IV. PRESENT-LAW TAX PROVISIONS RELEVANT TO CITIZENSHIP RELINQUISHMENT AND RESIDENCY TERMINATION

A. General Taxation of U.S. Citizens, Residents, and Nonresidents

1. Individual income taxation

(a) Income taxation of U.S. citizens and resident noncitizens

In general

A U.S. citizen generally is subject to U.S. individual income tax on his or her worldwide taxable income.[27] Thus, all income earned by a U.S. citizen, whether from sources inside or outside the United States, is taxable whether or not the individual lives within the United States. A noncitizen who resides in the United States generally is taxed in the same manner as a U.S. citizen if the individual meets the definition of a "resident" as described below.

The taxable income of a U.S. citizen or resident noncitizen is equal to the taxpayer's total worldwide income less certain exclusions, exemptions, and deductions. The appropriate tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may reduce his or her income tax liability by any applicable tax credits. A foreign tax credit is permitted for foreign income taxes paid on foreign-source income, subject to certain limitations.

In general, no U.S. income tax is imposed on unrealized gains and losses. When an individual disposes of property, any gain or loss on the disposition is determined by reference to the taxpayer's adjusted tax basis in the property, regardless of whether the property was acquired during the period in which the taxpayer was a U.S. citizen or resident.

Resident noncitizens

In general, a noncitizen is considered a resident of the United States[28] if the individual: (1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time -- 183 or more weighted days during

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[27] The determination of who is a U.S. citizen for tax purposes, and when such citizenship is considered lost, is governed by the provisions of the Immigration and Nationality Act, 8 U.S.C. sec. 1401, et seq. *See* Treas. Reg. sec. 1.1-1(c).

[28] The definitions of residents and nonresidents who are noncitizens are set forth in section 7701(b) of the Internal Revenue Code of 1986 ("the Code"). References in this document to section or sec. refer to the Code, unless otherwise noted. Section 7701(b) refers to such individuals as "resident aliens" and "nonresident aliens." Unless otherwise specified, this report will refer to the term noncitizen as opposed to alien.

a three-year period weighted toward the present year (the "substantial presence test"); or (3) makes an election to be treated as a resident of the United States (the "first year election.").[29]

An individual meets the 183-day part of the substantial presence test if the sum of: (1) the days present during the current calendar year; (2) one-third of the days present during the preceding calendar year; and (3) one-sixth of the days present during the second preceding calendar year, equals or exceeds 183 days.

An exception from being treated as a U.S. resident under the substantial presence test applies if (1) the individual is present in the United States for fewer than 183 days during the current calendar year, and (2) the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year.[30]

In general, an individual is treated as being present in the United States on any day if the individual is physically present in the United States at any time during such day.[31] An individual is not treated as present in the United States on any day during which (1) the individual regularly commutes to employment (or self-employment) in the United States from Canada or Mexico, (2) the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours, or (3) the individual is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession.[32]

For purposes of the substantial presence test, any days that an individual is present in the United States as an "exempt individual" are not counted.[33] Exempt individuals include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events.[34] In addition, the substantial presence test does not count days of presence in the United States of an individual

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[29] Sec. 7701(b)(1)(A).

[30] Sec. 7701(b)(3)(B). The facts and circumstances to be considered when determining whether an individual maintained more significant contact with a foreign country than the United States are outlined in Treas. Reg. sec. 301.7701(b)-2(d). These criteria include; location of the individual's permanent home, location of the individual's family, location of personal belongings (e.g., automobiles, furniture, clothing), location of social, political, and cultural connections, location of routine personal banking activities, and location where the individual conducts business activities.

[31] Sec. 7701(b)(7)(A).

[32] Sec. 7701(b)(7)(B)-(D).

[33] Sec. 7701(b)(3)(D)(i).

[34] Sec. 7701(b)(5).

who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States.[35]

In some circumstances, an individual who meets the definition of a U.S. resident (as described above) also could be defined as a resident of another country under the internal laws of that country. In order to avoid the double taxation of such individuals, most income tax treaties include a set of tie-breaker rules to determine the individual's country of residence for income tax purposes. In general, under these treaties a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him.[36]

(b) Income taxation of nonresident noncitizens

A noncitizen who does not meet the definition of resident (as described above) is considered to be a nonresident for U.S. tax purposes. A nonresident noncitizen is subject to U.S. tax on income from U.S. sources or effectively connected with the conduct of a trade or business within the United States. Foreign-source income earned by a nonresident noncitizen generally is not subject to U.S. tax. Bilateral income tax treaties may modify the U.S. taxation of a nonresident noncitizen.

