JUNE 2006

# Financial PLANNING

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A Special Supplement To The Connecticut Law Tribune

CHOOSE WISELY

# Diversity Key To Balanced Portfolio

Astute financial planners keep their eye on the prize of tax advantages

By JAMES J. FLAHERTY JR.

For those who become involved with a financial planner or for those who tend to do their own research on investments, the focus of any balanced portfolio ought to be diversification. It is generally accepted that diversification lowers the inherent risk in the average investment portfolio, making it less susceptible to fluctuations in the market.

Terms like asset allocation and sector allocation are all discussed, and with good reason. They address the ways in which the investor can reduce risk by avoiding putting all investment "eggs" in one basket.

There is another form of diversification that relates to the use of various investment vehicles. Whether it is a retirement plan, Roth IRA or traditional brokerage account, one has limited resources to invest. The commitment of scarce personal resources to one type of plan versus another option too often receives little thought. In many cases, the assumption is that contributions to a qualified retirement plan should be maximized because of its tax deferred nature. However, there are sound reasons for looking at all of the various investment options as part of the individual's efforts to diversify.

Asset allocation generally refers to the division of an investor's assets among various forms of investments. For example, for those who are invested in a company-sponsored pension plan, they may have the option of investing in stocks, bonds or cash (among many other options).

The allocation among these options will depend upon factors such as the investor's age, investment objectives and risk tolerance, to name a few. Generally, younger investors with a longer time horizon can afford to be more aggressive when investing as contrasted with older investors who must be concerned with the preservation of capital because of imminent retirement.

Sector Allocation is generally, although not always, a subset of asset allocation. In particular, it refers to the diversification of investment assets among various industries, such as utilities, manufacturing or high tech; or the division of investments among different types of investments such as precious metals, real estate and natural resources.

This is just as important as asset allocation. For younger investors who have the flexibility to be more aggressive, a portfolio heavily weighted in stocks from a particular market sector (i.e. airlines or utilities), is more susceptible to market fluctuations than a broader portfolio.

### Investment Vehicle Allocation

During a recent discussion with Anthony Salerno, a friend who happens to be a financial planner with Ameriprise Financial in Norwalk, Anthony raised the interesting issue of diversification as it relates to the types of investment vehicles appropriate for a personal portfolio. This element of the financial plan focuses on the tax ramifications of various investments. Most everyone is familiar with employer-sponsored retirement plans (e.g. 401(k) plans) which allow employees to contribute a portion of their before-tax salary.

This investment grows on a tax-deferred basis. However, there are other investment vehicles which offer either no distinct tax advantage or a different tax advantage from the traditional retirement plan. All forms of such plans may be advantageous to some degree depending upon the age, financial circumstances, family needs, and related considerations specific to the investor.

The most common tax-advantaged investment vehicle is a defined contribution retirement plan, such as a 401(k), or IRA. As noted, an employee's contributions to the plan are pre-tax, meaning the employees taxable income is reduced. In addition, the growth in the assets is tax deferred until the employee makes a withdrawal.

Moreover, many employers choose to contribute to the employee's account up to a certain amount. With respect to a withdrawal, the amount that is considered taxable income is the amount that is withdrawn. If the withdrawal occurs prior to the age of 59 1/2 , an additional penalty is levied, creating the incentive to hold these funds until at least that age.

It is safe to say that most financial planners would recommend contributing the maximum amount permitted in order to maximize the employer's contribution to the plan. For example, if an employer will contribute dollar for dollar up to a maximum of five percent of the employee's gross income, then the employee should contribute at least five percent of income to take advantage of the employer's maximum contribution.

**Most financial planners would recommend contributing [to a defined contribution plan] the maximum amount permitted in order to maximize the employer's contribution to the plan. For example, if an employer will contribute dollar for dollar up to a maximum of five percent of the employee's gross income, then the employee should contribute at least five percent of income to take advantage of the employer's maximum contribution.**

### Pay Now, Enjoy Later

There is another tax-advantaged form of investment. This involves the investment of after-tax dollars, enjoying a tax deferral during the growth of the portfolio and withdrawal of the plan's assets without incurring income tax. Plans such as Section 529 plans (qualified tuition programs), Roth IRAs, Coverdell IRAs, municipal bonds and cash value forms of life insurance are means of accomplishing this form of tax advantaged investing.

For example, the investment in a Roth IRA is done with after-tax dollars. The growth in the plan, however, remains tax deferred and ultimately the withdrawals may not be includable in the participant's gross income. As with tax qualified plans, there are significant limitations on contributions and withdrawals.

