US – MEXICO CROSS-BORDER ESTATE PLANNING: PLANNING TECHNIQUES FROM A U.S. AND MEXICAN PERSPECTIVE

MICHAEL J. BALDWIN
JACKSON WALKER LLP
100 Congress, Suite 1100
Austin, Texas 78701
(512) 236-2355
mbaldwin@jw.com

and

ABRIL RODRIGUEZ ESPARZA
MANCERA, S.C.
Ejército Nacional 843-B
Col. Granada, México D.F., Mexico
Direct: 1101 7208 | Office: 52831300 ext. 7208
abril.rodriguez@mx.ey.com

SAN ANTONIO ESTATE PLANNERS COUNCIL
February 17, 2015
San Antonio

© Michael J. Baldwin and Abril Rodriguez Esparza, 2015, all rights reserved.

THIS ARTICLE IS FOR INFORMATIONAL PURPOSES ONLY AND DOES NOT PROVIDE OR CONSTITUTE LEGAL ADVICE.

Michael J. Baldwin
Partner
Austin Office
512.482.6885
512.482.6859 (fax)

For more than 20 years, Michael J. Baldwin's wealth transfer and private client practice has been focused on representation of and counsel to high net worth individuals, affluent families, family offices, family and non-family business entities, estates, trusts, and charitable entities.

The primary focus of Mr. Baldwin's representation of individuals and families is preservation of wealth and the efficient transfer of wealth among generations. To achieve these goals, he spends extensive time educating his clients about various transfer techniques available, from the simple to the more advanced, and implementing the appropriate plan for each client.

Mr. Baldwin has extensive experience drafting individualized estate planning documents including wills, revocable management (living) trusts, irrevocable trusts, dynastic (exempt) trusts, and ancillary estate planning documents (powers of attorney/living wills). Additionally, he has vast experience in complex estate and transfer planning techniques, including proper use of irrevocable life insurance trusts, family partnerships and family limited liability companies, grantor retained annuity trusts, intentionally defective grantor trusts (including the sale of assets to such trusts), and foreign and domestic self-settled trusts.

Mr. Baldwin has considerable experience representing fiduciaries of estates and trusts. This representation includes counseling and assisting fiduciaries on all matters pertaining to the subject estate or trust, including all probate proceedings, estate and trust administrative matters, income and transfer tax planning, and asset distribution issues. He also represents fiduciaries, beneficiaries, and individuals in a variety of litigation matters, including trust modification and reformation suits, contested wills and trusts, and breaches of fiduciary duty.

Mr. Baldwin's practice also includes creating and representing various charitable trusts and charitable organizations. This practice area includes the planning and formation of charitable remainder trusts and charitable lead trusts, private foundations, supporting organizations, and the representation of exempt organizations for tax and non-tax matters.

He is also Board Certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization.

MEMBERSHIPS

Mr. Baldwin is a Fellow in the American College of Trust and Estate Counsel (ACTEC). He is a member of the American Bar Association Section of Real Property, Probate, and Trust Law; a member of the State Bar of Texas Section of Real Estate, Probate, and Trust Law; and a retired member of the Washington State Bar Association. Mr. Baldwin is a past President of the Estate Planning Council of Central Texas.

COMMUNITY INVOLVEMENT

Mr. Baldwin is on the Board of Trustees of the Synod of the Sun Presbyterian Foundation. He is also a former member of the Board of Directors of the Capital Area Food Bank Foundation and Board of Directors of the Capital Area Food Bank, where he was the Secretary from 2000 to 2006; and Board of Directors of the Austin Public Library Foundation, where he was Treasurer from 2000 to 2006.

AWARDS

Mr. Baldwin was named a "Rising Star" (2006 and 2007) and a "Super Lawyer" (2008-2015) by Thomson Reuters. He was also named a "Five Star Wealth Manager" (2010-2015) by Crescendo Business Services.

ADMITTED

- Texas
- Washington (inactive)
- United States Tax Court

EDUCATION

Mr. Baldwin received his B.A. degree in Business from Baylor University and his J.D. degree from Louisiana State University School of Law. He received his LL.M. in Taxation from the University of Denver.

Abril Rodriguez Esparza
Senior Manager / ITS
Mancera, S.C.
Ejército Nacional 843-B
Col. Granada, México D.F.
Mexico

Abril Rodríguez is a Senior Manager of the International Tax Services practice for Mancera, S.C., Ernst & Young's global member firm in Mexico. She is specialized in analyzing the tax implications in Mexico derived from cross-border business reorganizations, as well as advising wealthy individuals and families for an adequate and efficient estate planning. She holds a law degree from the Universidad Panamericana, Mexico City, and in 2007 she attended the Academy of American and International Law at the Center of American and International Law in Plano, Texas. She has authored and co-authored several domestic and International publications, such as the Mexican chapter of "Permanent Establishment" of the IBFD.

TABLE OF CONTENTS

I. INTRODUCTION. 1

II. DETERMINING A TAXPAYER'S STATUS FOR U.S. TAX PURPOSES. 1

A. Status for Income Tax Purposes. 1

1. Statutory Guidance. 1
2. Lawful Permanent Resident. 1
3. Substantial Presence Test. 1
4. First-Year Election. 2
5. Mexican-US Income Tax Treaty. 2

B. Status for Transfer Tax Purposes. 3

1. General Rules. 3
2. Relevant Domicile Factors. 3
3. Relevant Case Law. 3

III. NON-RESIDENT ALIENS (NON-RESIDENT/NON US CITIZEN). 4

A. Income Tax Issues. 4

1. Fixed or Determinable Annual or Periodical Gains, Profits and Income - ("FDAP Income") 4
2. FDAP Income Exceptions And Other Matters. 4
3. Effectively Connected Income. 5

B. Transfer Tax Issues. 5

1. Gift Tax. 5
2. Estate Tax. 6
3. Generation Skipping Transfer Tax. 8

IV. RESIDENT ALIENS (RESIDENT/NON-U.S. CITIZEN). 8

A. Income Tax Issues. 8

B. Transfer Tax Issues. 8

1. Gift Tax: 8
2. Estate Tax. 9
3. GSTT. 9
4. Marital Deduction Issues. 9
5. QDOT Requirements. 9

V. SUBSTANTIVE U.S. TAX RULES APPLICABLE TO FOREIGN TRUSTS AND FOREIGN GRANTORS 10

A. U.S. Trust vs. Foreign Trust. 10

1. Court Test. 10

2. Control Test. 10
B. U.S. Settlors Of Foreign Trusts....10
1. Grantor Trust Status Generally under IRC §679. 10
2. Trap For The Unwary Or Planning Tool - Foreign Trust or Grantor Trust Toggle Switch?....11
C. U.S. Trusts With Foreign Beneficiaries....11
1. Basic Rules....11
2. Trustee has certain withholding obligations. 12
D. U.S. Beneficiaries Of Foreign Trusts – Foreign Grantor Trust 12
1. General Rule. 12
2. Exceptions Allowing Foreign Grantor Trust.. 12
3. ECI/FDAP Income....12
4. Basis "step-up" on Death....12
5. IRC §901(b)(5)....12
6. Recipient of Distributions.. 12
E. U.S. Beneficiaries Of Foreign Trusts – Foreign Non-Grantor Trust 12
1. Taxation Of Accumulation Distributions From Foreign Non-Grantor Trusts....12
2. Throwback Rule Minimization Techniques....13
F. Reporting And Disclosure Requirements. 13
1. Settlor....13
2. Trustee Or Executor....14
3. Beneficiaries. 15
VI. MEXICAN TAX AND ESTATE PLANNING ISSUES. 15
A. Resident Individuals for Tax Purposes in Mexico....15
1. Tax Residency in Mexico. 15
2. Income on Worldwide Earnings....16
B. Nonresident Individuals for Tax Purposes in Mexico. 16
1. Mexican Source Income....16
2. Exemption for non-residents staying less than 183 days 17
3. Taxes on the Gains and Income. 17
C. Donation, Inheritance and Bequest 18
1. Definition. 18
2. Definition under MFCC:....19
3. Wills....19
4. Donation Agreement....19

D. Death, Inheritance and Gift Tax....19
1. No Specific Death, Inheritance or Gift Tax....19
2. Donations, Inheritance and Bequest Considered as Income in Mexico....19
3. Resident Individuals....20
4. Nonresident Individual Receipt of Donation, Inheritance or Bequest. 20
5. Donation Exception. 20
6. Tax Rates....20
7. Other Taxes....20
E. Mexican Marital Property Regime....21
VII. PLANNING TECHNIQUES AND CONSIDERATIONS....21
A. Preliminary Planning Considerations. 21
1. Coordination of Advisors....21
2. Non-Tax Considerations. 21
B. Individual Planning - Who are we planning for?....21
1. Domicile of Donor/Testator....21
2. Domicile of Donee/Beneficiary. 21
C. Asset Planning - What are we planning for? 22
1. Situs of Assets – Mexico or U.S.?. 22
2. Tangible or Intangible Assets?....22
D. Planning Techniques....22
1. Mexican Citizen (Non-US Resident) with U.S. Beneficiaries....22
2. Planning for U.S. Resident - Mexican Citizen (Mexican RA) and U.S. citizen with Mexican Tax Resident Beneficiaries. 24

US – MEXICO CROSS-BORDER ESTATE PLANNING: PLANNING TECHNIQUES FROM A U.S. AND MEXICAN PERSPECTIVE

By: Michael J. Baldwin and Abril Rodriguez Esparza

I. INTRODUCTION.

The border between the U.S. and Mexico is nearly 1,900 miles long. Texas and Mexico share 1,254 miles of that border. But it is not just a line on a map that these two countries share. The people of Mexico and the U.S. are bound together by close economic, cultural and historic relationships that have existed for generations. This article is intended to provide advisors a general perspective of the estate planning issues that arise from both the U.S. and Mexican perspective.

