U.S. TRANSFER TAXATION OF NONRESIDENT ALIENS: TOO MUCH OR TOO LITTLE?

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1. INTRODUCTION

In the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), Congress made major changes in the rules for imposing estate and gift taxes on transfers of U.S.-situs property by nonresident aliens. Congress eliminated the separate, lower estate tax rate schedule that had applied for nonresident alien decedents (ranging from 6% to 30%). Instead, estates of nonresident aliens were made subject to the same rate schedule that applies to U.S. citizens, ranging from 26% on transfers between $60,000 and $80,000 to a maximum of 55%. In addition, Congress for the first time granted a marital deduction to estates of nonresident aliens, subject to the same restrictions applied to estates of U.S. citizens. Congress continued the unified credit for nonresident estates at a level sufficient to exempt only the first $60,000 of the taxable estate.

The report of the Ways and Means Committee justified the dramatic increase in the rate schedule\(^1\) for nonresident alien

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\(^1\) One commentator described these 1988 changes as "[a] radical increase in U.S. federal estate tax rates . . . which doubled and, in some cases, tripled these taxes." Nathan Boidman, Taxation at Death: Current Issues and Developments (pt. I), 2 TAX NOTES INT'L 578, 578 (1990) [hereinafter Boidman I]. See, e.g., U.S. Trade Relationships with the Soviet Union and
decendents as achieving greater equity in the treatment of U.S. and foreign decedents. Some commentators have characterized the changes as "discriminatory." Somewhat paradoxically, others have suggested that the estate tax on foreigners should be repealed because it is so infrequently applied. This Article will evaluate the 1988 changes in the context of the entire structure of estate and gift taxation for nonresident aliens, including the operation of the rules in practice. By contrast, it does not appear that Congress undertook a comprehensive review of the estate and gift

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Hudson described the treatment of foreign investors as "discriminatory [but] cloaked in the language of parity." 1990 Hearings, supra note 1, at 57 (Hudson testimony). Hudson argued that "there has not been even a theoretical justification given for the estate tax differential created by the 1976 and 1988 legislative changes." Id. at 65. See also Bell & Shoemaker, TAMRA, supra note 1, at 87-89 (criticizing the 1988 rate increase). Bell & Shoemaker suggest that Congress "fail[ed] to consider the interests of the [nonresident alien] simply because he has no vote." Id. at 87. See also Steven A. Mushkin, Foreign Investment in U.S. Real Estate--The Impact of the Revenue Reconciliation Act of 1989 and Foreign Tax Equity Act of 1990, 19 TAX MGMT. INT'L J. 279, 293-94 (1990) (arguing that current estate tax rules for foreigners, combined with a capital gains tax on 10%-or-more foreign shareholders, would achieve "[t]heoretical [p]arity" but "[p]ractical [p]rejudice").


Bell & Shoemaker state that the rate increase was approved by the Ways and Means Committee without hearings, and that it was added to the Senate bill as a floor amendment. Bell & Shoemaker, TAMRA, supra note 1, at 87 n.85, 88. The 1988 changes in the marital deduction for transfers to noncitizen spouses are said to have been "offered to offset" the revenue loss of an unrelated provision, allowing "drought-stricken farmers" a one-
taxation of nonresident aliens in making the 1988 changes.  

This Article concludes that arguments for repeal of the estate tax on nonresident alien estates should be rejected. It further suggests that the unified credit and marital deduction rules for such estates should be liberalized. In addition, the United States should clearly assert jurisdiction to tax U.S. assets held through a partnership, although it cannot reach assets held through a foreign corporation. Finally, arguments to reinstate the pre-1988 rates and to limit the estate tax for nonresidents to the amount of appreciation in property should be rejected unless Congress wishes to put the goal of encouraging investment in the United States ahead of the goal of equity.

2. REVIEW OF PRESENT LAW AND ITS DEVELOPMENT

The federal estate and gift tax provisions of the Internal Revenue Code (the "I.R.C.") contain some special rules applicable to transfers by nonresidents who are not citizens (hereinafter "nonresident aliens"). (The estate of a nonresident alien decedent is sometimes hereinafter referred to as a "nonresident estate.")

