



# From Investment Vehicles to Treaties—What Foreign Investors Need to Know About Cross-Border Estate Planning

Considerations for asset ownership, transfers, and tax implications.

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**F**oreign investors generally have the same goal of minimizing their tax liabilities from their U.S. real estate and other U.S. investments, as do their U.S. counterparts, although their objective is complicated by the very fact that they are not domiciled in the U.S. The U.S. has a special estate and gift tax regime that is applicable to foreign investors that are not domiciled in the U.S. This article summarizes the basic estate and gift tax issues that affect foreign investors investing in the U.S. This article also discusses international tax planning opportunities that may be available to individuals that are not U.S. citizens.

## An Overview of U.S. Estate and Gift Tax

U.S. Federal law imposes a transfer tax upon the privilege of transferring property by gift, bequest, or inheritance. During an individual's lifetime, this transfer tax takes the form of a gift tax. For gift tax purposes, a gift is defined as the transfer of property for less

than adequate and full consideration in money or money's worth, other than a transfer in the "ordinary course of business." No U.S. gift tax, would be owed on a gift to a beneficiary until the gifts made to the beneficiary in a calendar year exceed an applicable exclusion amount for that year (\$17,000 for calendar year 2023). Upon an individual's death, the tax takes the form

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of an estate tax. The tax is measured against a tax base that includes all the assets owned at death.

The U.S. estate and gift tax is assessed at a rate of 18 to 40% of the value of an estate or gift. A unified credit is available to minimize the impact of the transfer tax. The unified credit gives a set dollar amount that an individual can gift during their lifetime and pass on to beneficiaries before a gift or estate taxes apply. U.S. citizens and resident individuals are permitted a unified credit that exempts \$12.92 million (for the 2023 calendar year) from the estate tax. This means that U.S. citizens and residents can pass \$12.92 million to their heirs without being assessed a gift or estate tax. The unified credit is significantly smaller for foreign individuals that are not domiciled in the U.S. The current unified credit for non-domiciliaries is equivalent to a \$60,000 exemption, unless an applicable treaty allows a greater credit. In addition to its smaller size, the unified credit available to non-U.S. citizens and non-U.S. domicil-

aries cannot be used to reduce their U.S. gift tax. The credit can only be used by their estates upon their deaths to reduce U.S. estate tax.<sup>1</sup>

There are also significant differences as to how the estate and gift tax is calculated for individuals domiciled in the U.S. compared to individuals not domiciled in the U.S. The worldwide estate of a decedent is subject to U.S. estate tax only if the individual was either a U.S. citizen or resident at the time of death.<sup>2</sup> In contrast, the estate of a non-U.S. citizen not domiciled in the U.S. is subject to estate tax solely on his or her U.S. situs assets. Similarly, all property gifted by a U.S. citizen or domiciliary is subject to U.S. gift tax regardless of where the property is situated. However, in the case of a donor who is neither a U.S. person nor a U.S. domiciliary, only gifts of real property or tangible personal property situated in the U.S. are subject to U.S. gift tax.

### Determining Domicile for U.S. Estate and Gift Tax

Because individuals domiciled in the U.S. are permitted a unified credit of \$12.92 million, for most U.S. citizens, the estate and gift tax is not an issue. This situation is different for foreign persons who are not domiciled in the U.S. Instead of a unified credit that would shelter up to \$12.92 million in lifetime gifts, individuals not domiciled in the U.S. are only provided a credit equivalent to an exemption of just \$60,000 against the estate tax. Given the differences in the way the U.S. estate and gift tax is calculated, it is crucial to understand when an individual can be classified as being domiciled in the United States. An individual is presumed to have a foreign domicile until such domicile is shown to have changed to the United States. A person acquires a U.S. domicile by living here, potentially even for a brief period of time, with no definite present intention of leaving. To be domiciled in the U.S.

for estate and gift tax purposes, an individual must physically present in the U.S. coupled with the intent to remain in the U.S. indefinitely or permanently.<sup>3</sup> For U.S. estate and gift tax purposes, an individual can only be domiciled in one country.<sup>4</sup> The term “domicile” for estate and gift tax purposes should not be confused with the terms “resident” or “residence” used in the income tax context. A foreign investor may be characterized as a resident of the U.S. for income tax purposes through either the green card test<sup>5</sup> or substantial presence test.<sup>6</sup> Just because a foreign person is classified as a U.S. resident for U.S. federal income tax purposes, does not mean the individual is domiciled in the U.S. for estate and gift tax purposes.

### How the Estate Tax and Gift Tax is Computed for a Decedent Not Domiciled in the U.S.

The estate tax for a decedent that was not domiciled in the U.S. is only assessed on its gross estate. The gross estate is made up of property or assets situated in one of the U.S. states or the District of Columbia at the time of

death. This is often referred to as U.S. situs assets or property. The gross estate is composed of revocable transfers, transfers taking effect on death, transfers with a retained life interest, or (to a limited extent) transfers within three years of death are includible in the U.S. gross estate if the subject property was U.S. situs property at either the time of the transfer or the time of death. In the case of corporate stock, the stock of a U.S. corporation is U.S. situs and stock of a foreign corporation is foreign situs, regardless of place of management or location of stock certificates.

The rules for determining gift tax for an individual not domiciled in the U.S. differ from the estate tax. As a general rule, the gift tax applies only if transfers of tangible property (real property and tangible personal property, including currency) are physically located in the United States at the time of the gift. The gift tax does not apply to intangible property such as stock in U.S. or foreign corporations even though such property is includible in the U.S. gross estate for federal estate tax purposes. Since the gift tax is not assessed on the transfer of securities,

<sup>1</sup> See I.R.C. Section 2505(a).

<sup>2</sup> See I.R.C. Sections 2001(a) and 2031(a).

<sup>3</sup> Treas. Regs. 20.0-1(b)(1) and 25.2501-1(b) provide an overview of the term “domicile” for estate and gift tax purposes by stating as follows: “a person acquires a domicile in a place by living there, even for a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.”

<sup>4</sup> A number of U.S. estate and gift tax treaties vary the domicile rules and permit dual domicile situations.

<sup>5</sup> Under the green card test, a lawful permanent resident for any part of a calendar year for U.S. immigration purposes is a U.S. resident for U.S. federal income tax purposes.

<sup>6</sup> Under the substantial presence test of I.R.C. Section 7701(b)(3), if an individual is present in the U.S. for 183 days or more in a single year, including partial days. An individual may also be considered a U.S. resident for the current calendar year under the substantial presence test if at least 31 days in the testing year and the following formula amounts to 183 days or more: add all of the days present in the year being tested, one-third present in the first preceding year, and one-sixth of the days present in the second preceding year.