II. DETERMINING A TAXPAYER'S STATUS FOR U.S. TAX PURPOSES.

A. Status for Income Tax Purposes.

Non-U.S. Citizens, for our purposes "aliens", are either residents ("RA") or non-residents ("NRA") pursuant to the Internal Revenue Code ("IRC") for income tax purposes. The consequences of being a NRA versus a RA are substantial from an income tax standpoint as we will describe in detail later. It is important, therefore, to examine the rules relating to determining the status.

1. Statutory Guidance.

IRC Section 7701(b) provides that an alien is a resident for income tax purposes if he: (1) is a lawful permanent resident; (2) meets the "substantial presence test," or (3) elects to be classified as a resident in certain circumstances.

2. Lawful Permanent Resident.

An alien who has lawfully been accorded the privilege of residing permanently in the United States through our immigration laws is considered to be a "lawful permanent resident " Generally, this occurs through the acquisition of a "green card." Interestingly, this rule applies to both "ordinary" green cards and "commuter" green cards. Significant Service Center Advice (SCA) 199950009. Although an individual may voluntarily abandon their green card, in which case he or she will lose U.S. resident status immediately, mere absence from the U.S. will not change the U.S. tax status until an official loss of green card status has occurred.

3. Substantial Presence Test.

An alien will meet the "substantial presence test" for the current calendar year if he is present in the United States on at least 31 days during the current year and the sum of the number of days on which he was present in the U.S. during the current year and the two preceding years equals or exceeds 183 days. In calculating the two preceding years, each day of the first preceding year is calculated at $1/3^{rd}$ of one day and each day of the second proceeding year is calculated at $1/6^{th}$ of one day. Under this formula, an NRA may be in the U.S. for up to 121 days each year without becoming a resident.

The "substantial presence test" does not apply to the following exempt individuals for purposes of determining residency status: foreign government employees or diplomats and their families, teachers and trainees and their families, students and their families and professional athletes and their families. IRC Section 7701 (b)(3)(D), (b)(5); Reg. 301 7701(b)(3).

Notwithstanding the fact that an alien has met the "substantial presence test", he or she may still avoid classification as a U.S. resident if he or she has a closer connection with another taxing jurisdiction. Pursuant to IRC 7701(b)(3)(B) and (C), if an alien is: (1) present in the U.S. for fewer than 183 days during the current year; (2) maintains a tax home in a foreign country during the entire year; (3) has a closer connection during the current year to the foreign country in which his tax home is located than to the United States; and (4) he has not personally applied, or taken other affirmative steps to change his status to that of a lawful permanent resident of the U.S. Obviously, exception 4 above will not apply and the "substantial presence test" formula will apply if the individual has applied for a green card.

4. First-Year Election.

There may be certain situations where it is beneficial for an alien to be a "resident" for U.S. tax purposes even though he or she has failed the "lawful permanent resident" test or the "substantial presence test", i.e., to take advantage of foreign losses or to avoid limitations placed on nonresident aliens with respect to certain exemptions and deductions. Generally, pursuant to IRC 7701(b)(1)(A)(iii),(b)(4), an individual may elect to be treated as a resident if she is present for a minimum of 31 consecutive days in the election year and meets the "substantial presence test" in the year following the election.

5. Mexican-US Income Tax Treaty.

There are certain situations where an individual is considered a resident for both U.S. income tax purposes and Mexican income tax purposes. Generally, the following tie-breakers should apply:

a. Taxpayer is a resident of the state in which a permanent home is available. If a permanent home is available in both states, then the taxpayer is a resident of the state with which the person's personal and economic relations are closer (center of vital interests);

b. If the taxpayer's center of vital interests cannot be determined or if the taxpayer doesn't have a permanent home available in either country, then the country where he or she last had a "habitual abode" will be deemed his or her residence;

c. If habitual abode existed in both states, then the deemed residence will be the state of which the individual is a national;

d. In the event none of the above apply, competent authorities of the contracting states shall settle by mutual agreement.

B. Status for Transfer Tax Purposes.

For purposes of determining residency for income tax purposes, taxpayers have the benefit of specific statutory guidance in IRC Section 7701. For transfer tax purposes, however, taxpayers have much less statutory guidance and are limited to case law and the guidance provided under IRC Treas. Reg. Section 20 0-1(b)(1).

1. General Rules.

For transfer tax purposes, an alien is a RA or a NRA based upon his or her domicile. Generally, to establish domicile, the alien must actually reside in the U.S. for a period of time and have demonstrated an intent to stay at that domicile. Pursuant to Treas. Reg. 20.0-1(b), "a resident decedent is a decedent who, at the time of his death, had his domicile in the United States".

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. Residency 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. Treas. Reg. 20.0-1(b)(1).

2. Relevant Domicile Factors.

The following factors have been considered for purposes of establishing an alien's domicile for transfer tax purposes:

a. the duration and purpose of stay in the U.S. and other countries;

b. type and cost of dwelling places in the U.S.;

c. geographical location of U.S. residence, i.e. resort v, non-resort;

d. location of cherished possessions;

e. personal motivations for location of residence including health, pleasure, and political repression;

f. address or declaration of intent on legal documents;

g. visa status;

h. location of business interests;

i. location of close friends and family;

3. Relevant Case Law.

a. *Estate of Jack v. U.S.*, 54 Fed. C1. 590 (2002). In *Jack,* the decedent was a Canadian citizen who came to the U.S. to teach on a temporary, non-immigrant work visa. The decedent's estate argued that it was impossible for the decedent to form the requisite intent

to stay because such intent would be in violation of the visa. The Court of Claims held that notwithstanding the fact that the intent to stay would have been in violation of the terms of the work visa, the I.R.S. should still be permitted to prove as a factual matter that the decedent did in fact possess such intent.

b. *Estate of Barkat Khan,* 75 T.C.M. 1597 (1998). In *Barkat Khan,* the decedent's estate took the somewhat unusual position of arguing that the decedent was a domicile to afford the decedent the unified credit. The IRS had assessed an estate tax based on Barkat's NRA status. The decedent had lived off and on in the United States for several years before obtaining a green card in 1985. Decedent's primary business contacts were in the United States, as was his son. In 1986 decedent returned to Pakistan for business purposes with the intent of returning to the U.S. Decedent's health began to fail and he died in Pakistan in 1991. The Tax Court held that he had obtained a U.S. domicile in 1985 and did not abandon it.

III. NON-RESIDENT ALIENS (NON-RESIDENT/NON US CITIZEN).

A. Income Tax Issues.

1. Fixed or Determinable Annual or Periodical Gains, Profits and Income - ("FDAP Income")

Pursuant to IRC Section 871(a)(1), a flat rate of 30% is withheld (and collected) at the source by the U.S. payor on amounts paid to a NRA who has U.S. source fixed or determinable annual or periodical income (i.e. salaries, wages, interest, dividends, and royalties). Generally, few deductions are allowed on FDAP Income. IRC Section 873(a).

2. FDAP Income Exceptions And Other Matters.

a. Portfolio Interest Exceptions. The most important exception to the general FDAP Income 30% withholding requirement is the "portfolio interest" exception pursuant to IRC Section 871(h) and (i). Generally, bank interest, interest on U.S. treasuries, interest on U.S. corporate obligations and interest on most other U.S. obligations will not be subject to the tax. This exception is particularly important because it does not depend on a treaty for its application.

b. Capital Gains Property. Generally, U.S. source capital gains are not FDAP Income and are not subject to the withholding requirement as long as the NRA is not present more than 183 days in the taxable year. IRC Treas. Reg. Section 1.871-7(a)(1).

c. Gain on the Sale of Intangibles is FDAP Income. Pursuant to IRC Section 871(a)(1)(d), gains from the sale of certain types of intangibles, including intellectually property such as patents and copyrights, are deemed to be FDAP Income and subject to the withholding requirements.

d. Rent. An NRA may make an election to treat his rental income or gains from U.S. real property as "effectively connected" income. IRC Section 871 (d).

e. Trust Distributions. Pursuant to the rules of Subchapter J, trust distributions are taxed in accordance with the kinds of income that makes up the distribution.

f. Mexican/U.S. Treaty Benefits. See attached Exhibit A.

