

# Common Mistakes and Tips for International Tax & Estate Planning Clients

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# Agenda

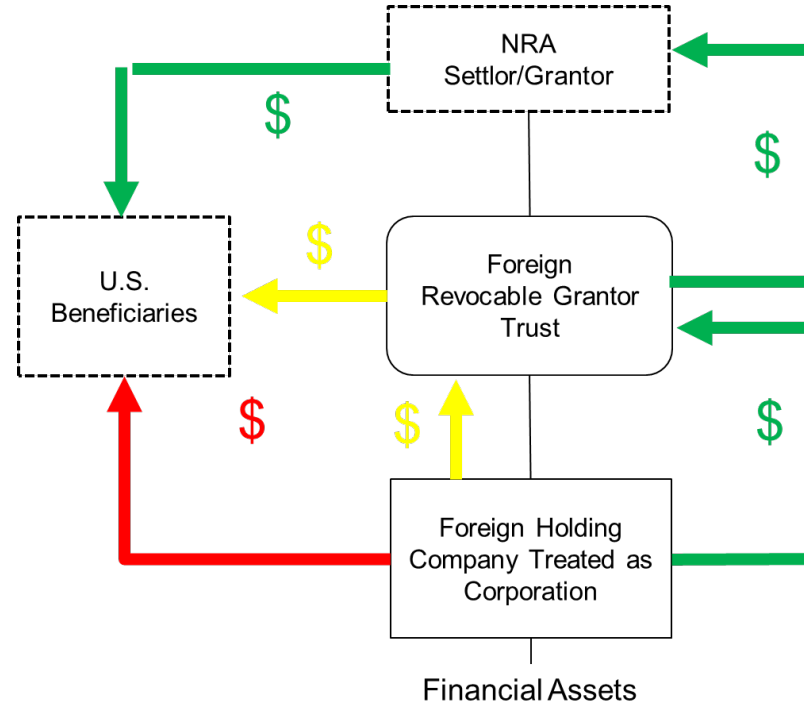
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- Improper Gifting Methods
- US Situs Asset Issues
- Community Property and Joint Ownership Issues
- Preimmigration Planning Mistakes
- Renting vs. Not Renting Personal Use Property
- Foreign Grantor Trust Issues
- Basis Step-Up Planning

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# IMPROPER GIFTING METHODS

# Gifts to U.S. Person During Settlor's Lifetime



# "Gifts" from Foreign Corporations and Foreign Partnerships

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- Transfers of money from foreign corporations (or foreign partnerships) are treated as taxable distributions
- Purported Gift Rules - Sec. 672(f)(4) & Regulations
  - "In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection."
  - "[I]f a United States donee directly or indirectly receives a purported gift or bequest...from any foreign corporation, the purported gift or bequest must be included in the United States donee's gross income as if it were a distribution from the foreign corporation."
    - Dividend to the extent of E&P
    - Sale or exchange to extent amount exceeds E&P (shareholder treated as having zero basis)

# Gifts of Cash from U.S. Bank Accounts

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- Foreigners are subject to U.S. federal gift tax on gifts of U.S. real property and tangible personal property located in the United States
- U.S. gift tax does not apply to transfers of intangibles (e.g., shares of stock in U.S. corporations)
- Cash is generally viewed as a tangible asset for U.S. federal gift tax purposes
- Money transferred from a U.S. bank account runs the risk of triggering U.S. federal gift tax (no unified credit for U.S. federal gift tax purposes, but \$16,000 annual exclusion amount)
- Preferable to transfer funds from a foreign bank account titled in the foreign donor's individual name
  - *Purported gift if from corporate bank account*
- Checks & wire transfers
- Gifts of money used to buy U.S. real estate or tangible personal property located in the United States
  - *Davies v. Comm'r*, 40 T.C. 525 (1963)
- Consider gifts of T-bills, stock, or bonds instead of cash

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# U.S. SITUS ASSET ISSUES

# Cash and Other Nuances

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- Cash in a bank account vs. cash in a brokerage account
  - Deposits with a U.S. bank are not subject to U.S. federal estate tax so long as such deposit is not effectively connected with a U.S. trade or business
    - Only applies to "deposits"
    - Checking or savings account, CDs, etc.
  - Cash held in a brokerage account and cash held in a safety deposit box are not considered *deposits* and are subject to U.S. estate tax
- Stock in a US corporation
  - Not subject to US gift tax (intangible)
  - Generally subject to US estate tax



# Tangible Personal Property

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- Tangible personal property located in the United States at the time of death is subject to U.S. federal estate tax:
  - Cars, artwork, jewelry, furnishings, etc.
- Planning for these assets often overlooked, particularly when structuring U.S. real estate investments
- *Consider:* Two-tier corporate structure for vacation home in Miami. Foreign "blocker" for the real estate itself, but...:
  - Expensive furnishings throughout the house
  - Valuable artwork and other collectibles in the home

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# **FAILURE TO RECOGNIZE COMMUNITY PROPERTY ASSETS AND OTHER JOINT OWNERSHIP ISSUES**

