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U.S. ESTATE PLANNING FOR NONRESIDENT ALIENS WHO OWN PARTNERSHIP INTERESTS

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This program will examine the international estate planning issues that arise when a foreign individual holds an interest in a partnership or other business entity where the partnership is organized in the United States or holds U.S. situs assets. How do the gift and estate tax rules operate in the case of partnerships and do we/should we use an aggregate or entity approach? What about situs rules for partnership interests and assets? What about treaties? How does gift and estate tax planning interact with income tax planning? Can we expect and should we want guidance from the IRS?

To try to answer these questions, this article first reviews the application of the U.S. transfer taxes (estate tax, gift tax and generation-skipping transfer tax) to nonresident aliens. Next, it examines how these taxes apply to interests in partnerships held by aliens and, in particular, reviews the rules and guidance concerning the situs of a partnership interest. Because the rules and guidance are thin and inconsistent, the outline also examines a variety of theories that might apply. The third part of the outline reviews income tax issues that nonresident aliens may encounter in investing in partnerships with U.S. activities or investments. The outline concludes with some thoughts on planning and structuring.

We have generally concentrated on describing current law and also the various theories for inclusion or non-inclusion of partnership interests and assets. However, we simply have to comment on the Internal Revenue Service's failure to provide any reliable published guidance on the situs issue and the related question of whether an aggregate or entity approach should be adopted. Not only does the Service decline to rule on this issue, it is collectively so uncertain of its position that a request to provide a speaker for this panel was declined. The guise of the ostrich does not suit the Service well.

1. Application of the U.S. Transfer Tax System to Nonresident Aliens

1.1 Overview

The United States imposes three taxes on gratuitous transfers – the estate tax, the gift tax and the generation-skipping transfer tax. The imposition of these taxes on nonresident aliens depends on the situs of the property. Each of the transfer tax systems has its own rules for determining situs for this purpose.

When a nonresident alien dies, the U.S. estate tax applies only to assets that are situated in the United States either at death or at the time of certain earlier transfers. The estate tax provisions applicable to nonresident aliens are found in sections 2101 through 2108 and in sections 2208 and 2209 of the Code.[1] But, to determine the estate tax liability of a nonresident alien, the advisor must also be familiar with all of the basic estate tax provisions that are applicable to U.S. persons, including the marital deduction provisions that are specifically applicable to noncitizen spouses.

[1] References to the "Code" and to the IRC in this outline are to the Internal Revenue Code of 1986, as amended. References to "section" unless indicated to the contrary, are to sections of the Code.

A nonresident alien is subject to the U.S. gift tax only on a gift of real property or tangible personal property situated in the United States at the time of the gift. The gift tax provisions applicable to nonresident aliens are found in sections 2501(a)(2) and (3), (b) and (c) and 2511 of the Code.

A generation-skipping transfers made by a nonresident alien is subject to the U.S. generation-skipping transfer tax only if the transfer is also subject either to the U.S. estate tax or the U.S. gift tax or, if the transfer is from a trust, if the nonresident alien's transfer to the trust was subject to the U.S. estate or gift tax.[2]

This outline does not discuss at all the separate set of transfer tax rules that apply to former U.S. citizens or long-term residents who gave up their citizenship or residence with the purpose of avoiding U.S. taxes.[3]

1.2 Determining Whether an Individual is a Nonresident Alien for U.S. Transfer Tax Purposes

(a) In General

The U.S. transfer tax system treats individuals as nonresident aliens if they are neither U.S. citizens nor residents of the United States.

(b) U.S. Citizenship.

U.S. citizenship is determined under the Immigration and Nationality Act.[4] In general, an individual acquires U.S. citizenship by:

(1) Birth within the United States,

(2) Birth outside of the United States to parents who are U.S. citizens,

(3) Birth outside of the United States to one parent who is a U.S. citizenship if that parent satisfies certain residency requirements, and

(4) Naturalization.

(5) An individual may lose U.S. citizenship by committing one of several different acts with the intent of relinquishing U.S. nationality, including:

(6) Voluntarily obtaining citizenship in another country,

(7) Swearing an oath of allegiance to a foreign country,[5]

(8) Entering the armed forces of another country,

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[2] Treas. Reg. § 26.2663-2. References in this outline to "Treas. Reg." are to the regulations promulgated by the U.S. Treasury under the Code.

[3] See IRC section 2107.

[4] 8 USC sections 1101 *et seq*.

[5] *But cf*., *United States v. Matheson*, 532 F.2d 809 (2d Cir. 1976), *cert. denied*, 429 U.S. 823 (1976).

(9) Formally renouncing U.S. citizenship before a foreign service officer abroad, and

(10) Committing treason.

Until 1986, the Immigration and Nationality Act did not require intent to renounce citizenship for a renunciation to be effective. The Supreme Court supplied this requirement by determining that Congress lacks the constitutional authority to establish acts, the commission of which will effect a renunciation of U.S. citizenship, unless the act is accompanied by a specific intent to renounce citizenship.[6] After these decisions, on November 14, 1986, Congress amended the Immigration and Nationality Act to expressly state this requirement.

This state of affairs left the IRS[7] in a difficult position. Not only was there no requirement that the IRS (or any other federal agency) be notified that an individual was relinquishing citizenship, but there was no objective way of determining whether any particular person had formed the requisite intent to relinquish U.S. citizenship.

Congress took a step toward remedying this problem as part of the 1996 Health Insurance Portability and Accountability Act. Section 512 of the Act added section 6039F to the Code. This section requires any individual who relinquishes U.S. citizenship to report loss of citizenship to the Department of State along with certain other information required by Treasury. Notice 97-19, 1997-1 C.B. 394, as modified by Notice 98-2, 1998-2 C.B. 29, sets forth the information required. The Department of State is required to notify the IRS.[8]

(c) U.S. Residency

Residency is a more difficult term. The term "resident" for transfer tax purposes is defined in Treas. Reg. §§20.0-1(b) as follows[9]:

> "A 'resident' decedent is a decedent who, at the time of his death, had his domicile in the U.S. . . . . A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal."

An identical definition of "resident" appears in the gift tax regulations.[10]

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[6] *See*, e.g., *Vance v. Terrazas*, 444 U.S. 252 (1980); *Afroyim v. Rusk*, 387 U.S. 253 (1967).

[7] References in this outline to the "IRS" refer to the Internal Revenue Service.

[8] An individual who fails to report his or her expatriative act is subject to a penalty equal to 5% of the tax required to be paid under IRC section 877 for each of the 10 years after the expatriation.

[9] Treas. Reg. §§ 20.0-1(b)(1) (as amended in 1980).

[10] Treas. Reg. §25.2501-1(b) (as amended in 1983).

Because application of the domicile test requires a determination of the subjective intention of an individual, it is a difficult test to apply after that individual's death. The courts will generally consider the following factors:

(1) The individual's statements as to his or her intentions. These statements may have been made orally or in writing. The written statements may have been made as part of certain legal documents such as visa applications, wills, trust agreements, and deeds. [11]

(2) The time spent in the United States and in other countries.

(3) The location of the individual's residences and the relative sizes and costs of the residences in different locations.

(4) The location of the individual's religious and social club memberships.

(5) The location of the individual's business activities.

(6) The location of the individual's bank accounts and personal property.

(7) The jurisdiction where the individual is registered to vote.

(8) The jurisdiction that issued the individual's driver's license.

(9) The location of the individual's family.[12]

Since the question of domicile cannot be settled by the application of an objective test, and since different countries may have different tests for establishing domicile, an individual could be deemed to be domiciled within more than one country or in no country.

Many of the estate tax treaties between the United States and other countries attempt to avoid the double domicile problem by providing an objective test to be applied if both countries have determined that an individual is a domiciliary.

Residency for U.S. income tax purposes does not determine residency for transfer tax purposes. Residency for U.S. income tax purposes is defined in section 7701(b). The section 7701 tests for residence is discussed later in this outline.[13]

This outline refers to non-U.S. citizens who are not domiciled in the United States for transfer tax purposes as "nonresident aliens" because this is the statutory term, unfortunately so given that the same term is used for income tax purposes even though the definition is quite different.

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[11] *See, e.g., Estate of Fokker,* 10 T.C. 1225 (1948), *acq*. 1948-2 C.B. 2.; *Frederick Rodiek, Ancillary Ex'r,* 33 B.T.A. 1020 (1936), *nonacq*. XV-2 C.B. 35, *aff'd* 87 F. 2d 328 (2d Cir. 1937).

[12] *See generally, Estate of Nienhuys v. Commissioner,* 17 T.C. 1149 (1952), and *Estate of Khan v. Commissioner,* T.C. Memo 1998-22. Legal residence is not necessary for domiciliary status. *See Estate of Jack v. United States,* 54 Fed. Cl. 590 (2002) (holding that an individual could develop a subjective intent to remain in the U.S. despite that fact that the intent was in violation of his visa); Rev. Rul. 80-209, 1980-2 C.B. 248 (ruling that an illegal alien could be domiciled in the U.S).

[13] See paragraph 3.1 below.

1.3 The Estate Tax

(a) The Gross Estate

(1) In General

Section 2103 defines the gross estate of a nonresident alien as "that part of his gross estate (determined as provided in section 2031) which at the time of his death is situated in the United States." The reference to section 2031 means that the gross estate of a nonresident alien is determined in the same manner as the gross estate of a resident except that property not situated in the United States may be excluded.

As a result, property owned by the decedent, property transferred with respect to which the decedent retained certain interests or powers, certain annuities, certain jointly held property, property subject to general powers of appointment, and certain life insurance policies on the decedent's life will be included in the gross estate.

(2) The Situs Rules

(i) Real Property and Tangible Personal Property.

Real property and tangible personal property are situated in the United States if physically located in the United States.[14] Real property includes land, improvements, fixtures, mineral interests crops and timber.[15] Obligations secured by real property are not generally treated as real property.[16] Leases are not generally treated as real property, but if they are long enough to be treated as real property under local law, they are likely to be real property for estate tax purposes too.

If a nonresident alien owns real estate in the United States which is subject to a nonrecourse mortgage, only the value of the equity is included in the gross estate.[17]

Currency is treated as tangible personal property.[18] As a result, a decedent's cash physically in the United States at death, including cash in safe deposit boxes, is situated in the United States.[19]

Section 2105(c) provides that works of art on loan to a not-for-profit public gallery or museum or on route to or from such gallery or museum for such purpose will be deemed not to be located in the United States.

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[14] Treas. Reg. § 20.2104-1(a)(1) and (2).

[15] *Laird v. United States*, 115 F. Supp. 931 (W.D. Wis. 1953); *Umsted v. United States*, 35-1 USTC ¶9130 (W.D. Ark.); *Peebles v. Commissioner*, 5 B.T.A. 386, *acq.* 1928-2 C.B. 50.

[16] *Estate of Tarafa y Armas v. Commissioner*, 37 B.T.A. 19 (1938), *acq.* 1938-1 C.B. 30.

[17] Treas. Reg. § 20.2053-7; *Estate of Johnstone v. Commissioner*, 19 T.C. 44 (1952), *acq.* 1953-1 C.B. 5.

[18] PLR 7737063.

[19] Rev. Rul. 55-143,1955-1 C.B. 465.

There is judicial authority holding that that tangible personal property that a nonresident alien brings while visiting in the United States is deemed not situated in the United States for estate tax purposes.[20]

(ii) Intangible Personal Property

The general rule for determining the location of intangible personal property is in Treas. Reg. § 20.2104-1(a)(4). This provision treats intangible personal property as located in the United States if the written evidence of the property interest is not treated as the property itself, and if it is enforceable against a resident of the United States or a domestic corporation or governmental unit. Conversely, Treas. Reg. § 20.2105-1(e) provides that intangible personal property the written evidence of which is not treated as the property itself is not situated in the United States if it is not issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit.

The Code contains several specific rules characterizing certain types of assets as situated in the United States and several exceptions to the general rule.

Section 2104(a), for example, provides that shares in a U.S. corporation owned by a nonresident alien are deemed situated in the United States regardless of where the certificates are physically located. Shares in a foreign corporation are deemed situated outside of the United States regardless of where the certificates are located and regardless of where its assets are located.[21] With certain exceptions, section 2104(c) provides that the situs of a debt obligation of a U.S. person, the United States, a State of the United States or any subdivision of a State or the District of Columbia is within the United States regardless of where the evidence of indebtedness is located. There are exceptions for bank deposits and deposits with insurance companies if the interest on such deposits would not be subject[22] to U.S. income tax by reason of section 871(i)(1) if the interest were received by the nonresident alien at the time of death. There is also an exception for certain debt obligations of U.S. persons. This exception is generally referred to as the "portfolio debt" exception. The types of obligations that are excluded are those the interest on which would be excluded from the gross income of the nonresident alien decedent under section 871(h)(1). Section 871(h)(1) permits nonresident aliens to exclude interest on obligations of U.S. persons issued after July 18, 1984 that meet the detailed requirements set forth in section 871(h)(1).