3. Effectively Connected Income.

Income which is effectively connected with a U.S. trade or business, pursuant to IRC Section 871(b), is subject to tax at the same rate applicable to U.S. citizen individuals.

a. Foreign Source Income as Effectively Connected. Pursuant to IRC Section 864(c)(4), if an NRA is engaged in a trade or business within the U.S. and has a U.S. office, certain foreign source rents, royalties, dividends, interest, and gain or loss derived from the sale or exchange of inventory property, if attributable to the U.S., will be considered "effectively connected."

b. Sale of U.S. Real Estate (Foreign Investment Real Property Tax Act ("FIRPTA") - IRC Section 897. Generally, gain on the disposition of "U.S. real property interests" will be treated as "effectively connected "

(1) "U.S. real property interests" includes both direct interests in U.S. real property and interests in domestic corporations, partnerships, trusts, and estates that hold U.S. real property.

(2) Pursuant to IRC Section 8970, "disposition" includes contributions to the capital of a foreign corporation.

(3) The FIRPTA withholding burden is born by the transferee of the real property. Generally, pursuant to IRC Section 1445, the transferee is required to withhold 10% of "the amount realized on the disposition".

B. Transfer Tax Issues.

1. Gift Tax.

a. Statutory Guidance. Pursuant to IRC Section 2511(a), gifts (gratuitous transfers) by NRA's are only subject to the gift tax if the gifts are "situated" in the U.S. Thus, in very general terms, NRA's are subject to gift tax on gifts of real or tangible property located in the U.S. Treas. Regs. Section 25.2511-3(a)(1). Gifts of intangible property by a NRA, regardless of where it is situated, are not subject to gift tax pursuant to IRC Section 2511(a)(2). No gift tax treaty exists between Mexico and U.S.

b. General Rules.

(1) No Unified Credit. NRAs are not entitled to a unified credit for gifts subject to the gift tax. IRC Section 2505(a). The tax rate is the same as applies to citizens and RAs. Generally, taxable gifts by a NRA are taxed at rates from 18% to 40%, depending on the size of the particular taxable gift and the value of all previous taxable gifts made by the NRA.

(2) Annual Exclusion Gifts. NRAs are entitled to the $14,000 exclusion for annual exclusion gifts and the unlimited exclusions for educational expenses and medical expenses. IRC Section 2503(b),(e).

(3) Gifts to Spouse. NRAs are entitled to an unlimited exclusion for gifts to U.S. citizen spouses and a $145,000 annual exclusion for gifts to non-citizen spouses (adjusted annually for inflation). Treas. Reg. Section 2523(i)-1(a) and (c)(2).

(4) Charitable Gifts. Generally, NRAs may make unlimited gifts to U.S. charities. IRC Section 2522(b).

(5) Gift Splitting. Gift splitting is not available to NRA with their respective spouses.

(6) Basis of Acquired Property. Generally, pursuant to IRC Section 1015, the transferee will receive property at the transferor's basis.

(7) Gifts of Tangible Personal Property. Gifts of tangible personal property, such as jewelry or art, should not be made in the U.S. as they are subject to gift tax.

(8) Gifts of Intangibles. Generally, one would think that the definition of intangibles for gift tax purposes would be simple, and it typically is. However, some gifts, such as cash, have continued to befuddle the IRS. In a series of letter rulings, the IRS has been unable to decide whether or not cash is an intangible. Because of this uncertainty, it is best to make cash gift outside of the U.S. Additionally, prudence is warranted in structuring the intangible gift transaction. Be wary of converting tangible property such as real property into intangible property. In *Davies vs. Commissioner*, 40 T.C. 525 (1963) (acq., in result, 1966-1 C.B. 3., an English NRA made a gift of funds into a foreign bank account for his son, conditioned on the son purchasing Hawaiian real estate. The IRS successfully stepped the gift of funds into the foreign account (clearly an intangible) and the purchase of the real estate together as a gift of real property and subject to gift tax.

(9) Gifts of U.S. Stock. Contrary to the situs rules for the estate tax, gifts of a U.S. corporation are gifts of intangible property and not subject to the gift tax. Treas. Reg. Sec. 25.2511-3(b)(3).

(10) U.S. Expatriates. These rules are substantially modified when applied to U.S. expatriates (and beyond the scope of this article).

2. Estate Tax.

a. Statutory Guidance. Pursuant to IRC Section 2101(a), NRA's are subject to estate tax only with respect to the portion of their taxable estates that is situated in the U.S. No estate tax treaty exists between the U.S. and Mexico.

b. General Rules.

(1) Limited Unified Credit. Pursuant to IRC Section 2102(c), NRAs are entitled to a very paltry unified credit of $13,000 which essentially permits a NRA to transfer

$60,000 worth of property, obviously, much less than their U.S. citizens or RAs. The estate tax rates for NRAs are the same as for U.S. citizens and RAs.

(2) Transfers to Spouse. NRAs are entitled to an unlimited exclusion for gifts to U.S. citizen spouses IRC Section 2106(a)(3). However, an NRA is subject to the requirements of 2056A, the qualified domestic trust ("QDOT") requirements, if her spouse is an NRA, which is quite likely.

(3) Charitable Gifts. Pursuant to IRC Section 2106(a)(2), charitable gifts are limited. Only gifts to a U.S. or a political subdivision thereof, a domestic (U.S.) corporate charity or a U.S. charitable trust would qualify for the deduction. Contrast this with IRC Section 2055 which allows RAs to make gifts to foreign charities. ***Additionally, the charitable deduction may only be made if the entire world-wide estate of the decedent is shown on the estate tax return.***

(4) Basis of Acquired Property. Generally, pursuant to IRC Section 1014, the transferee will receive a stepped up basis. Note however that stock in a foreign personal holding company will not be entitled to a basis step-up. IRC Section 1014(b).

(5) What is U.S. Situs Property?

- U.S. real property;
- Domestic Corporate stock (IRC Section 2104(a));
- U.S. Debt obligations (IRC Section 2104(c));
- U.S. Currency located in U.S.;
- Tangible personal property located in U.S. (note: generally does not include works of art on loan); and
- IRC Section 2035-2038 transfers if property was U.S. situs property at time of transfer.

(6) What is not U.S. Situs Property?

- Foreign real property;
- Stock in foreign corporate stock (IRC Section 2104(a));
- U.S. Currency located outside of the U.S.;
- Tangible personal property located outside of the U.S.; and
- Life insurance proceeds on life of NRA decedent, owned by the NRA, and issued by a U.S. insurance company.

(7) Major Exception to U.S. Situs Property. Pursuant to IRC Section 2105(b), the following property is *NOT* U.S. situs property under the general rules of IRC Section 2104(c): 1) amounts on deposit at a bank or insurance company which are described under IRC Section 871(i)(3); 2) deposits with a foreign branch of a domestic corporation or partnership, if he branch is engaged in the commercial banking business; 3) "portfolio interest" debt obligations under IRC Section 871(h); 4) certain original issue discount obligations. Note, the intention of the estate tax exceptions is to coincide with the income tax "portfolio interest" exemptions.

(8) Certain other Deductions. Pursuant to IRC Section 2106(a)(1) deductions for expenses and debts under IRC Section 2053 and IRC Section 2054 are deductible in proportion to the U.S. gross estate to the total estate. ***Because NRAs are required to disclose their entire worldwide estates in order to take advantage of these deductions, like the charitable deduction, they are often not taken.***

3. Generation Skipping Transfer Tax.

Generally, NRAs are subject to the generation skipping transfer tax ONLY to the extent the transfer is subject to gift or estate tax. Thus, if the underlying transfer did not cause the imposition of gift or estate tax, the generation skipping transfer tax should not apply. IRC Section 2663, Treas. Reg. 26.2663. Note however, NRAs are eligible for the entire GST exemption of $5,340,000. IRC Section 2631(a), despite the smaller estate tax exemption amounts.

IV. RESIDENT ALIENS (RESIDENT/NON-U.S. CITIZEN).

A. Income Tax Issues.

Generally, RAs are taxed on their worldwide income exactly like U.S. Citizens.

B. Transfer Tax Issues.

1. Gift Tax:

a. Statutory Guidance. Pursuant to IRC Section 2501(a), RAs are generally subject to gift tax on transfers in a similar manner as U.S. citizens.

b. Rules.