A nonresident noncitizen is taxed at regular graduated rates on net profits derived from a U.S. business.[37] A nonresident noncitizen is taxed at a flat rate of 30 percent on certain other types of income derived from U.S. sources.[38] A lower treaty rate may apply to such income. For example, dividends from portfolio investments frequently are taxed at a reduced rate of 15 percent under a treaty. Such income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income. However, there is no U.S. tax imposed on interest earned by a nonresident noncitizen for deposits with U.S. banks and certain

[35] Sec. 7701(b)(3)(D)(ii).

[36] If the individual has a permanent home available to him in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer (i.e., his "center of vital interests"). If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he is deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he is deemed to be a resident of the country of which he is a citizen. If each country considers him to be its citizen or he is a citizen of neither of them, the competent authorities of the countries generally agree to settle the question of residence by mutual agreement.

[37] Sec. 871(b).

[38] Sec. 871(a).

types of portfolio debt investments.[39] Gains on the sale of U.S. stocks or securities generally are not taxable to a nonresident noncitizen because they are considered to be foreign-source income.[40]

A nonresident noncitizen is subject to U.S. income taxation on any gain recognized on the disposition of an interest in U.S. real property.[41] Such gains generally are subject to tax at the same rates that apply to similar income received by U.S. persons. If a U.S. real property interest is acquired from a foreign person, the purchaser generally is required to withhold 10 percent of the amount realized (i.e., the gross sales price). Alternatively, either party may request that the IRS determine the foreign person's maximum tax liability and issue a certificate prescribing a reduced amount of withholding.[42]

(c) Resident or nonresident noncitizens who physically leave the United States

With certain exceptions, a noncitizen (resident or nonresident) who physically leaves the United States or any U.S. possession is required to obtain a certificate from the IRS District Director that he or she has complied with all U.S. income tax obligations.[43] This certificate often is referred to as a "sailing permit."[44] In practice, noncitizens who leave the United States generally do not obtain a sailing permit.[45]

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[39] Secs. 871(h) and 871(i)(3).

[40] Sec. 865(a).

[41] Secs. 897, 1445, 6039C, and 6652(f), commonly referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA"). Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. Included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). A U.S. real property holding corporation is any corporation if the fair market value of its U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)).

[42] Sec. 1445.

[43] Sec. 6851(d).

[44] A sailing permit is not required for individuals who have been in the United States for less than five days, foreign diplomats and their personal employees, certain short-term business visitors and industrial trainees, military trainees, individuals who commute to U.S. places of employment from Canada or Mexico, certain noncitizen students, and exchange visitors. A resident noncitizen who intends to maintains a U.S. residence is not eligible for these exceptions.

The requirements for obtaining a sailing permit depend upon whether the noncitizen's departure will jeopardize U.S. tax collection. If a noncitizen is a resident, the IRS District Director may determine that jeopardy exists only if there is information that indicates that the individual intends by his or her departure to avoid payment of income tax.[46] If, on the other hand, the departing noncitizen is a nonresident, the director can terminate the individual's tax year unless the individual establishes an intention to return to the United States and the departure will not jeopardize the collection of tax.[47]

If tax collection is not in jeopardy, a noncitizen who has no taxable income for the year must file with the IRS District Director a Form 2063, U.S. Departing Alien Income Tax Statement.[48] In addition, delinquent returns must be filed and taxes for prior tax years must be paid. A nonresident noncitizen who has taxable income for the year must file a Form 1040-C, U.S. Departing Alien Income Tax Return, for the tax year of the intended departure.[49] This return must show the income received and reasonably expected to be received for that year. Although the tax need not be paid on the amount shown, all returns must be filed and all taxes must be paid for prior tax years.[50] Noncitizens who have complied with these requirements will be issued sailing permits good for all departures during the current tax year. A sailing permit may be revoked if the IRS has reason to believe that a subsequent departure would result in jeopardy of tax collection.[51]

If tax collection is in jeopardy, the individual must file a Form 1040-C showing income received during the year through the date of departure.[52] The preceding tax year's return must be filed even if the period for filing has not expired.[53] All other tax returns also must be filed and

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Thus, a noncitizen who is a lawful permanent resident of the United States living near the Canadian or Mexican border technically is required to obtain a departure certificate before crossing the border to shop or have dinner.