Another form of investing involves the contribution of after-tax dollars to a non-qualified plan that still results in the deferral of tax until the time of withdrawal. At the time of withdrawal, the amount withdrawn is considered taxable income, to the extent that it is attributable to the growth in the investment.

An example of this type of investment is a traditional non-qualified annuity. Generally, such an annuity is created by the deposit of a lump sum or periodic payments of after-tax dollars by the annuitant. The fund continues to grow over a period of time until the annuitant begins to take withdrawals. At that time, the annuitant must report taxable income on a pro-rated basis, considering the overall value of the annuity in comparison to the annuitant's contributions.

Finally, there are traditional investments. These include bank accounts, certificates of deposit, or brokerage accounts. These assets are acquired using after-tax dollars, and income in the form of dividends or interest is taxable on an ordinary income basis. Upon the sale of the assets, capital gain is recognized on the amount received in excess of the basis.

There are potential tax advantages inherent in different traditional investments. For example, a stock that does not pay dividends but rather grows in value would not have an adverse tax consequence until the sale of the stock, at which time the seller would recognize a capital gain and pay tax at a far lower capital gains rate rather than ordinary income rate. Bonds, on the other hand, pay interest on a periodic basis, all of which is taxable interest and includable as ordinary income.

### Decisions, Decisions

So now what? Which of the above-mentioned planning vehicles best meets your needs? The answer is that ALL of these investment options are advisable to one extent or another. While the traditional 401(k) is great for retirement savings and tax-deferred investing, there are significant limitations on contributions and withdrawals.

A Roth IRA has fewer (but still significant) limitations with respect to withdrawals but is limited in its deductibility. A traditional investment, while offering fewer tax advantages, is generally more liquid, permitting the owner access to the funds without IRS penalties relating to early withdrawals.

To determine which mix of investment options is right for you, consult your financial advisor. Remember, diversify your portfolios to minimize risk, and also to maximize tax savings, while keeping an eye on investment goals and objectives. ■

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# Nurturing A Nifty Foreign Nest Egg

**Tax issues for overseas investments and retirement**

**By DAVID M. NEUENHAUS and WARD SCHEIDERMAN**

Financial and retirement planning for high net worth individuals frequently involves international tax planning. These considerations can arise, for example, where an investment portfolio includes non-U.S. assets (e.g., foreign situs real estate or stock in non-U.S. companies); a second home is purchased in a foreign country; or an individual retires to a foreign country. Each situation requires a close analysis of the tax, legal and relevant treaty-related issues. Many practitioners are comfortable with the general estate and gift tax planning considerations in the international context. This article, therefore, focuses on certain U.S. international income tax considerations that arise in the cross-border context.

### U.S. International Taxation

As a general rule, the United States taxes its citizens and residents (U.S. taxpayers) on their worldwide income. Thus, where a U.S. taxpayer owns an investment asset, the United States seeks to tax the income attributable to such asset regardless of whether the asset (or the taxpayer) is located in the United States or a foreign country. Therefore, investing in foreign assets or moving abroad generally does not reduce a taxpayer's U.S. tax burden on investment income.

As a threshold matter, two important rules should be kept in mind. First, the favorable long-term capital gains tax rate generally available to U.S. taxpayers on the sale of U.S. investment property is similarly applicable to capital gains realized on foreign investment property. Second, as described in greater detail below, where a foreign jurisdiction imposes an income tax on foreign source income, the United States will typically provide a limited credit (so-called foreign tax credit or FTC), pursuant to which a U.S. taxpayer may offset its U.S. tax liability by the foreign income taxes paid on that income. The FTC rules constitute a very important (and complex) aspect of U.S. international tax planning.

**U.S. taxpayers are subject to U.S. tax on their worldwide income, regardless of whether they reside in the United States at the time the income is earned.**

Due to the relatively expansive U.S. tax rules applicable to U.S. citizens, one approach sometimes considered is the renunciation of U.S. citizenship. Generally, an individual may voluntarily give up his U.S. citizenship at any time by performing one of the specifically enumerated expatriating acts with the intention of relinquishing U.S. nationality. Special antitax avoidance rules, however, may apply to such individuals (expatriates).

Congress recently adopted objective rules to presumptively determine whether an expatriation will be considered tax motivated for U.S. tax purposes. Generally, U.S. citizens are presumed to expatriate for a tax avoidance purpose if the taxpayer: (1) has an average annual net income tax for the five preceding years that exceeds $124,000 (adjusted for inflation after 2004); (2) has a net worth as of the date of expatriation of $2 million or more; or (3) fails to certify under penalty of perjury that he or she complied with all U.S. federal tax obligations for the preceding five years.