<sup>7</sup> I.R.C. Sections 871(a), 881(a)(1).

<sup>8</sup> I.R.C. Sections 871(h), 881(c), 1441(a)(9).

<sup>9</sup> Generally speaking, portfolio interest is any U.S.-source interest (other than interest effectively connected with the conduct of a U.S. trade or business) paid or accrued on debt obligations issued after July 18, 1984.

<sup>10</sup> The related party rules of I.R.C. Section 267(b) apply to determine which party is related.

<sup>11</sup> The general rule of I.R.C. Section 163(j) limits the deductibility of interest expense paid or accrued on debt property allocable to a trade or business to the sum of business interest income, and 30% of “adjusted taxable income.” For these purposes, a rough estimate of what will be adjusted taxable income will be earnings before interest and taxes or “EBIT.” Any deduction in excess of the limitation is carried forward and may be used in a subsequent year, subject to the limitations of EBIT.

<sup>12</sup> Generally when a foreign person or foreign corporation engages in a trade or business in the United States, all income sources within the U.S. connected with the conduct of that trade or business is considered effectively connected income.

<sup>13</sup> I.R.C. Section 884(e)(2)(B); Treas. Reg. 1.884-5T. See Notice 87-56, note 83, regarding favorable U.S. treaty jurisdictions.

<sup>14</sup> In Notice 87-56, 1987-2 C.B. 367, the IRS clarified which treaties may override the branch profits tax. Notice 87-56 indicates that many older U.S. tax treaties may serve to override the branch profits tax.

non-domiciliaries often transfer securities to heirs prior to death for planning purposes.

## Overview of Structuring Alternatives to Hold U.S. Real Property or U.S. Businesses for Estate and Gift Tax Planning

There are various ways foreign investors who are not domiciled in the U.S. may hold U.S. assets. In particular, this article will look at the estate and gift tax consequences of holding U.S. assets in a corporate structure, partnership, or trust. The discussion will begin by examining the estate and gift tax consequences of the foreign investor directly holding a U.S. asset. The simplest estate and gift tax planning option available to a foreign investor is to own real property or business directly and sell the asset before he or she dies. In many cases, this type of planning is not realistic due to the fact it is impossible to predict one's demise. However, in some cases direct ownership of U.S. assets by a non-U.S. domiciliary may be appropriate because of the availability of an estate tax and gift treaty.

Planning opportunities may also be available to non-U.S. domiciliaries that wish to directly hold U.S. real estate through the portfolio debt rules. Properly structured, the value of loan subject to the portfolio debt will be fully deductible from the taxable estate of a foreign investor. As a result, the portfolio debt rules may permit individuals not domiciled in the U.S. to reduce or eliminate equity in the real property through financing. The portfolio debt rules may also eliminate U.S. withholding on any interest payments associated with the financing. As a general matter, the U.S. imposes a 30% withholding tax on U.S. sourced payments of interest to foreign persons if such interest income is not effectively connected with a U.S. trade or business of the payee.<sup>7</sup> Interest paid to a foreign

person or persons with respect to a "portfolio debt instrument" is not subject to the 30% withholding rules.<sup>8</sup> Portfolio debt can be a very useful tool in inbound estate and gift planning.<sup>9</sup> There are however three important exceptions to the portfolio debt rules. First, the portfolio debt rules do not apply to interest paid to a bank. Second, portfolio debt cannot be paid to a "10% shareholder." Under this rule, if the borrower is a corporation, the 10% shareholder rule provides that the recipient of the interest does not own 10% or more of the combined voting power of all classes of the stock of such corporation. When the borrower is a partnership (or an LLC taxed as a partnership), the 10% shareholder requirement is measured by capital or profits interest. Third, the portfolio debt rules prohibit payments of interest to controlled foreign corporations or CFCs that are considered related parties.<sup>10</sup> Finally, Section 163(j) can potentially apply to limit deductions of interest payments on portfolio debt loans.<sup>11</sup>

## Holding U.S. Assets through a Foreign Corporation

Historically, foreign investors have made their direct investments in the U.S. principally through corporate ownership structures. Frequently, a foreign corporation was used as either the direct investment owner or as a holding company for a U.S. subsidiary (which, in turn, owned the direct U.S. real property). Individual foreign investors have frequently preferred use of corporate structures to avoid the U.S. estate and gift tax. Holding U.S. property through a foreign corporation will typically enable the foreign investor to avoid U.S. estate and gift tax because shares in a foreign corporation are not U.S. situs assets. However, there are significant U.S. income tax consequences with investing in U.S. real estate through a foreign corporation.

In many cases, the direct ownership of U.S. businesses or U.S. real estate is not advisable because of the branch profits tax. The branch profits tax specifically treats the deemed repatriation of already taxed profits from the United States by a foreign corporation as an occasion to impose a second tax under Section 884 of the Internal Revenue Code. Section 884 describes this second tax as the "dividend equivalent amount" of the "effectively connected earnings and profits" with certain adjustments. The branch profits tax is intended to be the functional equivalent of earnings distributed as dividends by a subsidiary either out of current earnings not invested in subsidiary assets or out of accumulated earnings withdrawn from such investment. The branch profits tax imposes a tax equal to 30% of a foreign corporation's dividend equivalent amount for the taxable year. The "dividend equivalent amount" is defined as the earnings and profits from the effectively connected taxable income for the year.<sup>12</sup> The "dividend equivalent amount" includes the gain from the sale of U.S. real property or a business. In other words, gains on U.S. assets held by foreign corporations are not taxed at favorable capital gains rates. Gains on U.S. assets such as real estate or businesses are typically taxed at the 30% branch profits tax rate.

In some limited cases, the branch profits tax typically will be reduced or are inapplicable if the foreign investor is from a favorable U.S. treaty country and the foreign investor utilizes a home-country/treaty company.<sup>13</sup> A careful review of applicable income tax treaties should be done to determine if the branch profits tax can be reduced or eliminated through an income tax treaty.<sup>14</sup> If a foreign investor is from a favorable U.S. treaty jurisdiction and the foreign investor is prepared to utilize a home-country/treaty company, then the use of such a company to directly own the U.S. real estate or busi-

ness usually will produce the best overall U.S. tax results.