[45] *See* generally, George Guttman, *News Analysis: the Sailing Permit: Tax Compliance and Departing Aliens*, 94 TNT 64-70 (April 4, 1994).

[46] Treas. Reg. sec. 1.6851-2(b)(1).

[47] *Id.*

[48] Treas. Reg. sec. 1.6851-2(b)(2).

[49] Treas. Reg. sec. 1.6851-2(b)(3)(ii)(A).

[50] Treas. Reg. sec. 1.6851-2(b)(3)(ii).

[51] Treas. Reg. sec. 1.6851-2(b)(2)(ii) and 1.6851-2(b)(3)(ii).

[52] Treas. Reg. sec. 1.6851-2(b)(3)(iii)(a).

[53] Treas. Reg. sec. 1.6851-2(b)(3)(iii)(b).

the tax required to be shown on the return and any taxes due and owing must be paid.[54] A bond or employer letter guaranteeing payment can be furnished instead of paying the income taxes due on Form 1040-C or the tax return for the preceding year if the period for filing such return has not expired.[55] The bond must equal the tax due plus interest to the date of payment as computed by the IRS. Taxes for earlier years cannot be postponed. The noncitizen will then be issued a sailing permit, but it will only be good for the specific departure date for which it is issued.[56]

(d) Transfers to foreign corporations, partnerships, estates, or trusts

Transfers to foreign corporations

The Code provides rules designed to prevent avoidance of U.S. tax with respect to gain inherent in property transferred to a foreign corporation. Gain generally is recognized when a U.S. person transfers appreciated property to a foreign corporation (notwithstanding general nonrecognition provisions of the Code).[57]

Certain exceptions from the general recognition rules apply. First, the rules generally do not apply unless there is a transfer by a U.S. person to a foreign corporation. Thus, individuals who relinquish U.S. citizenship or individuals who terminate U.S. residency generally are not subject to the section 367 rules after such relinquishment or termination.[58] A U.S. person who relinquishes citizenship or terminates residency may subsequently engage in transactions that involve the transfer of property to a foreign corporation without any adverse consequences under section 367.[59]

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[54] Treas. Reg. sec. 1.6851-2(b)(3)(iii)(c).

[55] Treas. Reg. sec. 1.6851-2(b)(3).

[56] *Id.*

[57] Sec. 367.

[58] The Department of Treasury has considerable regulatory authority under section 367 to address situations that may result in U.S. tax avoidance. For example, section 367(b) provides that certain tax-free corporate transactions that do not involve a transfer of property from a U.S. person (within the meaning of section 367(a)(1)) can be recharacterized as taxable "to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes." The legislative history of this provision suggests that it was directed principally at situations involving avoidance of U.S. tax on foreign earnings and profits.

[59] Section 877(d) generally provides for gain recognition in certain cases in which appreciated U.S.-source property is transferred by a former citizen or former long-term resident who is subject to the alternative tax regime in an otherwise tax-free exchange for foreign-source property. See Part IV.B, below, which contains a detailed discussion of certain anti-abuse rules

Second, section 367 does not apply in the case of property transferred by a U.S. person to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States.[60] Certain property, such as inventory and intangible property, is not eligible for this exception.[61] Third, section 367 does not apply to certain transfers by U.S. persons of stock in U.S. corporations to foreign corporations.[62]

Certain taxpayers may avoid gain recognition under section 367 by entering into a gain recognition agreement obligating the taxpayer to recognize gain and pay tax if the property is disposed of within a specified time period after the transfer. The gain recognition agreement rules generally require the taxpayer to agree to file an amended return for the year of the original transfer if the property is disposed of by the transferee foreign corporation.[63] If a U.S. person who has entered into a gain recognition agreement either loses U.S. citizenship or ceases to be taxed as a lawful permanent resident (as the case may be), then immediately prior to such loss of status, the gain recognition agreement is triggered as if the transferee foreign corporation disposed of all the stock of the transferred corporation in a taxable transaction. No further gain is required to be recognized after such loss of status.[64]

Transfers to foreign partnerships

Transfers of property by U.S. persons to partnerships, both foreign or domestic, generally qualify as tax-free exchanges. However, the Treasury Secretary has regulatory authority to provide for gain recognition on a transfer of appreciated property by a U.S. person to a

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applicable to former citizens and former long-term residents under section 877, including certain property transfers to foreign corporations.

[60] Sec. 367(a)(3).