(1) Unified Credit. RAs are entitled to the same unified credit against gift taxation as U.S. citizens.

(2) Annual Exclusion Gifts. RAs are entitled to the $14,000 exclusion for annual exclusion gifts and the unlimited exclusions for educational expenses and medical expenses. IRC Section 2503(b),(e).

(3) Gifts to Spouse. RAs are entitled to an unlimited exclusion for gifts to U.S. citizen spouses, IRC Section 2523(a), and a $145,000 annual exclusion for gifts to non-citizen spouses (adjusted annually for inflation). Treas. Reg. Section 2523(i)-1 (a) and (c)(2).

(4) Charitable Gifts. Generally, RAs may make unlimited gifts to qualified charities. IRC Section 2522(a). Note the more expanded definition of charity which applies to RAs as compared to NRAs.

(5) Basis of Acquired Property. Generally, pursuant to IRC Section 1015, the transferee will receive property at the transferor's basis.

2. Estate Tax.

a. Statutory Guidance. Pursuant to IRC Section 2001, RA's are subject to estate tax on their worldwide assets as U.S. citizens are. Generally, with the exception of the marital deduction, RAs are taxed similarly to U.S. citizens for estate tax purposes.

b. General Rules.

(1) Full Unified Credit. RAs are entitled to the exact same unified credit as U.S. citizens are.

(2) Transfers to Spouse. RAs are entitled to an unlimited exclusion for gifts to U.S. citizen spouses. An RA is subject to the QDOT requirements of 2056A if her spouse is not a U.S. citizen. See 4. below for further QDOT information.

(3) Charitable Gifts. RAs are entitled to the same charitable deduction as a U.S. citizen.

(4) Basis of Acquired Property. Generally, pursuant to IRC Section 1014, the transferee will receive a stepped up basis.

3. GSTT.

RAs are subject to the generation skipping transfer tax in the same manner as U.S. citizens.

4. Marital Deduction Issues.

a. Alien as Spouse. The marital deduction is not allowed for the surviving spouse of the decedent if the he or she is an RA or NRA. If the surviving spouse is a U.S. citizen, regardless of domicile, the marital deduction is allowed.

b. Exceptions. If the surviving spouse is an alien, the marital deduction would be allowed only if: 1) the spouse becomes a citizen before filing the federal estate tax return; or 2) the property passes to a qualified domestic trust ("QDOT") that meets the requirements described below.

c. IRC Section 2013 Credit. If the deceased spouse's estate pays estate tax on property that otherwise would have qualified for the marital deduction, and the surviving spouse dies in the U.S. and is subject to estate taxation on the same property, the estate will receive a credit for the tax paid in the first estate. There are no time limits for this deduction.

5. QDOT Requirements.

a. U.S. Trustee. The trust instrument must require that at least one trustee be a U.S. citizen.

b. Distribution Restrictions. No distributions, other than income, may be made from the trust unless a trustee who is an individual U.S. citizen or domestic corporation has the right to withhold from such distribution the tax imposed by IRC Section 2056A(b).

c. Many Treas. Reg. Requirements. In order to ensure the collection of the 2056A tax, the trust must meet numerous requirements imposed by the regulations.

d. QDOTS with more than $2,000,000. QDOTs with more than $2 million must provide for: 1) the appointment of a U.S. bank as trustee; 2) posting of a bond by the trustee in an amount equal to 65% of the value of the trust; or 3) furnishing an irrevocable letter of credit issued by a U.S. bank and in an amount equal to 65% of the value of the trust

e. Election. Pursuant to IRC Section 2056A, an election must be made by the decedent's executor.

f. QDOT tax treatments.

(1) Distributions from the QDOT to the surviving spouse are generally subject to estate tax at the decedent spouse's rate; however, the following distributions are not subject to this tax: i) income distributions to the surviving spouse; ii) distributions to the surviving spouse based upon hardship; or iii) distributions to reimburse the surviving spouse for any income tax on income generated by the QDOT and taxable to the surviving spouse.

(2) If a QDOT ceases to meet the requirements of a QDOT, estate tax is imposed on the value of the trust upon its failure date.

(3) If the alien surviving spouse becomes a U.S. citizen after the death of the decedent spouse, the QDOT rules will no longer apply to distributions to the surviving spouse.

V. SUBSTANTIVE U.S. TAX RULES APPLICABLE TO FOREIGN TRUSTS AND FOREIGN GRANTORS

A. U.S. Trust vs. Foreign Trust.

A trust is a U.S. trust if, pursuant to Treas. Reg Sec. 7701(a)(30)(E), it satisfies both the "Court Test" and the "Control Test." The trust is a foreign trust by default if it fails either.

1. Court Test. Under the "Court Test," i) U.S. court has authority to render orders or judgments concerning administration; ii) U.S. court has authority to determine substantially all issues regarding administration and; iii) the trust does not contain an automatic migration clause.

2. Control Test. If a non-U.S. person can veto a "substantial decision," the trust fails the control test. Substantial decision include (but are not limited to) the following: i) the timing or amount of distributions, selection of a beneficiary; ii) allocation of receipts between income and principal; iii) whether to terminate a trust; iv) whether to sue or defend the trust; v) whether to remove or add a trustee; vi) and investment decisions.

B. U.S. Settlors Of Foreign Trusts.

1. Grantor Trust Status Generally under IRC §679. A U.S. person who transfers property to a foreign trust that has a U.S. beneficiary remains the income tax owner of the property under IRC §679. There are at least four relevant inquiries in determining the applicability of §679: (1) whether there is a U.S. transferor; (2) whether there has been a transfer of

property within the meaning of §679; (3) whether the transferee trust is domestic or foreign; and (4) whether the trust has any U.S. beneficiaries.

a. U.S. Transferor. Pursuant to IRC §679(a)(4), a foreign person who transfers property to a foreign trust and becomes a U.S. citizen or resident within five years of such transfer will be treated as a U.S. transferor with respect to the portion of the trust that, as of the date of immigration, is attributable to such prior transfer.

b. Transfer of Property. In general, §679 does not apply to transfers by reason of the death of the transferor, nor does it apply to any sale or exchange for fair market value consideration. Pursuant to §679(a)(3), for purposes of determining whether the transferor of property to the trust received fair market value in exchange for such property, certain debt will be disregarded. Specifically, debt owed (or as may be provided in regulations, guaranteed) by the trust, by any grantor, owner, or beneficiary of the trust, or by certain persons related to a grantor, owner, or beneficiary will not be taken into account. Under this rule, even if the U.S. transferor transfers property to a foreign trust (with U.S. beneficiaries) in exchange for the trust's fair market value debt instrument, the transferor will be treated as the owner of the portion of the trust attributable to such property under §679.

c. Foreign Trust. Section 679(a)(5) provides that if a U.S. person transfers property to a domestic trust which subsequently becomes a foreign trust during the transferor's lifetime, such person will be treated under §§679 and 6048 (information reporting) as having transferred to a foreign trust an amount equal to the portion of such trust that, as of the date of such redomiciliation, is attributable to such prior transfer.

d. U.S. Beneficiary. Section 679(c)(1) provides that a trust will be treated as having a U.S. beneficiary for any given taxable year of the transferor unless (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during such taxable year to or for the benefit of a U.S. person, and (2) if the trust were terminated at any time during such taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person. Under §679(c)(3), if a foreign beneficiary of a foreign trust subsequently becomes a U.S. citizen or resident, §679 will apply to prior transfers by a U.S. person to the trust only to the extent they were made within five years of such immigration.

2. Trap For The Unwary Or Planning Tool - Foreign Trust or Grantor Trust Toggle Switch? Under IRC Sec. 679, it is possible (in fact, likely) to create a foreign trust that is a grantor trust for U.S. income tax purposes. But what happens if the trust is no longer a foreign trust? Unless the trust qualifies as a grantor trust under IRC Sec. 671 et seq., the trust becomes a U.S. NON-grantor trust.

C. U.S. Trusts With Foreign Beneficiaries.

1. Basic Rules. IRC Secs. 661 and 662 contain the basic rules governing income taxation of U.S. complex trusts and also apply to NRAs.

a. DNI. Trusts deduct amounts properly paid to the beneficiary up to distributable net income ("DNI"). Distributions are generally treated as consisting of pro-rata share of each type of income constituting DNI. Beneficiary who receives distribution reports equivalent income

on their tax return, as a result, income distributed by U.S. trust to an NRA beneficiary will be taxable only if the income received from the trust would have been taxable if earned by the NRA directly.

b. FDAP Income. FDAP income is generally taxable at 30%, however, pursuant to the U.S./Mexico Treaty, is substantially reduced (see Exhibit A for U.S./Mexico treaty rates).

c. Portfolio Interest Exception. As a result of the portfolio interest exception under IRC Section 871(h) and the exemption for bank deposits under IRC Section 878, very little U.S. source interest income is taxable when received by NRA.

d. Per IRC Section 871 most capital gains are not taxable.

e. ECI is taxable at graduated rates per IRC Section 871(b)

f. FIRPTA issues (subject to treaty modifications) apply to real estate.

