Case study for C-BEG 2015 US Seminar

Abraham Lincoln, a US citizen who was a resident in the UK for 20 years was married to Benjamin Disraeli, a UK citizen. There is one child aged 15 who is both a US and UK citizen. Abe has been current with both his US and UK income tax filings. Abe and Ben have a vacation home in Abe's home state of Florida and they spent on average three months per year in Florida.

Abe fell off his Boris bike and died on 1st May 2015 shortly after filing his 2014 US income tax return leaving the following estate:

1. joint bank accounts between Abe and Ben with $100,000 in New York and £100,000 in London;
2. a house in London free from mortgage in joint names worth £3m or $4.5m;
3. Abe's 50% interest in his manufacturing company, Honest Abe's Millinery Ltd, worth £3m or $4.5m;
4. a securities portfolio with the Merry Lunch brokerage company in New York owned by a revocable trust set up by Abe 10 years ago of which Abe and Ben are the trustees;
5. a Florida house owned by Abe worth $1m;

Abe left a 1995 Will made in Florida appointing Ben and the Merry Lunch Trust Company of Florida as his executors and trustees with a formula exemption discretionary trust for Ben and Abe's sister's family and an outright gift of residue to Ben.

Talking points:

1. Is the Will valid – same sex marriage validity / predated marriage
2. IHT / US estate tax – BPR?
3. Should the revocable trust pour over to the testamentary trust & excluded property issues?
4. QDOT planning
5. Foreign or US estate?
6. Section 645 election for Trust? Basis step up - should we check the box on Honest Abe? What about the trust portfolio?
7. Trust UK resident?

*** Glossary:**

Basis step-up	The US term for uplift in base cost for calculating capital gains
Check the box	To make an entity classification election for eligible entities. Any entity that is not a per se corporation (such as a PLC) may be classified for US tax purposes as a corporation or partnership or, if there is only one owner, a disregarded (fiscally transparent) entity. A partnership or disregarded entity election is often used to avoid controlled foreign company (CFC) or passive foreign investment company (PFIC) treatment and tax consequences. Making the election triggers a deemed liquidation of the entity.
Estate tax	Usually refers to the US federal estate tax, which, like the federal gift tax, applies to the worldwide assets of US citizens regardless of domicile, or of US domiciliaries, and to certain US assets of persons neither citizens nor domiciliaries of the US. Imposed at 40% on estates or aggregate taxable gifts over $5.4 million (for US citizens or domiciliaries) or $60 thousand (for US assets of non-US persons). Note, though, that s number of US states impose their own estate or inheritance taxes on the basis of domicile or situs within the state.
GST	Generation-skipping transfer tax, imposed at the estate tax rate on certain assets passing to grandchildren or more remote descendants.
Marital deduction	In the US, marital relief takes the form of a marital deduction for assets passing to the surviving spouse in qualified form.
Pour-over	See "revocable trust."
QDOT	Qualified domestic trust – a life interest trust for a surviving spouse who is not a US citizen, with a US trustee and additional security requirements to ensure US estate tax is paid at the death of (or payment of capital to) the surviving spouse.
Revocable trust	Typically used in the US as a will substitute to simplify or avoid probate; in the US, clients are often advised to settle most or all of their assets during their lifetime, with any remaining assets passing to the trustees by a **"pour-over"** will. Settlor may revoke or amend at any time, like a will, and it usually contains all the dispositive provisions one would expect in a will.
Section 645 election	An election to treat a qualified revocable trust as an estate for US income tax purposes.

Question 1. Is the Will valid?

Abe's Florida Will is valid:

Florida statute §732.507[1] states that "neither subsequent marriage, birth nor adoption of descendants shall revoke the prior Will of any person, but the pretermitted child or spouse shall inherit as set forth in §§ 732.301 and 732.302, regardless of the prior Will." Therefore, Abe's subsequent marriage and decision to have a child have not rendered his 1995 Florida Will void.

Ben may receive his share of Abe's estate per the terms of the Will:

Section 732.301[2] states that "when a person marries after making a Will and the spouse survives the testator, the surviving spouse shall receive a share in the estate of the testator equal in value to that which the surviving spouse would have received if the testator had died intestate, unless . . . the spouse is provided for in the Will."

Ben and Abe's marriage is valid under Florida law.[3] Ben is therefore Abe's spouse for purposes of s. 732.301. However, according the fact pattern, Abe provided for Ben in his 1995 Will. Ben should therefore receive the residue of Abe's estate as an outright gift, per the terms of the Will, and will not receive his intestate share of the estate.