Where an expatriation is found to be tax-motivated, special U.S. income tax rules apply for a period of 10 years and special estate and gift tax expatriation provisions apply to reduce or eliminate the benefits of expatriation. Anti-abuse rules have been adopted to restrict many planning methods that could potentially reduce the U.S. tax liabilities determined under the expatriation rules. Further, where an expatriate returns to the U.S. for more than 30 days during a calendar year the expatriate may again be taxed on his or her worldwide income. Expatriates are also subject to onerous tax reporting obligations.

### Foreign Tax Credits

Two different sets of FTC rules apply to foreign investments. At the risk of oversimplification, all individual investors, and corporate investors with a less than 10 percent ownership interest in a foreign corporate entity, are eligible for direct FTCs only. Corporate investors with a 10 percent or greater interest in a foreign corporation, on the other hand, are generally eligible for direct and indirect FTCs.

**Direct foreign tax credits:** U.S. individuals may claim a direct foreign tax credit for income taxes paid or accrued to a foreign country (including the allocable share of taxes passing through a partnership/fund). Creditable taxes include income taxes and withholding taxes applied by foreign countries to certain payments by resident portfolio companies (e.g., to dividends and interest paid by non-U.S. portfolio companies).

**Indirect foreign tax credits:** Indirect foreign tax credits generally relate to foreign taxes paid by non-U.S. business operations that are conducted through a foreign corporate subsidiary. For instance, when a foreign corporation distributes earnings to a qualifying U.S. corporate shareholder, the U.S. shareholder is deemed to have paid a proportionate share of the foreign taxes

■ See **U.S. TAX** on PAGE 7

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THE TAXMAN COMETH

# Business Purpose Is Back In The Family

**Law takes unfavorable turn for taxpayers using Family Limited Partnership technique**

**By SCOTT P. BORSACK and HEATHER B. ESHELMAN**

The early 20th century philosopher George Santayana once said "those who cannot remember the past are condemned to repeat it." Over the past several years, the Family Limited Partnership, or FLP, technique has followed a tortured path through the United States Tax Court and the various Circuit Courts of Appeal. The course of recent opinions has not been favorable.

There was little hope that a court opinion would bring a twist favorable to taxpayers. To the extent those hopes were pinned on the Court of Appeals for the 5th Circuit, they were dashed somewhat last year when a three-judge panel reconsidered in *Strangi v. Commissioner* (*Strangi II*). If it appeared that the "business purpose" inquiry was removed from the quiver of the Internal Revenue Service by prior opinions, it has come back into vogue, albeit through the back door of the *bona fide* sale exception to Section 2036(a) of the Internal Revenue Code of 1986, as amended. As the result of this holding, donors now may have to survive scrutiny by the finder of fact for the plausibility of asserted nontax reasons for utilizing the FLP technique.

At issue before the circuit court was the application of Code Section 2036(a), which draws into the gross estate of a decedent the value of property transferred away by the decedent during his lifetime.

### Caught In The Web

To get caught in the web of Code Section 2036(a), a transferor must retain i) possession, enjoyment or income from property; or ii) the right to designate who shall possess or enjoy the property. An exception is provided for a transfer which is the result of a *bona fide* sale for adequate consideration. In *Strangi II*, the estate ultimately argued that the *bona fide* sale exception applied. If the estate had been successful, the property transferred to the FLP would not be subject to estate taxation. Unfortunately for the estate, it could not carry its burden.

Code Section 2036 is an estate tax provision. It requires that the value of property be included in the taxable estate of a decedent if triggered. In the world of taxable gifts, Code Section 2036 has no application. Rather, to make an argument under Code Section 2036, the IRS must wait until the death of the donor. To trip the Code Section, the donor must retain a substantial present economic benefit in property that is not speculative or contingent. There must be an express or implied agreement that, following the transfer, the donor will continue to enjoy possession or some other benefit of the property transferred. If the *bona fide* sale exception does not apply, the value of the property transferred to a FLP will be included in the donor's estate.

At the trial level in *Strangi v. Commissioner*, the Tax Court had found that the retention of periodic payments, continued use of a house which the donor had transferred to the FLP, and the payment after death of various debts and expenses of the donor from property which was allegedly transferred to the FLP amounted to substantial benefits which were retained by the donor.

According to *Strangi II*, all that the fact finder had to conclude was that there was an express or implied agreement that the donor was to retain such possession or enjoyment. The Tax Court had found that an implied agreement existed. This finding of fact, however, could not be reversed unless the court found the conclusion to be clearly erroneous. Considering that the donor transferred substantially all of his assets, leaving him little if anything to provide for his support, and that he received periodic payments following the transfer, the court decided that a fact finder could reasonably conclude that an implied agreement existed. As such, the court was not inclined to find the determination of the fact finder to be clearly erroneous. Very little ink was devoted to this part of the analysis. The real meat in the case focused upon the *bona fide* sale exception.