In many cases, foreign corporations or the shareholders of foreign corporations are subject to a second 30% tax on “FDAP” income.<sup>15</sup> Most forms of U.S.-source income received by a foreign corporation not effectively connected with a U.S. trade or business will be subject to a flat tax of 30% on the gross amount of the income received.<sup>16</sup> The term “trade or business” is used throughout the Internal Revenue Code in many different contexts. Regardless of the consequences of its application, the term is always employed to describe the process of producing or seeking to produce income from actively engaging in business activities, as distinguished from merely owning income-producing property. Under the FDAP rules, any passive income received by a foreign corporation such as income received from rents or investment income could be subject to a 30% flat tax. Special withholding rules also apply to foreign corporations that hold U.S. real property interests under Section 897 of the Internal Revenue Code.

A foreign corporate structure should never be utilized as part of an estate plan in any case where there are U.S. beneficiaries. This is because a U.S. beneficiary may receive shares of a foreign corporation that will either become a CFC if one or more U.S. persons constructively,<sup>17</sup> indirectly or directly owns 10% or more of the shares of the entity or a passive foreign investment company or PFIC.<sup>18</sup> U.S. persons holding shares of a CFC may be subject to “GILTI” or “global intangible low-taxed income” tax regime.<sup>19</sup> Individual U.S. shareholders of a CFC must include any GILTI as ordinary income. The current highest federal tax rate applicable is 37%.<sup>20</sup> U.S. heirs that inherit shares of a CFC will need to annually file a Form 5471 with the IRS.<sup>21</sup> The Form 5471 is one of the most complicated reporting obliga-

tions in the U.S. offshore information tax reporting regime.

In the case of a foreign corporate share classified as a PFIC, U.S. persons owning shares in the PFIC must pay U.S. tax plus an interest charge based on the value of any tax deferral at the time the shareholder disposes of the PFIC stock at a gain or receives an “excess distribution” from the PFIC.<sup>22</sup> An excess distribution includes the following:

1. a gain realized on the sale of PFIC stock; and
2. any actual distribution made by the PFIC, but only to the extent the total actual distribution received by the shareholder for the year exceeds 125% of the average actual distribution received by the shareholder in the preceding three years.

The amount of an excess distribution is treated as if it had been realized pro rata over the holding period of the foreign share and, therefore, the tax due on an excess distribution is the sum of the deferred yearly tax amounts. This is computed by using the highest tax rate in effect in the

years the income was accumulated, plus interest.<sup>23</sup> As a result of these complex and punitive tax rules, a U.S. heir of a corporation often receives a “cursed inheritance.”<sup>24</sup>

There are other U.S. tax consequences that must be considered before placing an asset into a foreign corporation, particularly U.S. real estate. If a shareholder makes use of a home for personal reasons that is placed in a foreign corporation, any increases in value of the home will not qualify for an exclusion of gains under Section 121 of the Code.<sup>25</sup> Any increase in the value of the property that is reflected in an increase in the value of the shares may ultimately be subject to two layers of tax. If the foreign corporation can be classified as a PFIC, this taxable gain may be significantly increased.

Foreign investors seeking anonymity may continue to gravitate toward the use of foreign corporations to hold U.S. assets. Nonetheless, the overriding reason for using foreign corporate structures will probably not outweigh the negative U.S. income tax consequences for utilizing such a structure.

<sup>15</sup> Interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income is sometimes referred to as “FDAP income.”

<sup>16</sup> I.R.C. Section 881(a).

<sup>17</sup> In the CFC context, section 958(b) provides that the constructive ownership rules of section 318(a), with certain modifications, apply for purposes of determining whether: (1) a U.S. person is a U.S. shareholder; (2) a foreign corporation is a CFC under section 957; (3) the stock of a domestic corporation is owned by a U.S. shareholder of a CFC; and (4) a corporation or other person is related to the CFC.

<sup>18</sup> The Tax Reform Act of 1986 added the PFIC to the Internal Revenue Code. The object of the PFIC provisions is to deprive a U.S. taxpayer of the economic benefit of U.S. tax on the taxpayer’s share of the undistributed income of a foreign investment.

<sup>19</sup> The tax on GILTI was enacted as part of Public Law 115-97 (commonly referred to as the 2017 Tax Cuts and Jobs Act). GILTI was intended to impose a current year tax on income earned from intangible property subject to no or a low tax rate outside the United States. GILTI is defined as the residual of a CFC’s income (excluding Subpart F income, income that is effectively connected with a U.S. trade or business on its investment in tangible depreciable assets (defined as “qualified business asset investment” or QBAI). These rules presume that tangible property should provide an investment return of no greater than 10%. GILTI is not limited to income from intangibles. Any non-excluded income in excess of the

baseline, whether derived from intangibles or not, is currently included in the GILTI taxing regime.

<sup>20</sup> Individual shareholders of CFC’s typically cannot offset their U.S. tax liability with foreign tax credits for taxes paid by the CFC.

<sup>21</sup> Form 5471 is used by certain U.S. persons who are officers, directors, or shareholders in respect of certain foreign entities that are classified as corporations for U.S. tax purposes. The Form 5471 and its schedules are used to satisfy the reporting requirements of I.R.C. Sections 6038 and 6046 along with applicable regulations.

<sup>22</sup> I.R.C. Section 1291(a)(1) and (2).

<sup>23</sup> I.R.C. Section 1291(a)(2).

<sup>24</sup> See *Home Thoughts From Abroad, When Foreigners Purchase U.S. Homes*, Tax Notes Federal, August 17, 2020, p. 1165.

<sup>25</sup> I.R.C. Section 121 allows a taxpayer to exclude up to \$250,000 (\$500,000 for certain taxpayers who file a joint return) of the gain from the sale of property owned and used as a principal residence for at least two of the five years before the sale. A taxpayer can claim the full exclusion only once every two years.

<sup>26</sup> See I.R.C. Section 897(c)(1)(A)(ii); I.R.C. Section 1445(e)(3).

<sup>27</sup> In 1980, Congress enacted the Foreign Investment in Real Property Tax Act or “FIRPTA” which tried to equate the tax treatment of real property gains realized by foreign investors.

<sup>28</sup> See I.R.C. Section 1445(a). A transferee must file Forms 8288 and 8288-A to report and deposit any tax withheld within 20 days of withholding.