The child of Abe and Ben will not be entitled to an intestate share of Abe's estate:

Section 732.302[4] states that "when a testator omits to provide by will for any of his or her children born or adopted after making the Will and the child has not received a part of the testator's property equivalent to a child's part by way of advancement, the child shall receive a share of the estate equal in value to that which the child would have received if the testator had died intestate, unless . . . the testator had one or more children when the Will was executed and devised substantially all the estate to the other parent of the pretermitted child and that other parent survived the testator and is entitled to take under the Will."

The child did not receive a part of Abe's estate by way of advancement, and Abe and Ben did not have one or more children at the time that the Will was created. Therefore, under s. 732.302, their child would be entitled to his intestate share of Abe's estate.

However, section 732.104,[5] relating to the spouse's share of an intestate estate, stipulates that, if the decedent is survived by one or more descendants, all of who are also descendants of the surviving spouse, and the surviving spouse has no other descendant, then the spouse will take the entire estate.

The child is also a descendant of Ben under Florida law, and, according to the fact patter, Ben has no other descendants. Therefore, applying both ss. 732.302 and 732.102 together, the child's intestate share of Abe's estate is nothing, as the entire estate would go to Ben via intestacy. The child therefore does not take an intestate share of Abe's estate.

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[1] Fla. Stat. §732.507 (2014).

[2] Fla. Stat. §732.301 (2014).

[3] Same-sex marriage became legal in Florida on 6 January, 2015 by temporary injunction issued by a District Court judge in *Brenner v Scott*, 999 F. Supp. 2d. 1278. The decision has been appealed pending a determination on the legality of State bans on same-sex marriage by the US Supreme Court.

[4] Fla. Stat. §732.302 (2014).

[5] Fla. Stat. §732.102 (2014).

Question 5: is Abe's estate US or foreign?

Is the estate US or foreign?

- Whether an estate is classified as a US or non-US estate can have significant US tax consequences, as a US estate is subject to US federal tax on a worldwide basis while a non-US estate is only subject to US federal tax on certain types of US source income.
- Determining whether an estate is classified as a US or foreign estate is a fact specific issue; the facts and circumstances of each case must be examined in light of the rulings issued by the IRS to determine the proper classification of an estate as US or foreign for US tax purposes.[6]
- An estate only qualifies as a foreign estate for US tax purposes if such estate is both an alien estate is not resident in the US.[7]
- While no clear guidelines have been issued to determine alienage and residence of an estate, subsequent IRS rulings indicate that the following key characteristics should be considered in determining an estate's status as US for foreign.

Abe's estate:

1. Bank account held jointly with Ben in London with £100,000
2. A house in London, free from mortgage, held as joint tenants with Ben, worth £3m/$4.5m
3. A 50% interest held by Abe in his English company, worth £3m/$4.5m
4. A house in Florida held in Abe's sole name worth $1m
5. Bank account held jointly with Ben in New York with $100,000
6. A securities portfolio with the Merry Lunch brokerage company in New York, held by a revocable trust set up by Abe 10 years ago, of which Abe and Ben are the trustees.

Abe left a 1995 Will made in Florida:

1. Ben and the Merry Lunch Trust Company of Florida are executors
2. Ben and the Merry Lunch Trust Company of Florida are trustees
3. There is a formula exemption discretionary trust for Ben and Abe's sister's family
4. There is an outright gift of the residue to Ben

[6] In Revenue Ruling 62-154, the IRS held that the treatment of an estate as US or non-US should be determined in the same manner as a trust under a facts and circumstances test.

[7] Rev Rul 62-154.

Key Characteristics:

1. Alienage:
    a. the jurisdiction of the estate's creation;[8]
    b. the country under whose laws the estate is administered.
2. Residence:
    a. the residence of the decedent;[9]
    b. the situs of the estate's assets;
    c. the location of the management and administration of the estate;
    d. whether the estate maintained a fixed place of business in the US.[10]

Conclusions:

[8] PLR 7832002

[9] Revenue Ruling 64-307 (1964-2 C.B. 163) explained that a "decedent's residence is one of the most important facts to be considered in determining the residence of an estate," as an estate is "merely a representative" of the deceased.

[10] B.W. Jones Trust, 46 B.T.A. 531 (1942, *aff'd*, 132 F.2d 914 (4th Cir. 1943); Revenue Ruling 81-112.