However, nothing in the Code or the regulations provides rules that explicitly regulate the appropriate situs of a nonresident alien's interest in a partnership. This issue is discussed in further detail later in Part 2 of this outline.

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[20] *Delaney v. Murchie*, 177 F.2d 444 (1st Cir. 1949). The Tax Court construed the predecessor of IRC section 2103, which taxes property "situated" in the U.S. as not referring to actual physical location. It concluded that the word "situated" means that the "property, considering its particular nature, has such a relationship to the state as to make it reasonable to attribute to that state the power of dealing with it in some particular way." It then concluded that for purposes of imposing an estate tax the concept of "situated" carried with it some degree of permanence of location.

[21] Treas. Reg. § 20.2015-1(f).

[22] IRC section 2105(b).

(iii) Time for Determining Situs

Section 2104(b) provides that property transferred by a nonresident alien, to the extent subject to sections 2035 through 2038, will be deemed situated in the United States if it was situated in the United States either at the time of transfer or at the time of death. For example, suppose a nonresident alien gave a diamond ring to her son while she and the ring were in the United States. The gift was subject to her retained right to possess the ring until her death. At the time of her death, she and the ring were located outside of the United States. Section 2104(b) and section 2036(a) will require the inclusion of the ring in her gross estate for U.S. estate tax purposes. It is unclear whether inclusion would be required if the ring were sold prior to her death and the proceeds invested in other property not located in the United States.[23]

PLR 9507044[24] deals with a decedent who created a trust in 1923, funded it with U.S. securities, and retained the right to income for life. When she died in 1991, the trust held no U.S. securities. The IRS concluded that the property in the trust should be included in the decedent's gross estate under section 2104(b). Although this creates a harsher result than would have applied if the decedent had never created the trust, as the IRS observed, "if section 2104(b) does not apply in the present case, it is difficult to envision a situation where the provision would apply."

(iv) Shifting Situs

The exclusion of shares of stock of a foreign corporation appears to make it possible for nonresident aliens to avoid U.S. estate taxation on assets situated in the United States by transferring these assets to foreign corporations. The IRS, however, will treat the nonresident alien as owning directly the assets of the corporation if it finds that the corporation is a mere nominee.[25] To avoid this result, the nonresident alien should consistently treat the corporation as a separate entity. For example, corporate meetings should be held, corporate officers and directors should be elected, and the shareholder should not deal with the corporation's assets as if he or she owned them directly.[26]

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[23] See discussion in Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation, 6-12 (7th ed. 1997).

[24] PLR 9507044 (May 31, 1994).

[25] *Fillman v. United States*, 355 F.2d 144 (2d Cir. 1957).

[26] Even when all of the normal formalities are observed, some commentators have suggested that the IRS might argue that a transfer of assets to a corporation is a transfer within the meaning of either IRC section 2036 or 2038 because the transferor has retained the right to all of the income from the corporation, and has retained the right to effectively amend the transfer by taking the property out of the trust. To reduce the possibility of the success of such an argument, if possible, the property initially transferred to the foreign corporation should be property located outside the U.S. The corporation could then purchase the U.S. property. The counter argument is that the transfer to the corporation is a bona fide sale for adequate and full consideration in money or money's worth. Such sales are excluded from §§2036 and 2038. The legislative history to §2107 suggests that section 2036 and 2038 should not apply. S. Rep. No. 1707, 89th Cong. 2d Sess. 54 (1966). *See*, Troxel, D. Chase, Aliens - Estate, Gift and Generation-Skipping Transfer Taxation, 201-4th TM A-11 and Robert C. Lawrence III, "U.S. Estate and Gift Taxation of the Nonresident Alien with Property in the U.S.," 1990 Philip E. Heckerling Institute on Estate Planning 10-12, footnote 61. The risk of inclusion under IRC section 2036 has been exacerbated by the IRS's recent success in including the assets held in a family limited partnership in the decedent's estate under IRC section 2036. *See, e.g. Kimbell v. United States,* 2003 WL 138081 (N.D. Tex. 2003).

It seems reasonable to assume that similar arguments might be made in the case of a partnership or entity classified as a partnership where the formalities were not observed and the partnership were treated as a mere nominee. Since *Moline Properties* was decided by the Supreme Court, it has always been clear hat a corporation should be recognized as a separate entity if it serves a business purpose or engages in a business activity[27] and the Tax Court has held that the principle in *Moline Properties* applies to partnerships as well.[28]

(b) The Taxable Estate

(1) In General

Section 2106 provides that the gross estate of a nonresident alien is reduced by deductions for funeral and administrative expenses, debts, losses, charitable transfers, and marital transfers.

(2) Funeral and Administrative Expenses, Debts, and Losses

Section 2106(a)(1) permits the estate of a nonresident alien to deduct a portion of the expenses, debts, and losses that the estate of a citizen or resident would be entitled to under sections 2053 and 2054. The portion allowed is a fraction, the numerator of which is the value of the estate situated in the United States and the denominator of which is the gross estate determined as if the decedent were a U.S. citizen or resident. The limitation on the deductibility of a nonresident alien's debts can have the effect of subjecting a disproportionately large portion of the U.S. assets to United State estate tax. This result can be avoided if the nonresident alien can avoid personal liability on debt secured by U.S. assets. In that case, only the value of the property net of the debt will be included in the gross estate.[29]

Section 2106(b) provides that no section 2053 or 2054 deduction will be permitted to a nonresident' alien's estate unless the nonresident alien's executor files a U.S. estate tax return that reports all of the gross estate situated outside of the United States.

(3) Charitable Deduction

Section 2106(b) provides that the charitable deduction will not be permitted unless the nonresident alien's executor files a U.S. estate tax return that includes all of the gross estate situated outside of the United States.

(4) Marital Deduction

Section 2106(a)(3) permits the estate of a nonresident alien to deduct a portion of the transfers to his or her spouse that the estate of a citizen or resident would be entitled to under section 2056. The deduction is limited to transfers of property included in the nonresident alien's U.S. gross estate. If the nonresident alien's spouse is not a U.S. citizen (residence status is not sufficient for

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[27] *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943).

[28] *SABA Partnership, et al. v. Commissioner*, T.C. Memo. 2003-31.

[29] *Estate of Johnstone v. Commissioner* 19 T.C. 44 (1952), *acq.* 1953-1 C.B. 5.

this purpose), no marital deduction will be allowed unless the transferred property is held in a qualified domestic trust (a so-called "QDOT").[30]

A trust that otherwise qualifies for the marital deduction is a QDOT if the terms of the trust require that at least one trustee be a U.S. person,[31] that the U.S. trustee has the right to withhold U.S. estate taxes from principal distributions from the trust,[32] and that the trust comply with regulations that are promulgated to ensure that the U.S. estate tax imposed on the trust or distributions from the trust will be paid,[33] and if the executor elects to treat the trust as a QDOT. If the nonresident alien decedent has transferred property to the spouse outright, and if the spouse transfers such property to a QDOT before the United State estate tax return is filed, the marital deduction will be allowed if the executor elects to treat the trust as a QDOT. If the nonresident alien transfers property in trust for the spouse and the trust terms do not satisfy the QDOT requirements, but if the trust is reformed in such manner as to satisfy the requirements and the reformation is made before the estate tax return is filed or if a reformation proceeding is begun before the due date for the return and is satisfactorily concluded, the marital deduction will be allowed if the executor elects to treat the trust as a QDOT.

(c) The Estate Tax Base

The estate tax is calculated on the sum of the nonresident alien's taxable estate plus adjusted taxable gifts.[34] A nonresident alien's adjusted taxable gifts are all lifetime gifts made after 1976 that are not included in the gross estate for U.S. estate tax purposes.

(d) Rates and Calculations of Tax

The estate tax rates applicable to the estate of a nonresident alien are the same as those applicable to the estate of a citizen or resident. The rates are set forth in section 2001(c). They range from a low of 18% on amounts under $10,000 to a high, under current law, of 49% on amounts over $2,000,000. The estate tax is calculated by computing a tentative tax on the sum of the nonresident alien's taxable estate and adjusted taxable gifts and subtracting a tentative tax computed on the amount of adjusted taxable gifts.[35]

(e) Credits

The estate of a nonresident alien is entitled to a unified credit of $13,000.[36] The amount of the credit is equal to the tax imposed on the first $60,000 of estate tax base. If required by treaty, the credit may be equal to the amount which bears the same ratio to the applicable credit amount

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[30] IRC section 2056(d). The same limitation applies to U.S. citizens or residents who transfer property to noncitizen spouses.

[31] IRC section 2056A(a)(1)(A).

[32] IRC section 2056A(a)(1)(B).

[33] IRC section 2056A(a)(2); Treas. Reg. § 20.2056A-1 through 20.2056A-13.

[34] IRC section 2101(b).

[35] IRC section 2102(b).

[36] IRC section 2102(c)(1).

under section 2010(c) (currently $345,800) as the value of the nonresident alien's U.S. gross estate bears to the gross estate wherever situated.[37]

A nonresident alien's estate is also entitled to the credits allowed under section 2011 through 2013.[38] The section 2011 credit is limited to an amount which bears the same ratio to the credit computed under section 2011 as the value of the property subject to state death taxes bears to the nonresident alien's total U.S. gross estate.[39]

1.4 The Gift Tax

(a) Transfers Subject to Tax

(1) In General

Section 2511(a) provides that the gift tax applies to nonresident aliens only in the case of gifts of property situated in the United States. Section 2501(a)(2) provides that gifts by nonresident aliens of intangible personal property are not subject to U.S. gift tax. As a result, the general rule is that the gifts of nonresident aliens are subject to U.S. gift tax only if the gifts are of real estate located in the United States or of tangible personal property located in the United States. The situs rules discussed above in connection with the estate tax treatment of real estate and tangible personal property generally apply to the gift tax. There is, however, no statutory exception for works of art on loan for exhibition purposes.

(2) Currency

A gift by a nonresident alien in the form of a check drawn against a U.S. bank or a wire transfer of funds into an account in the United States to a U.S. donee may be treated as a transfer of currency. If so, it would be treated as a gift of tangible personal property.[40]

(3) Converting Tangible U.S. Property Into Intangible Personal Property

If a nonresident alien owns interests in U.S. real estate or tangible personal property located in the United States through an entity such as a corporation or partnership, gifts of such interests should be exempt from U.S. gift tax under §2501(a). If, however, the real or tangible personal property is transferred to a entity shortly prior to the gift and for the purpose of avoiding the gift tax, the gift may be treated as a gift of the underlying property.[41]

(b) Taxable Gifts

The amount of an individual's taxable gifts for a particular year is equal to the total amount of gifts reduced by the exclusions provided in section 2503(b) and (e) and by the deductions permitted in sections 2522 and 2523.

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[37] IRC section 2102(c)(3).

[38] IRC section 2102(a).

[39] IRC section 2102(b).

[40] Treas. Reg. §25.2511-3(b)(4)(iv); Rev. Rul. 55-143, 1955-1 C.B. 465.

[41] *See De Goldschmidt-Rothschild v. Commissioner*, 168 F.2d 975 (2d Cir. 1948).

(1) Exclusions

Section 2503(b) permits an annual exclusion of $11,000 of gifts to unlimited numbers of donees. The exclusion is available only for gifts of present interests in property. If the spouse of a donor is a noncitizen of the United States, the amount of the annual exclusion for gifts to such spouse is increased to $112,000 but only to the extent the gifts to him would have been eligible for the marital deduction if he had been a citizen of the United States at the time of the gift.[42]

Section 2503(e) permits an exclusion for tuition paid on behalf of another individual if the payment is made directly to the educational institution and for the payment of medical expenses of another if paid directly to the provider of medical care.

(2) Gift Splitting

A nonresident alien is not permitted to treat one-half of gifts as having been made by his or her spouse. "Gift splitting" under section 2513 requires that both spouses be citizens or residents of the United States.

(3) Deductions

(i) Charitable Deduction

Section 2522(b) permits a nonresident alien to deduct a portion of transfers to charity that a citizen or resident would be able to deduct under section 2522(a). A nonresident alien, however, is not entitled to a deduction for transfers to a charitable corporation unless it is a corporation organized in the United States, for transfers to a trust unless the transfers are to be used for charitable purposes within the United States, or for transfers to veterans organizations unless organized in the United States. If a transfer is made to a charitable corporation, there is no requirement that the gift be used for charitable purposes within the United States.