## Holding U.S. Assets through a Domestic Corporation

Given the disadvantages of placing U.S. assets in a foreign corporation, foreign investors may consider contributing U.S. assets to a domestic corporation. From a U.S. income tax point of view, a U.S. corporation will avoid some of the harsh tax consequences discussed above. For example, as long as a domestic corporation is not held by a foreign corporation, the branch profits tax regime may potentially be avoided. U.S. beneficiaries of an estate plan that includes shares of a domestic corporation may also avoid the CFC or PFIC tax rules. However, foreign shareholders of a domestic corporation may still be subject to FDAP withholding on any dividend distribution from the domestic corporation.<sup>26</sup>

There are a number of other income tax consequences that must be considered before placing a U.S. asset into a domestic corporation. This is particularly the case when U.S. real estate is transferred to a domestic corporation. If a foreign investor is a shareholder of a domestic corporation and makes use of the real property held by the domestic corporation for personal reasons, the IRS may impute taxable rental income from the domestic corporation to the foreign investor. If the real property placed into the domestic corporation is a primary residence, and if the real property increases in value, the appreciation will not qualify for a Section 121 exemption. As a result, any increase in the value of real property held as a primary residence will be taxed at the corporate level. A second layer of tax will be assessed at the shareholder level as FDAP income potentially subject to the 30% flat tax.

Sometimes foreign investors will place real property into a domestic corporation to avoid the FIRPTA withholding rules.<sup>27</sup> To ensure collection of FIRPTA tax, those acquiring a U.S. real

property interest must deduct and withhold a tax equal to 15% of the amount realized on the disposition.<sup>28</sup> Section 897 imposes FIRPTA withholding on real estate placed in a domestic corporation. Section 897 provides that the tax on real property gains will apply to the sale of stock in U.S. corporations that hold 50% or more of specified assets in the form of U.S. real property.

**Instead of a unified credit that would shelter up to \$12.92 million in lifetime gifts, individuals not domiciled in the U.S. are only provided a credit equivalent to an exemption of just \$60,000 against the estate tax.**

In certain cases, a domestic corporation can be an effective tool for estate and gift tax planning. Recall that the U.S. federal gift tax applies to non-domiciliaries when they make transfers of tangible property physically located in the U.S. at the time of the gift. Thus, the gift tax may not apply when domestic stocks are transferred through a gift.

The consequence of the death of the foreign owner depends on the structure of the ownership of the domestic corporation. If a non-domiciliary directly owns shares of a domestic corporation, the domestic corporate shares will be subject to the U.S. estate tax. This is because stock in the domes-

tic corporation has a U.S. situs for estate tax purposes. In some cases, shares of domestic stock holding U.S. assets can avoid the U.S. estate tax as a result of a treaty.

## Holding U.S. Real Property through a Multi-Tiered Blocker Structure

Many non-domiciliaries investing in U.S. real property are advised to hold property through multi-tiered structures. These multi-tiered corporate blocker structures typically consist of U.S. corporations which in turn are owned by foreign corporations. Individuals not domiciled in the U.S. are sometimes led to believe that multi-tiered corporate structures can be utilized to avoid the U.S. estate and gift tax. Prior to 2004, multi-tiered corporate structures could be utilized to protect foreign investors from the U.S. federal estate and gift tax. This is no longer the case.

Prior to 2004, a U.S. corporation was able to reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation with a foreign parent corporation. These transactions were commonly referred to as asset inversion transactions. In asset inversions, a U.S. corporation generally recognized gain (but not loss) under Section 367(a) of the Internal Revenue Code as though it had sold all of its assets, but the shareholders generally did not recognize gain or loss, assuming the transaction met the requirements of a reorganization under Section 368. To remove the incentive to engage in corporate inversion transactions, Congress included several provisions in the 2004 JOBS Act aimed at corporate inversions. One of these provisions was Section 7874 to the Internal Revenue Code.

The anti-inversion rules are designed to prevent corporate inversions by providing different methods of taxation depending on whether the former U.S. shareholders own at least

80% of the new foreign corporation or at least 60% (but less than 80%) of the shares of a new foreign corporation.

The anti-inversion rules apply if pursuant to a plan or series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a translation; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Internal Revenue Code.

In determining whether a transaction meets the definition of an inversion, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called “hook” stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded.

Although there are many variations of inversions, as a general rule, when a domestic corporation holding U.S. real estate merges into a foreign

corporation to avoid U.S. estate and gift taxes, the transaction can be classified as inversion. This is because the U.S. corporation holding the real estate becomes a subsidiary of a foreign corporation and the former shareholders of the U.S. corporation will ultimately hold at least 80% (by vote or value) of a foreign corporation by reason of holding stock in the U.S. corporation. This type of a structure will not likely trigger the recognition of the inversion gain. However, it will deny the intended tax benefit by treating the foreign corporation as a domestic corporation for all purposes of the Internal Revenue Code.

Section 7874 of the Internal Revenue Code will result in adverse U.S. federal estate and gift tax consequences because the transfer of shares of a domestic corporation to a foreign corporation is an inversion. The foreign investor who directly owned the shares in the U.S. corporation now owns all of the shares of the foreign corporation, which holds the stock of the U.S. corporation. Because multi-tiered corporate structures that hold U.S. real property trigger the inversion rules, the foreign corporation (acquiring the U.S. corporation holding U.S. real estate) will be treated as a U.S. corporation for all U.S. federal tax purposes. This means, a foreign investor (who is not a U.S. domiciliary) is treated as holding shares in a U.S. corporation rather than stock in a foreign corporation. Since U.S. corporate stock is treated as U.S. situs property for purposes of the estate tax, utilizing a multi-tiered corporate structure described above to hold U.S. real property is completely worthless for purposes of avoiding the estate tax.

## Holding U.S. Assets through a Partnership

Foreign investors can form a partnership or an entity classified as a partnership to acquire and hold U.S. property. The U.S. estate tax rules for non-U.S. citizens or non-U.S. domiciliaries with respect to partnerships are somewhat more complex and less certain than the rules governing corporate stock. A partnership provides a vehicle for making U.S. tax-exempt gifts of the partnership’s underlying asset through transfer of the partnership interest itself.<sup>29</sup> In contrast, if a non-U.S. domiciliary were to own U.S. real estate or business directly and transfer that asset, the transfer would be subject to the U.S. gift tax. However, the gift tax on non-U.S. domiciliaries is not applicable to gifts of intangible property, such as a partnership interest.<sup>30</sup>

The use of a partnership (regardless of whether it is domestic or foreign, general or limited) has the very significant advantage of enabling the individual foreign investor not to be subject to two layers of tax (as with corporate structures). The extent to which the U.S. estate tax rules apply to partnerships and other pass-through entities held by foreign investors are not totally free from doubt. There is at least some risk that the IRS might assert that a partnership holding a U.S. asset is a U.S. situs asset for purposes of the U.S. estate tax, regardless of whether it is a domestic or foreign partnership.<sup>31</sup>

However, if a partnership holding U.S. real estate or a U.S. business is formed in a jurisdiction outside the United States (regardless of whether it is engaged in a U.S. trade or business)

<sup>29</sup> I.R.C. Section 2501(a)(2).