See William W. Bell & David B. Shoemaker, Foreign Direct Investment in U.S. Real Estate: The Screws Tighten, 8 J. PARTNERSHIP TAX'N 258, 267 (1991) [hereinafter Bell & Shoemaker, Foreign Investment]. They argue that unfavorable treatment of nontreaty foreign investors in the United States has arisen "through inadvertence, and in particular from a failure to understand the relationship between the NRA's income and estate tax situations." Id.; see also Bell & Shoemaker, TAMRA, supra note 1, at 82, 88-89 (noting that rates should not have been increased without establishing enforcement mechanisms for partnership interests).

2.1. Tax Base

In the case of nonresident alien transferors, the U.S. federal estate and gift tax applies only with respect to property situated within the United States\(^8\) at the time of the transfer,\(^9\) and the gift tax is inapplicable to transfers of intangible property.\(^10\) Stock is considered situated in the United States if and only if it is stock in a domestic corporation.\(^11\) There is considerable uncertainty\(^12\) regarding

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\(^8\) See Treas. Reg. § 20.2104-1(a)(1) to (2) (as amended in 1974); BITTKER & LOKKEN, supra note 7, ¶ 134.2.3, at 134-7 to 134-15.


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the situs rule for partnership interests.\textsuperscript{13}

The United States has estate tax treaties in effect with sixteen countries and a combined or separate gift tax treaty with eight of these countries.\textsuperscript{14} These treaties limit source-based taxation and require the country of residence to prevent double taxation of property permitted to be taxed by the source country by granting a credit or an exemption.\textsuperscript{15}

2.2. The Marital Deduction And Other Deductions

The estate of a nonresident alien is allowed the deductions accorded by I.R.C. sections 2053 and 2054 for expenses, indebtedness, taxes, and losses. However, the estate is allowed only that proportion of the deductions which the value of the gross estate situated in the United States bears to the value of the entire gross estate, which must be disclosed on the return.\textsuperscript{16} Under the 1988 Act (as modified in 1989 and 1990),\textsuperscript{17} nonresident aliens for the first time became entitled

\textsuperscript{13} The authorities that may be relevant to this issue include: Treasury Department's Technical Explanation of U.S. Model Estate and Gift Tax Treaty of Nov. 20, 1980, reprinted in 1 Tax Treaties (CCH) \textsection 210 at pp. 10,565 to 10,566; Blodgett v. Silberman, 277 U.S. 1 (1928); Sanchez v. Bowers, 70 F.2d 715 (2d Cir. 1934); Treas. Reg. \textsection 20.2104-1(a)(4) (as amended in 1974); Rev. Rul. 55-701, 1955-2 C.B. 836 (applying the U.S.-U.K. estate tax treaty). For discussion, see, e.g., Hudson, Post-1989, supra note 10, at 219-26; Llewellyn & Umbrecht I, supra note 10, at 254-55; Smiley, supra note 10, at 143-44.


\textsuperscript{16} See I.R.C. \textsection 2106(a)(1),(b); see also Goldberg, supra note 7, at 43-46; Llewellyn & Umbrecht I, supra note 10, at 255.

\textsuperscript{17} See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-
to claim the estate and gift tax marital deduction, subject to special new restrictions in the case of a transfer to an alien spouse. The same restrictions also became applicable to such transfers made by U.S. citizens.

2.3. The Rate Schedule And The Unified Credit

The estate tax rate schedule for nonresident estates has undergone changes over the past three decades. Before the 1966 Act, the estate and gift tax rate schedules for nonresident aliens were the same as for citizens. A separate, lower estate tax rate schedule was established for nonresident estates in 1966. The schedule was modified in 1976, and


20 See Pub. L. No. 99-809, § 108(a), 80 Stat. 1571 (indicating the range of rates from 5% to 25%).

21 See I.R.C. § 2101(d), prior to its repeal by Pub. L. No. 100-647, § 5032(c), 102 Stat. 3669, 3669. The rates ranged from 6% for amounts not over $100,000 to 30% for amounts over $2 million, a small increase from prior law. STAFF OF JOINT COMMITTEE ON TAXATION, 94th Cong., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, H.R. DOC. No. 10612, 529-

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was finally eliminated in 1988.\textsuperscript{22} Thus, currently the estate and gift tax rate schedule is the same for nonresident aliens and citizens. The schedule ranges from 18\% on the first $10,000 of taxable transfers to 55\% on transfers over $3 million.\textsuperscript{23} In addition, there is a 5\% surcharge on very large estates, which is designed to recapture the benefits of the lower brackets and the unified credit.\textsuperscript{24}

By contrast, nonresident aliens have never enjoyed the same specific exemption or unified credit accorded to citizens.\textsuperscript{25} Currently, the unified credit for citizens is

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30 (Comm. Print 1976) [hereinafter 1976 JCT REPORT].
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\textsuperscript{22} \textit{See} Pub. L. No. 100-647, § 5032(c), 102 Stat. 3669, \textit{repealing} I.R.C. § 2101(d).