(ii) Marital Deduction

Section 2523 permits a nonresident alien to deduct those gifts to his or her spouse that a citizen or resident of the United States would have been able to deduct. No deduction is permitted if the spouse is not a citizen of the United States.[43]

There are however, two special rules that govern the gift tax treatment of transfers by a spouse to a non-citizen spouse of a joint interest in property. Gifts of joint interests in real estate are not treated as taxable gifts until the termination of the joint interest.[44] Gifts of joint interests in personal property are to be treated as a gift of a one-half interest to the donee spouse despite the fact that the value of such interest, calculated on an actuarial basis, might be less.[45]

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[42] This amount is adjusted each year for inflation. The latest adjustment is set forth in Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

[43] IRC section 2523(i)(1).

[44] IRC section 2523(i)(3). This section provides that such gifts are subject to the principles of IRC section 2515 prior to its repeal in 1981, except that no election to treat the transfer as a gift is permitted.

[45] IRC section 2523(i)(3). This section provides that such gifts are subject to the principles of IRC section 2515A prior to its repeal in 1981.

(c) Rates and Calculation of Gift Tax

The gift tax rates applicable to the gifts of a nonresident alien are the same as those applicable to the gifts of a citizen or resident. The rates are set forth in section 2001(c). They range from a low of 18% on amounts under $10,000 to a high, under current law, of 49% on amounts over $2,000,000. The gift tax for a particular year is an amount equal to the excess of a tentative tax computed on the sum of the nonresident alien's taxable gifts for such year and for all prior years over a tentative tax computed on the sum of taxable gifts for all prior years.[46]

(d) Credits

No credits are applicable in calculating a nonresident alien's gift tax. Only citizens or residents may use the unified credit allowed under §2505.

1.5 Generation-Skipping Transfer Tax

Section 2663(2) directs the promulgation of regulations:

> "(consistent with the principles of chapter 11 and 12 for the application of . . . [the generation-skipping transfer tax] in the case of transferors who are nonresidents not citizens of the U.S.." In the absence of such regulations, it is impossible to determine the applicability of the generation-skipping transfer tax to transfers made by nonresident aliens and to transfers made with respect to trusts created by nonresident aliens."

Treasury issued these regulations in 1995.[47] These regulations impose the generation-skipping transfer tax on transfers by nonresident aliens only if the transfer is subject to the U.S. estate or gift tax. Similarly, the tax is imposed on distributions from trusts to the extent funded by nonresident aliens (or on taxable terminations that occur with respect to such trusts) only if the nonresident alien's transfer to the trust was subject to the U.S. estate or gift tax.

If a nonresident alien transfers property to a trust that is in part subject to the U.S. estate or gift tax, a pro rata portion of the distributions from such trust (or its taxable terminations) will be subject to the generation-skipping transfer tax.

1.6 Estate and Gift Tax Treaties

In determining the estate, gift or generation-skipping transfer tax of non-U.S. persons, the advisor must also take into account any applicable treaties between the United States and the country in which the individual is resident or of which the individual is a citizen. At the present time, the United States has estate and/or gift tax treaties with 17 different countries - Australia, Austria, Canada, Denmark, Finland, France, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland, United Kingdom, and West Germany. Although these are important trading partners of the United States, the network is much narrower than the network of income tax treaties.

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[46] IRC section 2502(a).

[47] Treas. Reg. § 26.2663-2.

This outline does not discuss in detail how each of the various treaties may impact on the principles discussed above. In general, we may say that the pattern of many treaties is to limit U.S. estate tax (and often gift tax) on transfers by domiciliaries of the treaty country to taxation of U.S. real estate and property used in a U.S. trade or business conducted through a permanent establishment. We refer below to the small number of treaties that actually address the situs of a partnership interest.

2. Partnership Classification and Situs Issue

2.1 Aggregate v. Entity

The threshold question when analyzing a partnership interest is whether it should be treated as a distinct entity which is separate from its owners (often referred to as the entity theory) or whether it is merely a collection of underlying assets and businesses (often referred to as the aggregate theory). Only once this question has been answered can the situs analysis be applied, either analyzing the entity or the different assets aggregated in the partnership.

If the aggregate theory is adopted, then the situs rules of the Code would be separately applied to each asset in the hands of a nonresident alien partner. U.S. situs real estate would be subject to transfer taxes, for example, whereas non-U.S. situs real estate would generally not be subject to U.S. transfer taxes. Moreover, the place of organization of the partnership, as well as its residence, would be irrelevant.

On the other hand, if the entity theory were adopted, then the application of the situs rules to this entity can be analyzed under several different theories, depending on the characterization of the partnership interest for estate and gift tax purposes. Under the entity theory, the partnership would generally be treated as intangible property which can be treated as situate (i) where it is engaged in a trade or business, (ii) where it is legally organized, (iii) where the partner is domiciled, or (iv) where the partnership's legal records are maintained and where title transfer of partnership interests occurs.

In the past, the IRS has not suggested that the aggregate theory should be applied to the question of the situs of assets for purposes of applying the estate tax (or the gift tax) to a gift or the estate of a nonresident alien transferor. But as we shall see, its few pronouncements relevant to the application of the estate tax to nonresident aliens are fairly ancient and it has sought in a 1991 income tax ruling to apply an aggregate theory to the sale of a partnership interest, as described in paragraph 3.5 below.

Under those ancient pronouncements, the IRS seems to favor the first approach under the entity theory, so that a partnership should be treated as an entity for estate tax purposes which would be situated where it is engaged in business. However, this theory in turn raises further questions in its application to frequently complex international partnership structures.

In the gift tax arena, the IRS has placed the issue of whether a partnership interest should be treated as intangible property on its list of issues on which it will not ordinarily rule, although it is difficult to believe that a different view would be taken for gift tax than for the estate tax.[48]

[48] Rev. Proc. 2003-7, 2003-1 I.R.B. 233, section 4.01. This seems to have first appeared on the no-rulings list in Rev. Proc. 91-6, 1991-1 C.B. 413.

What is unusual about this no-rulings policy is that many situations in which the IRS will not rule involve primarily factual issues, whereas the question of whether a partnership interest should be treated as intangible property does not seem to have any predominantly factual element. In this case, the IRS seems to be saying that it is aware there is an unresolved legal issue and, for 13 straight years, it has not resolved it.

2.2 Basic Entity Classification

(a) U.S. rules

The United States has always required all business entities to be classified as corporations, partnerships or, in some cases, trusts. In most cases, the entity, once classified is subject to very different regimes of taxation based on its entity classification. In the past, entities were classified by reference to a set of six factors, two of which (associates and the object to make a profit) were common to corporations and partnerships and were therefore not determinative. In 1996, recognizing that the four remaining factors could be readily manipulated to produce the result desired by the taxpayer, the Treasury promulgated the check-the-box regulations to give business entities a great deal of flexibility in choosing how they wish to be classified.[49]

The check-the-box regulations classify, for all U.S. tax purposes, a foreign business entity, other than an entity that is automatically classified as a corporation (sometimes referred to as a *per se* corporation), as a partnership if it has more than one member at least one of which does not have limited liability, or as an association taxable as a corporation if all of its members have limited liability.[50] If the entity has only one member and that member does not have limited liability, the entity is disregarded as an entity separate from its owner. A business entity is, generally, any entity other than an entity properly classified as a trust.

If a foreign entity is not automatically classified as a corporation, but is classified as an association taxable as a corporation because all of its members have limited liability, it may elect to be classified as a partnership by filing Form 8832 with the appropriate IRS service center. The election made on Form 8832 will be effective on the date specified on the form, provided that the effective date may not be more than 75 days prior to or more than 12 months after the form is filed.

One immediate question in the estate and gift tax areas is how these rules apply, assuming, for the present, that tax is imposed on the partnership interest rather than on the underlying assets. The issuance of the check-the-box regulations under the authority of section 7701 compels the view that they apply for all purposes of the Code and not just income tax purposes, even if one may reasonably assume that estate and gift taxes were not much on the minds of the drafters of the regulations. Moreover, the regulations themselves refer more than once to "federal tax purposes", which one may take to include estate and gift taxes.[51] There seems every reason to

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[49] Treas. Reg. § 301.7701-2 and -3.

[50] Treas. Reg. § 301.7701-2. Foreign entities that are automatically classified as corporations include the Societe Anonyme in Belgium, France, and Switzerland, the Aktiengellschaft in Austria, Germany and Switzerland, the Naamlose Venootschaap (N.V.) in the Netherlands (but not the Netherlands Antilles), the Sociedad Anonima in Mexico, Spain and many Latin American countriies, and the Public Limited Company in the United Kingdom.

[51] E.g., Treas. Reg. § 301.7701-2(a) and (b) and -3(a).

believe that entities should be classified for transfer tax purposes just as they would be for all other purposes under the section 7701 regulations.

If the check-the-box regulations are the controlling authority for classifying business entities for transfer tax purposes, the logical conclusion would be that it should make no difference whether the entity in question is, for governing law purposes, a partnership, a limited liability company or a foreign entity that is not a *per se* corporation. Logic is not always the hallmark of our tax system, but we have encountered no authority or even any strong reason that would favor of a different conclusion. We might speculate that there could be a difference between entities that have some form of juridical existence and relationships that, notwithstanding the absence of formal documentation, are treated as partnerships by reason of the parties conduct and the intent manifested by such conduct. But one might readily assume that once the tax law has classified a relationship as creating a partnership, all of the consequences of such classification should flow.

(b) Entity Classification Issues in Foreign Jurisdictions

From a tax planning perspective, a U.S. planner considering the income tax aspects of an investment by a nonresident alien in an entity treated by the United States as a partnership needs to consider whether that entity will be treated as fiscally transparent in the alien's home country. Foreign countries generally do not take the U.S. approach.[52] An entity's status as a corporation is often determined by its legal form. In many cases a partnership, especially a partnership in which one or more partners have unlimited liability, will be taxed like a corporation. The United Kingdom has stated, for example, that it regards a U.S. limited liability as a taxable entity – and it reaffirmed this as recently as April 3, 2003 in a bulletin relating to the new U.K.-U.S. income tax treaty that has just entered into force.[53] It follows that there is a significant difference from a U.K. investor's point of view between investing in a U.S. limited partnership and a U.S. limited liability company, for example.

The United Kingdom at least recognizes a limited partnership as fiscally transparent, whereas Australia and France, for example, tax such a partnership as a taxable entity. In many civil law countries, where the concept of the limited partnership is not well known, most entities, other than partnerships engaged in the rendering of professional services, are typically treated as taxable entities. The civil law countries include not only the countries of continental Europe and Latin America but also countries like Japan and Korea whose legal systems borrowed significantly from civil law.

2.3 Review of Authorities

As noted above, the Code provides for estate tax to be imposed on nonresident aliens through the application of the situs rules but does not specify how the situs rules should apply to partnerships. The regulations do not provide clear rules for the taxation of partnership interests and while Treas. Reg. section 20.2104(a) elaborates on the broad based situs rules for the estate

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[52] A history of the U.S. approach to classifying foreign entities prior to the check-the-box regulations may be found in Committee on Taxation of International Transactions, New York City Bar Association, "U.S. Tax Treatment of Partnerships and Partners Under U.S. Income Tax Treaties" (June 7, 1995), Part III, reproduced at 95 Tax Notes International 131-10 (July 10, 1995).

[53] U.K. Inland Revenue Bulletin on U.K.-U.S. Income Tax Treaty. (Special Edition 6) (April 2, 2003), reproduced at 2003 Tax Analysts Worldwide Tax Daily 64-14.

taxation of U.S. property interests of nonresident aliens it leaves open the question of how to interpret the situs rules as they apply to partnership interests. As one commentator noted "[the] situs regulations are unclear because the wording is convoluted."[54] The regulations do not specifically refer to partnerships although the IRS has interpreted them as applying to partnerships.[55]

(a) Treasury Regulations

The regulations cover intangible personal property "the written evidence of which is not treated as being the property itself" and Treas. Reg. section 20.2104-1(a)(4) treats the property as having a U.S. situs if it is enforceable against a resident of the United States. The IRS seems to accept that provided that a partnership is accepted as an entity (rather than following the aggregate theory) an interest in the partnership should be treated as intangible property.[56] Therefore this regulation does govern the situs of a partnership for estate tax purposes.

The exclusion of interests where the written interest is the property itself seems to be designed to convert bearer partnership interests into tangible personal property for purposes of the estate tax situs rules. A bearer partnership interest would be unusual in a common law jurisdiction, although it might become more common since the advent of the entity election (or check the box) rules under Code section 7701.

Most partnerships are transferable only on the books of the partnership and interests in such property would therefore appear to be governed by the rules relating to intangible property. Accordingly the next situs test under the regulations would appear to depend on whether the partnership is enforceable against a resident of the United States. Read literally, this could mean that any partnership with a U.S. resident partner would be enforceable against a U.S. resident, but, consistent with the entity theory, the test is depends on whether the partnership itself is resident in the United States.