<sup>30</sup> I.R.C. Section 2512(a), (b).

<sup>31</sup> Under Treas. Reg. 301.7705-5, a partnership is deemed to be a resident of the U.S. whenever it is engaged in a U.S. trade or business, regardless of where it is formed. Thus, Treas. Reg. 301.7701-5 could be read as saying that interests in a partnership are U.S. situs assets if the partnership is engaged in a U.S. trade or business. In contrast, the U.S. Supreme

Court in *Blodgett v. Silberman*, 277 U.S. 1 (1928), indicated that a partnership interest is a separate intangible asset, and the location of its assets or the place where the partnership carries on its business is immaterial in determining the situs of the partnership interest. Under the holding of *Blodgett*, a non-U.S. domiciliary would be exempt from the U.S. estate tax on a partnership was formed outside the U.S.

<sup>32</sup> I.R.C. Section 665(a).

it is more likely not to be classified as U.S. situs property for purposes of U.S. estate tax. It may be argued that under applicable foreign law, a foreign partnership interest is an entity separate from its partners and is not a U.S. situs for purposes of estate tax. If a foreign investor is considering holding U.S. assets through a partnership, the investor should either form the entity outside the U.S. or establish a multi-tiered partnership held by a foreign partnership.

For income tax purposes, the Internal Revenue Code adopts an aggregate approach to partnerships for some purposes and an entity approach for other purposes. For example, under the aggregate approach, a partnership is treated as a conduit which passes income through to the partners to be reported on their individual returns. A partnership is considered an entity, however, for purposes of determining the amount, character, and timing of partnership items. Unlike corporations, partnerships are typically only subject to one layer of tax and as a result, the partners of a partnership are taxed more favorably than shareholders of C corporations. However, foreign partners of U.S. partnerships are subject to a complex set of withholding rules.

In Notice 2018-29, 2018-16 I.R.B. 495, the IRS and the Department of Treasury published interim guidance for addressing partnership withholding tax treatment. Under Section 864(c)(8), the disposition either directly or indirectly by a nonresident interest in a partnership engaged in any U.S. trade or business, results in gain or loss on the sale or exchange to be statutorily treated as income effectively connected with the conduct of a U.S. trade or business. This means that the amount treated as effectively connected income is the portion of the partner's distributive share that would have been effectively connected income if the partnership had all of its assets at fair market value as of the date

of the sale of the partnership interest. If the partnership is receiving income that is not effectively connected with a trade or business, the partnership may need to withhold 30% of the tax on U.S. sourced payments to foreign persons.

### Ownership of U.S. Property through a Trust

A non-U.S. domiciliary foreign investor may hold U.S. property in an irrevocable trust. The trust can be domestic or foreign. An irrevocable trust is potentially an attractive vehicle for newly acquired U.S. real property or a U.S. business as long as there are no U.S. beneficiaries of the trust. This type of planning depends on avoiding triggering of the grantor trust rules of Internal Revenue Code. If a trust were treated as a grantor trust, the U.S. estate tax rules may result in the trust being taxed to the grantor's estate for U.S. federal estate tax purposes. If properly planned, an irrevocable trust will avoid U.S. estate tax.

Trusts are taxed at the same rates applicable to individuals, although the tax brackets are compressed. In the case of a foreign trust, a trap lurks for amounts distributed to any U.S. beneficiaries from the trust within a year following the year of sale. This is because of the "throwback rule." Although repealed in 1997 for domestic trusts, this rule continues to apply to foreign trusts. Under this rule, distributions of a foreign trust's "undistributed net income" or (UNI) to a U.S. beneficiary are taxed as if the beneficiary received the income in the year in which it was earned by the trust. The UNI for any particular year is equal to the amount by which its "distributable net income" or (DNI) for such year exceeds the sum of:

1. the amount of trust accounting required to be distributed in such year;
2. the amount of any other amount properly paid or credited or re-

quired to be distributed for such year; and

3. the amount of any taxes imposed on the trust that are attributable to its DNI for the year.<sup>32</sup>

The throwback rule effectively results in federal tax being levied at the recipient's highest marginal income tax rate for the year in which the income or gain was earned by the trust.

**Historically, foreign investors have made their direct investments in the U.S. principally through corporate ownership structures. Holding U.S. property through a foreign corporation will typically enable the foreign investor to avoid U.S. estate and gift tax because shares in a foreign corporation are not U.S. situs assets. However, there are significant U.S. income tax consequences with investing in U.S. real estate through a foreign corporation.**

This means any capital gains accumulated by a foreign trust for distribution in a later taxable year will lose its favorable rate and instead be taxed at ordinary income rates. In addition, the throwback rule adds an interest charge to the taxes on a throwback distribution in order to

offset the benefits of tax deferral. The interest charge accrues for the period beginning with the year in which the income or gain is recognized and ending with the year that the UNI amount is distributed. The interest charge is assessed at the rate applicable to underpayments of tax under Section 6621, as adjusted, compounded daily. The number of years over which interest is calculated is determined by a process which is said to produce a “dollar-weighted” number of years.

Given the harsh tax consequences to the U.S. beneficiaries of a foreign trust, foreign trusts are not recommended vehicles for use in cross-border estate planning involving U.S. beneficiaries.

## Introduction to Estate and Gift Tax Treaties

In some cases, a non-U.S. citizen can utilize an estate and gift tax treaty to eliminate the U.S. estate and gift tax. The U.S. currently has treaties with 15 countries regarding estate, gift, or generation-skipping transfer tax. Some of the transfer tax treaties provide for more beneficial deductions, such as marital deduction and charitable deduction, or a larger exemption from estate tax than otherwise would normally apply to a non-domiciliary of the United States.

The U.S. has entered into treaties with Finland, Greece, Ireland, Italy, the Netherlands, South Africa, and Switzerland that cover only estate taxes. The U.S. has treaties with Australia and Japan that cover estate and gift taxes. The U.S. has treaties with Austria, Denmark, France, Germany, and the United Kingdom that cover estate, gift, and generation-skipping transfer taxes. The U.S.-Canada income tax treaty substantially modifies the U.S. estate tax for Canadian citizens and residents.

