DEATH OF THE US DEATH TAX? NOT ALL ROSES FOR FAMILIES WITH UK CONNECTIONS

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Introduction[3]

To the surprise of many, the United States Congress adjourned for 2009 unable to agree an appropriate measure for the federal estate and generation-skipping transfer ("GST") taxes for 2010. The congressional impasse resulted in the scheduled one-year repeal of the federal estate and GST taxes, effective 1 January 2010.

Although advertised as a tax relief measure, the repeal provisions include some surprising consequences for families with UK (or other non-US) connections. Indeed, the repeal has itself created US tax exposure where none previously existed for many families. For example,

- Non-US excluded property trusts settled by US persons[4] for UK Inheritance Tax purposes will now be subject to US income tax on a deemed sale of assets upon the death of the settlor;

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3 Special thanks to Stephen Liss, Sharon Soloff and David Lehn of Withers Bergman LLP for their initial briefing note titled *Death of the Death Tax*.

- US persons will no longer be able to leave their first $3,500,000 (the 2009 US equivalent of the UK nil rate band amount) of assets tax free to UK or other non-US persons, rather US tax would be owed on a deemed sale;

- US persons married to UK or other non-US persons previously intending to defer US death taxes on assets in excess of $3,500,000 via a qualified domestic trust ("QDOT") arrangement will now be subject to US tax on a deemed sale of their assets unless the QDOT arrangement qualifies as a US trust;

- US persons inheriting assets from UK or other non-US persons (either outright or in trust) will take over the decedent's (i.e., the deceased's) historic base cost in those assets regardless of whether UK Inheritance Tax (or other non-US death tax) is payable;

- US taxes arising from deemed or actual asset sales are unlikely to be offset by UK inheritance tax (or other non-US death tax) owed in connection with the same assets. Nor is it likely that relief will be available under the US/UK Estate and Gift Tax Treaty.

Fortunately, with additional planning most of these tax traps can be avoided as discussed in more detail below.

Background

As the US position now stands, the estate of a decedent who dies in 2010 is not subject to federal estate or GST tax, and lifetime transfers made in 2010 are not subject to GST tax. However, the federal gift tax remains in force throughout 2010, with a $1,000,000 lifetime exemption (unchanged from 2009) and a top gift tax rate of 35% (reduced from 45% in 2009). The stepped-up basis regime, which provided that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedents death[5], has been repealed and replaced with the carryover basis regime, which provides that the basis of property acquired from a decedent is the decedent's basis in such property (or the fair market value if less than

4 § 7701(a)(30). The term "US person" means a citizen or resident of the United States (including green card holders and individuals who meet the substantial presence test), any estate other than a non-US estate and any trust other than a non-US trust. The term "non-resident alien", or "NRA", means any individual who is not a US person. Unless the context requires otherwise, all section or § references herein are to the United States Internal Revenue Code of 1986, as amended (the "Code") and to the Treasury regulations promulgated thereunder.

5 § 1014.

the decedent's basis).[6] In addition, a testamentary transfer from a US person to an nonresident alien ("NRA") or a non-US trust is subject to immediate gain recognition to the extent the fair market value of the property transferred exceeds the US decedent's adjusted basis.[7]

It has been proposed that Congress should act in 2010 to reinstate the federal estate and GST tax, however it is not known what tax rates and exemption amounts will apply or whether the legislation will be prospective or retroactive to 1 January 2010. Some observers believe that a retroactive reinstatement resulting in taxation of the estates of persons who had already died in 2010 would be unconstitutional. However, the United States Supreme Court has upheld retroactive tax legislation on several occasions[8], and Senator Max Baucus (Chairman of the Senate Finance Committee), Secretary Timothy Geithner (United States Treasury Secretary) and President Barack Obama have all expressed their support for retroactive reinstatement of the federal estate and GST taxes. Still, an ever-increasing number of observers feel that Congress will be unable to breach the impasse carried forward from 2009, and therefore, neither prospective nor retroactive legislation will be passed in 2010 – deaths in 2010 will remain subject to the rules currently in effect. Therefore, practitioners must develop an understanding of the new rules in light of the increasing likelihood that this latter view comes to pass. This is particularly true in the international context where the tax implications under the new rules can be shockingly adverse.