\textsuperscript{23} \textit{See} I.R.C. § 2001(c)(1). The 55\% and 53\% rates had been scheduled to expire, but were reinstated by the Revenue Reconciliation Act of 1993. \textit{See} Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13208(a), (b)(1), 107 Stat. 312.

\textsuperscript{24} The surcharge applies, in the case of estates of citizens, to the portion of the taxable estate in the range of $10,000,000 to $21,040,000. \textit{See} I.R.C. § 2001(c)(2), as amended by Pub. L. No. 103-66, § 13208(b)(2), 107 Stat. 312. This range generally does not extend as high for nonresident estates. \textit{See infra} note 319.

\textsuperscript{25} Prior to the 1966 Act, nonresident aliens were allowed a specific exemption of $2,000 for estate tax purposes (compared to $60,000 for U.S. citizens). \textit{See} \textit{Removal of Tax Barriers to Foreign Investment in the United States: Hearings on H.R. 5916 Before the House Comm. on Ways and Means}, 89th Cong., 1st Sess. 14 (1965) [hereinafter 1965 Hearings]; H.R. REP. NO. 1450, 89th Cong., 2d Sess. \textit{reprinted} in 1966-2 C.B. 965, 1001 [hereinafter 1966 HOUSE REPORT]; \textit{see also} Stanford G. Ross, \textit{United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments}, 22 \textit{TAX L. REV.} 277, 356 (1967). Nonresident aliens were allowed no gift tax specific exemption (compared to $30,000 for citizens). \textit{See} 1976 JCT REPORT, supra note 21, at 532. In the 1966 Act, the estate tax specific exemption for nonresident estates was increased to $30,000. I.R.C. § 2106(a)(3) (prior to repeal by Pub. L. No. 94-455, § 2001(c)(1)(F), 90 Stat. 1846, 1852); \textit{see also} Ross, supra, at 357. In 1976, nonresident aliens were granted a unified credit, for estate tax purposes only, of $3,600 (equivalent to an exemption of $60,000). \textit{See} I.R.C. § 2102(c) (prior to amendment by Pub. L. No. 100-647, § 5032(b)(1), 102 Stat. 3669, 3669); I.R.C. § 2505(a); 1976 JCT REPORT, supra note 21, at 532; H.R. REP. NO. 1380, 94th Cong., 2d Sess. 17 (1976) [hereinafter 1976 HOUSE REPORT]. This compared to a credit for U.S. citizens that was equivalent to an exemption of $175,000. Pub. L. No. 94-455, § 2001(a)(2),(d)(1), 90 Stat. 1846, 1848, 1854. \textit{See generally 1990 Hearings}, supra note 1, at 61 (Hudson testimony). Hudson argues that because the "broad liberalizations introduced by the 1976 legislation were restricted to U.S. persons," the "U.S. estate and gift tax laws" became "discriminatory against foreigners." \textit{Id.}
$192,800,\textsuperscript{26} while that for nonresident aliens is $13,000, except as otherwise provided by treaty.\textsuperscript{27}

3. THE PRACTICAL IMPACT OF THE PRESENT LAW

3.1. Introduction

A variety of legal means permit foreigners to make U.S. investments without being subject to U.S. estate and gift taxation. In addition, it seems likely that in many cases, U.S. gift or estate tax liability of foreigners is not enforced. In fact, it has frequently been suggested that the U.S. estate and gift tax regime is so easily avoided by foreigners that it merely represents a "trap for the unwary."\textsuperscript{28} This suggestion is consistent with IRS statistics which show that only 161 nonresident estates filed U.S. estate tax returns for 1986, and only $62 million of U.S. assets (includible in the gross estate) were reported on these returns.\textsuperscript{29}


\textsuperscript{27} See I.R.C. § 2102(c)(1),(3)(A). This is equivalent to an exemption of $60,000 as under prior law. The credit is available only for estate tax purposes. See 1988 CONFERENCE REPORT, supra note 18, at 116; see also I.R.C. § 2505(a).