2. Trustee has certain withholding obligations.

D. U.S. Beneficiaries Of Foreign Trusts – Foreign Grantor Trust

1. General Rule. The grantor trust rules only apply if they result in a U.S. person being treated as the grantor of the trust. IRC Sec. 672(f).

2. Exceptions Allowing Foreign Grantor Trust. There are two exceptions which allow foreign grantor trust treatment for foreign trusts: (i) trusts that are revocable by the foreign grantor; and (ii) trusts that during the foreign grantor's lifetime can only make distributions to the grantor or the spouse of the grantor.

3. ECI/FDAP Income. Generally, the foreign grantor is only taxed on ECI and FDAP income (subject to the treaty modifications) and tax-free accumulations are possible. However, if U.S. situs assets owned, will be includible in estate of NRA.

4. Basis "step-up" on Death. Note that trust language might need to be modified to comply with IRC Sec. 1014(b).

5. IRC §901(b)(5). In the event §672(f) denies grantor trust status to a foreign trust, but the grantor is nevertheless subject to foreign taxes on the trust's income *(i e ,* because he is treated as the owner of the trust's assets under his country's grantor trust-type rules), IRC §901(b)(5) provides that the U.S. beneficiaries who are taxed on distributions will be entitled to a foreign tax credit corresponding to the foreign taxes previously paid by the grantor.

6. Recipient of Distributions. Subject to certain reporting requirements, U.S. beneficiary of foreign grantor trust who receives distributions during the term of the trust are not subject to U.S. tax.

E. U.S. Beneficiaries Of Foreign Trusts – Foreign Non-Grantor Trust

1. Taxation Of Accumulation Distributions From Foreign Non-grantor Trusts.

a. The U.S. tax law applicable to foreign non-grantor trusts contains complicated rules for the taxation of trust distributions which represent accumulations of trust income (i e , distributions from a "complex trust"). These "throwback rules" are designed to approximate and capture the incremental amount of U.S. tax (if any) that would have been collected if amounts accumulated by the trust and later distributed to a U.S. beneficiary had instead been distributed when earned.

b. Contrary to the general rule, capital gains are included in the "distributable net income" (amounts that must be distributed currently in order to avoid accumulation distribution status in later years) of any foreign trust, even if such gains are allocated to corpus under local law or under the terms of the trust instrument. Because accumulation distributions do not retain their character in the hands of the recipient beneficiary, beneficiaries of foreign nongrantor trusts are taxed at ordinary income rates on distributions of accumulated capital gains.

c. The exemption from the throwback rules for amounts accumulated prior to the beneficiary's 21st birthday that formerly applied to domestic trusts does not apply to foreign trusts.

2. <u>Throwback Rule Minimization Techniques.</u>

a. Distribute DNI annually.

b. Consider offshore private placement insurance or offshore private placement annuity.

F. Reporting And Disclosure Requirements.

1. <u>Settlor.</u>

a. <u>Form 3520—Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts</u>. A U.S. person who creates a foreign trust or otherwise transfers money or property to a foreign trust must report such event on Form 3520. Form 3520 is due on the date the reporting party's income tax return is due, including extensions. The penalty for failure to file is equal to 35% of the amount transferred, with additional $10,000 penalties every 30 days for continuing failure after notice from the IRS.

b. <u>Form 3520-A—Annual Information Return of Foreign Trust With a U.S. Owner</u>. A U.S. person who is taxable as the owner of a foreign trust under any of the grantor trust rules (IRC §671-679) must ensure that the *trustee* files an annual return on Form 3520-A. Although the filing requirement is imposed on the trustee, the penalty for failure to file is imposed on the U.S. grantor. Such penalty is equal to 5% of the trust assets treated as owned by the U.S. grantor, with additional $10,000 penalties every 30 days for continuing failure after notice from the IRS.

c. <u>Form 709—U.S. Gift (and Generation-Skipping Transfer) Tax Return</u>. Even if a transfer to a trust is incomplete for gift tax purposes (which will be the case with regard to an asset protection trust, for example, when the grantor retains a special power of appointment), the transferor must nonetheless file a Form 709 to advise the IRS of the incomplete gift. Disclosure of all relevant facts, including a copy of the trust document, is required. This

form is a calendar year form that is due April 15 following the year of the transfer. The penalty for failure to file is based on the amount of tax required to be shown on the return, which will be zero in the case of an incomplete gift.

2. Trustee Or Executor.

a. Form 3520-A—Annual Information Return of Foreign Trust With a U.S. Owner. The trustee of a foreign grantor trust with a U.S. grantor must file Form 3520-A annually with the Philadelphia Service Center. The form generally must be filed by March 15 (unless such deadline is extended pursuant to Form 2758).

b. Foreign Grantor Trust Owner Statement. The trustee must furnish a Foreign Grantor Trust Owner Statement (page 3 of Form 3520-A) to the U.S. grantor of the trust at the same time that the trustee files Form 3520-A.

c. Appointment of U.S. Agent for Tax Reporting Purposes. The IRS has authority to unilaterally determine the income of a foreign grantor trust to be included on the U.S. grantor's tax return if the trustee of a foreign trust fails to authorize a U.S. person to act as its limited agent for purposes of applying IRC §§7602, 7603, and 7604 (relating to the examination of records and the service and enforcement of a summons for the examination of such records). The IRS has provided sample language in the instructions to Form 3520-A. In addition, the name, address, and TIN of the agent must be set forth on the trust's Form 3520-A and the grantor's Form 3520, and a copy of the authorization of agent document must be attached to the Form 3520-A that is filed with the IRS.

d. Foreign Trust Beneficiary Statement. A U.S. beneficiary of a foreign trust must provide the IRS with information regarding the proper tax treatment of any distributions from the trust occurring after August 20, 1996. In this regard, the trustee of a foreign trust must furnish, as applicable, a Foreign Grantor Trust Beneficiary Statement (page 4 of Form 3520-A) or a Foreign Nongrantor Trust Beneficiary Statement to any U.S. beneficiary who received a distribution from the trust during the year. The information to be included in a Foreign Nongrantor Trust Beneficiary Statement is set forth in the instructions to Form 3520-A. The Statements must be furnished at the same time that the trustee files Form 3520-A.

e. Form 3520—Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. In the case of a transfer to a foreign trust by reason of the death of a U.S. person occurring after August 20, 1996, the executor of the decedent's estate must report such transfer on Form 3520. In addition, the executor of the estate of a U.S. person who died after August 20, 1996, must report the death of such person if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or if any portion of a foreign trust was included in the decedent's gross estate. Although the instructions to Form 3520 do not address this point, Form 3520 probably should be filed by the due date (including extensions) of the decedent's final income tax return in this situation. Beginning with the 2000 form, Form 3520 is filed solely with the Philadelphia Service Center. The penalty for noncompliance is equal to 35% of the reportable amount, with additional $10,000 penalties every 30 days for continuing failure after notice from the IRS.

f. Form 1041—U.S. Income Tax Return for Estates and Trusts. Current regulations provide that the trustee of a foreign trust that is a grantor trust for U.S. income tax purpose must file a statement (a "grantor trust information letter") attached to Form 1041 to report the income of the trust. The form and attached letter generally must be filed with the Philadelphia Service Center by April 15 each year.

g. Form 1040NR—U.S. Nonresident Alien Income Tax Return. The trustee of a foreign trust that is *not* a grantor trust for U.S. income tax purposes but which has U.S. source income must file a Form 1040NR with the Philadelphia Service Center if the U.S. tax attributable to such income was not withheld at its source by the payor. Because Form 1040NR is designed to report income attributable to nonresident alien *individuals,* as opposed to nonresident *trusts,* the trustee must make appropriate adjustments on the form. The IRS reportedly is developing a new form (Form 104INR) to be used by foreign trusts for tax reporting purposes.

Form 1040NR generally must be filed by June 15 each year (or by April 15, if the trust has a U.S. office). The penalty for failure to file is generally 5% of the amount of tax required to be shown on the return, with an additional 5% penalty for each month or partial month during which such failure continues (usually up to a maximum penalty of 25%). The penalty for failure to pay any tax required to be shown on the return within 21 days of notice and demand therefore (10 business days in the case of an amount over $100,000) is generally equal to 0.5% of the amount of such tax, with an additional 0.5% penalty for each month or partial month during which such failure continues (up to a maximum penalty of 25%).