## Claiming a Treaty Position to Reduce or Eliminate the U.S. Estate Tax

The taxation of non-U.S. domiciliaries can be harsher than that of U.S. domiciliaries. Non-U.S. domiciliaries are subject to estate tax on their U.S. situs assets and are allowed an exemption of only \$60,000. However, in certain circumstances the non-domiciliary may utilize an estate, gift, and/or generation-skipping tax treaty to eliminate a U.S. tax. Each treaty's terms are different. Some estate tax treaties, such as the U.S.-South Africa estate tax treaty, only permit credits to offset an estate tax.<sup>33</sup> Other treaties such as the ones with the U.K., Canada, and Germany, permit non-U.S. domiciliaries the benefit of a larger unified credit available to domiciliaries.

The three illustrations below show how each of the U.S.-U.K., U.S.-Canada, and U.S.-Germany treaties may be utilized to eliminate the U.S. estate tax.

**Illustration 1.** Assume a United Kingdom domiciliary dies while owning U.S. real estate valued at \$125,000. Since the U.K. domiciliary died owning U.S. situs property worth more than \$60,000, the U.K. domiciliary's estate would typically be subject to the U.S. estate tax. However, Article 8, paragraph 5 of the U.S.-U.K. estate, gift, and generation-skipping tax treaty states “Where property may be taxed in the United States on the death of a United Kingdom national who was neither domiciled in nor a national of the United States and a claim is made under this paragraph, the tax imposed in the United States shall be limited to the amount of tax which would have been imposed had the decedent become domiciled in the United States immediately before his death, on the property which would in that event have been taxable.”

In order to determine if the estate of a U.K. domiciliary owes a U.S. estate tax, it will be necessary review the

decedent's worldwide assets at the date of death and calculate a hypothetical estate tax on the decedent's worldwide assets as if the decedent were domiciled in the U.S. In this example, assume that the U.K. domiciliary owed U.K. assets valued at \$1,356,939 which she died in 2023. Since she owed U.S. situs assets valued at \$125,000, the U.K. domiciliaries total worldwide estate was valued at \$1,481,939. The estate tax exemption in 2023 is \$12.92 million. The U.S. assets comprised 16% of the total worldwide assets (\$125,000 / \$1,356,939). Under the estate tax treaty between the U.S. and the U.K., the estate is able to take a pro rata credit of \$2,007,520. The estate tax on \$1,481,939 is approximately \$592,775 ( $\$1,481,939 \times 40\% = \$592,775$ ) which is offset in full by the unified credit, leaving a U.S. estate tax of zero.

**Illustration 2.** Assume a Canadian domiciliary dies owning U.S. real estate valued in excess of \$60,000. Similar to *Illustration 1*, the executor may file a U.S. estate tax return with an attached Form 8833 “Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)” citing Article XXIX B of the United States-Canada Income Tax Treaty. The purpose of Article XXIX B is to better coordinate the operation of the death tax regimes of the two countries. Such coordination is necessary because the U.S. imposes an estate tax, while Canada applies income tax on gains realized at death rather than an estate tax.

As with the U.S.-U.K. estate, gift, and generation skipping tax treaty, the U.S.-Canada income tax treaty permits a deceased Canadian domiciliary a pro-rata percentage of the same unified credit available to U.S. domicil-

<sup>33</sup> Internal Revenue Code Section 2013 allows a credit against the federal estate tax imposed on the present decedent's estate for the federal estate tax paid on the transfer of property from a transferor who died within ten years before, or within two years after, the present decedent's death.

<sup>34</sup> The U.S.-German Estate, Gift, and Generation Skipping Tax Treaty, Article 10 paragraph 4.



aries. The resulting percentage is applied to the unified credit for the year of death. This amount is the maximum unified credit allowed, which is limited to the actual amount of tax.

**Illustration 3.** For this example, assume a husband and wife were domiciled in Germany. They decided to acquire U.S. real estate in the resort town of Park City, Utah. Husband died when the U.S. real property had a fair market value of \$5,000,000. Assume that the Park City real estate was the only asset the couple held on the date of the husband's death.

The executor of the deceased German domiciliary husband may utilize the U.S.-German estate, gift, and generation skipping tax treaty to reduce the estate's exposure to the U.S. estate tax. Under the U.S.-German estate, gift, and generation-skipping tax treaty, for purposes of determining the estate tax, "the taxable base is to the extent by its value (after taking into consideration any applicable deductions) exceeds 50% of the value of all property."<sup>34</sup>

Under Article 10, Paragraph 4, for purposes of determining the U.S. estate tax for the estate of the deceased German husband, 50% of the value of the property passed to the surviving spouse is not subject to the U.S. estate tax (this will be discussed in more detail below). In determining the estate tax imposed by the United States, Article 10, Paragraph 5 provides that if a decedent was domiciled in Germany at the time of the decedent's death, the estate tax shall be allowed a unified credit equal to the greater of: a) the amount that bears the same ratio to the credit allowed to the estate of the citizen of the United States as to the value of the part of the decedent's gross estate that at the time of the decedent's death is situated in the United States bears to the value of the decedent's entire gross estate wherever situated; or b) the unified credit allowed to the estate of a nonresident not a citizen of

the United States. Under Article 10, Paragraph 5 of the treaty, the estate of the husband is allowed a unified credit of \$12.92 million against the estate tax.

**Prior to 2004, multi-tiered corporate structures could be utilized to protect foreign investors from the U.S. federal estate and gift tax. This is no longer the case.**

The U.S. estates of individuals domiciled in Australia, Finland, France, Greece, Japan, and Switzerland are also entitled to utilize a proportion of the applicable unified credit amount otherwise available only to the estates of U.S. citizens and U.S. domiciliaries.

### Treaties and the Marital Deduction

U.S. tax law allows an unlimited deduction for property passing from a decedent to his or her surviving spouse. Referred to as the unlimited marital deduction (UMD), this deduction is the most important deduction available to married couples wishing to minimize transfer taxes on their property. The UMD excludes from U.S. estate and gift taxes all the property transferred by one spouse to another. However, in order to take the UMD, the spouse receiving the transferred property must be a U.S. citizen. Whether or not the receiving spouse is domiciled in the U.S. is irrelevant for purposes of this deduction.