# What is Community Property?

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- No universal definition - general theory is that it is like a partnership between the spouses of which property/income/debts acquired after marriage is owned/shared 50-50 regardless of title
- General exceptions:
  - Gifts and inheritances received by one spouse during marriage
  - Separate property of one spouse prior to marriage
- United States:
  - Separate property is the dominant marital property regime (e.g. Florida)
  - 9 U.S. states have community property laws + Guam + Puerto Rico (and a few others have special laws to establish community property)
- Foreign countries - typically civil law countries - have some form of community property

# Tax Planning Risks With Community Property: Gift Tax Considerations

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- When spouses make a gift of community property they are generally treated as each making a gift of 50% of the value of the property:
  - If spouses are both U.S. citizens or U.S. domiciliaries, they can elect to gift split
  - If one spouse is NRA and the gift of U.S. situs property, could be a taxable gift if over the annual gift tax exclusion (\$16,000) and not covered by applicable treaty
  - Extra care has to be taken when setting up trusts if to be funded with community property
  - Making gifts of community property between spouses usually does not accomplish anything
- Transmutation of separate property into community property:
  - Usually not an issue for U.S. citizen donee spouse
  - Gifts to non-U.S. citizen spouses are not entitled to unlimited marital deduction, but instead, can qualify for annual exclusion if the value of property transferred is US\$155,000 or less (adjusted for inflation)

# Tax Planning Risks With Community Property: Estate Tax Considerations

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- When a spouse dies, generally 50% of the value of community property is included in the spouse's gross estate; and 100% of separate property
- If deceased spouse is a U.S. citizen/domiciliary, then could have additional (and sometimes unexpected) increase to such deceased spouse's gross estate
- If deceased spouse is a non-U.S. citizen/non-domiciliary, then community property U.S. situs assets could cause significant U.S. estate tax result for deceased spouse
- Upon death of first spouse, 100% of the community property of the spouses receives a "stepped up" (or "stepped down") adjustment of the historic cost basis to current fair market value

# Joint Property Ownership for Spouses

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- Tenants In Common
- Joint Tenancy with Rights of Survivorship
- Tenancy by Entirety (TBE)
  - In Florida, real property and bank accounts titled as "husband and wife" presumed to be TBE
  - Real property held TBE is not community property on death - so transmutation is as easy as holding real property TBE

# Joint Ownership Between Spouses: Tax Traps

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## Real Estate:

- Completed gift to other spouse of undivided interest in joint property generally upon recording deed if other spouse furnishes no consideration
- If donee spouse is a U.S. citizen then unlimited marital deduction applies
- If donee spouse is not a U.S. citizen then unlimited marital deduction generally does not apply:
  - Exception for real estate provided upon sale of the real estate the sale proceeds are received by the spouse that furnished original consideration otherwise gift will be completed and taxable
  - Joint tenancy property acquired with community property or with sale proceeds from community property may be treated as if each spouse furnished 50% of the consideration (Rev. Rul. 55-605)

# Joint Ownership Between Spouses: Tax Traps (Continued)

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## Bank Account:

- Completed gift generally upon joint owner withdrawing funds from joint bank account if other joint owner can withdraw all of the funds without consent (i.e., revocable transfer)
- In a spousal joint account situation, if the donee spouse is a non-U.S. citizen there is a gift on creation of the account of half of the value of the account if the donee spouse did not contribute any funds to the account:
  - If donor spouse is also a non-U.S. citizen/non-domiciliary then is there is a taxable gift of U.S. situs property?
  - If donor is a U.S. citizen/domiciliary then can potentially eat into donor spouse's estate tax exemption over time (in excess of available annual gift tax exclusion)



# Joint Ownership Between Spouses: Tax Traps (Continued)

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- Generally for joint property with rights of survivorship only 50% of the value of the property is includible in the gross estate of the first spouse to die
- For joint property only 50% of the property's historic cost basis is stepped up/stepped down to current fair market value
- If joint property passes to a non-U.S. citizen spouse, the first spouse to die must include 100% of the value of the joint property in their gross estate unless the deceased spouse's estate can prove that the surviving spouse contributed separate consideration at the time the property was acquired
  - At risk of double estate tax on 100% of the value of the property at death of each spouse
  - Joint tenancy property acquired with community property or with sale proceeds from community property may be treated as if each spouse furnished 50% of the consideration (Rev. Rul. 55-605)

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# PRE-IMMIGRATION PLANNING BLUNDERS

# U.S. Federal Estate and Gift Tax Residence - Domiciliary

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- U.S. Domicile = physical presence with intent to reside in the U.S. indefinitely
- U.S. citizens are considered U.S. “domiciled” regardless of their actual residence
- Can be a non-domiciliary and still a U.S. federal income tax resident
- Based on objective facts and circumstances



# Domicile: Tax Traps

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- Assuming your domicile is tied to your income tax residency status
- Doing your Florida estate planning documents and other legal documents before you move (e.g., postnuptial agreement governed by FL law)
- Not believing the IRS will look at the little factors like the value of the contents of home, use of gym memberships, and possession of your most beloved family photos
- The IRS taking position you are not domiciled and only having \$60,000 exemption against taxable U.S. situs assets