3. Beneficiaries.

Form 3520—Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. A U.S. beneficiary of a foreign trust must provide information to the IRS regarding distributions from a foreign trust occurring. The penalty for failure to file is equal to 35% of the amount of the distribution, with additional $10,000 penalties every 30 days for continuing failure after notice from the IRS. Failure to provide adequate information to determine the proper tax treatment of a distribution may also result in treatment of the distribution as an accumulation distribution. The beneficiary can avoid such default treatment by attaching either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement (see above), as appropriate, to Form 3520.

VI. MEXICAN TAX AND ESTATE PLANNING ISSUES.

A. Resident Individuals for Tax Purposes in Mexico.

1. Tax Residency in Mexico.

a. Dwelling Place in Mexico. Under the Mexican Federal Fiscal Code ("MFFC") an individual is considered to be a resident in Mexico for tax purposes when his or her "dwelling home" is in Mexico.

b. Tie breaking rule. When an individual has a "dwelling home" in Mexico and another abroad, such will be considered a resident in Mexico for tax purposes, provided that

his or her "center of vital interests" is in Mexico. For these purposes, under the MFFC, the center of vital interest will be deemed to be in Mexico if in a calendar year an individual has more than 50% of his total income arising from Mexican-source income or if the center of his professional activities is in Mexico.

c. Mexican Citizens. Mexican citizens are presumed to be Mexican tax residents, unless otherwise proven.

Please note that unlike the USA, once a Mexican citizen files a notice of his or her change of tax residence to another country, such will no longer be compelled to pay income tax in Mexico, unless he or she receives a Mexican source income.

d. Change of residence. When a Mexican tax resident individual changes his or her residence to a jurisdiction abroad where his or her income is subject to a preferential tax regime, this is that no tax is paid or that the income tax paid abroad is less than the 75% of the tax that would be payable in Mexico, such individual will still be considered as a resident in Mexico for the year in which the change is notified and for the 3 subsequent years. This rule will not be applicable when Mexico has an information exchange agreement signed with such jurisdiction.

2. Income on Worldwide Earnings.

Under Mexican Income Tax Law ("MITL"), individuals that are residents in Mexico for tax purposes pay income tax on all income they receive in the tax year despite its source of wealth, i.e. Mexican tax residents pay income tax on its worldwide income.

Provided certain requirements are met, taxpayers are allowed to credit in Mexico the income tax paid directly or withheld abroad in connection to the foreign source income,

B. Nonresident Individuals for Tax Purposes in Mexico.

1. Mexican Source Income.

Under the MITL, nonresident individuals without a permanent establishment ("PE") in Mexico will pay income tax in Mexico only on Mexican source income.

For these purposes, the MITL set forth different types of income and the rules to determine when such are considered as Mexican sourced, and therefore taxable in Mexico. The types of income comprised in the MITL include, among others, income derived from salaries, personal independent services, leasing immovable property, leasing of movable property, sale of fixed assets, sale of shares, dividends and other profit distributions, interests, financial leasing, royalties and technical assistance, construction and installation services, prizes, artistic and sport activities, as well as intermediation.

Derived from the above, a foreign resident, without a PE, will be taxed in Mexico when the following requirements are met: (i) the specific item of income is expressly considered as taxable, and (ii) the hypotheses for having a Mexican source of wealth are fulfilled.

Please note that the rules for determining when income has a Mexican source of wealth vary depending on the nature of the income.

The MITL provides for the tax to be paid, in most of the cases, through withholding made by the payer if such is a Mexican tax resident or non-resident with a PE. For these purposes, any other way of fulfilling obligations diverse from payment, will be treated as payment for tax purposes.

Please note that the MITL sets forth that if the payer of the item of income assumes or absorbs the taxes on account of the non-resident, such amount will be considered as a taxable income for the latter.

2. Exemption for non-residents staying less than 183 days

a. Length of stay. For purposes of determining the tax residence or the existence of a PE[1], the MITL does not make reference to the length of days spent by a non-resident in Mexico; nevertheless, said law sets forth that an individual who temporarily stays in Mexico less than 183 days (consecutive or not) in a 12 month period could be exempted only when receiving specific items of income.

b. Exemption. Regarding only Mexican source income arising from salaries or independent services, a non-resident staying less than 183 days in Mexico, might be exempted from income tax on Mexican source income if:

(1) The payments are made by a foreign tax resident with no PE in Mexico; and

(2) The service provided has no connection with any establishment of the foreign resident.

3. Taxes on the Gains and Income.

a. Real Estate transfer by Foreign Tax Resident. Regarding the sale of real estate, the MITL provides that the source of wealth of the income will be Mexican sourced when said property is located within the country. In such cases, as a general rule, a 25% withholding tax to the gross income obtained by the foreign resident, without any deductions, will be applicable. The tax will be withheld by the acquirer, provided such is a Mexican resident or a foreign resident with a PE in Mexico; otherwise, the taxpayer must pay the corresponding tax by filing a tax return before the tax authorities within 15 days following the reception of the income.

(1) 35% Withholding Rate. taxpayers can elect to be taxed at a 35% rate over the gain, provided they fulfill the following requirements: (i) have a representative in Mexico that is a resident of Mexico for tax purposes or a foreign resident with a PE in Mexico, who will maintain available to the tax authorities the supporting documentation related to the tax payments on account of the taxpayer for 5 years

[1] Only regarding the existence of a PE for construction services, there is a specific provision making reference to the 183 days in a 12 month period.

after the tax return is filed; and (ii) the transfer of land is recorded in a notarial instrument/deed..

(2) Gain Calculation. The gain is calculated as the difference between the updated acquisition cost of the real estate and the consideration received from the transferees.

b. REITs. Foreign tax residents that acquire certificates in a Mexican real estate investment trust (REIT) (also known as FIBRA) qualify for tax-free treatment on the sale of these instruments provided that the certificates are traded to third parties through the Mexican Stock Exchange or a recognized foreign market.

c. Shares of Mexican Company.

(1) Transfer of Shares. The transfer of shares or securities are subject to withholding tax in Mexico at a rate of 25% on the consideration, with no deductions, if either: (1) the person who issued the shares or securities is a Mexican tax resident; or (2) more than 50% of the accounting value of the shares or securities is directly or indirectly related to Mexican real estate.

The following transactions are also taxed as a transfer of Mexican shares: execution of a usufruct or the right to use such shares is constituted; or when any right to receive yields over such shares is transferred.

(2) Foreign Tax Residents. Foreign tax residents can choose to be subject to a withholding tax at a rate of 35% on the net capital gain obtained on the transfer of the shares, securities and interests, if they comply with all the following requirements: (1) they appoint a Mexican tax resident as their legal representative for the transaction; (2) they do not reside in a preferential tax regime for Mexican tax purposes; and (3) they file an audited tax report on the transaction's tax implications with the Mexican tax authorities, prepared by an authorized certified public accountant.

(3) Transfer of Public Shares. Foreign tax residents are subject to withholding tax on the transfer of Mexican shares placed with the general investing public on the Mexican stock exchange. The withholding tax will be 10% on the gain. For these purposes, the intermediary will determine the gain of each transaction and will withhold the tax. However, when the taxpayer is resident of a treaty country, the transfer will be tax exempted, as long as the taxpayer provides to the intermediary a statement under oath declaring its resident status and its tax identification number. If this information is not provided, the 10% WTH will be applicable.

C. Donation, Inheritance and Bequest

1. Definition.

The MITL does not contain a definition of a donation, inheritance or bequest, therefore, the definitions contained in the Mexican Federal Civil Code ("MFCC") will be applicable:

2. Definition under MFCC:

a. Donation. "Donation" is an agreement by means of which a person transfers to a third party, gratuitously, part or all of his current goods;

b. Inheritance. "Inheritance" is the transmission of all the goods and rights (not extinguished by death) of a deceased person at the moment of its death; and

c. Bequest. "Bequest" is the act of transferring specific goods, property of the deceased, to a third person by means of a will.

3. Wills.

In Mexico a will must comply with the local regulations applicable to the state in which it is granted. For the case of the Federal District, in general terms, the following rules are applicable:

a. A will is a personal act, that shall be granted freely and that may be revoked (i.e. by a new will).

b. A will shall be granted before a Notary Public (or a Mexican consul if granted abroad).

c. The Notary Public will issue the will in the terms required by the testator.

d. The testator shall sign the will before the Notary Public.

e. Under certain circumstances, witnesses may be required.

4. Donation Agreement.

Donation agreements may be verbal, written or granted before a Notary Public and in all cases shall be accepted by the donee in order to be valid. If the goods donated exceed $5,000 Mexican Pesos the donation shall be granted before a Notary Public; however, if this requirement is not complied with, unless when donating real estate, the donation will still be valid but the parties may request its compliance.