Part 1 summarises the significant changes to the federal estate, gift and GST taxes (referred to collectively as "federal transfer taxes") made by the Economic Growth and Tax Relief Reconciliation Act of 2001. Part 2 outlines the new carryover basis regime and considers alternatives that may be available to the estates of NRAs to increase the basis of assets inherited by US persons. Part 3 analyses the gain recognition provisions, as expanded in 2010 to apply to testamentary transfers to NRAs, as well as US persons utilising non-US trusts. Here, some simple solutions are available to provide protection from immediate gain recognition.

1. Death of the US death tax

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act"), effective for tax years 2002 through 2010.[9] Over this nine-year period, the 2001 Act has made a series of changes to the federal transfer

6 § 1022.

7 § 684.

8 *See, e.g., United States v. Carlton,* 512 U.S. 26 (1994); *United States v. Hemme,* 476 U.S. 558 (1986).

9 P.L. 107-16, (June 17, 2001).

tax system. The federal estate tax exemption amount gradually increased from $1,000,000 in 2002 to $3,500,000 in 2009, and the maximum federal estate tax rate gradually decreased from 50% to 45% over the same period.[10] The 2001 Act made similar changes to the federal gift and the GST taxes during this period. The phased reductions to the federal transfer tax base culminated in a one-year repeal of the federal estate and GST taxes in 2010, which is effective only for decedents dying and generation skipping transfers made in 2010.

The 2001 Act did not repeal the federal gift tax, which was kept in place to deter taxpayers from transferring income-producing assets to lower bracket taxpayers. For 2010, the federal gift tax exemption is $1,000,000 and the top gift tax rate is 35%.[11]

In conjunction with the repeal of the federal estate and GST taxes[12], the 2001 Act made other relevant changes to the Code. The 2001 Act repealed section 1014 of the Code, which provided that the basis of property acquired from a decedent equals the fair market value of such property at the date of the decedent's death.[13] Section 1014 was replaced by section 1022, which provides that the basis of property acquired from a decedent equals the lesser of the decedent's adjusted basis in the property or the fair market value of the property at the date of the decedent's death. In addition, the 2001 Act expanded the scope of section 684 of the Code, which is a gain recognition provision that taxes transfers of appreciated property by US persons to non-US trusts and estates.[14] As amended, section 684 also applies to testamentary transfers from US persons to NRAs.[15]

At the stroke of midnight on 31 December 2010, the provisions of the 2001 Act will expire.[16] Absent Congressional action, on 1 January 2011, the US transfer tax system will revert to the law in effect at the end of 2001. The estate, gift and GST tax exemptions will be $1,000,000[17], and the maximum tax rate will be 55%.[18] Once again, the federal transfer tax system will be unified.

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10 P.L. 107-16, sections 521 and 511.

11 *Id*.

12 §§ 2210 and 2664, respectively.

13 P.L. 107-16, section 541.

14 P.L. 107-16, section 542.

15 § 684(a).

16 P.L. 107-16, section 901.

17 The GST tax exemption will likely be higher than $1,000,000, as it is adjusted for inflation.

18 P.L. 105-34, section 501.

2. Carryover basis regime

As noted, the 2001 Act repealed section 1014 of the Code (the "stepped-up basis regime") and replaced it with section 1022 (the "carryover basis regime").[19] Therefore, the income tax basis of property acquired from a decedent who dies in 2010 is not the fair market value of the property. Rather, it is the lesser of the decedent's adjusted basis in the property, or the fair market value of the property at the date of the decedent's death.[20] This means that many beneficiaries will inherit assets with a built-in gain, which will be taxable to the beneficiary on a subsequent sale.