### *Bona Fide* Sale

The *bona fide* sale exception has two parts. First, the donor must receive adequate consideration. As stated by the 5th Circuit in 2004 in *Kimbell v. U.S.*, the adequate consideration inquiry will be satisfied where assets are transferred to a partnership in exchange for a proportionate interest therein and entity formalities are observed. Following *Kimbell*, the "adequate consideration" inquiry offered little challenge. Rather it is the second prong, the "*bona fide* sale" inquiry, which causes the most mischief for taxpayers.

To satisfy the "*bona fide* sale" requirement, a transfer to a FLP must, "as an objective matter, serve a substantial business or other non-tax purpose." The finder of fact must identify nontax business purposes that the transfer was likely to achieve from the outset.

The estate offered five nontax rationales for creation and funding of the FLP. In no particular order, the estate identified: i) tort litigation protection; ii) deterring a will contest; iii) persuading a corporate executor not to serve; iv) creating a joint investment vehicle; and v) centralized asset management.

The Tax Court found that each of these nontax rationales were "factually implausible." As noted above, to overturn these findings of fact, the circuit court had to conclude that the determination of the Tax Court was clearly erroneous. In every instance, the circuit court noted, the Tax Court had sufficient evidence before it that rendered the motivations for each of these stated purposes illusory.

For example, as to tort litigation, the estate claimed to be concerned for the potential of a lawsuit by the decedent's housekeeper stemming from an accident suffered on the job. Evidence adduced during the trial, however, suggested that a suit by the housekeeper was unlikely because the decedent had paid all of the loyal housekeeper's medical bills and paid her salary during the period of convalescence. As to the claims of avoid-

■ See **BONA FIDE** on PAGE 5

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# Bona Fide Sales Exception Applies To FLP Transfer

■ From **BUSINESS** on PAGE 4

ing a will contest, at the time the FLP was formed, the potential claimants faced substantial statute of limitations hurdles. In addition, counsel for those who were asserted to be aggrieved by the transfer never threatened litigation.

Though reasonable minds might differ on the outcome, the circuit court concluded that the finding that a will contest was unlikely was not clearly erroneous. The circuit court rejected out-of-hand the claim that use of the FLP would make service by a corporate executor unpalatable because the value of the taxable estate would not yield a significant commission. As to claims the FLP was a joint investment vehicle, the contributions of others were "*de minimis*" in comparison to those of the decedent. This rationale did not hold water either. With respect to active management, there was no evidence offered at the trial level that there was any management at all. Accordingly,

The *bona fide* sale exception will protect the donor's estate from including the value of the transferred property in the estate of the donor if it can be demonstrated that plausible nontax reasons existed for creation of the FLP.

*Strangi II* seems to be another example of bad facts making for bad law.

## No Death Knell

To succeed under the *bona fide* sale exception, a donor must demonstrate that there existed a nontax reason for creating the FLP in the first instance. This requirement bears a striking resemblance to the business purpose test that the IRS had argued for and lost in the past when it tried to disregard the legal existence of FLPs. Indeed it was the Tax Court, in *Strangi I*, that concluded that if state law formalities were observed, the court would not examine the purposes for forming the entity.

For example, in *Knight v. Commissioner*, the IRS argued that a FLP should be disregarded under the "substance over form" doctrine; in other words, if the formation of a FLP lacked business purpose, it should be disregarded. The court concluded, however, that where a donor creates a FLP which is valid under state law, neither the IRS nor the courts are free to disregard the entity. Rather, the existence and vitality of the entity must be respected. The IRS lost the battle over the application of business purpose for the creation of a FLP. However, it may have won the war in that the nontax purpose is now applicable in deciding whether a transfer to fund the FLP satisfied the *bona fide* sale exception.

When a donor creates a FLP and retains the general partner interest, he has retained the right to designate possession or enjoyment of the property, invoking Code Section 2036(a) if the interest is held until death. Yet if the donor does not retain this right but instead holds an interest as a limited partner in which substantial income rights are retained, Code Section 2036(a) is nonetheless invoked. Excluding from the gross taxable estate of the donor the value of property contributed to a FLP depends upon the application of the *bona fide* sale exception. So long as entity formalities are observed and the donor receives a proportionate interest in the FLP, the *bona fide* sale exception will protect the donor's estate from including the value of the transferred property in the estate of the donor if it can be demonstrated that plausible nontax reasons existed for creation of the FLP.