D. Death, Inheritance and Gift Tax.

1. No Specific Death, Inheritance or Gift Tax.

There is no specific death, inheritance or gift tax in Mexico ("Mexican Transfer Tax") that is analogous to the transfer tax system of the United States.

2. Donations, Inheritance and Bequest Considered as Income in Mexico.

Although there is not a Mexican Transfer Tax, donations, inheritance and bequest are considered "income" in Mexico and are subject to income tax in the hands of the recipient, absent an exemption under the MITL.

3. Resident Individuals.

a. Exemptions from Income Tax. Individuals that are residents in Mexico for tax purposes are exempted from the income earned from the following:

(1) Inheritance and bequests; to the extent such income is properly informed to the Mexican Tax Authorities;

(2) Donations from spouses or straight line ascendants; and

(3) Donations from straight line descendants, to the extent the goods received are not subsequently transferred to another straight line descendant.

b. Reporting Required. Income received by Mexican tax resident individuals from inheritance, bequests and donations (when applicable) in a given tax year, must be reported to the tax authorities in their annual tax return. Income received by resident individuals from donations shall be reported to the tax authorities when all donations (including prizes and loans) received in a tax year exceed $600,000 Mexican Pesos.

4. Nonresident Individual Receipt of Donation, Inheritance or Bequest.

Unlike individuals that are tax residents in Mexico, individuals that are tax residents abroad are subject to taxation in Mexico when they receive Mexican sourced income from a donation, inheritance or bequest of the following assets:

a. shares issued by an entity that is resident in Mexico or by an entity whose value is derived from greater than 50% of Mexican real estate; and

b. Real estate located in Mexican territory.

5. Donation Exception.

Properly structured donations of the abovementioned goods, from a spouse or straight line ascendant are exempt from this tax. Nevertheless, donations made from a descendent to a straight line ascendant are not exempted.

6. Tax Rates.

In any other case of donation or inheritance/bequest of this type of shares or real estate, the nonresident acquirer shall pay income tax in Mexico by applying a 25% tax rate over the appraisal value of the good. This tax shall be paid through a Mexican Notary Public (when the transaction is executed before one) or directly by the nonresident.

7. Other Taxes.

The acquisition of real estate (either land and/or constructions) is subject to real estate transfer tax, payable by the acquirer upon the acquisition. Since this is a local tax, the location of the property will determine the applicable rate; however, the rate varies between 2 to 6% over the higher of the following values: (i) consideration paid; (ii) cadastral value of the property; or (iii) appraisal value.

The acquisition of real estate in Mexico due to a donation or an inheritance is not taxed for value added tax purposes.

E. Mexican Marital Property Regime.

When parties marry in Mexico, they must declare that they are being married either: (a) with all goods and property in common (all goods held as "community property") or (b) under the regime of ("separación de bienes") separate property. Property held under the separate property regime is fully managed and administered by each respective spouse owner. Property held under the community property regime is administered jointly, however, spouses may also enter into a "conjugal partnership" whereby the property may be managed in a different manner, pursuant to the terms of the agreement.

VII. PLANNING TECHNIQUES AND CONSIDERATIONS.

A. Preliminary Planning Considerations.

1. Coordination of Advisors. One of the most important considerations when representing individuals with cross-border issues, whether it is a U.S. citizen or resident with children residing in Mexico or Mexican citizen or resident with children in the U.S., is proper coordination with counsel and advisors on both sides of the border. This coordination includes, but is not limited to, lawyers, financial advisors, accountants and insurance professionals. Competent and qualified counsel is paramount to good representation.

2. Non-Tax Considerations.

a. Matrimonial Property Considerations. An advisor must be very cognizant of the marital property characteristics of the assets subject to the planning. Generally, the rights of an individual's personal property is governed by the law where he or she is domiciled. For real property located in Texas or Mexico, the law of the land will apply despite the domicile of the owners. However, the community or separate property character of the property when obtained will control upon the death of the individual.

b. Immigration Considerations and Issues. It is also important for the advisors to understand the current immigration status of the client. Is it a U.S. client who is considering expatriation to Mexico? How about a Mexican national considering immigrating to the U.S.? These planning issues will be critical to the planning techniques proposed.

B. Individual Planning - Who are we planning for?

1. Domicile of Donor/Testator. Prior to beginning the planning process it is important to explore the domicile and/or tax residency of the donor. See II(A) and (B) above.

2. Domicile of Donee/Beneficiary. It is equally important to determine what the domicile or tax residence of the recipient of the donation or bequest is. See II(A) and (B) above.

C. Asset Planning - What are we planning for?

1. Situs of Assets – Mexico or U.S.?. A full understanding of the nature of the assets to be transferred and where they are sitused, in Mexico or the U.S. is very important from a planning perspective. See II(B)(1)b.

2. Tangible or Intangible Assets? A proper understanding of the nature of the assets as being tangible or intangible is important for the process. See II(B)(7).

D. Planning Techniques.

1. Mexican Citizen (Non-US Resident) with U.S. Beneficiaries.

a. U.S. Tax Issues/Planning.

(1) Gifts/Bequests of Intangible Property. Gifts of intangible property (as discussed under Section III(B)(1)(b)(8) above) are remarkable powerful transfer tools as they are not subject to U.S. gift or estate tax. However, care must be taken when considering the gift or estate tax consequence of the gift – note that U.S. corporate stock is included in the estate of the Mexican NRA, but may be gifted on a gift tax free basis.

(2) Gifts/Bequests of Intangible Property to Dynastic Trusts. As the GST tax does not apply to gifts of intangibles because it is not considered a "gift" for U.S. transfer tax purposes, the use of dynastic trusts in proper jurisdictions such as Delaware or Alaska should strongly be considered.

(3) Gifts/Bequest of Tangible Personal Property. Gifts of tangible personal property in the U.S. are subject to U.S. gift tax. Thus, gifts of tangible personal property, such as jewelry or art should not be made in the U.S.

(4) Gifts/Bequests of U.S. Real Property. U.S. real property is includible in the estate of the Mexican NRA and would also be subject to gift tax if given to the U.S. beneficiary.

b. Mexican Tax Issues/Planning.

(1) Donation, Inheritance or Bequests of Shares in Mexican Entity or of Mexican Real Property. Careful consideration must be used when planning for transfers of Mexican entity interests and Mexican real estate passing to a non-Mexican tax resident as a flat 25% income tax (based on the value of the transferred asset) is imposed on non-exempt transfers.

(2) Donations Exemption for Shares in Mexican Entity or Mexican Real Estate. Mexican NRAs should strongly consider gifting (donating) these interests to their non-Mexican tax resident descendants, as such a transfer is an exempt transfer and if structured correctly, should pass free of Mexican income tax to the donee.

c. Miscellaneous Planning Issues.

(1) Ancillary Planning Documents. If the Mexican NRA spends significant time in the U.S., they should execute appropriate ancillary planning documents such as a power of attorney for financial matters and a medical power of attorney.

(2) Revocable Trust Planning. Although a probated Mexican will is generally admissible in Texas, the favored planning tool is a revocable management trust.

- Fund Trust. The trust will take the place of a will, and if funded properly, will pass assets privately to the grantor's intended beneficiaries;
- Privacy. With many clients (both Mexican and U.S.) the privacy features of the revocable management trust are very important;
- Patriot Act/Know Your Client Issues. A revocable management trust is a better vehicle for transferring securities upon the death of Mexican NRA rather than individual account with "pay on death" clause, because of Patriot Act issues.
- Note regarding Wills/Intestacy. Although the Texas Estates Code will recognize a properly probated will in Mexico, a will that has not been probated must comply with the Texas Estates Code, which might be difficult. If the will does not comply, the property will pass subject to the laws of intestacy. Texas law would apply to real property located in Texas, however, generally the law of Mexico would apply to the succession of personal property.

(3) Real Property Issues. Ownership of U.S. real property by a Mexican NRA individual can pose multiple adverse issues that the individual (and often times their counsel) is rarely aware of.

- Outright Ownership. Outright ownership of real property is included in taxable estate of Mexican NRA. Considering the $60,000 estate tax exemption for Mexican NRAs, this can pose a significant estate tax issue;
- Foreign Corporation Ownership. Many consider ownership of real property through a foreign corporation, however this type of ownership can have adverse income tax consequences and should be closely reviewed;
- FIRPTA issues. Upon sale of real property, generally FIRPTA requires a 10% retention of amount realized;
- Revocable Trust Ownership. Revocable trust passes property outside of probate however property will be included in taxable estate of Mexican NRA;
- Irrevocable Trust Ownership. Irrevocable trust ownership is an option, however, Mexican NRA should pay reasonable rent to trust for usage;
- Consider Ownership Effect on Tax Residency. Real property ownership can cause tax residency issues if not managed appropriately;
- Marital property consideration must be carefully considered. For example, Mexican NRA purchases U.S. real estate with her separate property and later decides to put her husband on the deed. U.S. gift tax consequences could arise as this would be a gift of real property.