The carryover basis regime provides relief in the form of basis increase, which is intended to replicate, loosely, the estate tax relief previously provided by the federal estate tax exemption. Section 1022 provides that the executor of a decedent's estate may allocate additional basis to appreciated property that was "owned by"[21] and "acquired from"[22] the decedent. Provided the appreciated property was both owned by and acquired from the decedent, two basis adjustments are available.

The first basis adjustment is defined as the "aggregate basis increase."[23] The basis increase for any property is the portion of the aggregate basis increase which is allocated to the property. The aggregate basis increase for a US decedent is $1,300,000. This amount may be increased further by unused built-in losses, capital loss carryovers and net operating loss carryovers.[24] The aggregate basis increase for an NRA decedent is limited to $60,000, and there is no further increase allowed for losses.[25] However, the executor of an NRA's estate may achieve far greater basis increase (up to fair market value) by other means discussed further below.

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19 § 1014(f).

20 § 1022.

21 § 1022(d)(1). The basis increase applies only to property owned by the decedent at the time of death. This can include jointly held property, property held in a revocable trust and community property. However, a decedent is not treated as owning property by reason of holding a power of appointment with respect to such property.

22 § 1022(e). The basis increase applies only to property acquired from the decedent. Generally, the following property is considered to have been acquired from the decedent: (i) property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent; (ii) property transferred by the decedent during his lifetime to either a qualified revocable trust (as defined in section 645(b)(1) of the Code), or to any other trust provided the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust; (iii) any other property passing from the decedent at death to the extent that such property passed without consideration.

23 § 1022(b)(2).

24 § 1022(b)(2)(C).

25 § 1022(b)(3).

The second basis increase is defined as the "aggregate spousal property basis increase."[26] The spousal basis increase for property defined as "qualified spousal property" is the portion of the aggregate spousal property basis increase which is allocated to the property. The aggregate spousal property basis increase for any estate (including an NRA's estate) is $3,000,000.

The spousal basis increase applies only to "qualified spousal property."[27] There are two types of qualified spousal property: (i) outright transfer property, and (ii) qualified terminable interest property. Outright transfer property includes any interest in property acquired from the decedent by the decedent's surviving spouse. However, outright transfer property does not include terminable interests (e.g., a life estate).[28] Qualified terminable interest property ("QTIP") is property that passes from the decedent, and in which the surviving spouse has a qualifying income interest for life.[29] A surviving spouse has a qualifying income interest for life if he or she is entitled to all of the income from the property (payable annually or more frequently), or has a usufruct interest for life in the property, and no person has a power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's lifetime.[30] This means that if a surviving spouse's life interest were subject to a trustee's overriding power of appointment, it would not qualify as qualified spousal property.

There are several restrictions to basis increase. First, basis increase does not apply to property acquired by the decedent by gift or inter vivos transfer for less than adequate and full consideration in money or money's worth during the three-year period ending on the date of the decedent's death. However, this limitation does not apply to property acquired from the decedent's spouse unless such spouse acquired the property by gift during the same three-year period.[31] Second, basis increase does not apply to stock in certain non-US corporations, such as personal non-US holding companies, non-US investment companies and passive non-US investment companies.[32] Third, the basis adjustments cannot increase the basis of any interest in property acquired from the decedent above its fair market value in the hands of the decedent as of the decedent's date of death.[33]

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26 § 1022(c)(2).

27 § 1022(c)(3).

28 § 1022(c)(4).

29 § 1022(c)(5).

30 *Id.*

31 § 1022(d)(1)(C).

32 § 1022(d)(1)(D).

33 § 1022(d)(2).

As noted above, the executor of an NRA's estate may achieve basis increase by other means. For example, to the extent an NRA owned assets through a wholly owned "foreign eligible entity" (e.g., a BVI holding company), the executor should consider making an election to treat the company as a disregarded entity for US federal income tax purposes. This is commonly referred to as a "check-the-box" election.[34] If a non-US corporation elects to be a disregarded entity, it is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the non-US corporation.[35] Distributions to shareholders in liquidation of a corporation are treated as taxable events. The shareholders are treated as if they sold their stock back to the corporation in return for the corporate assets, or in the case of a deemed liquidation, in return for assets in-kind.[36] The shareholder calculates gain or loss by subtracting his or her adjusted basis in the shares from the amount realized on the deemed sale and takes a basis in the assets deemed distributed equal to fair market value.[37] Provided the non-US corporation did not own certain US situate assets (e.g., US real estate), there should be no resulting tax liability either to the NRA or his estate. A check-the-box election can be retroactive up to 75 days prior to the date on which the election is filed. The executor should anchor the election to the day before the decedent's death so that the gain from the deemed liquidation flows through to the NRA decedent and not the estate, especially if there are US beneficiaries of the estate.

