

# U.S. Income Taxation of Foreign Estates

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NYSBA and STEP USA  
March 12, 2015  
New York, NY

# Who May Be Affected?

- ▶ U.S. citizen residing abroad at death may have a foreign estate
- ▶ RA who is taxed as a U.S. income tax resident may have a foreign estate
- ▶ NRA decedent's estate that has a U.S. beneficiary may realize income in a foreign country
- ▶ NRA who dies holding U.S. income producing assets may have a domestic estate
- ▶ A foreign estate may have a U.S. trade or business if its NRA decedent was conducting a U.S. trade or business at death
- ▶ A foreign estate may be treated as being engaged in a U.S. trade or business if it succeeds to the ownership of a U.S. partnership that was engaged in a U.S. trade or business at the time of death

# U.S. Tax Rules Governing NRAs Govern Foreign Estates

- ▶ Rules for foreign trusts do not apply to foreign estates
- ▶ Foreign estates are subject to special rules that are not applicable to domestic estates
- ▶ U.S. tax rules governing NRAs provide the basic rules for U.S. income taxation of foreign estates
  - ▶ These principals are then applied to particular income items received by foreign estates

# Initial Determination: Is the Estate Foreign or Domestic?

- ▶ This determination governs the income tax treatment of the estate and its beneficiaries
  - ▶ Domestic estate is taxed on its worldwide income
  - ▶ Foreign estate is taxed only on its U.S. source income and ECI

# Definition of Foreign Estate for Income Tax Purposes: IRC §7701(a)(31)

“... “foreign estate” . . . means an estate. . . the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not included in gross income under Subtitle A.”

- ▶ more of a conclusion than any guidance

# Determination is a Question of Facts and Circumstances

- ▶ IRS focuses on:
  - ▶ Country under whose law the estate is created
  - ▶ Residence status of:
    - ▶ Decedent
    - ▶ Fiduciary
    - ▶ Beneficiaries

Rev. Rul. 81-112, 1981-1 CB 598
- ▶ Precedents focus on:
  - ▶ Location of estate assets
  - ▶ Country of domiciliary administration of the estate
  - ▶ Citizenship and residency of ancillary administrator of the estate
  - ▶ Extent and duration of ancillary administrator's activities in the U.S.
    - ▶ Not determined solely on the country in which the estate is subject to domiciliary administration (Rev. Rul. 62-154, 1962-2 C.B. 148)

# U.S. Taxation of Foreign Estates

- ▶ Taxed like an NRA
  - ▶ Not subject to U.S. income tax on foreign source income that is not ECI (even if income is distributed)
    - ▶ Such income includes income earned outside of the U.S., including deemed earnings, e.g., bank interest or deposits with U.S. banks (IRC §861(a)(1)(A))
  - ▶ Taxed on U.S. source income (IRC §871(a))
    - ▶ FDAP income that is not effectively connected with a U.S. trade or business
    - ▶ ECI (Taxed at regular U.S. graduated rates)
    - ▶ Capital gain on sale or exchange of USRPI
    - ▶ May be taxed on U.S. source capital gains
      - ▶ Is the estate present in the U.S.?
  - ▶ Not subject to the IRC §1411 net investment income tax

# Taxation of U.S. Beneficiaries of Foreign Estates

- ▶ Taxed on all current income distributions regardless of source
  - ▶ However, subject to IRC §662(a), amount includable in gross income is limited to beneficiary's share of DNI
- ▶ Foreign estate having only foreign source income has no DNI, and therefore distribution is not taxable (IRC §§662, 665)
- ▶ Distributions of foreign-source income from foreign estate with UNI from prior years are not subject to the throwback or accumulation trust rules
- ▶ Places foreign estates in more favorable position than foreign trusts with respect to accumulation distributions



# Taxation of U.S. Beneficiaries of Foreign Estates (continued)

- ▶ Subject to IRC §1411 net investment tax on distributions of net investment income (Treas. Reg. §1.1411-3)
- ▶ U.S. person who transfers appreciated property to a foreign estate must recognize gain as if the property had been sold or exchanged (IRC §684)
  - ▶ Gain recognition may be reduced or eliminated to the extent a basis increase is allocated to the property (Rev. Proc. 2011-41, 2011-35 IRB 188)
- ▶ U.S. beneficiary is eligible for foreign tax credits for foreign taxes paid by estate on distributed income, subject to certain limitations