[61] Sec. 367(a)(3)(B). Under section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving payments from the corporation that are commensurate with the income attributable to the intangible. The deemed payments under section 367(d) are treated as foreign-source income to the same extent that an actual royalty payment would be considered to be foreign-source income. Regulatory authority is granted to provide similar treatment in the case of a transfer of intangible property to a partnership.

[62] Sec. 367(a)(2) and Treas. Reg. sec. 1.367(a)-3(c).

[63] If a certain election is made, the taxpayer may file a return for the period in which the transferee foreign corporation disposes of the property, reporting gain from the original transfer plus interest on additional tax due. Treas. Reg. sec. 1.367(a)-8(b)(3).

[64] Gain recognition agreements filed under the special tax rules under section 877 (as discussed in Part IV.B.1.d, below) may not be used to avoid triggering gains under a section 367 gain recognition agreement. Treas. Reg. sec. 1.367(a)-8(e)(3)(ii).

partnership in cases in which such gain otherwise would be recognized by a foreign partner.[65] No regulations have been issued under this grant of authority.

Transfers to foreign estates or trusts

A U.S. person must recognize gain or loss upon the transfer of property to a foreign estate or trust as if such property was sold for an amount equal to its fair market value.[66] Certain exceptions from this general rule are provided in regulations.[67] The general recognition rule does not apply in the case of a transfer to a trust to the extent that any person is treated as the owner of the trust under section 679 (i.e., a grantor trust). For purposes of these rules, a U.S. trust that becomes a foreign trust is treated as having transferred all of its assets to a foreign trust. Thus, a U.S. trust that converts into a foreign trust is subject to the general gain recognition rule unless the foreign trust qualifies as a grantor trust. An individual who has renounced U.S. citizenship or terminated U.S. residency is not subject to these rules for transfers after such renunciation or termination.

(c) Like-kind exchanges

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" that also is to be held for productive use in a trade or business or for investment.[68] If this "like-kind" exchange rule applies to an exchange, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

In general, real estate is treated as of a like-kind with other real property as long as the properties are both located either within or without the United States. Thus, an exchange of U.S. real estate for foreign real estate would not qualify for tax-free treatment. Similarly, personal property predominantly used within the United States and personal property predominantly used outside the United States are not like-kind properties.

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[65] Sec. 721(c).

[66] Sec. 684.

[67] Treas. Reg. sec. 1.684-3.

[68] Sec. 1031. Certain types of business property, such as inventory, stocks, bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

2. Estate, gift, and generation-skipping transfer taxation

(a) In general

Application of the estate and gift tax

U.S. citizens and resident noncitizens are subject to estate tax on the transfer of their worldwide estate at the time of death.[69] Estate tax also is imposed on the transfer of property belonging to nonresident noncitizens which, at the time of death, is situated in the United States.[70] EGTRRA repealed the estate tax for estates of decedents dying after December 31, 2009. However, EGTRRA included a "sunset" provision, pursuant to which the estate tax repeal "sunsets" one year later. Thus, the estate tax is repealed for 2010 and then is reinstated for estates of decedents dying after December 31, 2010.

U.S. citizens and resident noncitizens are subject to gift tax on transfers of property by gift made directly or indirectly, in trust or otherwise.[71] Nonresident noncitizens are subject to gift tax with respect to transfers of tangible real or personal property that is situated in the United States at the time of the gift. In general, no gift tax is imposed on gifts made by nonresident noncitizens of intangible personal property situated within the United States (e.g., U.S. stocks and bonds).[72] EGTRRA did not repeal the gift tax for any year.

Residency for purposes of estate and gift taxation is determined under rules different from those applicable to the income tax. In general, an individual is considered to be a resident of the United States for estate and gift tax purposes if the individual is "domiciled" in the United States.[73] An individual is domiciled in the United States if the individual lives in the United States, for even a brief period of time, with no definite present intention of later leaving the United States.

The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.[74] The highest marginal rate is 49 percent for 2003, phasing down to 45 percent by 2007.[75] A unified

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[69] Secs. 2001 and 2031.

[70] Secs. 2101 and 2103.

[71] Sec. 2501.

[72] Sec. 2501(a)(2).

[73] Treas. Reg. sec. 20.0-1(b)(1).

[74] For gifts made during 2010, when the estate tax is repealed under present law, a separate gift tax rate schedule applies, with rates beginning at 18 percent on the first $10,000 of taxable gifts and reaching a maximum marginal rate of 35 percent on taxable gifts over $500,000. Sec. 2502(a).