Alternatively, if the NRA decedent owned the assets through a non-US revocable grantor trust, the executor and trustee should consider making an election, referred to as a "section 645 election", to treat the trust as part of the NRA's estate for US federal income tax purposes.[38] This can be particularly advantageous when there are US beneficiaries of the estate because non-US estates are taxed differently than non-US trusts. By making the election and disposing of the assets (other than certain US assets), it is possible to distribute the proceeds of the sale from the NRA's estate to the US beneficiaries with minimal, if any, tax consequences to the US beneficiaries. On the other hand, if the trustees do not wish to sell the trust assets, the trustees and executor may be able to make the section 645 election in conjunction with a check-the-box election to achieve the same result. These methods are available under prior and current law, but the utility is enhanced with the repeal of the estate tax.

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34 § 301.7701-3.

35 *Id*.

36 § 331.

37 §§ 1001 and 1012.

38 § 645.

3. Gain recognition on testamentary transfers to NRAs, non-US trusts and non-US estates

In 2010, if a US person makes a testamentary transfer of appreciated property to an NRA, or if a US settlor of a non-US trust dies, he (or his estate) will be subject to immediate gain recognition under section 684 of the Code. The transfer will be treated as a deemed sale, and the gain will equal the excess of the fair market value of the property transferred, or deemed transferred in the case the death of a US settlor of a non-US trust, over the adjusted basis of such property in the hands of the decedent. [39] The gain recognized from the deemed sale is determined on an asset-by-asset basis, and losses are not recognized and may not be used to offset gains realized on the transfer.[40]

A testamentary transfer to an NRA and a deemed transfer upon the death of a US settlor of a non-US trust are discussed in more detail below.

Testamentary transfer to an NRA

Section 684, as amended, provides that any US person who transfers appreciated property to an NRA shall be required to recognize gain at the time of the transfer. However, there is an exception for *lifetime* transfers to NRAs.[41] The 2001 Act added this exception to account for the expansion of section 684 to transfers to NRAs. The effect of the exception is that section 684 applies only to testamentary transfers to NRAs. Lifetime transfers to NRAs remain subject to US federal gift tax. The lifetime exception does not apply to lifetime transfers to non-US trusts or non-US estates.

Under prior law, there was an exception for testamentary transfers. The exception provided that gain recognition under section 684 would not apply to any transfer of property by reason of death of the US transferor if the basis of the property in the hands of the non-US transferee was determined under section 1014 (i.e., the stepped-up basis regime). However, the stepped-up basis regime is not applicable to decedents who die in 2010. Therefore, a US decedent who dies in 2010 and leaves appreciated property to an NRA is required to recognize gain to the extent that the fair market value of the property exceeds the US decedent's adjusted basis. Contrast this with the tax implications under the law in effect in 2009. In 2009, a US person could transfer up to $3,500,000 in appreciated assets to an NRA with no estate or income tax implications. This is not the case in 2010.

39 § 684, as amended, and § 1.684-1.

40 § 1.684-1(a).

41 § 684(b)(2).