The test for determining whether a partnership is U.S. resident is set forth in Treas. Reg. section 301.7701-5, which was probably designed more with the income tax rules in mind (for example, the rule that interest paid by a noncorporate resident of the United States has a U.S. source).[57] U.S. residence depends on whether the partnership is engaged in a U.S. trade or business. The test is fairly simple so that any partnership, including one formed under the laws of a U.S. state, which is not engaged in a trade or business in the United States is treated as a nonresident partnership with a foreign situs under the estate tax regulations. It should be noted that the existence (or otherwise) of a U.S. trade or business is a long standing no ruling area for the IRS, on the ground that it is largely a question of fact.[58] Therefore, if this is the correct interpretation of the regulations, it hardly provides a clear "bright line" test for estate tax purposes. The development of the regulations has been criticized by several commentators, as discussed below.

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[54] Glod, "United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues", 51Tax Law. 110 (1997) ("Glod").

[55] Rev. Rul. 55-701, 1955-2 C.B. 836.

[56] Ltr. Rul. 7737063.

[57] IRC section 861(a)(1).

[58] For a clear discussion of the difficult question of what constitutes a U.S. trade or business see Professor Isenbergh's discussion in *International Taxation*, chapter XX.

In the absence of clear regulations on this issue other authorities must be relied upon. There are several leading cases from the 1930s and one Revenue Ruling from the 1950s which still provide the framework for any analysis of the estate tax rules in this area. Below these authorities are summarized before considering the different theories as to situs taxation in the light of these authorities.

(b) Cases on Intangible Property

In an early case the Supreme Court considered the issue of the estate taxation of a partnership interest in the context of a dispute relating to the taxing jurisdiction of a state, the issue of the situs of a partnership interest was considered.[59] The case concerned a rule in Connecticut which sought to tax all personal property of a domiciliary and the Supreme Court upheld this statute determining that the partnership interest in question should be classified as intangible property. Accordingly the Court upheld the analysis of the partnership interest as an ownership interest in an entity rather than in the underlying assets. It might be thought that *Blodgett* stands for the principle that a partnership should be treated as situate where the decedent is domiciled, but in fact the case concerned the constitutionality of the Connecticut law (albeit a law to the effect that the domiciliary state could tax intangibles) and although the Court upheld the law as constitutional, it did not rule on the application of the rule as a general situs rule.

One of the leading cases on the taxation of partnerships is the decision of the Second Circuit in *Sanchez v Bowers*,[60] where Judge Learned Hand considered the estate taxation of a Cuban domiciliary who owned an entity formed under then Cuban law known as a *sociedad de gananciales* which had investments in US property which would have been subject to U.S. estate tax if owned directly by the decedent. In this case, the *sociedad*, which was treated as equivalent to a partnership for U.S. tax purposes, terminated on the death of the decedent and so the court analyzed the application of the estate tax based on the finding that the estate tax applied to the assets rather than the entity. It might be thought that this case would support the aggregate theory rather than the entity theory of the taxation of partnerships since that was the method adopted by the court. However, as noted by commentators, the decision depended on the termination of the entity at the death of the decedent and in dicta the court both implied that the *sociedad* should be treated as a separate entity and that the situs for estate tax purposes could be the place where it conducts business. This provides a basis for the position subsequently adopted by the IRS[61]

In *Estate of Vandenhoeck*,[62] the Tax Court considered the status of U.S. situate marital property owned as community property by reference to the law governing the decedent's estate. Although the court applied the law of the decedent's domicile to determine whether to grant a 50% deduction from the value of the gross estate (based on the community property rights), it seems to stretch the reasoning of the case to use it to support a theory that the domicile of a decedent should determine status. There was no separate legal arrangement which governed who owned the assets, and the rights were determined by the law governing the decedent's estate.

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59 *Blodgett v Silberman*, 277 U.S. 1 (1928), *aff'g Appeal of Silberman* 134 A. 778 (Sup. Ct. Errors Conn. 1926).
60 70 F.2d 715 (2d Cir. 1934).
61 Rev. Rul. 55-701.
62 4 T.C. 125 (1934).

(c) Rev. Rul. 55-701 and the Position of the IRS

Although Rev. Rul. 55-701 predates the current section 7701 regulations, which define a resident partnership by reference to whether it is engaged in a U.S. trade or business, this ruling builds on the concept that the necessary jurisdictional nexus for determining that a partnership interest should be treated as situate in the United States for estate tax purposes requires the partnership to be engaged in a U.S. trade or business. It might appear that this builds on the dicta of Judge Learned Hand in *Sanchez* but the ruling cites the Supreme Court ruling in *Blodgett* as its primary authority. In her discussion, Glod takes the view that this reliance is misplaced and that *Blodgett* provides no clear support for its conclusions.

This ruling is of particular interest because the IRS took the opportunity to review several competing theories as to the situs of a partnership interest before concluding that the situs should be determined by reference to the location of a partnership's trade or business. It concerned a claim made with respect to a partnership interest in a partnership with a New York business by the estate of a U.K. domiciliary under the former U.S.-U.K. estate and gift tax treaty, which did not specifically address the taxing rights of the contracting states with respect to partnership interests. However, that treaty generally allocated respective taxing rights based on a series of situs rules, which can be contrasted with the current treaty which generally allocates taxing rights based on domicile and citizenship.

In this ruling the IRS considered, first, whether the partnership interest should be classified as a debt, by way of a variation on the entity theory, which would have led to a clear answer under the then treaty (the U.K. would have had sole taxing rights), and rejected that analysis. Second, the IRS considered whether the aggregate theory should be applied, and the underlying partnership assets should be analyzed to determine the situs of those assets. Interestingly, the IRS rejected this approach on the ground that there may have been authority to support this approach at the state tax level, but there was insufficient authority at the federal level. Accordingly, the IRS concluded that the appropriate test should be whether the partnership was engaged in a U.S. trade or business and the ruling concluded that this was the case.

It should be recalled that this ruling was based on an interpretation of a former estate and gift tax treaty, rather than providing guidance as to the domestic estate tax rules. Therefore, although the theories may have a broader application, it does not provide the needed authority on the interpretation of the Code and Treasury Regulations.

Significantly predating this Revenue Ruling, are two old general counsel memoranda, which initially adopt the aggregate theory, determining situs based on the assets comprised in the partnership, and then one year later reverse positions and adopt the entity theory.[63] The 1937 ruling was declared obsolete in 1970, although the conclusion that the entity theory should be applied to partnership interests would appear still to represent IRS policy.[64]

Although there is little direct authority as to the current position of the IRS on the different situs theories that should apply, assuming that the entity theory forms the basis for the analysis. However, informally the trend of the IRS thinking seems to be to take a similar analysis to the

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[63] G.C.M. 16164, XV-1 C.B. 363 (1936) and G.C.M. 18718, 1937-2 C.B. 476.
[64] Rev. Rul. 70-59, 1970-1 C.B. 280.

income tax analysis for estate tax purposes and apply a situs theory based on the presence of a U.S. trade or business.[65]

(d) Estate and Gift Tax Treaties

A small number of U.S. tax treaties address the situs issue. It should be borne in mind that, unless the taxpayer seeks a benefit under the treaty, the IRS cannot enforce its provisions against the taxpayer.

Australia. Under Article III(g) of the estate tax treaty and of the separate gift tax treaty, a partnership is deemed to be situated where the business of the partnership is carried on but only to the extent of the partnership business at that place. The Australian treaty is, incidentally, our oldest estate tax treaty and it is a little surprising that it is still in place given that Australia repealed its estate duties many years ago. On the other hand, the treaty is much more limited in scope than more recent estate tax treaties.

Canada. Two terminated treaties (from 1950 and 1961) did provide that a partnership was deemed to be situated where its business "is principally carried on". Canada does not have an estate tax but it does tax capital gains on death; there is therefore no estate tax treaty at present; coordination with the U.S. estate tax occurs through the income tax treaty, which does not refer to partnerships.

France. Article 5(2) of the French estate and gift tax treaty of 1978 provides the conventional rule for taxing nondomiciliaries only on real estate and assets used or held for use in a permanent establishment. The treaty says that if an individual is a member of a partnership or other non-corporate association that is engaged in industrial or commercial activity through a fixed base, the partner is deemed to be engaged in such activity to the extent of his interest "therein" – "therein" appears to refer to the activity rather than the partnership.

Germany. Article 8 of the German estate and gift tax treaty of 1980 provides that a partnership interest forming part of the estate or of a gift by a nondomiciliary may be taxed if the partnership owns real property or assets that forms part of the property of a permanent establishment. Article 10 allows certain related debts of the partnership to be deducted.

Netherlands. Article 7 of the Netherlands estate and gift tax treaty of 1969 is similar to the French treaty.

Sweden. The estate and gift tax treaty with Sweden has an unusual provision. The treaty has the usual rule that limits the nondomiciliary state to taxing real estate and assets attributable to a permanent establishment. In Article 7(2), which deals with all other property, the treaty clarifies that if one country would apply an aggregate theory and the other an entity theory, the nature of the right is determined under the law of the nondomiciliary country. In other words, in the case of a Swedish decedent, U.S. law would govern. Of course, we don't know exactly what U.S. law is and the Treasury Department Explanation and Joint Committee on Taxation note the application of the provisions of Article 7(2) in the event of a conflict between Swedish and U.S law without explaining which country is likely to espouse one theory and which the other.

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[65] Glod.

2.4 Different Situs Theories for Partnership Interests

The IRS discussed three different situs theories in Rev. Rul. 55-701, as noted above, before reaching the favored situs theory based on the entity theory and the presence of a trade or business. However, other theories have been canvassed by commentators.

By analogy to the corporate rules one theory would determine situs of a partnership interest based upon where the partnership is organized. This would have the merit of treating the situs of a partnership in a manner which is consistent with the situs of a corporate interest and would provide an easily administered bright line test. Certain commentators have suggested that this can provide a basis for planning particularly where the partnership is formed under foreign law and is treated as an entity separate from its partners under foreign law.[66] However, it should be noted that there are no court cases which address this theory and it appears that the IRS would not follow this approach.

Although forming a partnership under foreign law must be a helpful factor in reviewing the overall foreign situs of a partnership interest, it does not accord with IRS views as expressed informally. Because partnerships are generally treated as pass-through entities for both US and foreign tax purposes, it is frequently relatively straightforward to move a partnership or to reorganize it under the laws of a different jurisdiction without triggering a tax charge. Therefore it can be expected that the IRS would not use this as an equivalent jurisdictional tie compared with the use of this test for determining the situs interest in a corporation.

Hudson has also advanced the theory that a principal argument for determining the situs of a partnership interest should follow the equitable maxim of *mobilia sequuntur personam* and cites in support of the application of that principle the case of *Estate of Vandenhoeck*.[67] Arguably *Estate of Vandenhoeck* builds upon the principles of *Blodgett*, but that case did not in fact articulate the principle of m*obilia sequuntur personam*. *Estate of Vandenhoeck* specifically states this principle is subject to any contrary provision by a statute or otherwise (and indeed that case did not concern a partnership interest) and it can be expected that the IRS position would be that the regulations, assuming that they are authorized by the Code, provide such a different position. Both Glod and Hudson have argued that the regulations may not be fully authorized by the Code to the extent that they try to maintain that the place of business test should control. Nevertheless, such a position may be controversial.

A different principle can be seen in a number of US estate and gift tax treaties including in particular the current estate and gift tax treaty between the United States and the United Kingdom. This broadly reserves to each contracting state primary jurisdiction to tax intangible property of its domiciliaries, subject only to the reservation of each contracting state of the right to claim primary taxing jurisdiction over real estate and business property on a situs basis. Therefore it could be argued that to the extent that the IRS is adopting a policy of taxing the business property of a partnership entity which is located in the United States, this is consistent with treaty policy. On the other hand, it could also be argued that the treaty was not addressing itself to partnership interests and was simply confirming that if an intangible asset, such as a

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[66] Hudson, "Tax Effects of Choice of Entities for Foreign Investment in US Real Estate and US Businesses", 4 BET 4 March 2002.
[67] 4 TC 125.

trademark or a patent, is used in a trade or business, that asset would continue to be subject to the estate tax by the situs country.

The most compelling difficulty which has been articulated with respect to the approach of the IRS that jurisdiction to tax a partnership interest should be based upon treating the US situs as equivalent to a US trade or business results from the degree of uncertainty which this brings to taxpayers. In the case of investors in widely held partnership interests, it is very routine for the offering circular to represent whether it is intended that the partnership should be engaged in a US trade or business because this will affect the income tax position of nonresident alien investors as well as the estate tax position. Based on a representation in an offering circular a non resident alien investor can reasonably expect the partnership to maintain its business or non business status, as the case may be, in the knowledge that if this changes unexpectedly the investor may withdraw from the partnership. However, that option is not, of course, available for a deceased nonresident alien partnership investor.