We have gone full circle. In theory, we could avoid the inquiry altogether if one spouse formed the FLP and transferred all interests in the entity to the other spouse and children. In that case, no one person could be found to have transferred property while also having retained a prohibited interest in the entity. Short of that, planners will now struggle to document nontax reasons for using the FLP technique. Many more taxpayers are likely to find themselves on the wrong end of an argument with the IRS as the result of this opinion. Though *Strangi II* is was not the death knell of the FLP technique as originally feared, it has made it harder to be successful with the FLP technique if you are confronted with bad facts. This is probably not the end of the road. ■


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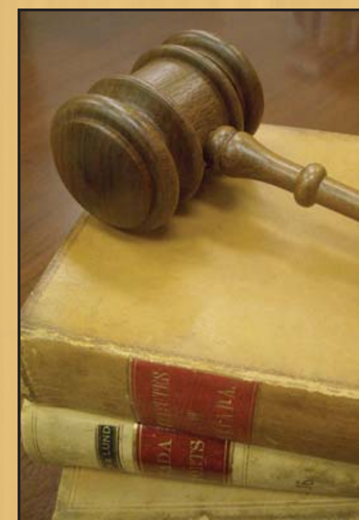

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CHARITY BEGINS AT HOME

# Proper Planning Defers Capital Gains

**Charitable remainder trusts are an effective planning tool for retirement assets**

**By RITA M. DANYLCHUK**

Individuals nearing retirement or who have already retired with an investment portfolio consisting of low basis assets may be concerned with the capital gains tax. If these retirement assets are sold—a sale is often necessary or desirable to provide liquidity in retirement or diversify an investment portfolio—a capital gains tax must be paid. To address this concern, consider the transfer of the low basis assets to a charitable remainder trust.

A charitable remainder trust will not recognize capital gain on the subsequent sale of the assets and the charitable remainder trust can provide a fixed annuity to the individual for the remainder of his or her lifetime. Further, if someone dies owning retirement assets, such as 401(k) plans or IRAs, Uncle Sam may be the beneficiary of as much as 80 percent of the value of the retirement assets. The IRS will impose an estate tax on retirement assets at a current rate of approximately 47 percent.

In addition, individual beneficiaries other than a spouse will pay income tax on receipt of these assets. To reduce this income and estate tax burden, a charitable remainder trust can be designated as the primary beneficiary of one's retirement assets.

## Two Flavors Of Trusts

There are two types of charitable remainder trusts: a charitable remainder annuity trust and a charitable remainder unitrust. Section 664(d)(1) of the Internal Revenue Code of 1986, as amended, provides that a charitable remainder annuity trust must pay to one or more noncharitable or income beneficiaries a sum certain of at least 5 percent of the initial fair market value of the trust assets on the date the assets were transferred to the charitable remainder trust. Under Code Section 664(d)(2), a charitable remainder unitrust pays to one or more noncharitable beneficiaries a fixed percentage of at least five percent of the net fair market value of its assets valued annually.

As an alternative to payment of a fixed percentage, the unitrust may pay the lesser of the fixed percentage or the actual income for the year, with the option of having any shortfall (the amount by which the income of the trust falls below the fixed percentage) made up in subsequent years when the income exceeds the fixed percentage.

Under Code Section 664(d), the noncharitable interest in a charitable remainder trust can be measured by the life (or lives) of the noncharitable or income beneficiaries or for a term of years not to exceed 20 years. When the fixed period ends, or the noncharitable beneficiary dies, the remaining assets held in the charitable remainder trust are distributed to one or more charities.

Code Section 664(d) further provides that the actuarially determined remainder value of the assets in the charitable remainder trust must be at least 10 percent of the value of the property at the time of the contribution to the charitable remainder trust. A typical charitable remainder trust has the annuity or unitrust interest paid to a married couple for their lives and the remainder interest passing to charity.

In the case of an *inter-vivos* charitable remainder trust, the grantor is entitled to a charitable income and gift tax deduction for the fair market value of the remainder interest that passes to charity. If someone other than the grantor or the grantor's spouse is the income beneficiary, the grantor is treated as making a taxable gift equal to the value of the income interest given to the noncharitable beneficiary. If the income beneficiary is the grantor's spouse, Code Section 2523(g) allows for a marital deduction with respect to the annuity or unitrust interest given to the grantor's spouse as the sole noncharitable beneficiary other than the donor.