In the case of gifts made to a spouse who is not a U.S. citizen, the annual

gift tax exclusion amount is increased from \$17,000 to \$175,000 (for calendar year 2023). In the case of passing property upon the death to a surviving spouse who is not a U.S. citizen, the UMD can be available if the property is transferred to a qualified domestic trust (QDOT). The QDOT arrangement allows the estate to postpone payment of the decedent's estate tax, generally until the surviving spouse's death. The postponed tax is imposed on the QDOT property revalued at the time of taxation at the decedent's top marginal estate tax rate and the property held in the QDOT is taxed as if it had been included in the decedent's gross estate.

There are a number of treaties that abrogate these rules. For example, the United Kingdom estate, gift, and generation-skipping tax treaties provide for an unlimited marital deduction for property which would have been eligible for such a deduction had the decedent been domiciled in the U.S. at his death.

### The United States Estate, Gift, and Generation-Skipping Tax Treaty: the United Kingdom and the Marital Deduction

The United Kingdom's estate and gift tax treaties with the United States provide for a UMD which would have been eligible for such a deduction had the decedent been domiciled in the U.S. at his death. Under these treaties, individuals domiciled in the United Kingdom can claim a UMD for purposes of U.S. estate or gift taxes as if they were domiciled in the United States. This offers a significant planning opportunity for mitigating the consequences of the U.S. estate and gift tax. In essence, the United Kingdom estate, gift, and generation-skipping tax treaty exempts most if not all U.S. situs assets from the U.S. estate and gift tax in connection with interspousal transfers. That is, as long as the world-

wide assets of the transferor U.K. domiciled spouse does not exceed the applicable unified credit (\$12.92 million for 2023).

### United States-German Estate, Gift, and Generation Skipping Tax Treaty

Under the U.S.-German estate, gift, and generation-skipping tax treaty, interspousal transfers are excluded from a qualifying decedent's gross estate for U.S. estate tax purposes to the extent that their value does not exceed 50% of the value of all property included in the U.S. taxable base. This marital deduction is limited to the amount that would reduce the U.S. estate tax due to what would apply to U.S. citizens or resident aliens. Under the wording of the United States-German estate, gift, and generation-skipping tax treaty, the estate would then be subject to U.S. tax in the lower amount of a) the figure determined using the marital deduction; or b) that generally imposed upon nonresident aliens under U.S. law. In general, the treaty provides the following benefits to foreign investors that are residents of Germany:

1. The estate of a German domiciliary may claim a proportion of U.S. estate unified credit based upon the respective values of the decedent's U.S. gross estate and his worldwide gross estate.
2. An estate of a German domiciliary is entitled to a marital deduction equal to the value of any "qualified property" passing to the decedent's surviving spouse so long as such amount would qualify for the U.S. estate marital deduction if the surviving spouse were a U.S. citizen and all applicable elections were properly made, providing that: (a) At the time of the decedent's death, both the decedent and the surviving spouse were domiciled in either the U.S. or Germany; (b) If the decedent and the surviving spouse were at

the time both U.S. domiciliaries and one or both of them were German citizens; and (c) The executor of the decedent's estate elects to use the marital deduction treaty benefits and irrevocably waives the right to make a QDOT election on behalf of the estate.

To illustrate how the marital deduction is applied, the Treasury Department has provided a number of examples in the Treasury Department's Technical Explanation to the protocol governing estate tax in the United States-German estate, gift, and generation-skipping tax treaty illustrates the operation of the pro rata unified credit and marital deduction. The examples provided by the Treasury Department presume that: (1) H (the decedent) and W (his surviving spouse) are German citizen residents in Germany at the time of the decedent's death; (2) H died in 2016, when the Section 2010 unified credit was \$2,125,800 and the related applicable exclusion amount was \$5,450,000; (3) the conditions set forth in the Protocol are satisfied; (4) no deductions are available under the Internal Revenue Code in comparing the U.S. estate tax liability.

#### Example 1

1. H has U.S. real property worth \$10,000,000, all of which he bequeaths to W. The remainder of H's estate consists of \$10,000,000 of German situs property.
2. Pursuant to the existing marital deduction provision of the Germany Treaty [Article 10(4), as modified by the Germany Protocol], the U.S. gross estate equals \$5,000,000 [the amount by which the \$10,000,000 of U.S. real estate bequeathed to W exceeds \$5,000,000 (50% of the total value of U.S. property taxable by the United States under the Germany Treaty)]. H's worldwide gross estate equals \$15,000,000

(\$5,000,000 plus \$10,000,000 of German situs property).

3. The \$5,000,000 U.S. gross estate is reduced by the \$2,500,000 marital deduction of Germany Treaty Article 10(6), resulting in a \$2,500,000 U.S. taxable estate. The tentative tax on the taxable estate equals \$945,800. H's estate would also be entitled to the pro rata unified credit allowed by Germany Treaty Article 10(5) of \$708,600 [ $\$2,125,800$  (the full 2016 unified credit)  $\times$   $\$5,000,000/\$15,000,000$  (the \$5,000,000 U.S. gross estate divided by the \$15,000,000 worldwide gross estate)]. Thus, the total U.S. estate liability is approximately  $\$237,200$  ( $\$945,800 - \$708,600 = \$237,200$ ).

#### Example 2

1. The facts are the same as in Example 1 except that H bequeaths \$1,000,000 of his real property to W and \$9,000,000 of his real property to C, H's child.
2. The \$9,000,000 of U.S. real property bequeathed to C is included in H's U.S. gross estate. Pursuant to the U.S.-Germany Treaty Article 10(4), none of the U.S. real property bequeathed to W is included in the gross estate because such property would be included only to the extent its value (i.e., \$1,000,000) exceeded 50% of the \$10,000,000 total U.S. situs property taxable under the applicable provisions of the Germany Treaty. H's worldwide gross estate equals \$19,000,000 (\$9,000,000 plus \$10,000,000 of German situs property).
3. Because none of the U.S. situs property bequeathed to W is included in the U.S. gross estate, the property is not "qualifying property," and therefore no marital deduction is allowed with respect to that property under Germany Tax Treaty Article 10(6). The ten-

tative tax on the \$9,000,000 gross estate equals \$3,545,800. H's estate would also be entitled to the pro rata unified credit allowed by Germany Treaty Article 10(5), which equals approximately \$2,125,800 (the full 2016 unified credit), multiplied by a fraction equal to the \$9,000,000 U.S. gross estate over the \$19,000,000 worldwide gross estate. Thus, the total U.S. estate tax liability is \$2,538,843 (\$3,545,800 - \$1,006,957).