Moreover most partnership interests are privately held and are not the subject of offering circulars. Where the partnership does not routinely make income distributions there may be no partnership withholding tax trigger (see below) which would lead to a determination of whether the partnership should be treated as engaged in a US trade or business. Therefore the advisor to a nonresident alien owning a US partnership interest may not have any clear indication as to whether the partnership should be treated as a US situs asset in accordance with what appears to be the IRS approach.

Moreover this approach does not deal with the increasingly common position where one partnership with international operations may have more than one trade or business in more than one jurisdiction. A strict interpretation of the IRS position under the regulations would seem to lead to the conclusion that an interest in a partnership which may have its principal trade or business outside the United States, but which includes a trade or business within the United States, may be treated in its entirety as a US situate asset. While the possibility of double taxation may be resolved under an estate and gift tax treaty, the treaty network is not nearly as widespread in the estate and gift tax area as in the income tax area and in any event most treaties do not directly address the issue of the situs of partnership interest.

A proposal submitted on behalf of the Taxation Section of the California State Bar has recently suggested that additional clarity be provided by adopting a rule for partnership interests which is similar to the rule for stock and other interests in corporations.[68] The essential features of the proposal are that partnerships should be recognized as entities and that Code section 2104 should specify that an interest in a partnership should only be treated as U.S. situate if it is issued by a domestic resident partnership. In particular the proposal would specify that situs would be determined without reference to the location of the partnership agreement or certificates, which are jurisdictional ties which have been widely criticized. The effect of the California bar proposal would be to limit the U.S. estate tax jurisdiction in the case of a non-resident alien estate to an interest in a partnership, which is engaged in an U.S. trade or business. It does not

[68] State Bar of California, Taxation Section, International Committee, "Why Section 2104 Must Address when Partnership Interests Owned by Foreign Investors are (and are not) subject to United States Estate Tax" (May 2003). The principal author of the paper is Patrick W. Martin of Procopio, Cory, Hargreaves & Savitch LLP

suggest whether there should be any additional guidance on when a partnership should be treated as engaged in a trade or business.

This proposal has significant merit in that it would provide valuable confirmation that what many commentators understand is the IRS interpretation of the current rule does have the force of law. It would effectively end the debate on the threshold question of whether the aggregate or the entity theory should be adopted. It would also resolve the discussion as to which situs theory should be adopted. Hudson maintains that the current rules only permit an interpretation that would locate intangible property including all partnership interests at the domicile of the decedent and that there is no regulatory authority to impose a trade or business test. The silence of the IRS in this area could be interpreted as implying that the IRS shares Hudson's doubt as to the scope of their regulatory authority, but it could also suggest that this is a difficult area, which has not received sufficient attention from government. Glod, in what must be one of the most comprehensive surveys of the authorities in this area, essentially concludes that the entity theory situs issues raise too many difficulties and that the entity theory should be confined to subchapter K of the Code, leaving the aggregate theory to prevail in the estate tax area. Although her position is intellectually consistent and well considered from a tax policy perspective, it does not directly address the practical concerns of practitioners in this area.

Given the diversity of views represented among commentators and the absence of any guidance from the government, the California Bar proposal would offer a significant advance for practitioners in this area. However, it leaves open the question of how to determine whether a partnership should be treated as engaged in a trade or business, and whether the partnership has a business presence in the United States. This question can be difficult for active participators in a partnership business, and can therefore be virtually impossible to determine for an outside passive investor. The California Bar proposal would provide an additional degree of practical certainty in this area by extending the system of transfer certificates used for transfers of corporate stock into the partnership arena and imposing a compliance burden on the designated tax matters partner. This would have the effect of ensuring that the situs of different partnership ownership interests are effectively ruled on by the IRS and might well aid practitioners in this area.

However, it still leaves open a number of related issues. For example, it does not address the question of a partnership with multiple businesses in different jurisdictions including the United States. Should the non-resident alien partner in such a partnership be subject to U.S. estate tax on the entire partnership interest, none of the partnership interest, or just the piece that relates to the U.S. business? If the comparison with the estate tax rules pertaining to corporate interests is pursued this would suggest that the entire partnership interest should be subject to estate tax. At least an "all or nothing" approach would provide certainty and would permit planning. However, it could raise difficult issues in the foreign tax credit area if another country also sought to tax the same partnership interest based on a business presence there. Perhaps the answer here is that this question of competing jurisdiction should be left to the estate and gift tax treaty network to resolve, and certainly the California Bar proposal would provide a significant and welcome advance over the present fog of uncertainty.

While different commentators have adopted different positions on the desirability of different approaches, all are united in calling for greater certainty. Additional certainty is required in this area in order to allow investors to plan and comply with their obligations. With the increasing popularity of partnerships and flow through entities as US investments, as described in the next section of this outline, this will presumably have beneficial economic consequences.

3. Income Tax Issues for Partnerships and Partnerships with Nonresident Alien Partners

The decision to conduct business or investment activities in the form of a partnership or other entity potentially treated as a partnership is often made primarily for income tax reasons – estate and gift tax considerations intrude upon but rarely drive this decision, particularly if the investment has a short- to medium-term life expectancy before the assets are liquidated and the proceeds returned to the partners. For many U.S. citizens and residents, the reason to use a partnership is clear: Pass-through treatment with respect to the net income of the partnership or other noncorporate entities and of various specific partnership items, with only one level of tax on partnership income and the potential for long-term capital gain on the sale of the partnership interest or its capital or trade or business assets.

For foreign individuals, going into partnership with a U.S. partner presents complications both in terms of the estate and gift tax, as we have already seen, but also in terms of the income tax treatment of both investment and business partnerships. Because this is a program about estate planning, we focus on the income treatment of individual nonresident alien partners in relation to their investments, although some of the issues are also relevant to foreign corporate investors. This section examine income tax issues affecting nonresident alien partners in partnerships engaged in a trade or business within the United States and or that invest in U.S. securities and other passive investments that do not generate income from a trade or business.

3.1 Definition of NRA

We should begin by noting that the definition of a nonresident is different for purposes of Subtitle B (estate, gift and generation skipping taxes) and the rest of the Internal Revenue Code.

For all purposes of the Code other than Subtitle B, residence is governed by section 7701(b). This definition therefore covers residence for purposes of the income tax and, interestingly, the reporting of gifts by foreign persons. Section 7701(b) provides that an alien is a resident if he or she meets one of two tests, usually referred to as the green card test and the substantial presence test. These tests involve a high degree of objectivity, although there are certain subjective elements, especially in applying the foreign tax home/closer connection exception to the substantial presence test and in applying income tax treaty tiebreakers.[69]

As noted earlier in this outline, section 7701(b) does not apply for the purposes of Subtitle B, which deals with the gift, estate and generation skipping taxes. In short, residence is determined based on a subjective test of the domicile of the donor or decedent.[70] Dual residents may find relief from dual domicile under estate and gift tax treaties, but the United States has entered into

[69] A complete description of section 7701(b) is beyond the scope of this outline.
[70] See discussion at 1.2(c) above.

many fewer such treaties than it has income tax treaties. The dual residence provisions of our estate and gift tax treaties are similar but not identical to those in our income tax treaties.

Although in many cases, especially where an alien holds a green card, the facts are likely to cause the alien to be resident for the purposes of all U.S. taxes, there will also be a significant number of cases where an alien will be found to be resident for income tax purposes but not for estate and gift tax purposes. Examples include green card holders who spend a majority of their time outside the United States, especially in their country of origin, as well as non-immigrant individuals who spend less than half of their time here but are caught up by the formulae of the substantial presence test.

3.2 General Considerations:

(a) Applicability of Subchapter K

The general rules of Subchapter K concerning the taxation of income related to partnerships operate in the case of all partnerships and all partners having some connection with the United States. The fact that a partnership is domestic or foreign by reason of its organization or resident or nonresident by reason of where it is engaged in business normally makes no difference to the approach taken by Subchapter K. A nonresident alien who is a partner of a partnership, whether domestic or foreign, will therefore be directly taxable on his or her allocable share of the partnership's net income and its separately stated items, to the extent such net income would be taxed if directly earned by the partner.

Because foreign persons are taxed on a more limited basis than U.S. persons, the general anti-avoidance provisions of Subchapter K are more likely to come into play. But in the absence of some artificial avoidance tactics counteracted by these provisions, the principal differences will concern the rate of tax and the application of Chapter 3 withholding, but these differences come into play primarily after the allocation of the partnership's income and other items in accordance with the partnership agreement and any overriding requirements of Subchapter K.

(b) Partnership engaged in a U.S. trade or business

Where a foreign person is a partner in a partnership engaged in a U.S. trade or business, the partner will be deemed to be engaged in that trade or business and will therefore be taxed the graduated rates applicable to individuals or corporations, as the case may be. Where a foreign person is a partner in a U.S. partnership, the Code specifically provides that such person will be deemed to be engaged in a U.S. trade or business if the partnership is so engaged. [71] It has been held that, for treaty purposes, a partner will be deemed to have a U.S. permanent establishment if the partnership has one.[72]

We consider below some of the advantages and disadvantages of the partnership form of engaging in a U.S. business for individual nonresident aliens in comparison with investing through a domestic or foreign corporation.

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[71] IRC section 875.

[72] *Donroy v. United States*, 301 F.2d 200 (9th Cir. 1962); *Unger v. Commissioner*, TCM 1990-15.

Some of the issues that affect the choice of entity from an income tax perspective operate differently if the entity will not be engaged in a U.S. trade or business. However, a foreign investor should almost never invest in U.S. securities or other passive investments through a taxable domestic corporation because of the gratuitous addition of a second layer of tax. Since many individuals may, however, choose to invest in such securities through a foreign corporation, the comparisons drawn in relation to investment income relate primarily to the income tax differences between investing through a partnership and through a foreign corporation.

3.3 Avoidance of Double Taxation

(a) Corporation-shareholder double taxation

The United States tax system continues to be built on the theoretical foundation of the double taxation of corporate earnings, first at the corporate level and then in the hands of the shareholders. In 2002, President Bush proposed significant changes that would largely eliminate the double tax but the fate of this proposal is not known.

In the case of a nonresident alien, double taxation cannot be avoided through an S election because a nonresident alien is not an eligible shareholder.[73] Double taxation operates in the case of foreign investors in any domestic corporation and also in any foreign corporation engaged in an active U.S. business. This is because the corporation will be taxed at regular graduated rates and then dividends of a domestic corporation will be taxed at 30% and amounts withdrawn from the U.S. business of a foreign corporation, whether or not distributed to the shareholders, will be subject to the 30% branch profits tax.[74]

In the case of foreign investors in a foreign corporation that is not engaged in a U.S. trade or business, no double tax will apply because the branch profits tax only applies where there are "effectively connected earnings and profits".

The burden of two levels of taxation by the United States may be alleviated by double tax treaties. Rates on dividends paid to direct corporate investors can be as low as 5% or, following three recently ratified treaties and protocols with Australia, Mexico and the United Kingdom, even zero in some circumstances. However, for the individual foreign shareholder, the treaty rate will almost never be below 15%, although lower rates could be secured by investing through a treaty-protected foreign corporation whose BPT rate is keyed to the rate for direct corporate investment.

By contrast, a nonresident alien who invests in a partnership does not have to deal with the problems of two levels of U.S. tax on corporate earnings. As noted below, however, that partner may still experience double taxation if the home country taxes income from the partnership but does not give a credit for the U.S. tax.

(b) Unavailability of home country double tax relief

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[73] IRC section 1361(b)(1)(C).

[74] IRC sections 871(a) and 881(a) (taxation of dividend); section 884(a) (taxation of "dividend equivalent amount" of foreign corporation.

In addition to two levels of taxation by the United States, there is also the problem of cross-border double taxation. Typically, foreign countries that impose tax on worldwide earnings of their residents will allow a credit, either unilaterally or by treaty with the United States, for U.S. tax on U.S. income. This system works well enough, in theory, in the case of direct corporate investment because the credit is given not just for U.S. withholding taxes but also on U.S. tax paid by a U.S. corporation. However, an individual foreign investor is typically not able to claim a credit for corporate level tax but only for the withholding tax.[75]

The foreign individual may therefore prefer a partnership as a means of investing in the United States because the U.S. tax is imposed on the individual – and such tax is typically creditable. The availability of the credit may depend on the partnership actually making a distribution to the foreign individual partner because it may not be recognized by foreign tax law as a pass-through entity. This is particularly a problem with limited liability companies but some countries treat even limited partnerships as corporations.

3.4 Rates

(a) Graduated rates.