## 'Contribution Base'

The charitable income tax deduction available to the grantor depends upon the type of property contributed to the charitable remainder trust. Under Code Section 170(b), the charitable deduction generally is limited to 50 percent of the individual's adjusted gross income, referred to as "contribution base." If appreciated property is contributed to the charitable remainder trust, the amount of the charitable deduction depends upon whether the property is ordinary income or capital gain property. The deduction ceiling for contributions of long-term capital gain property generally is 30 percent of the individual's contribution base. If the charitable beneficiary is a private foundation, the deduction ceiling generally is further reduced to 20 percent of the individual's contribution base. If the charitable deduction is limited in a calendar year because of the percentage limits discussed above, any unused charitable deduction may be carried forward for five years.

The income beneficiary of the charitable remainder trust is taxed on distributions from the trust in accordance with a tier system of taxation under Code Section 664(b) as follows:

1) Any distribution from the charitable remainder trust is deemed to consist of ordinary income to the extent of the trust's ordinary income for the taxable year of the distribution and any ordinary income from prior years not deemed to have been previously distributed.

2) If a distribution in a particular year exhausts the current year's income and all prior undistributed ordinary income, the distribution is next deemed to consist of capital gain income to the extent of the trust's capital gain income for the current year and undistributed capital gains from prior years.

3) After the ordinary income and capital gain tiers are exhausted, distributions are deemed to come from other income, such as tax-exempt bond income.

4) When the current and accumulated income from the above three categories is exhausted, remaining distributions are considered to have been made as a tax-free return of basis.

**The use of a charitable remainder trust for an individual's retirement assets also may provide valuable diversification for the individual's investment portfolio, which will now include an asset that provides a fixed annuity for life.**

A charitable remainder trust may be superior to traditional retirement assets or it may enhance the value of one's retirement assets. For example, a retiree or individual approaching retirement who has low basis assets in his investment portfolio that will result in substantial capital gains tax if sold should consider transferring those assets to a charitable remainder trust. If the trustee sells the low basis assets, the charitable remainder trust will not pay capital gains tax. Consequently, the full sales proceeds will be available to the individual to likely increase the individual's retirement income.

The use of a charitable remainder trust for an individual's retirement assets also may provide valuable diversification for the individual's investment portfolio, which will now include an asset that provides a fixed annuity for life. Further, the charitable deduction may be available to offset other ordinary income.

## Testamentary Trust

In addition to an *inter-vivos* charitable remainder trust, a testamentary charitable remainder trust provides a variety of tax benefits at death. If an individual designates a charitable remainder trust as the primary beneficiary of his or her IRA or 401(k), no income tax will be due on distribution of the IRA or 401(k) to the charitable remainder trust. Instead, the full amount of the IRA will be held in the charitable remainder trust and available to make the annual payments to the noncharitable beneficiaries. Distributions to the noncharitable beneficiaries are, however, subject to income tax under the tier system of taxation discussed above.

Let's consider an example for use of a charitable remainder trust at death: Assume that you establish a charitable remainder unitrust at your death to be the beneficiary of your IRA on the death of the surviving spouse. The charitable remainder unitrust makes an annual payment of 5 percent to your children in equal shares for 15 years. For estate tax purposes, your estate will receive a charitable contribution deduction equal to 46.78 percent of the value of the IRA at the time of your death. If your IRA has a value of $1 million at your death, your estate will be entitled to a charitable contribution deduction of approximately $468,000, generating federal estate tax savings of approximately $220,000.

At the same time, your children will receive five percent of the value of the charitable remainder unitrust each year for 15 years. If the charitable remainder unitrust grows by six percent each year, your children will receive from the IRA over 15 years a total of approximately $1,122,000. Over the same 15 year period, the federal estate tax savings of $220,000 would grow at the same hypothetical rate of six percent, to approximately $530,000. In total, over 15 years, the benefits of the charitable remainder trust would be almost $1,650,000.

In contrast, if the IRA is paid directly to your children in a lump sum following your death and your children are in a 30 percent income tax bracket, your children will inherit only approximately $200,000 from the IRA. If this amount is invested at 6 percent for 15 years, your children will receive approximately $480,000, or $1,170,000 less than the amount they will receive from the charitable remainder trust and its tax savings.

The use of a charitable remainder trust (whether *inter-vivos* or testamentary) is substantially enhanced if the charitable interest belongs to a private foundation. A private foundation is a family business organized for the purpose of making gifts to public charities. Under current law, contributions to a private foundation are deductible for estate, gift and income tax purposes. Under current law, a private foundation is obligated to distribute five percent of the value of its assets each year to one or more public charities.

The private foundation is typically managed and controlled by family members, who are entitled to compensation for services they render to the private foundation. The amount of compensation must be reasonable under all relevant facts and circumstances but nevertheless provide an opportunity to continue to provide benefits to the family from dollars that have qualified for deductions for income, gift and estate tax purposes. ■

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# U.S. Tax Liability Circles The Globe

■ From NURTURING on PAGE 3

incurred at the foreign corporate level to generate the income. Individual investors, however, do not qualify for these types of credits.