## The United States-Canadian Income Tax Treaty

The U.S.-Canada income tax treaty provides relief from the U.S. estate tax (the treaty does not, however, provide any relief from the U.S. gift tax). Some Canadian investors in the U.S. are also able to enjoy an estate tax marital deduction. The U.S.-Canada income tax treaty provisions relevant to the U.S. estate tax and marital deduction may be summarized through the following examples:

**Illustration 1.** Justine Lieber owns a vacation home in Florida with a value of \$10,000,000, unencumbered by a mortgage. His other worldwide assets amount to U.S. \$1,000,000. There will be no U.S. estate tax whether or not Justine Lieber is survived by his spouse.

This is because Canadian citizens who die owning U.S. assets are entitled to a credit against his or her U.S. estate tax liability in an amount equal to that proportion of the U.S. unified credit his U.S. situated estate would apply to his worldwide estate.

Below, *Illustration 2* provides a more detailed discussion as to how the U.S.-Canadian income tax treaty operates.

**Illustration 2.** Bryan Bosling, a Canadian resident, owns vacation homes in California and Hawaii with a value of \$10,900,000, unencumbered by mort-

gage, and Canadian property valued at \$10,900,000. If Bryan Bosling died, his estate, for U.S. estate tax purposes would be entitled to a credit of U.S. \$4,417,800 [the U.S. \$4,417,800 (for proration of unified credit for 2018) "unified credit" x [(U.S. assets)/(Worldwide assets)] (\$10,900,000 + \$10,900,000 = \$21,800,000)]. Bryan Bosling's estate tax will be U.S. \$96,308 [U.S. Worldwide Assets x \$4,417,800

tax tangible personal property such as cash, debt obligations, and U.S. corporate stock owned by a Germany domiciliary. The treaty completely removes cash, debt obligations, and corporate stock from U.S. situs for purposes of U.S. estate and gift tax. As a result of the U.S.-German tax treaty, an individual domiciled in Germany may hold shares of U.S. stock free from U.S. estate tax. The same rules do not apply to U.S. partnership interests.

Under Article 8 of the treaty, if a German domiciliary operates a U.S. partnership that has either business property or a permanent establishment in the United States, the value of the partnership will be subject to U.S. estate tax.

The U.S. estate tax treaties with the United Kingdom, Austria, France, Denmark, and the Netherlands contain similar provisions. However, the United Kingdom and Austria estate tax treaties do not contain specific provisions regarding partnerships. Article 8 of the U.S.-France estate, gift, and generation-skipping tax treaty has its own unique provisions governing corporate stock, debt obligations, and other intangible property that changes the situs rules. Under Article 8 of the treaty, "only France should tax shares or stock in a corporation, debt obligations (whether or not there is written evidence thereof), other intangible property, and currency" owned by a decedent domiciled in France.

The U.S.-France estate and gift tax treaty provides significant limitations on French domiciliaries wishing to hold U.S. real property through domestic corporate structures, partnerships, and limited liability companies.

## Utilizing an Estate Tax Treaty to Potentially Avoid Foreign Inheritance Tax

A number of foreign countries have enacted inheritance taxes. In some cases, a foreign inheritance tax can be assessed on a relatively small gift or be-

**The U.S. currently has treaties with 15 countries regarding estate, gift, or generation-skipping transfer tax.**

unified credit (2018) = \$96,308] unless Bryan Bosling is married and makes a qualifying transfer to a QDOT. Instead of relying on the rule that allows a deduction for bequests by a Canadian resident to a non-U.S. citizen spouse provided assets are timely transferred to a QDOT, the U.S. will allow an election to be made for an additional non-refundable marital credit up to the amount of the proportionate credit.

## How Certain Treaties Abrogate the Situs Rules

As discussed above, only the U.S. situs assets of non-U.S. domiciliaries are subject to the estate tax. A number of estate and gift tax treaties abrogate the usual situs rules for purposes of estate and gift taxation.

Under Article 9 of the U.S.-German estate tax treaty, only Germany may

quest. By way of example, the United Kingdom imposes an inheritance tax on the estate of decedents domiciled in that country. U.K. inheritance tax is typically levied at a rate of 40% on the decedent's worldwide estate with values in excess of 325,000 British Sterling Pounds (approximately \$402,000). In contrast, individuals domiciled in the U.S. are provided with a far more generous \$12.92 million exclusion from U.S. estate tax.

Given the more favorable tax treatment under U.S. law, an individual who can be classified as domiciliaries of both countries may prefer to be treated solely as a U.S. domiciliary in accordance with the U.S.-U.K. estate, gift, and generation-skipping tax treaty. In so doing, a dual domiciliary can break his or her U.K. domiciliary status and potentially avoid the assessment of U.K. inheritance tax on U.S. situs assets.

Set forth in Article 4 of the treaty are tie-breaker rules, ranked in order of priority, to determine the domiciliary status of a dual domiciliary. First, a dual domiciliary will be deemed solely a U.K. domiciliary if the individual is not a U.S. citizen and did not re-

side in the U.S. for at least 7 out of the previous 10-year period. Otherwise, the dual domiciliary will be deemed solely a U.S. domiciliary if the individual is a U.S. citizen (but not a U.K. national) and did not reside in the U.K. for at least 7 out of the previous 10-year period. If neither rule applies, a dual domiciliary will be deemed solely the domiciliary of the country where the individual's permanent home, "centre of vital interest," or habitual abode is located. If no such location exists (or if there are multiple places for these locations), then the dual domiciliary will be a U.S. domiciliary. If none of the rules apply, the U.S. and U.K. taxing authorities will make the domiciliary determination by mutual agreement.

If the facts and circumstances of the particular case warrant, in certain cases, utilizing the treaty to break U.K. domiciliary in favor of being classified a U.S. domiciliary may significantly reduce an individual's exposure to the U.K. wealth transfer tax. Each case needs to be carefully examined to determine if this strategy is beneficial from a global tax perspective.

## Conclusion

This article is intended to acquaint readers with some of the principal U.S. estate and gift tax considerations that can come into play when investors who are not U.S. citizens or residents invest in a business or real estate in the United States. This area is relatively complex and is constantly evolving with Congress entertaining new tax laws, the IRS issuing new regulations and interpretations, and courts rendering new rulings in this area. As a result, it is crucial that non-U.S. investors consult with a qualified international tax attorney when planning to invest in a U.S. business or real estate. This is to ensure that the proposed investment is appropriate given the investor's tax circumstances and that no developments have arisen in the area that can impact the investment's tax objectives. With careful, individualized planning, non-U.S. investors may be able to substantially reduce the U.S. estate and gift tax consequences of their U.S. investments that affect not only themselves but their heirs and beneficiaries as well. ■