Further, it does not appear that basis increase under the carryover basis regime is available to reduce the deemed section 684 gain. The Treasury regulations provide that when a US person transfers property at death and basis is not determined under the stepped-up basis regime, the US person is treated as having transferred the property to the NRA[42] *immediately before* the US person's death and must recognize gain at that time. Thus, the recognition event is deemed to occur prior to the decedent's death and prior to the basis adjustment under section 1022.[43] Presumably, the NRA would take a basis in the property equal to the fair market value as of the date of the decedent's death.[44] On the other hand, it could be argued that the NRA acquired the property by bequest, and therefore section 1022 should determine basis and the aggregate basis increase thereunder should be available to reduce the section 684 gain. There is no clear answer here. If section 1022 is not available, then a transfer of property with an adjusted basis in the hands of the US decedent of $1,000,000 and a fair market value of $3,500,000 would generate a tax liability of approximately $375,000. And this is assuming the entire gain is taxable at the lower long-term capital gains rate of 15%. It may well be the case that the gain is taxable at a much higher rate (e.g., up to 35%).

If the transfer is to an NRA surviving spouse, the surviving spouse and the executor of the US decedent's estate could avoid section 684 gain recognition by making what is known as a section 6013(g) election.[45] Section 6013(g) provides generally that an NRA spouse who is married to a US spouse at the close of the taxable year[46] may elect to be treated as a US person for federal income tax purposes and file a joint tax return with the US spouse. Thus, the testamentary transfer would be treated as a transfer to a US person rather than a non-US person, and there would be no deemed gain recognition. The section 6013(g) election would apply only for the year of the US decedent's death, and the NRA's "US person" tax status would automatically revert to NRA status the year following the US decedent's death.[47] The section 6013(g) election also should solve the basis increase issue because the $3,000,000 aggregated spousal basis increase should be available to increase the

42 § 1.684-3(g), Example 3. The Treasury Regulations refer to a non-US trust, but we have used NRA here to account for the changes made by EGTRRA to the statute.

43 § 1.1002-1. The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section §1001 is that the entire amount of such gain or loss is recognized except in cases where specific income tax provisions provide otherwise.

44 § 1012.

45 §§ 6013(g) and 1.6013-6. The election is available only if the NRA spouse has not previously elected under section 6013(g) and revoked it.

46 § 1.6013-6(a)(2)(iii) and 1.6013-4(a)(2). If one spouse dies during the taxable year, the status as husband and wife for purposes of determining whether two individuals are married at the close of the taxable year is determined at the time of the death.

47 §§ 6013(g)(4)(B) and 1.6013-6(b)(2).

basis of appreciated qualified spousal property. However, the section 6013(g) will not be appropriate in all cases. The effect of the election is to treat the NRA spouse as a US person for federal income tax purposes. As such, the NRA spouse will be subject to federal income tax and reporting obligations on his or her worldwide income and gains for the entire tax year. Therefore, the NRA should consider this election carefully.

Alternatively, if a section 6013(g) election would be tax inefficient or if the transfer is to a non-US person who is not the surviving spouse, the section 684 gain can be avoided by transferring the property at death to a US trust for the benefit of such non-US person. Of course, unlike the section 6013(g) election, the US person will need to have the US trust in place at the time of his death, though it can remain unfunded until his death. In contrast to an outright transfer to an NRA, this alternative could be structured to avoid US federal estate tax on the beneficiary's subsequent death, when the estate tax will mostly likely be in force again.[48] A trust is classified as a US trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust (the "court test"), and (ii) one or more United States persons have the authority to control all substantial decisions of the trust (the "control test").[49] The Treasury regulations explain in detail the court and control test.[50] A trust that does not satisfy both the court test and control test is classified as a non-US trust.[51]

Under prior law, when a US citizen or domiciliary[52] (or a non-citizen non-domiciled spouse owning US situate property) left assets to a surviving spouse who was not a US citizen, the assets were required to pass into a trust known as a QDOT in order to

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48 Generally, an NRA, as defined for federal estate and gift tax purposes, is subject to US federal estate tax only on certain assets situate or deemed situate within the United States (e.g., real estate, stock issued by a US domestic corporation, etc.). At least this was the case under prior law and will most likely be the case after 2010. In general, an NRA for federal estate and gift tax purposes means a non-US citizen who was not domiciled in the United States at the time of his death.

49 § 7701(a)(30)(E).

50 § 301.7701-7.

51 § 7701(a)(31)(B).