\textsuperscript{28} For example, the Staff of the Joint Committee on Taxation stated recently:

Some may argue that regardless of the theoretical basis for applying the estate and gift tax to nonresident aliens, in practice the tax is very difficult to enforce .... Indeed, in view of the possibilities for exempting what is effectively U.S. property from the tax, some may argue that it is little more than a trap for the unwary.

1990 JCT REPORT, supra note 4, at 84. The staff notes the exemptions for bank deposits and portfolio debt and the fact that "other U.S. property may sometimes be rendered exempt by being held through a foreign corporation." Id. For similar comments, see FLORIDA BAR, supra note 12, at 910 (estate and gift taxes for nonresidents "can become a classic trap for unwary"); 1990 HEARINGS, supra note 1, at 63 (Hudson testimony, referring to TAMRA rates as "trap for the unwary"). See also TASK FORCE ON TRANSFER TAX RESTRUCTURING, ABA SECTION OF TAXATION, Report on Transfer Tax Restructuring, reprinted in 41 TAX LAW. 395, 419 (1988) [hereinafter ABA TASK FORCE] (expressing "concer[n] about the ineffectiveness of the transfer taxes [for nonresident aliens], the ease of avoidance through incorporation, and the lack of consistency between the gift and estate tax situs rules").

\textsuperscript{29} Dewitt Long, Nonresident Alien Estates, 1986, SOI BULLETIN, Spring 1992, at 51, 54, 58 (1992). Long reports the following distribution of returns 

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3.2. Legal Means Of Avoidance

U.S. citizens have a number of legal means at their disposal to make "substantial transfers of wealth" without incurring U.S. estate or gift tax liability. These include: the use of each spouse's unified credit and the $10,000 annual per donee gift tax exclusion; the use of lifetime gifts to effectively exempt the amount of gift tax from transfer taxation; "lavish" payments of "support"; transfers of "economic advice . . . and managerial ability"; removal of subsequent appreciation from transfer taxation by the use of trusts; and keeping the incidents of ownership of a life insurance policy out of the hands of the decedent or his estate. Some commentators have emphasized the importance of favorable valuation techniques as a means of avoidance.

In the case of a nonresident alien, many of the same means of legal avoidance are available. The most notable differences are that, absent a treaty, the unified credit is limited to $13,000, it cannot be used to offset the gift tax, and gift-splitting is not allowed.

At the same time, a number of additional legal means exist by which foreigners can avoid U.S. estate and gift tax liability with respect to U.S. investments. These tax avoidance opportunities have been widely discussed, and are apparently

based upon the domicile of the decedent: Canada 51, United Kingdom 12, West Germany 11, Venezuela 8, Mexico 7, Puerto Rico 7, Switzerland 6, Australia, Belgium, Ecuador, and Hong Kong 4 each, France and Italy 3 each, and all other countries 37. See supra note 18. For 1982, 169 returns were filed, reporting U.S. assets of $47 million. Daniel F. Skelly & James R. Hobbs, Statistics of Income Studies of International Income and Taxes, SOI BULLETIN, Fall 1986, at 1, 15 (1986).


31 Id. at 1415-17.

32 See Henry J. Aaron & Alicia H. Munnell, Reassessing the Role for Wealth Transfer Taxes, 45 NAT'L TAX J. 119, 135-37 (1992); see also Joseph M. Dodge, Redoing the Estate and Gift Taxes Along Easy-to-Value Lines, 43 TAX L. REV. 241, 244, 254-60, 294-98 (1988) (discussing "minority interest discounts", "buy-sell agreement[s]" and private annuities). According to Aaron & Munnell, "$123 billion of wealth [was] slated to be transferred across generations in 1986", but only $36 billion was reported "on estate tax returns." Aaron & Munnell, supra, at 134.

33 I.R.C. § 2513(a)(1); see Troxell, supra note 14, at A-19; Plaine & Spector, supra note 18, at 400; Butros Bissell, supra note 18, at 84.
widely used. However, such tax avoidance opportunities are perhaps less widely used where the U.S. estate tax liability is fully creditable against estate taxation in the decedent’s country of residence.  