# Computation of Distributable Net Income (DNI)

- ▶ Computed in same manner as for a domestic estate
  - ▶ Generally, taxable income, with exclusion of capital gains, foreign source income and income exempt under a treaty
    - ▶ But disallowance of distribution deduction, divided exclusion and personal exemptions deduction (IRC §643(a)(1),(2),(7))
    - ▶ Modifications to IRC §643(a)(6) definition of DNI for foreign trusts do not apply
    - ▶ Administration expenses of a foreign estate not engaged in a U.S. trade or business are not deductible
      - ▶ Must claim these expenses on Form 706

# Computation of Distributable Net Income (DNI) (continued)

- ▶ The estate is allowed the IRC §661 deduction for distributions to beneficiaries
  - ▶ Even if the income is not taxed to the beneficiary
  - ▶ But, distributions deduction may not exceed DNI
- ▶ Withholding on Distributions to Beneficiaries
  - ▶ Beneficiaries must include distributions in income
  - ▶ Income will have same character to beneficiary as it did in the hands of the estate
  - ▶ Generally, withholding by the executor on NRA's income

# Taxation of Foreign Beneficiaries of a U.S. Estate

- ▶ As an NRA, taxed on ECI, FDAP and capital gains on sale or exchange of USRPI (Rev. Rul. 68-621, 1968-2 CB 286)
- ▶ Tax characterization of distribution carries over to the foreign beneficiary
- ▶ Not subject to IRC §1411 net investment tax on distributions of net investment income (Treas. Reg. §1.1411-3)

# Withholding

- ▶ Payments of FDAP to foreign estates are subject to 30% withholding, absent applicable treaty benefits
- ▶ Distributions to beneficiaries
  - ▶ Must determine:
    - ▶ Extent to which distribution carries out DNI
    - ▶ Type and source of income making up DNI
    - ▶ Is the NRA entitled to treaty benefits?
    - ▶ Rate of withholding for type and source of income
  - ▶ If distribution exceeds DNI, no withholding required (unless an accumulation distribution is involved)(Rev. Rul. 59-177, 1959-1 C.B. 229, *distinguished* by Rev. Rul. 68-605, 1968-2 C.B. 390)

# Reporting Requirements

- ▶ Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
  - ▶ A U.S. person who receives bequests exceeding \$100,000 from a foreign estate during the tax year must file
- ▶ Form 56, Notice Concerning Fiduciary Relationship
  - ▶ Filed by executor or administrator of foreign estate to notify IRS of existence and termination of fiduciary relationship
- ▶ Form 1040NR, U.S. Nonresident Alien Income tax Return
  - ▶ Filed by foreign estate to report income of \$600 or more of U.S.-source income
  - ▶ U.S. ancillary personal representative must report the entire income of an estate if the domiciliary personal representative is an NRA (Rev. Rul. 64-307, 1964-2 CB 163)
  - ▶ Form 1041 is not used

# Reporting Requirements (continued)

- ▶ Form 706-706NA, United States Estate (and Generation-Skipping Transfer) Tax Return
  - ▶ Filed by a foreign estate having a U.S. gross estate of at least \$60,000, reduced by prior gifts
- ▶ Fin Cen Form 114, Report of Foreign Bank and Financial Accounts
  - ▶ Filed by U.S. beneficiary of foreign estate who inherits a financial interest in or has signature authority over an applicable foreign bank or financial account valued in excess of \$10,000
- ▶ Form 8938, Statement of Specified Foreign Financial Assets
  - ▶ Filed by U.S. individual, including RAs and certain NRAs, who have beneficial interests in foreign financial accounts and assets of a foreign estate

# State Income Taxation of Foreign Estates and Foreign Beneficiaries

- ▶ State income tax is imposed by many states on income derived in that state by foreign persons
- ▶ The tax base in a particular state may be determined by reference to the U.S. federal income tax return, with various adjustments