Question 6: Making the Section 645 election for the Trust:

The Issue:

8. If a trust qualifies as a grantor trust, on the passing of the grantor the trust automatically converts from a grantor trust to a non-grantor trust.[11]

9. Similarly to non-US estates, non-US non-grantor trusts are only subject to US federal income tax on certain types of US source income and gains.[12]

10. In order to prevent US Persons from using non-US trusts to accumulate income and gains on a tax-free basis, distributions from non-US non-grantor trusts to US Person beneficiaries are subject to the accumulation-distribution rules, also known as the 'throwback' rules.[13]

11. The potential negative tax consequences of distributions to US Person beneficiaries are determined, in part, by the amount of income that has been accumulated (rather than distributed) by the non-US non-grantor trust in previous years.

12. In practice, when a non-US trust (with only US Person beneficiaries) converts from a grantor trust to a non-grantor trust, consideration should be given to annually distributing income and gains in the year earned (or within 65 days after the close of the taxable year in which such income and gains were earned) to prevent income from accumulating and thus avoiding the negative tax implications of the throwback rules. These distributions will be taxable in the hands of the US Person beneficiaries on a worldwide basis.

13. However, unlike non-US non-grantor trusts, distributions from non-US estates are *not* subject to the throwback rules, meaning that income and gains earned by a non-US estate can be accumulated within the estate in a tax-advantageous way.

The Section 645 Election:

1. Section 645 provides that certain 'qualified revocable trusts' ('QRTs')[14] can elect to be treated as part of the grantor's estate for US federal income tax purposes until the earlier of the day on which the QRT and the estate have distributed all of their assets or the day before the 'applicable date.'[15]

2. The Section 645 election, once made, is irrevocable.

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[11] See generally, Treas. Reg. §1.671-4(h).

[12] See generally, Code §641(b); §871.

[13] The throwback rules are a complex set of rules delineated in Subpart D of Subchapter J of the Code. In short, distributions of 'undistributed net income' ('UNI') to US Person beneficiaries are taxed at ordinary income tax rates and are subject to an interest charge. §§ 665-668. Further rules determine whether income earned in a previous year is treated as UNI and to what extent income earned and distributed in a current year constitute 'distributable net income' ('DNI').

[14] Code §645(a); Treas. Reg. §1.645-1(f)(2).

[15] For the purposes of Section 645, the term 'qualified revocable trust' means a trust that is treated as a grantor trust as to the decedent under Section 676 by reason of the power to revoke that was held by the grantor. If a US federal estate tax return is required to be filed, the applicable date is the later of the day that is two years after the date of the decedent's death or six months after the final determination of US federal estate tax liability.

If a US federal estate tax return (IRS Form 706NA) need not be filed, then the applicable date is the day that is 2 years after date of decedent's death. If a US federal estate tax return must be filed, the applicable date is the later of the day that is 2 years after date of decedent's death or the day that is 6 months after the date of final determination of liability for US estate tax.

Abe's Trust:

1. During Abe's lifetime, the Trust is a revocable grantor trust.

2. After Abe's death, the Trust will cease to be treated as a non-US grantor trust.

3. The Trust may elect to be treated as part of Abe's estate or to be treated as a non-US non-grantor trust for US federal tax purposes.

4. If the Trust makes a Section 645 Election to be treated as part of Abe's estate, income and gains earned between 30 May and 31 December 2015 (and income and gains earned in 2016) can be accumulated in a tax-advantageous way without regard to the throwback rules.

5. A Section 645 Election is made by filing IRS Form 8855 no later than 6 months and 15 days after the close of the Estate's first taxable year.

6. Both the trustee and the executor must make the Section 645 Election. Ben is the remaining trustee of Abe's Trust (Abe was the other trustee) and Ben and the Merry Lunch Trust Company of Florida are executors of his estate. Ben and the Merry Lunch Trust Company should make the Section 645 Election jointly.

7. Assuming that both the Trust and the estate do not distribute all of their assets, the Section 645 Election should be effective until the later of 1 May 2017 (2 years after Abe's death) or one day before 6 months after the date of final determination of tax liability for the estate.

Should the Trust fail to made a Section 645 Election to be treated as part of Abe's estate, consideration should be given to distributing income and gains earned by the Trust in order to avoid the potential negative tax consequences of the throwback rules on future distributions to US Persons (i.e., Abe's sister's family, possibly Abe's child