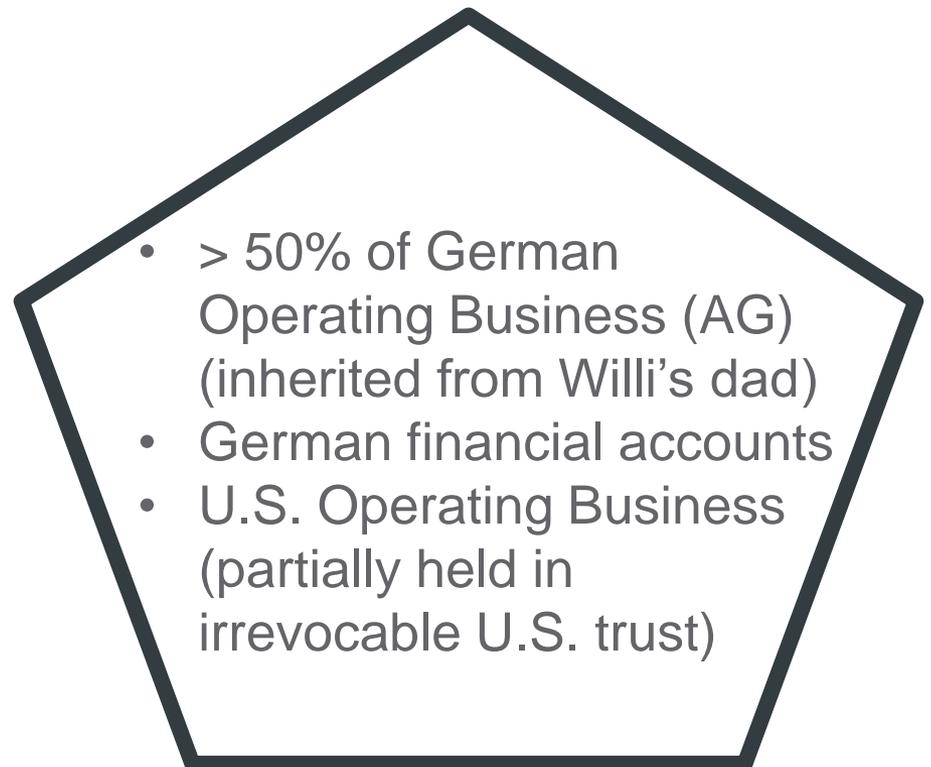
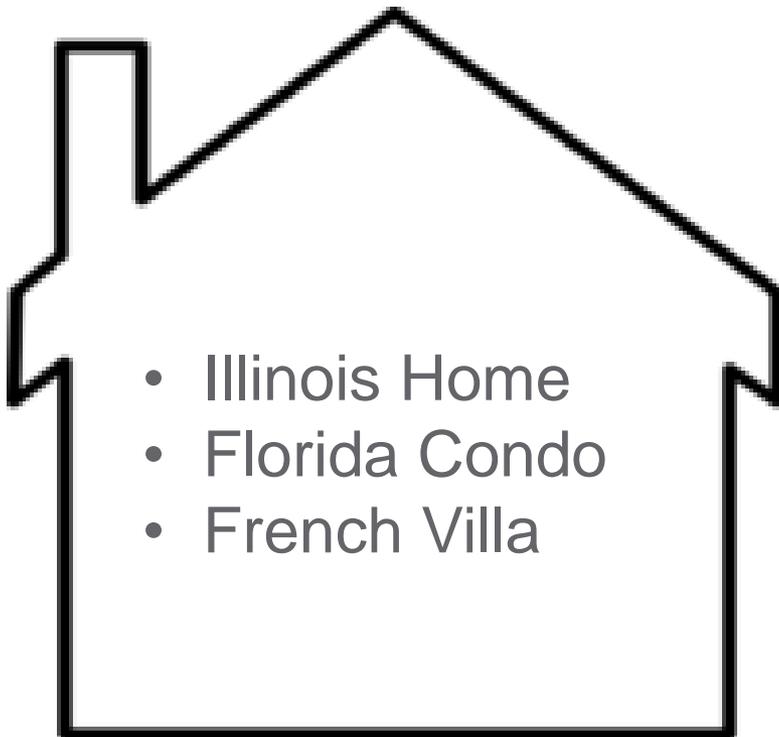
- Traditional compliance reporting
  - FATCA
  - FBARs
  - Forms 8938, 1042, and 3520

## PLUS

- New compliance reporting
  - UK Criminal Finances Act
  - Forms 1120 and 5472 for Disregarded Entities
  - FinCEN Customer Due Diligence Requirements

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# Concluding Observations

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# CONCLUDING OBSERVATIONS



# Questions?

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