Corporate rates and individual rates are broadly comparable with top rates converging as a result of the 2001 individual tax rate cuts. The differences by themselves probably don't make a great deal of difference to planning.

(b) Availability of long-term capital gains rates for individuals.

On the other hand, a foreign individual will prefer the partnership form to the corporate form if a significant portion of the profits will be in the form of long term capital gains earned by the partnership from its U.S. business activities. This will be the case particularly where the partnership invests in real estate.

3.5 Sale of Partnership Interest

The treatment of the sale of a partnership interest where the partnership is engaged in a trade or business has been the subject of some debate. Prior to 1991, the conventional wisdom had been that the sale of a partnership interest by a foreign person can only be taxed if the gain is treated as effectively connected income (ECI) and that, since the Code treats the sale of a partnership as the sale of a capital asset, separate from the underlying assets, gain recognized by a foreign person should not be taxed unless and to the extent the consideration was taxable under Section 897(g) or was otherwise held an asset of a trade or business.[76]

For the gain to be taxable as ECI, two requirements had to be satisfied:

- The partner had to be engaged in a trade or business within the United States -- plainly the case if the partnership was so engaged; and

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[75] Many foreign countries do not tax U.S. earnings under so-called territorial systems of taxation, but this does not necessarily alleviate potential double taxation.

[76] IRC section 741. See also *Pollack v. Commissioner*, 69 T.C. 142 (1977).

- the gain had to be effectively connected with such trade or business.

The partner's trade or business is that of the partnership. However, it is by no means obvious that gain from the sale of a partnership interest is effectively connected with the business of the partnership. Section 864(c)(2) says that the factors to be taken into account include whether (A) the income is derived from assets used in or held for use in the conduct of such trade or business; or (B) the activities of such trade or business were a material factor in the realization of the income. Neither section 864(c)(2) nor the regulations address the question of the application of these principles to the sale of a partnership interest. If one adopts the entity approach, the answer is negative, by analogy with the rules governing the sale of stock. It can also be argued that IRC section 897(g) evinces a recognition by Congress that a special provision was required to cause gain on sale of a partnership interest to be treated as ECI.[77]

On the other hand, the words of section 864(c)(2) would not have to be stretched very far to support the view that the foreign partner's income derived from the assets used in the partnership's business. One commentator further suggested that the IRS might be justified in imposing a tax on the portion of any gain from sale of a partnership interest represented by the partner's share of "hot assets" (unrealized receivables and substantially appreciated inventory).[78] The same commentator recognized, however, that section 751 is a characterization provision which arguably cannot make an otherwise tax exempt transaction taxable.

The stakes here are clear: Although the analogies between sale of a partnership interest and sale of corporate stock are obvious, there is one key difference: The purchaser of a partnership interest can obtain the benefit of a taxfree step-up in basis through an IRC section 754 election. (Even without the election, the purchaser will have a high outside basis in the partnership interest which in the year the partnership is liquidated will generate a loss to offset gain realized in liquidating the partnership's assets.) By contrast, the purchaser of a corporation can obtain a step-up only by means of an election under IRC section 338(e), which deems the target to dispose of and re-acquire all of its assets in a taxable transaction.

In Rev. Rul. 91-32, the IRS decided to apply the aggregate approach.[79] In the ruling, FP1 was a nonresident alien individual who was a partner in PS1, a partnership that was not a publicly traded corporation. Note that the ruling did not state whether the partnership was foreign or domestic: apparently this made no difference to the IRS. PS1 was engaged in a U.S. trade or business through an office or fixed place of business; it owned appreciated personal real and property both in a foreign country as well as appreciated personal property used in its U.S. trade or business. It did not trade in stocks or securities.

The IRS ruled that, where FP1 disposed of its interest in PS1, a partnership engaged in a trade or business through a fixed place of business in the United States, gain or loss would be U.S. source

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[77] Compare also former section 386 (amount of gain recognized by a corporation on distribution of a partnership interest treated as if distribution included corporation's proportionate share of appreciated property).

[78] Smiley, "Disposition of U.S. Partnership Interests by Nonresident Aliens", 8 Journal of Partnership Taxation 133, 139-140 (1991 – this article predated Rev. Rul. 91-32, discussed below).

[79] 1991-1 C.B. 107.

ECI (or loss that is allocable to ECI, as the case may be). However, this was limited to the extent that the partner's distributive share of unrealized gain or loss would be attributable to property the sale of which would give rise to ECI or loss allocable to ECI.

In the ruling, the IRS considered what would happen if a foreign partner resident in a country with a treaty identical to the Draft U.S. Model Income Treaty disposed of his interest in a partnership with assets used in a U.S. permanent establishment. The IRS held that the treaty did not protect the foreign partner. It cited *Donroy*, which holds, as noted above and consistently with IRC section 875, that a foreign partner of a partnership with a U.S. permanent establishment is treated itself as having a permanent establishment, and Unger for the proposition that the office of a partnership is the office of each partner.[80] The IRS then applied "analogous principles" to those considered earlier in the ruling to hold that income from sale of the partnership interest was attributable to a U.S. permanent establishment. As before, the IRS held that taxable gain includes only that portion of the gain that is attributable to the partner's share of the unrealized gain of the partnership's assets that are attributable to the U.S. permanent establishment.

If the IRS is right and the pre-1991 conventional wisdom is wrong (and this by no means a foregone conclusion), a sale of a partnership interest will be treated like an asset sale, at least with respect to the partnership's U.S. trade or businesses. This is a significant factor in choosing a form of doing business.

3.6 Need for NRA to File Personal Income Tax Returns (Including State Returns)

Where a nonresident alien invests through a partnership that is engaged in a U.S. trade or business, he or she will have to file an individual U.S. income tax return. This is a significant disincentive to many foreign investors.

If instead the investment is made through a corporation, the corporation will be responsible for filing the return. In the case of a domestic corporation, the individual will only have to file in the event that the corporation fails to withhold tax at the appropriate rate on distributions (unless FIRPTA comes into play). In the case of a foreign corporation, the individual will not be subject to a filing requirement with respect to distributions except in unusual circumstances.[81]

3.7 U.S. Partner Preference.

In a great many cases, U.S. persons prefer to use a form of business entity that will be classified for U.S. tax purposes as a partnership rather than as a corporation. Increasingly, the dominant form of entity for such joint enterprises is a limited liability company formed under state law and classified as a partnership. The reasons are legion and need not be recited in any detail in this outline. A nonresident alien that wants to participate in a partnership but does not want to deal with the estate tax uncertainties (and the problems associated with section 1446 withholding, described in greater detail below) can instead choose to form a corporation to participate in the

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[80] See footnote 72, *supra*.

[81] For example, if the corporation has made an election under section 897(i) to be treated as domestic.

partnership. However, this is a solution with several other undesirable consequences, particularly in the form of the double taxation of corporate earnings.

3.8 Withholding

(a) Section 1446 – Partnership engaged in U.S. trade or business

Withholding operates very differently for a nonresident alien who invests in a partnership engaged in a trade or business within the United States as compared with investing in such a business through a corporation. Withholding on the foreign stockholder of a domestic corporation is required at a flat rate of 30% on dividends, subject to treaty rate reductions which as already noted do not generally fall below 15%. The branch profits tax achieves a comparable effect if the business is conducted through a foreign corporation.

Where a foreign person invests through a partnership in a U.S. business, withholding under section 1446 comes into play. Where the partnership has ECI, the partnership is required to withhold tax on the foreign partner's distributive share and remit it on behalf of the foreign partner. This is one of a patchwork of situations in which withholding with respect to ECI is required – the other two principal examples being income from disposition by a foreign person of a U.S. real property interest[82] and the other being compensation for performance of services in the United States.[83]

Section 1446 may be the single most significant income tax impediment to foreign investment through partnerships. It requires withholding at the highest applicable rate, which for individuals is 38.6% at present.

Section 1446 in its present form requires any partnership which is engaged in a U.S. trade or business to withhold tax on a quarterly basis using the estimated tax procedures of section 6655(e)(2). Section 1446(a) therefore requires that a partnership make installment payments of withholding tax based on the amount of "effectively connected taxable income" allocable to its foreign partners.[84]

A payment of tax with respect to a foreign partner is treated as a distribution to that partner. Distributions generally are not taxable to partner except to the extent that the amount of the distribution exceeds the partner's basis in the partnership (investment, including the partner's share of the partnership liabilities, adjusted by distributions and allocations of profits and losses).[85] Excess distributions are unlikely to occur under normal conditions. However, a distribution does reduce the partner's basis and its capital account and is normally treated in partnership agreements as made on account of the partners' normal entitlement to distributions.

Section 1446 almost invariably will mandate overwithholding unless the foreign partner is tax-exempt or the partnership's ECI is rising quite quickly (but not doubling)[86] from year to year.

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[82] IRC section 1445

[83] See IRC sections 1441(b) and 3402; Treas. Reg. § 1.1441-4 coordinates the foreign person and wage withholding rules.

[84] *See* Revenue Procedure 89-31, ' 7, 1989-1 C.B. 895, 898-9.

[85] IRC section 731(a)(1)

[86] *See* Rev. Proc. 89-31 ' 7.012(ii)(4).

There are two reasons. First, section 1446 requires the use of the highest rate of tax applicable to the class of taxpayer into which a partner falls. Thus, an individual partner will be subject to withholding at 38.6% and a corporation at 35%, with no account taken of lower graduated rates. Second, no account is taken of certain partner level deductions to which a partner may be entitled. Such deductions include net operating loss and capital loss carryovers and carrybacks from other years and previously suspended passive activity losses. In addition, no account is taken of state taxes which may be imposed on the foreign partner's share of partnership income. A foreign partner may also have unrelated deductions generated by other U.S. activities.[87]

Section 1446 visits upon nonresident aliens who do business through a partnership an estimated tax regime much more severe than they would face if they conducted business either directly through a sole proprietorship or through a domestic corporation. If a nonresident alien individual conducts the trade or business as a sole proprietorship, or a foreign corporation conducts the business through a branch, withholding is generally not required. The foreign person is instead required to make payments of estimated taxes but the estimated tax calculation has built into it the ability to take into account the factors not taken into account in a section 1446 calculation, such as loss carryovers, state taxes and other deductions which in the case of a partnership would have been taken into account at the partner level.

The burden of overwithholding does not fall solely on the foreign partner. Withholding on the foreign partners can affect partnership cash flow, as the following example shows:

> P, a partnership composed of N, a nonresident alien, and C, a U.S. citizen, is engaged in a U.S. trade or business. C is the general partner; N may be a general partner or limited partner. N and C contribute nothing to the partnership capital, but succeed in borrowing $1,000 from a bank. In year 1, the entire $1,000 is expended on deductible items and losses of $500 are allocated to N and C. No withholding is required under section 1446, since there is no income.
>
> In year 2, P earns $1,000 from the conduct of its trade or business. All $1,000 is paid to the bank, perhaps under the terms of a security agreement. P is required to deduct and withhold 39.6% of $500, or $198, under section 1446. P has no funds with which to pay this tax unless the bank allows it to use part of its earnings, in which case the bank will be short repayment of $198. Assume that N refuses or is unable to advance $198 to P. C will be obligated to pay the tax. Then, N can file a tax return, reporting $500 of taxable income with a $500 net operating loss carryover from the prior year. Ignoring the impact of the AMT, N will receive a $198 refund which C cannot force the IRS to return to P.

Section 1446 upsets an assumption made by many partnership agreements that, especially during the early years of a partnership's life, distributions may be limited or may not be made at all and

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[87] Under partnership tax accounting rules, certain deductions of the partnership, including charitable contributions, capital and section 1231 losses, deductions for foreign taxes and a variety of items specified by regulation, which are required to be taken into account at the partner level, are nevertheless allowable for purposes of section 1446. IRC sections 702 and 703; Treas. Reg. '' 1.702-2 and 1.703-1.

that the partners will have to bear any resulting cash flow disadvantage of taxation without distributions.

(b) Section 1441 – Partnership income not effectively connected with U.S. trade or business)

Where a partnership is domestic, that is organized in the United States under Federal or, almost always, state law, payments of FDAP income to the partnership are not subject to withholding merely by reason of the partnership having partners some or all of which are foreign. The partnership is, however, required to withhold tax on any foreign partner's allocable share of FDAP income. The regulations require withholding to take place when a distribution is made to the foreign partner or, if no distribution is made, withholding must be made when the partner's Form K-1 is due or is actually filed, whichever is earlier.[88]

Where the partnership is foreign, the partnership itself will either be a withholding foreign partnership or a nonwithholding foreign partnership. If the partnership is a withholding foreign partnership, it will generally be able to avoid withholding by U.S. payors but will itself be required to behave in all respects like a U.S. withholding agent. To be entitled to this status, the foreign partnership must enter into an agreement with the Internal Revenue Service.[89]

If the partnership is a nonwithholding foreign partnership, the regulations require a determination of whether the withholding agent must treat the partnership or the partners as the payee. Essentially, if the withholding agent holds a Form W-8BEN or W-8IMY from the foreign partner, it can treat the partner as the person with respect to which any withholding must be undertaken based on the information in the form; otherwise, the regulations set out various operating presumptions.[90] Provision is also made for withholding in the case of tiered partnerships.