52 *See* § 20.0-1(b)(1). For US federal estate and gift tax purposes, "[a] person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefore." Subject to possible exceptions under an estate and gift tax treaty, US citizens (wherever resident or domiciled) and non-US citizens domiciled within the United States are subject to US federal estate and gift tax on a worldwide basis. In general, a green card holder is presumed domiciled in the United States for US federal estate and gift tax purposes. Strictly speaking, one is not domiciled in the United States but in one of its constituent states. Individual states' laws may differ on certain points, although they are generally quite similar. Each state, however, will have its own body of case law setting out factors in determining domicile.

qualify for the estate tax marital deduction (the US equivalent of the UK spouse exemption) and defer federal estate tax until the death of the surviving spouse. Assets left to a non-citizen surviving spouse not passing into a QDOT were subject to federal estate tax on the death of the first spouse to the extent the value of the assets included in the decedent's estate exceeded the decedent's available federal estate tax exemption ($3,500,000 in 2009 for citizens and green card holders and $60,000 for NRAs). The purpose of the QDOT was to ensure that the assets passing to a non-citizen surviving spouse, for which estate tax deferral was allowed, were subject to estate tax, or "QDOT tax", when the assets were either withdrawn from the QDOT during the surviving spouse's lifetime or at the death of the surviving spouse to the extent assets remained in the trust.

Under current law, with respect to a non-citizen surviving spouse of a decedent who died before 1 January 2010, the 2001 Act provides that the QDOT tax will continue to apply to lifetime capital distributions of corpus through 31 December 2020. However, the QDOT tax that applies at the death of the non-citizen surviving spouse will not apply in 2010.[53]

In general, a trust must meet the following requirements in order to qualify as a QDOT. The trust instrument must provide that at least one trustee of the trust be an individual citizen of the United States or a domestic corporation, and that no distribution (other than a distribution of income) may be made from the trust unless a trustee who is a US citizen or a domestic corporation has the right to withhold from the distribution the estate tax imposed on the distribution.[54] The trust instrument also must satisfy the additional requirements set out in the Treasury regulations[55], and the executor of the decedent's estate must timely elect on the decedent's federal estate tax return to treat the trust as a QDOT.[56] Generally speaking, if the fair market value of the assets passing to a QDOT is in excess of $2,000,000, either (i) at least one trustee must be a qualified US bank or US branch of a foreign bank, (ii) the trustee must furnish a bond in favour of the IRS in an amount equal to 65% of the fair market value of the trust corpus, or (iii) the trustee must furnish an irrevocable letter of credit in an amount equal to 65% of the fair market value of trust corpus.[57] If the fair market value of the assets passing to the QDOT are $2,000,000 or less, the trust instrument must provide that the trustee will

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53 § 2210(b).

54 § 2056A(a).

55 § 2056A(a)(2); *see* Rev. Proc. 96-54 (Nov. 27, 1996). Sample trust language is provided, which, if adopted in a trust instrument, would allow a QDOT to satisfy the requirements for securing collection of additional estate tax under section 2056A; *see also* Rev. Proc. 2010-1 (Dec. 31, 2009), referring to Revenue Procedure 96-54 as a safe harbour.

56 §2056A(a)(3) and (d).

57 *See* § 20.2056A-2(d)(1)(i).

either satisfy the bank, bond or letter of credit requirements described above, or limit the fair market value of real property that is held by the trust and situated outside the United States to 35% of the value of the trust at the close of the taxable year.[58]

A QDOT can be classified as either a US trust or a non-US trust.[59] For example, if the non-citizen surviving spouse is co-trustee with the US trustee, and the non-citizen spouse has authority to make a "substantial decision"[60] of the trust, the trust will fail the control test described above and thus, be classified as a non-US trust for US tax purposes. A similar case would arise if a trust instrument provides that all substantial decisions are to be decided by a majority vote among the trustees and a majority of the trustees are non-US persons. As the law now stands in 2010, if a US person transfers appreciated assets at death to a QDOT that is classified as a non-US trust, the transfer will be subject to immediate gain recognition under section 684. This would not have been the case under prior law, so one should ensure that the QDOT qualifies as a US trust to avoid deemed sale treatment.