(4) Foreign Trust Consideration. Consider creation of foreign grantor trust for certain non-U.S. assets.

(5) Pre-Immigration Planning

- Step-Up Basis of Assets. Because upon immigration to the United States, a step-up adjustment in basis to fair market value is generally not allowed, it may behoove the Mexican NRA to attempt to adjust her basis in assets prior to immigration. A taxable reorganization or sale to a family member may accomplish this goal.
- Accelerate Income. Careful consideration should be made to determine if it would be beneficiary for the Mexican NRA to accelerate income on a pre-immigration basis. The exercise of stock options and acceleration of receipt of deferred compensation programs are prime examples of income acceleration vehicles that may be utilized to maximize the pre-immigration tax matters.
- Postponement of Deductions and Losses. As discussed above, Mexican NRA's have restricted deductions under the Code. In the event a Mexican NRA is anticipating an immigration position, postponement of such deduction and losses until the NRA had become an RA and therefore can offset the deductions and losses might be beneficial.
- Evaluation of Corporate Holdings and Avoidance of Anti-Deferral Tax Regimes. The corporate anti-deferral regimes of the IRC, can have severe tax consequences on shareholders. Once the Mexican NRA becomes a RA or U.S. citizen he or she may immediately become subject to one of the corporate anti-deferral regimes. With proper pre-immigration planning, the ownership interest which would cause one to be affected by the regime can be avoided prior to immigration with transfers of corporate shares to other NRAs. Because of the catch-all "constructive ownership" rules of the anti-deferral regimes, such transfers should be carefully scrutinized prior to the transfers.
- Planning for U.S. Beneficiaries. A gift by a NRA of intangible property not sitused in the U.S. to his or her heirs located in the U.S. is an extraordinarily powerful estate planning tool. First, because the gift is of intangibles not sitused in the U.S., the gift should not attract U.S. gift taxation. Second, because the generation skipping tax does not apply to transfers that are not considered gifts for U.S. tax purposes, i e , gifts of foreign intangibles, transfers to dynastic trusts established in jurisdictions which have abolished the rule against perpetuities, either foreign or domestic, will not only escape gift taxation on the transfer, but should not be included in the taxable estate of the U.S. beneficiary. Lastly, as the gift is from a third person, the trust could be established as a "spend thrift" trust and avoid the reach of most creditors.

2. Planning for U.S. Resident - Mexican Citizen (Mexican RA) and U.S. citizen with Mexican Tax Resident Beneficiaries.

a. U.S. Tax Issues/Planning.

(1) Subject to U.S. Gift/Estate Tax. The worldwide assets of the Mexican RA/U.S. citizen are subject to U.S. gift and estate tax. Therefore, traditional planning techniques to reduce and minimize transfer tax exposure should be explored and considered.

(2) Make use of Exemption Planning. The rather generous estate and gift tax exemption of $5,340,000 per person (in 2015, indexed to inflation) should be maximized.

(3) Marital Planning – Spouse is U.S. Citizen. If the spouse of the Mexican RA is a U.S. citizen, the U.S. marital deduction applies and traditional marital trust/QTIP planning may be used.

(4) Marital Planning – Spouse is NOT a U.S. Citizen. If the spouse of the Mexican RA is not a U.S. citizen, the U.S. marital deduction does not apply and a QDOT panning should be considered. See Section IV(B)(5).

(5) Consider Annual Exclusion gift to non-citizen Spouse. The Mexican RA should consider making gifts of the special "spousal" annual exclusion amount of $145,000 to his or her non-citizen spouse.

b. Mexican Tax Issues/Planning.

(1) Donation, Inheritance or Bequests of Shares in Mexican Entity or of Mexican Real Property. Careful consideration must be used when planning for transfers of Mexican entity interests and Mexican real estate passing to a non-Mexican tax resident as a flat 25% income tax (based on the value of the transferred asset) is imposed on non-exempt transfers.

(2) Donations Exemption for Shares in Mexican Entity or Mexican Real Estate. Mexican RAs should strongly consider gifting (donating) these interests to their non-Mexican tax resident descendants, as such a transfer is an exempt transfer and if structured correctly, should pass free of Mexican income tax to the donee.

(3) Bequests to Mexican Tax Residents. Although inherited assets are generally exempted from income in Mexico under the MITL, careful consideration with Mexican counsel should be applied in structuring the vehicle, i.e. trust, to receive the inheritance.

(4) Donation/Gift to Mexican Tax Resident. Careful consideration should be made to the regarding the recipient of gifts from a U.S. citizen or Mexican RA. Donations from a straight line ascendant or descendant are exempt from Mexican income tax.

c. Miscellaneous Planning Issues.

(1) Careful Consideration Relating to Wills. It is generally recommended that Mexican RAs and U.S. individuals with property in Mexico have a separate Mexican will to dispose of the Mexican property. This will should be carefully drafted to identify the property being transferred subject to the will.

(2) Marital/Gift Tax Exclusion. The marital deduction exclusion of $145,000 is a powerful technique in transferring assets to the Mexican RA spouse. The technique can be effectively used to equalize estates and distributions from a QDOT are taxed at the deceased spouse's rates.

(3) Pay Estate Tax. In certain situations, the payment of estate tax would appear to be the best option upon the death of the decedent. Although a QDOT allows for distributions of income, in the event the taxable estate is not one which would produce income or the surviving spouse is very young and not likely to stay in the U.S., payment of tax might be the best alternative.

EXHIBIT "A"

Country of Residence of Payee					Dividends				Copyright Royalties					
Name	Code	Interest Paid by U.S. Obligors General	Interest on Real Property Mortgages	Interest Paid to a Controlling Foreign Corporation	Paid by U.S. Corporations – General [a]	Qualifying for Direct Dividend Rate [a]	Capital Gains[v]	Industrial Royalties	Motion Pictures and Television	Other	Real Property Income and Natural Resources Royalties[v]	Pensions and Annuities	Social Security Payment[u]
Mexico	MX	[g,qq] 15	[g,ff,qq] 15	[g,qq] 15	[g,x] 10	[b,g,x] 5	[g,l] 0	[g] 10	[g] 10	[g] 10	30	[d,t] 0	30

[2]

a. No U.S. tax is imposed on a dividend paid by a U.S. corporation that received at least 80% of its gross income from an active foreign business for the 3-year period before the dividend is declared.

b. The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation that has the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g., a certain percentage of its total income must consist of income other than dividends and interest). For Italy, the reduced rate is 10% if the foreign corporation owns 10% to 50% of the voting stock (for a 12-month period) of the company paying the dividends.

d. Exemption does not apply to U.S. Government (federal, state, or local) pension and annuities; a 30% rate applies to these pensions and annuities. For this purpose, railroad retirement tier 2, dual, and supplemental benefits are not considered U.S. Government pensions or annuities. U.S. Government pensions paid to an individual who is both a resident and national of Mexico, are exempt from U.S. tax.

g. The exemption or reduction in rate does not apply if the recipient has a permanent establishment in the United States and the property giving rise to the income is effectively connected with this permanent establishment.

l. Exemption does not apply to gains from the sale of real property.

t. The exemption does not apply if (1) the recipient was a U.S. resident during the 5-year period before the date of payment, (2) the amount was paid for employment performed in the United States, and (3) the amount is not a periodic payment, or is a lump-sum payment in lieu of a right to receive an annuity.

u. Applies to 85% of the social security payments received from the U.S. Government. The effective rate on the total social security payments received is 85% of the rate shown in the table. These rates also apply to the social security equivalent portion of tier 1 railroad retirement benefits (income code 22) received from the U.S. The remainder of tier 1, all of tier 2, dual, and supplemental railroad retirement benefits (income code 23) are taxed as shown in column 14, "Pensions and Annuities."

v. Gains on the disposition of U.S. real property interests are considered effectively connected with a U.S. trade or business and thus are subject to graduated rates of tax rather than the flat percentage shown in this column.

x. The rate in column 6 applies to dividends paid by a regulated investment company (RIC) or a real estate investment trust (REIT). However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is an individual holding less than a 10% interest in the REIT.

ff. Exemption or reduced rate does not apply to an excess inclusion for a residual interest in a real estate mortgage investment conduit (REMIC).

qq. The rate is 4.9% for interest derived from (1) loans granted by banks and insurance companies and (2) bonds or securities that are regularly and substantially traded on a recognized securities market. The rate is 10% for interest not described in the preceding sentence and paid (i) by banks or (ii) by the buyer of machinery and equipment to the seller due to a sale on credit.

---

[2] William H. Newton, III, *International Income Tax and Estate Planning*, App. 2-10, 2-12, 2-13 (2d. ed. 2004).