Matters become yet more complicated when a treaty is involved. The United States has struggled, on its own and in treaty negotiations, to reach a coherent policy that takes into account the fact that foreign countries may tax either the partnership or the partners or both. In brief, the United States has aimed to apply treaty rates only to foreign persons who were subject to tax in the foreign jurisdiction, so that if a foreign partner is taxable on a partnership's share of income, any U.S. rate reduction would depend on the treaty with the country of which the foreign partner was resident rather than with the country where the foreign partnership was resident.[91]

3.9 Basis step-up on death

The final difference between investing through a corporation and through a partnership that we need to consider relates to the application of the basis step-up rules. When an a nonresident alien dies, the basis of any asset in his or her estate or that is transferred by reason of death will be

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88 Treas. Reg. § 1.1441-5(b)(2).

89 Treas. Reg. § 1.1441-5(c).

90 Treas. Reg. § 1.1441-5(d); see also Treas. Reg. § 1.1441-1(b)(3).

91 IRC section 894(c) and Treas. Reg. § 1.894-1(d). The statement in the text does not really do justice to this complex issue. For a more detailed look, see Greenwald, Hecker and Crowley, "Section 894(c) Final Regs. Simplify Treaty-Benefit Rules for Income Paid to 'Fiscally Transparent Entities'", 11 Journal of Intl. Tax. No. 12, 28 (Dec. 2000).

stepped up (or down).[92] If a U.S. investment is held in corporate form, the step-up occurs with respect to the shares but not the underlying assets. If it is held in partnership form, however, the basis step-up occurs at both levels if the partnership makes an election under section 754. As far as we can tell, section 754 operates irrespective of whether a partnership is foreign or domestic or of whether it is engaged in a U.S. trade or business.

Basis step-up may not be of particular importance where a nonresident alien is investing in U.S. securities, whether through a foreign corporation or a foreign partnership, and is not engaged in a U.S. trade or business. But the one exception is where the heirs are U.S. persons.

4. Planning

The objective of this segment is to provide some summary for the prior discussions through identifying some specific cross-border estate planning ideas, many relevant to the ownership of partnership interests. These ideas consider the possible avoidance of U.S. federal estate tax, gift tax and generation skipping transfer tax liabilities, as well as income tax planning arising in the context of gratuitous transfers of partnership interests. Many of the ideas are also identified in other contexts in earlier segments of the papers prepared by other panel members.

As a general matter, planning has to take into account not only the lack of certainty as to the situs of a partnership interest but also whether a transfer of a partnership interest should be treated as a transfer of an interest in the entity or as a gift of a proportionate share of the underlying assets. This lack of certainty is an opportunity for the well advised and can provide a potential escape route for the ill advised.

4.1 Federal Gift Tax Planning

(a) U.S. Gift Tax Jurisdiction to the Nonresident Alien

The planner should recognize that the applicability of gift tax to the assets of a nonresident alien is less comprehensive than is the applicability of the federal estate tax (particularly with respect to the transfers of intangible property -- which might include a partnership interest, irrespective of where the partnership is formed or where it does business in the United States). Therefore, arrangements should be assured to enable death-bed transfers to occur (perhaps through usage of a durable power of attorney) so as to extract the property from the more expansive applicability of the transfer tax at death. Clearly, pre-mortem planning has to be coordinated with income tax considerations discussed below.

(b) The Gift Transfer of Cash

Because of long standing confusion concerning whether, for the nonresident alien, even the transfer of cash in the United States constitutes (from the IRS perspective) the transfer of a U.S. based tangible asset, alternative approaches might be implemented to completing a transfer of cash. This issue arises since, as noted above, the gift of tangible property in the United States by a nonresident alien is subject to the gift tax, but not if the transferred property is intangible

[92] IRS section 1014(b)(1) and (9).

property. Some are concerned that even a bank transfer from one account to another within the United States will invoke U.S. gift tax jurisdiction.

If the issue could be significant, the planning option (which should generate little additional burden) is often to have the transfers reflected on accounts of the donor and the donee at the foreign office of the U.S. (or foreign) bank or securities firm. If a partnership risks being treated as a conduit in this context, similar transfer arrangements might be implemented when partnership fund balances or interests are being shifted to younger generation members.

4.2 Federal Estate Tax Planning

(a) The Attitude of the IRS Towards Partnership Interests

Will the attitude of the Service change towards not answering the question of the status of the partnership interest for U.S. transfer tax purposes? Rev. Proc. 2003-7, 2003-1 I.R.B. 233, Section 4.01(25), continues the long-standing position of the Service that it will not "ordinarily" rule "[w]hether a partnership interest is intangible property for purposes of section 2501(a)(2) (dealing with transfers of intangible property by a nonresident not a citizen of the United States)." As the focus of the discussion of this panel indicates, in the planning context this necessitates a constant evaluation of the risks of (i) matching favorable income tax structuring arrangements while (ii) undertaking the risk that a transfer in anticipation of death of a partnership interest holding U.S. property may not be immunized from U.S. gift tax by the protection of Code Section 2501(a)(2). If the gift tax risk is great then the transfer might be postponed, with subsequent inclusion in the NRA's gross estate.

(b) The Allocation of Debt Against the NRA's U.S. Estate

If a particular debt can be collected only from property mortgaged to secure the debt and not from an estate generally, the full amount of the debt is to be excluded from the gross estate. This rule applies even in the case of a nonresident alien.[93] If the debt can be collected from the estate generally, and a part of that estate is not being taxed in the United States, then only a proportionate part of the debt may be deducted. The debt is allocable between the property taxable in the United States and that deemed to be outside the sphere of U.S. estate taxation. When the nonresident alien has significant interests in property both within and outside the United States, including properties held through partnership form, an important estate tax planning objective might be to have the net value of the U.S. property significantly reduced . This could be accomplished through the use within the partnership of nonrecourse debt which, therefore, need not be proportionately allocated (after attribution to the partner) in determining the debts apportioned to the United States.

(c) Possible Inclusion in the NRA's Estate of Certain Debt Instruments

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[93] See *Estate of Hon Hing Fung v. Commissioner*, 177 T.C. 247 (2001), affirmed, **Error! Main Document Only.**2003 U.S. App. LEXIS 4053 (9th Cir., Mar. 6, 2003). This case also should provide a cautionary note to tax planners who thought that California's anti-deficiency rules automatically cause may types of real property security to be nonrecourse. Despite the fact that California law precludes a deficiency judgment if the creditor chooses the virtually universally used procedure of a non-judicial sale as the means of foreclosing on the debt, the theoretical possibility that the creditor could choose judicial foreclosure followed by a deficiency suit (even though as a practical matter this is almost never done) was sufficient to render the loan a recourse loan for tax purposes.

For federal income tax purposes interest derived from state and local bonds is not included in gross income under Code Section 103 (and Code Section 871(g)(1)(B)(ii) for nonresident aliens). The interest income from bank deposits and many other debt instruments when received by a nonresident alien is excluded from gross income in the United States. See Code Section 871(h) (concerning portfolio debt instruments, including most OID instruments) & 871(i) (providing income exclusion for bank deposit interest). Most U.S. debt instruments are excluded from the U.S. gross estate of an NRA. Code Section 2106(b) specifies that property not treated as being deemed with in the United States includes bank deposits and portfolio debt. Not included in this listing are state and local bonds (i.e., Section 103 bonds). Ordinarily a NRA would not acquire state and local bonds since this would constitute a doubling of the available exemptions for federal income tax purposes, i.e., one because of the taxpayer's status and one because of the bond's status (i.e., state or local obligation). Note that, in the unique circumstance that such bonds would be owned by the NRA decedent at death (possibly including through a partnership interest), no estate tax exemption would be available, unlike other debt.

(d) Impact of the Differences in the Unified Credit Availability

The estate of a nonresident alien is allowed a credit in the amount of $13,000 against the U.S. estate tax liability. Code Section 2102(b)(1). This credit enables immunity from estate tax for $60,000 of U.S. property. In contrast, for the estates of domestic decedents during the year 2003 the unified credit applicable exclusion amount is $1 million, increasing to $1.5 million for the year 2004. For purposes of the applicability of the estate tax the roles concerning status may be reversed as the unified credit/exclusion amount increases for domestic taxpayers. Executors of the estates of deceased aliens may take the position that the decedent was a resident so that the much larger unified credit/exclusion amount is available. Since, however, the estate tax is applicable on a worldwide basis to estates of resident aliens, the dilemma (and responsibility) will then exist for the executor concerning full disclosure of all foreign based assets.

4.3 Federal Generation Skipping Transfer Tax Planning

(a) Transfer Non-U.S. Assets to Grandchildren

The generation skipping transfer tax applies to a nonresident alien individual when that individual transfers (at death or during lifetime) certain U.S. based assets to grandchildren and similar second or lower tier beneficiaries. Assuming U.S. based assets, including held through a partnership, this risk certainly exists for numerous foreign decedents. See, e.g., Estate of Milade S. Neumann v. Commissioner, 106 T.C. 216 (1996), where the Service determined that a testamentary transfer of property to a decedent's grandchildren was subject to the generation skipping transfer tax. A resident and citizen of Venezuela at her death, her estate included U.S. situs property consisting of works of art and other tangible personal property, and a cooperative apartment, all located in New York City. The estate also included foreign situs property including cash and securities located in Venezuela and in a Cayman Islands trust. At the time of death, the U.S. situs property had a value of approximately $20 million, and the foreign situs property had a value of approximately $15 million. One-half of the decedent's U.S. property was transferred to grandchildren. In examining the validity of the pertinent regulations the Tax Court indicated that in "enacting section 2663(2), Congress simply recognized that there would be problems of allocation and calculations of tax in respect of nonresident aliens because,

unlike citizens and residents, not all the property of nonresident aliens is subject to U.S. estate tax." Holding these regulations to be valid the generation skipping transfer tax was imposed on the transfer of the U.S. based assets to the grandchildren, accomplished in this situation through a "direct skip". This analysis could be equally applicable to the transfer of a partnership interest at death, if deemed to be U.S. property.

4.4 Federal Income Tax Planning

(a) U. S. Tax Status of the Individual

Tax planners should continually be aware that, as noted earlier, residency status for federal income tax purposes is determined differently (more mechanically) than is such status for federal transfer tax purposes. Consequently, even though an alien client may be a resident for federal income tax purposes, the client should be continually advised to maintain sufficiently foreign nexus to enable a possible claim of foreign domiciliary status as of death, assuming that this status remains desirable.

(b) Tax Basis Step-up at Death

Code Section 1014 provides for the tax basis step-up (or step-down) to the fair market value of the assets held at the time of death (or as of the alternate valuation date). The step-up applies to, among others, assets acquired by bequest, devise or inheritance, assets held in a revocable trust to pay the income to the decedent during lifetime and assets passing under the exercise by a decedent of a testamentary general power of appointment. In these and certain other circumstances, the step-up is allowed whether or not the asset was includible in the gross estate for estate tax purposes and therefore applies if the decedent was a nonresident alien. (On the other hand, a step-up is not available in cases covered by section 2036 and 2038 retained powers unless as a result of those sections the assets were includible in the gross estate.)

(1) Partnerships

With a partnership, if the outside interest is stepped up, section 754 provides a mechanism for a step-up in the basis of the underlying assets.

(2) Corporations

Basis adjustment applies only to the stock of the corporation but not to the corporation's assets.

Nevertheless, in a case not involving business assets located in the United States, the tax on the unrealized appreciation in a corporation's assets can be avoided by using a combination of three foreign corporations to protect the nonresident alien's U.S. assets from U.S. estate tax, rather than one. The nonresident alien would own all of the shares of two of the foreign corporations. The two wholly owned foreign corporations would each own 50% of the shares of the third foreign corporation. The third foreign corporation would own the nonresident alien's U.S. assets. Each of the three foreign corporations must be one of the types of corporations that will

be classified as a partnership for U.S. income tax purposes, if a check-the-box election is made[94] and none of them would have any presence or business activities within the United States.