Deemed transfer when non-US trust no longer treated as owned by a US person

Section 684, originally and as amended, provides generally that any US person who transfers property to a non-US trust shall be required to recognize gain at the time of the transfer.[61] However, there is an exception for transfers to non-US trusts that are treated as owned by US persons for federal income tax purposes (known as "grantor trusts").[62] In general, if a US person transfers property to a non-US trust and retains an interest in or power over the trust, or if there is a US beneficiary of any portion of such trust, the US grantor[63] will be treated as the owner of such trust (or portion thereof) for federal income tax purposes.[64] A US grantor who is treated as the owner of a non-US trust is required to include in computing his taxable income all items of trust income, gain, deduction, etc. as if he had received such items directly.[65] Therefore, section 684 does not treat a transfer to a non-US trust treated as owned by

58 *See* § 20.2056A-2(d)(1)(ii).

59 *See* PLR 1999180039. Classification of a trust as a non-US trust within the meaning of section 7701(a)(31)(B) will not affect its qualification as a QDOT under section 2056A.

60 *See* § 301.7701-7(d)(1)(ii). The term "substantial decisions" means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial (e.g., bookkeeping).

61 *See* § 1.684-1(a).

62 § 684(b)(1).

63 § 1.671-2(e)(1). A grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to such trust.

64 §§ 671 through 679.

65 § 671.

a US person as a sale because the US person is still treated as the owner of the assets transferred and the income generated from such assets for federal income tax purposes. Essentially, the non-US trust is ignored as a taxable entity.[66]

However, the exception applies only so long as a US person is treated as the owner of the trust assets. Upon the US grantor's death, the non-US trust will become what is known as a non-US "nongrantor" trust, which is a separate taxable entity. When a trust transitions from a grantor trust to a nongrantor trust, the grantor is treated as having transferred the assets of the trust to a non-grantor trust.[67] For section 684 purposes, such transfers at death are subject to immediate gain recognition.[68] The Treasury regulations issued under section 684 provide that if any US person ceases to be treated as the owner of a non-US trust by reason of death of the grantor, the grantor shall be treated as having transferred, immediately before his death, the assets to a non-US trust and generally is required to recognize gain unless an exception applies.[69] Under prior law, there was an exception to section 684 deemed sale treatment for transfers at death provided the basis of the property in the hands of the non-US trust was determined under section 1014 (i.e., the stepped-up basis regime). However, because the 2001 Act repealed section 1014, this exception is no longer applicable. The Treasury regulations provide that when a US grantor of a non-US trust dies and the basis of property is not determined under the stepped-up basis regime, the US grantor is treated as having transferred the property to a non-US nongrantor trust immediately before his death, and must recognize gain at that time.[70]

As with outright testamentary transfers to NRAs, it is unclear whether basis increase under section 1022 will be available to reduce the gain. To avoid section 684 in this instance, the US grantor should consider changing the trust to a US trust for 2010, which as noted above generally can be done by appointing US trustees and changing the governing law of the trust to that of a US state. Should one so wish, the US trustee could be a Private Trust Company owned and/or administered by the current trustee.

4. Conclusion

While the one-year repeal of the US federal estate and GST taxes may provide tax relief in the domestic context, it has certainly raised a myriad of tax traps for

66 Rev. Rul. 85-13, 1985-1 C.B. 184; *But see Rothstein v. United States,* 735 F.2d 704 (2nd Cir. 1984).

67 § 1.1001-2(c), Example 5.

68 *But see* § 1.684-2(e)(2), Example 1.

69 *See* § 1.684-2(e), Example 2.

70 § 1.684-3(g), Example 3.

families with non-US connections. For families willing to review and possibly revise their existing estate plans, most of these tax traps can be avoided or substantially mitigated. Those who do not wish to take this opportunity need to hope the current system is retroactively repealed or that the IRS issues transitional relief.