[75] Sec. 2001(c).

credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from estate tax transfers totaling $1 million in 2002 and 2003, $1.5 million in 2004 and 2005, $2 million in 2006, 2007, and 2008, and $3.5 million in 2009.[76] In 2010 the estate tax is repealed, and in 2011 and thereafter the estate tax is reinstated with a unified credit exemption equivalent amount of $1 million. For gift tax purposes, the effective exemption never increases above $1 million.[77] Both the estate tax and gift tax provide an unlimited deduction for certain amounts transferred from one spouse to another spouse, provided that the recipient spouse is a citizen of the United States.[78]

(b) Estate tax

U.S. citizens and resident noncitizens

An estate tax is imposed on the taxable estate of any person who is a citizen or a resident noncitizen of the United States at the time of death.[79] The taxable estate is equal to the decedent's worldwide gross estate, less allowable deductions (including the marital deduction).[80] Certain credits are allowed, including the unified credit, which directly reduce the amount of the estate tax.

The gross estate generally includes the value of all property in which a decedent had an interest at death.[81] The amount included in the gross estate generally is equal to the fair market value of the property at the date of the decedent's death, unless the executor elects to value all property in the gross estate at the alternate valuation date (which is six months after the date of the decedent's death).[82] The estate tax generally is due nine months after the date of the decedent's death.[83] The IRS may grant a reasonable extension for a period not to exceed six months.

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[76] The benefit of the unified credit applies at the lowest estate and gift tax rates. For example, in 2002, the unified credit applied between the 18-percent and 39-percent estate and gift tax rates. Thus, in 2002, taxable transfers, after application of the unified credit, were subject to estate and gift tax rates beginning at 41 percent.

[77] Sec. 2505.

[78] Secs. 2056 and 2523.

[79] Sec. 2001(a).

[80] Sec. 2051.

[81] Sec. 2031.

[82] Sec. 2032.

[83] Sec. 6081.

The gross estate includes the value of certain properties not owned by the decedent at death if certain circumstances are met. These generally include pre-death transfers for less than adequate and full consideration if: (1) the decedent retained the beneficial enjoyment of the property during his life; (2) the property was previously transferred during the decedent's lifetime but the transfer takes effect at the death of the decedent; and (3) the decedent retained the power to alter, amend, revoke, or terminate a previous lifetime transfer.[84] Beneficial interests in a trust that the decedent owns at the time of his death and which do not terminate with his death generally also are includible in his or her gross estate.

<u>Nonresident noncitizens</u>

The estate of a nonresident noncitizen generally is taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death.[85] This includes the value at death of all property, real or personal, tangible or intangible, situated in the United States. Property situated within the United States (i.e., U.S.-situs property) also includes stock issued by a U.S. corporation,[86] transfers within three years of death, and certain revocable transfers if such property was situated in the United States either at the time of transfer or at death.[87] Special rules apply which treat certain property as being situated outside the United States for these purposes.[88]

To the extent provided by treaty, the estate of a nonresident noncitizen is allowed a pro rata portion of the generally applicable unified credit. The amount allowable in this case is the amount that bears the same ratio to the unified credit as the portion of the gross estate situated in the United States bears to the total gross estate.[89] Absent treaty relief, the estate of a nonresident noncitizen is allowed a unified credit of $13,000 (which effectively exempts the first $60,000 of the estate from tax).[90]

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[84] Secs. 2036 through 2038.

[85] Sec. 2103.

[86] Sec. 2104(a).

[87] Sec. 2104(b).

[88] *See, e.g.,* sec. 2105 (certain life insurance proceeds, bank deposits, and debt instruments).

[89] Sec. 2102(c)(3).

[90] Sec. 2102(c)(1).

(c) Gift tax

U.S. citizens and resident noncitizens

U.S. citizens and resident noncitizens are subject to gift tax on any transfer of property by gift made directly or indirectly, in trust or otherwise.[91] Thus, the gift tax applies to transfers of property, regardless of where such property is situated (in the United States or outside the United States). The amount of a taxable gift is determined by the fair market value of the property on the date of gift. An annual exclusion from the gift tax applies for gifts up to $11,000 ($22,000 if the non-donor spouse consents to treat the gift as having been made one half by each spouse), adjusted periodically for inflation.[92]

Nonresident noncitizens

Nonresident noncitizens are subject to gift tax with respect to certain transfers by gift of U.S.-situated property.[93] Such property includes real estate and tangible property located within the United States. Nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.[94]

(d) Generation-skipping transfer tax

In general

A separate transfer tax is imposed on generation-skipping transfers in addition to any estate and gift tax that applies to such transfers.[95] This tax generally is imposed on transfers, either directly or indirectly or through a trust or similar arrangement, to a beneficiary in more than one generation below that of the transferor. The generation-skipping transfer tax is imposed at the maximum Federal estate tax rate, i.e., a flat rate of 49 percent for 2003, on generation-skipping transfers in excess of a $1.1 million lifetime generation-skipping transfer exemption for 2003.[96] The generation-skipping transfer exemption amount is adjusted periodically for inflation.