Within 75 days after the death of the nonresident alien, the lower tier foreign corporation would file an election to be classified as a partnership for U.S. income tax purposes effective the day before the death of the nonresident alien. The effect of the election will be to treat the lower tier corporation as having distributed all of its assets and liabilities to its two shareholders in complete liquidation of the corporation on the day before the effective date of the election.[95] The lower tier corporation will be treated as recognizing gain to the extent the fair market value of its assets exceeds its basis in those assets,[96] but will not pay U.S. income tax on this gain because it is not subject to U.S. income tax. The basis of the lower tier corporation's assets in the hands of its corporate shareholders will be the fair market value of the assets on the day before the shareholder's death.[97] The deemed receipt by the upper tier corporations of the lower tier corporation's assets will be treated as amounts received in exchange for their stock in the lower tier corporation.[98] Any gain recognized, however, will not be subject to U.S. income tax since the corporations are not U.S. persons for U.S. income tax purposes.

After the lower tier corporation has made its election to be treated as a corporation, the two upper tier corporations would make the same election. In order to avoid partnership treatment on the date of her death and the uncertain U.S. estate tax consequences of that status, the effective date of the upper tier corporations' elections would be the day after the nonresident alien's death. The effect of the upper tier corporations' elections will be to treat them as having liquidated and as having distributed all of their assets to their shareholders, the nonresident alien's estate or her U.S. beneficiaries. Because the upper tier corporations' assets received a basis adjustment two days earlier as a result of the deemed liquidation of the lower tier corporation, the deemed liquidation of the upper tier corporations should produce minimal gain recognition. The shareholders of the upper tier corporations will be treated as having received the corporations' assets in exchange for their stock. If the nonresident alien's estate owns the stock, and if her estate is a foreign estate, there will be no U.S. income tax consequences. If the nonresident alien's U.S. beneficiaries own the stock, their gain on their deemed receipt of the corporations' assets should be minimal since their basis in the stock of the corporations will be the value as of the date of death of the nonresident alien.[99]

(c) FIRPTA Applies in Many Alternative Scenarios

The FIRPTA provisions (Code Section 897 and 1445) apply to sales of U.S. real property with the gain being subjected to a net gains tax regime, but only after applicability of a withholding at

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[94] See discussion at 1.1 above.

[95] Treas. Reg. 301.7701-3(g)(1)(iii).

[96] IRC section 311(b). U.S. income tax could be imposed, however, if the lower tier corporation owns U.S. real estate.

[97] IRC section 334(a).

[98] IRC section 331(a).

[99] IRC section 1014.

source regime as applied to the gross (rather than net) proceeds. Foreign clients often do not want to understand the expansive scope of the definition of real property for this purpose. This concept is often beyond the norm of "real property" as perceived by the U.S. based real property attorney. These many manifestations (often held through partnerships) include interests in oil and gas wells, natural resource deposits, co-ownership interests, real estate improvements, leaseholds, options to acquire land or improvements, and options to acquire land or improvements on real estate. This concept also includes movable walls, furnishings, and other personal property associated with the use of the real property being sold. It applies to the proportionate ownership of real estate assets held by partnerships, trusts and estates. It applies to gain realized when a loan transaction includes an "equity kicker" component, but indexed interest rates are acceptable to avoid FIRPTA jurisdiction. Remember, further, that the receipt of installment obligations (particularly where a very low down payment is received) can cause immense complications for both the seller and the withholding agent who is required to withhold 10 percent of the gross sales price unless a qualifying statement is applied for and received from the Service.

(d) No-Rulings Positions of the Service Concerning Business Status and Associated Income

Ordinarily U.S. tax advisors can determine whether activities in the United States (including by or through a partnership) constitute engaging in a trade or business in the United States or, alternatively, that a permanent establishment does (or does not) exist where a bilateral tax treaty may be applicable. Because this determination is primarily based on factual analysis the Service retains its long standing position to not rule (in response to a private letter ruling request) whether ETBUS or P.E. status exists. Rev. Proc. 2003-3, 2003-1 I.R.B., Section 4.01(3) specifies that a ruling will not ordinarily be issued concerning whether a taxpayers is engaged in a trade or business within the United States and whether income is effectively connected with the conduct of a trade or business within the United States. Similarly Section 4.01(9) of that Revenue Procedure indicates that the Service will not ordinarily rule whether a taxpayer has a permanent establishment in the United States for purposes of any United States income tax treaty and whether income is attributable to a permanent establishment in the United States.

4.5 Special Issues Related to Transfer Tax Planning for Nonresident Aliens With U.S. Beneficiaries

(a) Transfer Tax Planning for the U.S. Beneficiaries of Nonresident Aliens

Property that is given or bequeathed outright to a U.S. person will potentially be subject to U.S. gift, estate or generation-skipping transfer tax when it passes from her to her children and grandchildren. Nonresident aliens can protect the property they give to their U.S. beneficiaries from future transfer taxes indefinitely by giving property in trust rather than outright and by situating the trusts in jurisdictions that have no rule against perpetuities. So long as their U.S. beneficiaries do not have general powers of appointment over such trusts within the meaning of sections 2041 and 2514, and so long as the property the nonresident aliens give or bequeath to the trusts in not subject to U.S. gift or estate tax, the trust property, so long as it remains in the

trust, will not be exposed to U.S. transfer taxes. This protection is available whether the trusts used to hold the property are U.S. or foreign trusts.

(b) The Use of Foreign Corporations

(1) In General

A nonresident alien who invests in U.S. assets that would be subject to U.S. estate tax at death if held by them outright may choose a foreign corporation for various reasons, including the greater certainty of the estate tax treatment of stock in a foreign corporation. For the reasons discussed above, if the corporate form is respected and the corporate formalities observed, ownership of U.S. assets through foreign corporations will generally insulate them from U.S. estate tax.

When interests in such a foreign corporation pass to U.S. beneficiaries, however, the beneficiaries may be faced with difficult income tax issues. After the death of the nonresident alien, the foreign corporation used to hold the U.S. assets may be a controlled foreign corporation (a "CFC"), a foreign personal holding company (an "FPHC") or a passive foreign investment corporation (a "PFIC"). Treatises can be and have been written about this subject and the comments below are intended to highlight the income tax difficulties that the nonresident alien can bequeath to U.S. heirs, by comparison with the treatment of the bequest of a partnership interest.

(2) CFC's and FPHC's

A foreign corporation is a CFC if over 50% (by vote or value) of its stock is owned by "United States shareholders."[100] For purposes of this definition, a "United States shareholder" is a United States person[101] who owns either directly, through one or more foreign entities,[102] or through the application of certain constructive ownership rules,[103] at least 10% of the total combined voting power of all classes of stock entitled to vote.[104]

A U.S. person who owns directly or through a foreign entity shares of a CFC must include in gross income for each year her pro rata share of the CFC's "Subpart F" income.[105] A shareholder's pro rata share of a CFC's Subpart F income is that amount which would have been distributed with respect to the stock which such shareholder directly or indirectly (but not constructively) owns if, on the last day of the taxable year, the CFC had distributed all of its Subpart F income pro rata to its shareholders.[106] Subpart F income includes insurance income,

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[100] IRC section 957(a).

[101] The term "United States person" generally has the same meaning assigned to it by IRC section IRC section 7701(a)(30). It includes individuals who are citizens or residents of the U.S., domestic partnerships, domestic corporations, and estates or trusts other than foreign estates and trusts.

[102] IRC section 958(a).

[103] IRC section 958(b).

[104] IRC section 951(b).

[105] IRC section 951(a).

[106] IRC section 951(a)(2).

foreign base company income, international boycott income and foreign bribe-produced income.[107] Special rules are provided for CFCs that have more than one class of stock with different dividend rights.[108]

A foreign corporation is an FPHC if (i) at least 60% of its gross income for the taxable year is foreign personal holding company income ("FPHCI") and (ii) at any time during the taxable year more than 50% (by vote or value) of its stock is owned by not more than five individuals who are citizens or residents of the United States.[109] FPHCI is that portion of the corporation's gross income which includes dividends, interest, royalties, annuities, gains from the sale or exchange of stock or securities, personal service income from services performed by a shareholder, and rents (unless rents constitute 50% or more of the gross income).[110] For purposes of determining whether not more than five U.S. individuals own 50% of the stock of a foreign corporation, an individual will be treated as owning his or her proportionate share of all stock owned directly or indirectly by a corporation, partnership, estate or trust in which he or she is a shareholder or partner or of which she is a beneficiary. The individual will also be treated as owning stock owned directly or indirectly by family members (siblings, spouse, ancestors, and descendants) and partners.[111]

Each U.S. person who owns, directly or through a foreign entity, shares of a FPHC must include in gross income, as a dividend, the amount that would have been received as a dividend if, on the last day of the taxable year, the FPHC distributed all of its undistributed income for the taxable year.[112] The CFC rules take precedence over the FPHC rules; that is, if a shareholder could be taxed under either set of provisions, tax will be imposed under the CFC rules.[113]

If one or more U.S. beneficiaries receive shares of corporations that are or as a result of the transfer become FPHC's and CFC's, retention of the shares will subject them to current income tax at ordinary income tax rates on their pro rata share of corporate income whether or not the income is distributed to them. If, to avoid this result, they liquidate the corporation, they will be taxed on their share of the unrealized appreciation in the corporation's assets on liquidation and,

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[107] IRC section 952(a). Generally, foreign base company income includes, among other things, dividends, interest, royalties, rents, annuities, gains from the sale or exchange of certain types of property, gains from commodities, foreign currency gains, profits from the certain purchases and sales of certain types of personal property, and income from the performance of certain services for or on behalf of a related person outside the CFC's country of incorporation. IRC section 954(a).

[108] Treas. Reg. § 1.951-1(e)(2).

[109] IRC section 552(a). The minimum FPHCI is 50% of gross income after the first taxable year for which the corporation is a FPHC.

[110] IRC section 553(a).

[111] IRC section 554(a).

[112] IRC section 551(b).

[113] IRC section 951(d).

if, their share of the value of the assets received on liquidation exceeds their basis in the stock of the corporation, on that gain as well.[114]

The PFIC rules were intended to remove the competitive advantage in attracting U.S. investors previously enjoyed by offshore mutual funds over domestic funds. However, the definition of a PFIC is much wider. Specifically, it describes any foreign corporation if 75% of its gross income is FPHC income or 50% or more of its assets produce passive income. Once a corporation meets this definition for any particular U.S. shareholder, that shareholder must continue to treat the corporation as a PFIC even after the corporation ceases to meet the definition. The PFIC rules either impose an interest charge on the tax on accumulation distributions by the PFIC or they require the U.S. shareholder to make a qualified electing fund ("QEF") election that will result in current inclusion of a ratable share of the PFIC's income.[115]

The PFIC rules will require relatively prompt attention by any U.S. beneficiary acquiring a minority interest in shares in a foreign corporation. The U.S. beneficiary should evaluate whether any foreign corporation in which he or she inherits shares is a PFIC and if so, consideration should be given to making the QEF election with effect from the date of acquisition.

(3) Pre-Mortem/Pre-Gift Planning

Where a nonresident alien owns stock in a corporation that may become a CFC, FPHC or PFIC in the hands or U.S. citizen or resident heirs or donees, it is generally advisable to consider measures to step up the basis of appreciated assets and also to distribute accumulated earnings and profits to the nonresident alien shareholders. Transactions may be designed to step up assets without selling them or to cause the earnings and profits to be treated as distributed without actually distributing them. The objective of this type of planning is to avoid U.S. shareholders being taxed either immediately or at a later stage on capital gains that accrued and profits that accumulated prior to the transfer.

With a partnership, this type of planning should be unnecessary because of the availability of the section 1014(a) step-up upon death and the section 754 election to deal with built-in gain and the fact that all income actually recognized before death will be allocated to the nonresident alien decedent. (It may nevertheless be beneficial to accelerate income and gain recognition in some circumstances.) What is necessary, however, is to plan to avoid having the partnership interest includible in gross estate without sacrificing the step-up (as can happen if the partnership interest is held in an irrevocable trust rather than directly). Avoiding the estate tax inclusion is not a problem if the partnership is foreign, is not engaged in a U.S. trade or business and has no U.S. assets, so that none of the various theories for inclusion considered above will apply. On the other hand, if the partnership interest is domestic, is engaged in a U.S. trade or business and/or has U.S. assets, then depending on which of the various theories for estate tax inclusion is correct, the price of a step-up may be estate tax – a price which it may then be desirable to avoid

[114] If the liquidation takes place shortly after the death of the nonresident alien, the basis adjustment normally applicable under IRC section 1014 will often eliminate the tax on the unrealized gain with respect to the shares of stock.

[115] IRC sections 1291 *et seq.*

by cashing out of the partnership pre-mortem and removing the cash from U.S. taxing jurisdiction.

Many of the judgments involved in what to do pre-mortem with a partnership interest may therefore require a fine balance to be struck between the estate tax and income tax consequences. Once again, the lack of certainty on the estate tax treatment complicates the situation significantly.

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