# "Give-and-Go" Trust Trap

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- **Scenario:** Prior to moving to US, NRA makes a gift to a trusted friend or family member, who then creates a trust for the benefit of the NRA
- **Result:** IRS will treat the NRA (now a US person) as the grantor of the trust
- Code § 672(f)(5)

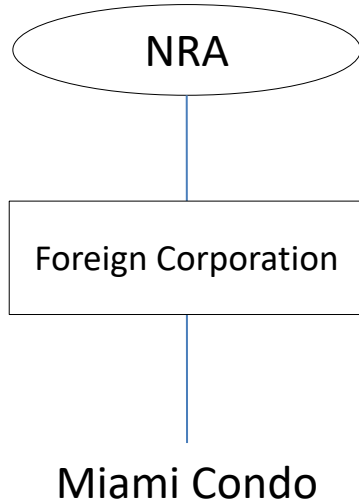
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# CORPORATE OWNED REAL ESTATE & PAYMENT OF RENT

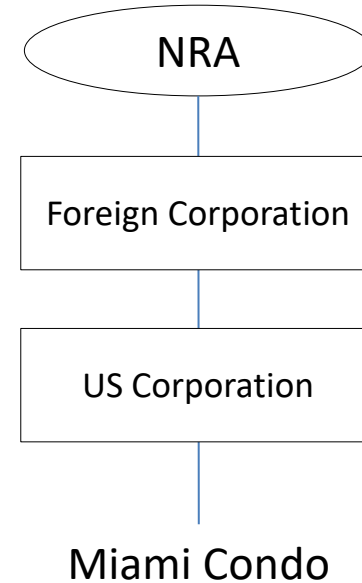
# Common Structures for Foreign Clients

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## Single Foreign Blocker



## Two-Tier Corporate Structure



# Planning Issues Related to Payment of Rent

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- Do I have to pay rent to my own corporation for when I use the apartment?
- IRS generally views rent-free use of corporate-owned property as a constructive distribution to the shareholder for the amount of FMV rent that should have been paid
  - *G.D. Parker, Inc.*, TC Memo 2012-327
- IRS imputing rental income to the corporation
  - *Accipitor Trading Ltd. v. Commissioner*, No. 18842-19
- Estate tax implications of not paying rent? Substance over form?



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# FOREIGN GRANTOR TRUST ISSUES

# Foreign Grantor Trust Overview

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A trust is a grantor trust (with a foreign person as the grantor and treated as the owner of the assets of the trust for federal income tax purposes) to the extent:

- The grantor has the power to revest absolutely in himself title to the trust property provided that such power is exercisable solely by the grantor without the approval or consent of any other person or with the approval or consent of a related or subordinate party who is subservient to the grantor; or
- The only amounts distributable from such portion (whether income or corpus) of the trust during the lifetime of the grantor are distributable to the grantor or the spouse of the grantor

# Incapacity of Settlor

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- Meaning and significance of incapacity
- To preserve grantor trust treatment in the event the grantor becomes incapacitated“... if the power to revest absolutely in the grantor title to such portion is exercisable solely by the grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) without the approval or consent of any other person, then the grantor can be continuously treated as the owner of the trust assets under the grantor trust rules”
- Irrevocable grantor trusts -- need incapacity provision?
- When does it need to be in the trust instrument? How should it be written?
- Power of appointment over income (for step-up in basis)

# Other Grantor Trust Issues

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- Who is the transferor (e.g., community property, indirect and nominee transferors, etc.)?
- Once a nongrantor trust, always a nongrantor trust
  - See Treas. Regs. Sec. 1.672(f)-3

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# FAILURE TO PLAN FOR BASIS STEP-UP

# Step-Up In Basis for Assets in Trust: Relevant Law

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- Sec. 1014(b)(2): Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before death **to revoke the trust**
- Sec. 1014(b)(3): Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before death **to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust**
- Sec. 1014(b)(9): "Catch-all" rule that applies to any asset **required to be included in determining the value of the decedent's gross estate:**
  - Only applicable if asset subject to U.S. federal estate tax

# Step-Up in Basis Drafting Mistakes

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- In addition to power to revoke or amend (or other similar powers), provide power of appointment over income or right to income for life:
  - Make sure power is not limited by local law; and
  - Make sure power does not have to be exercised by the settlor in a fiduciary manner
- Consider whether the settlor continues to have the appropriate powers during incapacity

# Check-the-Box Election

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- A “check-the-box” election is an entity classification election that is made according to the desired tax treatment of any domestic or foreign entity for U.S. tax purposes
- The tax implications of making such election can be extremely significant; depending on the taxpayer goals, structures and tax strategies, there are a number of benefits and/or consequences that need to be considered before deciding which election(s) to take
- There can be important income and estate tax implications, and depending on the type of entity
- Also, there are limitations on what types of entities can or cannot use the “Check-the-Box” election (IRS Form 8832)



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