**FTC Limitations:** The purpose of the FTC regime is to prevent the double taxation of a U.S. taxpayer's income. Therefore, specific limitations apply to prohibit taxpayers from using FTCs in a manner that may reduce an investor's tax burden below the normal U.S. income tax rates. To prevent any such abuse, the maximum FTC that a taxpayer may claim in a given year is generally equal to the product of: (A) the U.S. tax calculated for the taxpayer's worldwide income; and (B) a fraction, the numerator of which is the U.S. taxpayer's foreign source income and the denominator of which is the U.S. taxpayer's worldwide income. The limitation is calculated each year and can be quite complex. Should any credits remain after the current year limitation, the possibility of carry-back/carry-forward does exist. Ultimate utilization will be dependent upon excess related income in the carry-to year.

Generally, a greater amount of foreign source income will result in a more generous (increased) limitation for a U.S. taxpayer. The source of income (U.S. versus foreign) is therefore of significant importance for tax planning purposes. Special rules described below apply to taxes relating to foreign earned income (e.g., compensation for services provided abroad).

In addition to income tax considerations, cross-border investing frequently involves planning for withholding taxes. Withholding taxes are generally imposed on the gross amount of payments made (e.g., dividends, interest, royalties) to non-resident investors. The actual rate of withholding tax depends on the nature of the payment involved and the local foreign country tax rules. The Netherlands, for instance, imposes a 25 percent withholding tax on dividends but generally no withholding tax on interest paid to non-Dutch residents. Canada imposes a withholding tax of 25 percent on both interest and dividends. Foreign withholding taxes, similar to directly-incurred foreign income taxes, are generally creditable by individual U.S. taxpayers against their U.S. tax burden. Tax treaties often reduce or eliminate the rate of the withholding tax.

### Common Investments

Investments in publicly-traded foreign corporations can sometimes be made on the U.S. markets (e.g., through American Depository Receipts, or ADRs), or directly on an overseas exchange. While the general U.S. tax classification for an ADR and a direct stock interest is the same (i.e., both are considered foreign assets that typically generate foreign source income for purposes of FTC calculations), an important difference can arise.

**Dividends:** Only dividends paid by foreign companies readily tradable on an established securities market in the United States—or eligible for benefits of a comprehensive income tax treaty with the United States (that includes an exchange of information provision)—are taxed by the United States at favorable capital gains rates. If the foreign portfolio company is not readily tradable on a U.S. exchange or eligible for benefits under a qualifying treaty, the dividends are taxed at the higher ordinary income rates.

Stock is generally considered readily tradable on a U.S. market if the corporation's common or ordinary stock, or an ADR for that stock, is readily tradable on the Nasdaq or an established securities market that is registered under section 6 of the Securities Exchange Act of 1934.

**Anti-Deferral Rules:** Special tax rules can result in a U.S. taxpayer being subject to U.S. tax on deemed dividend payments from foreign corporations. In the portfolio investment scenario, the purpose of the anti-deferral rules is generally to prevent the accumulation of income offshore to delay or avoid the United States' ability to tax such income. For individual investors, the passive foreign investment company (PFIC) anti-deferral rules are of special concern.

Under the PFIC rules, if at least 75 percent of a foreign company's gross income or 50 percent of the company's assets are passive in nature, the company is generally a PFIC. U.S. investors in a PFIC are generally subject to current U.S. taxation on certain earnings (or an interest charge on deferred taxes), regardless of whether an actual distribution is made. From a practical standpoint, it is often difficult to determine whether a foreign company is a PFIC. However, foreign companies that are required to file with the SEC frequently address PFIC status in their filings. With respect to privately-owned companies, a high-level financial statement analysis by a qualified professional can generally provide an initial indication as to a company's potential PFIC status.

A second set of anti-deferral rules (subpart F) may result in taxable income where the U.S. taxpayer owns at least 10 percent of a foreign company and all U.S. 10 percent (or greater) shareholders own in the aggregate more than 50 percent of the company. The subpart F rules typically do not apply to portfolio investments due to the fairly high level of minimum ownership required.

Where a U.S. taxpayer invests in a debt obligation issued by a foreign person, the investor is taxed on the interest and original issue discount (OID) in much the same manner as is applicable to obligations issued by a U.S. person—subject to a few caveats.

First, the interest income paid on such an obligation is foreign source (for purposes of FTC calculations) and may be subject to creditable foreign withholding taxes imposed by the debtor's jurisdiction (possibly reduced under an applicable tax treaty).