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[91] Sec. 2501.

[92] Sec. 2503(b).

[93] Secs. 2501, 2511(a).

[94] Sec. 2501(a)(2).

[95] Secs. 2601 through 2663.

[96] Sec. 2631.

<u>Nonresident noncitizens</u>

Nonresident noncitizens are subject to generation-skipping transfer tax only on transfers of property situated within the United States.[97] Nonresident noncitizens are allowed the $1.1 million generation-skipping transfer tax exemption.[98]

3. Income taxation of trusts, estates, and their beneficiaries

(a) Taxation of trusts and estates

<u>In general</u>

A trust or estate generally is treated as a conduit for income purposes in that the trust or estate is allowed a deduction for distributions to its beneficiaries during the year. The trust or estate is taxed on its income, reduced by the distribution deduction, as a separate taxable entity with certain exceptions.[99]

<u>Grantor trusts</u>

The grantor of a trust is taxed as the owner of the trust (or a portion thereof) if he or she retains certain powers or rights over the trust.[100] A U.S. person who transfers property to a foreign trust generally is treated as the owner of a portion of the trust.[101] The portion of the trust

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[97] Treas. Reg. sec. 26.2663-2(b), (c).

[98] Treas. Reg. sec. 26.2663-2(a).

[99] In addition to the distribution deduction, these exceptions include: (1) a separate tax rate schedule applies to estates and trusts; (2) an unlimited charitable deduction is allowed for amounts paid to (and, in the case of estates, amounts permanently set aside for) charity; (3) a personal exemption of $600 is allowed to an estate, $300 to a trust that is required to distribute all of its income currently, or $100 to any other trust; and (4) no standard deduction is allowed.

[100] Secs. 671 through 679. A grantor of a trust generally is treated as the owner of any portion of a trust if: (1) the grantor has a reversionary interest in either the corpus or the income from the corpus, if certain conditions are satisfied; (2) the grantor has a power of disposition without the approval or consent of any adverse party; (3) the grantor can exercise certain administrative powers over the trust; (4) the grantor or a nonadverse party has the power to revoke, i.e., revest in the grantor title of a portion of the trust; and (5) without prior approval of an adverse party, the income from the trust may be distributed to or for the benefit of the grantor or the grantor's spouse.

[101] For income tax purposes, a foreign trust is any trust, except if (1) a court within the United States is able to exercise primary supervision over the administration of the trust, and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. Sec. 7701(a)(31). Trusts that meet these two exceptions are treated as U.S. persons for income tax purposes. Sec. 7701(a)(30).

that the U.S. person is deemed to own is the portion that is attributable to the property transferred by the U.S. person, provided there is a U.S. beneficiary for any portion of the trust.[102] These rules generally do not apply, however, to any transfer made by reason of the death of the transferor or to sales or exchanges of property at fair market value.[103]

(b) Taxation of distributions to beneficiaries

Distributions from a trust or estate to a beneficiary generally are includible in the beneficiary's gross income to the extent of the distributable net income of the trust or estate. Distributable net income serves to measure the total amount of distributions that an estate or trust can deduct from its gross income, as well as the total amount of income that a beneficiary must include in gross income.[104]

There may be instances in which a trust beneficiary's income tax bracket is higher than the trust's tax bracket. Certain rules, which generally apply only to foreign trusts, apply to avoid the accumulation of income in the trust. Under these rules, an additional tax is imposed on the distribution of previously accumulated income in the year of distribution, but at the average marginal rate of the beneficiary during the previous five years.[105]

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[102] Sec. 679(a)(1).

[103] Sec. 679(a)(2).

[104] Sec. 643(a).

[105] Sec. 667(a) and (b). The amount of the distribution is grossed up by the amount of foreign taxes paid by the trust on the accumulated income, and a deduction or nonrefundable credit is allowed to the beneficiary for such taxes. Sec. 667(d). An interest charge is imposed under these throwback rules. Sec. 668.