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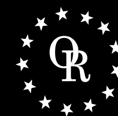

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Secondly, where the indebtedness is denominated in a foreign currency (e.g., Euros), gain or loss can result due to fluctuations in foreign exchange rates. For instance, a U.S. taxpayer may realize additional gain or loss on the repayment of the obligation's principal due to shifts in the exchange rate between the investment date and the payoff date. Interest payments can also give rise to foreign exchange gain or loss. Foreign exchange fluctuations are ordinary in character (rather than capital), which can lead to a mismatch in resulting gains and losses (see example below).

### Real Estate Investments

Investments made in foreign real estate are subject to many of the familiar tax rules applicable to U.S. investments. For instance, where an investment is in a second home (e.g., vacation house), the mortgage interest deduction rules are applicable. As with U.S. real estate investments, if the property is considered a business asset (such as a rental property), losses may be deductible and gain may be taxable. If the property is not business related, gain may be taxable while any loss may be considered personal and nondeductible.

A mortgage denominated in a foreign currency is subject to the foreign exchange rate gain and loss rules described above, leading to two potentially taxable events for an investor. For example, if a U.S. taxpayer's foreign real estate investment appreciates in value and the U.S. dollar appreciates versus the currency in which the mortgage is denominated, capital gain (on the property sale) and ordinary income (due to the foreign exchange rate shift) can result.

Where a foreign real estate investment constitutes a separate business, assuming books and records are kept in the local currency, the real estate investment activities may constitute a qualified business unit (QBU), which can frequently reduce gains and losses related to exchange rate fluctuations.

Investments made in pass-through entities, such as a private equity or venture capital partnership fund, are generally subject to look-through rules. Under these rules, income sourcing, character and taxes are traced to the direct source generating the item. Where the income is subject to tax in a foreign jurisdiction, the foreign taxes generally flow through to the investors and may be treated as direct taxes for FTC purposes. Frequently funds offer—or will implement when requested—structures (e.g., parallel arrangements) to accommodate the special considerations of U.S. and foreign investors.

### Retirement Abroad

Upon retirement, a U.S. taxpayer may move to a foreign country on a full or part-time basis. While living in the foreign country, the taxpayer may liquidate certain investments or savings (e.g., investment accounts or benefits under pension arrangements) accumulated while living and working in the U.S. The individual may also take up some type of employment in the foreign country.

As described above, U.S. taxpayers are subject to U.S. tax on their worldwide income, regardless of whether they reside in the United States at the time the income is earned. Relief is typically provided through FTCs. However, where the U.S. taxpayer incurs foreign income tax on U.S. source income (e.g., liquidation of portfolio of U.S. situs assets or receipt of dividends from a U.S. portfolio investment) double taxation may result because of the FTCs application to only foreign source income. Fortunately, certain jurisdictions do not tax income from foreign (United States) sources. In other situations an applicable tax treaty can limit the ability of a country to tax such income by ceding the right to tax pension and similar benefits to the source country (i.e., the country in which the benefits were earned).

### 911 Exclusion

With respect to income that may be earned while working abroad (e.g., remuneration received for services provided by the U.S. taxpayer in the foreign jurisdiction) an important exception applies to the expansive U.S. tax rules. Specifically, if the U.S. taxpayer has a tax home in a foreign country and he is: i) a *bona fide* resident of a foreign country for a full calendar year; or ii) physically present in the foreign location for a minimum of 330 days out of any consecutive 12-month period, special income exclusions are allowed. Specifically, the taxpayer may exclude from income up to $80,000 of foreign earned income (which may be salary income or self-employment income), and may also exclude (subject to certain limitations) a significant amount of qualified foreign housing expenses. The exclusions are often referred to as the "911 Exclusion," in reference to the Internal Revenue Code section providing the benefits.

The 911 exclusion is an election which must be made in a timely manner, and generally applies for all years going forward. Further, the exclusion will typically decrease the amount of related foreign tax credits which may be claimed because a taxpayer may not claim a credit for the portion of foreign taxes paid which relate to the foreign income excluded. Although an exclusion election generally results in a lower overall tax liability, each case must be examined on its own merits.

The foreign earned income exclusion is not available for income that is earned in the United States and paid after the recipient moves abroad, nor is it available for income earned while residing abroad but related to services performed within the United States. For instance, if an employee has benefits under a deferred compensation arrangement for services delivered in the United States (e.g., deferred cash payments or equity compensation) the compensation is subject to the normal U.S. tax rules.

This article provides a limited overview of just a few U.S. income tax considerations involved in foreign investment and retirement. There are a great number of U.S. and foreign income, estate and local tax issues to be considered. Where the issues are identified and addressed, the resulting tax savings can provide significant economic benefit. ■


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