3.2.1. Avoidance Techniques

First, the I.R.C. provides an exemption from U.S. estate taxation for U.S. bank deposits, certain portfolio debt obligations, and the proceeds of insurance on the life of a nonresident alien. Second, a nonresident alien can reduce the includible value of U.S. real estate, or other U.S.-situs property, for estate tax purposes by borrowing against the property on a nonrecourse basis and keeping the proceeds outside the United States, or by borrowing on a recourse basis within a partnership. Third, the more recent U.S. estate tax treaties exempt from tax any intangible, such as stock in a U.S. corporation or a U.S. patent. This exemption permits an investor to avoid the U.S. estate tax with respect to U.S. real estate or other U.S. business assets by placing such assets in a U.S. holding company.

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34 See Musher, supra note 3, at 291 & n.48.
35 I.R.C. § 2105(b).
36 I.R.C. § 2105(a) (amount receivable treated as property without the United States).
37 Nonrecourse debt is treated as reducing the value of the property by which it is secured. See Treas. Reg. § 20.2053-7 (as amended in 1963); Goldberg, supra note 7, at 45 & nn.86 & 87; Oliver II, supra note 14, at 309; Nathan Boidman, Cross-Border Death Taxes: Current Issues and Developments (pt. II), 2 Tax Notes Int’l 702, 703-04 (1990) [hereinafter Boidman II]. Borrowing within a partnership reduces the value of the partnership interest and may thus avoid the need for apportioning the debt to the worldwide estate. See Bell & Shoemaker, Foreign Investment, supra note 6, at 264-65.
38 See Troxell, supra note 14, at A-28 to A-29 (the seven most recent treaties limit source-based taxation to real property, business assets connected with a permanent establishment and, in one case, certain other tangible personal property).
Fourth, there is a statutory exemption from U.S. gift taxation for any intangible. At a cost of a carryover basis, a foreign investor may avoid U.S. transfer taxation by transferring intangibles (including stock in a U.S. holding company and perhaps including any partnership interest) before death, even if death is imminent.\footnote{See, e.g., Hudson, Post-1989, supra note 10, at 222; Boidman II, supra note 37, at 704; Llewellyn & Umbrecht I, supra note 10, at 255; Oliver II, supra note 14, at 301, 308. For gifts made within three-year period ending at death, see I.R.C. § 2035(a),(b),(d), discussed in BORIS I. BITTKER & ELIAS CLARK, FEDERAL ESTATE & GIFT TAXATION 195-202 (6th ed. 1990) [hereinafter BITTKER & CLARK]. The inclusion rule of I.R.C. § 2035(c) does not apply because no gift tax is owing on a nonresident alien’s transfer of an intangible.}

Fifth, and perhaps most important, a nonresident alien may avoid U.S. estate taxation by placing any asset in a foreign holding company.\footnote{See e.g., Llewellyn & Umbrecht I, supra note 10, at 234-35; Llewellyn & Umbrecht II, supra note 39, at 313-14; Musher, supra note 3, at 279, 287-88, 290-94; Oliver II, supra note 14, at 309 (warning of potential problem under section 2038); Austrian & Schneider, supra note 7, at 430-31; Krauthamer, supra note 12, at 269-71; Robert F. Hudson, Jr., Post-1988 Tax Planning for Foreign Direct Investment in the United States, 18 TAX MGMT. INT'L J. 3, 4-5 (1989) [hereinafter Hudson, Post-1988]; Bell & Shoemaker, TAMRA, supra note 1, at 79 (recommending use of corporate structure for U.S real estate); see also FLORIDA BAR, supra note 12, at 911 (“well-advised alien” owning U.S. condo would place in foreign holding company); Mene, supra note 7, at 627-28; Harvey P. Dale, Effectively Connected Income, 42 Tax L. Rev. 689, 714 (1987) (“well-advised foreign investors will hold U.S. real estate in foreign corporate solution” to achieve advantage under FIRPTA and to “eliminat[e] U.S. estate taxes”); Galvin, supra note 30, at 1417; David R. Tillinghast, Structuring Foreign Investments in U.S. Real Estate After the Tax Amendments of 1986, 1987, and 1988, in 19TH ANNUAL INSTITUTE ON INTERNATIONAL TAXATION 93, 100 (PLI 1989).} Tax advisors continue to suggest the use of a foreign holding company, often to serve as the parent company to a U.S. subsidiary, especially given the 1988 estate tax rate increases.\footnote{See e.g., Hudson, Post-1989, supra note 10, at 222; Boidman II, supra note 37, at 704; Llewellyn & Umbrecht I, supra note 10, at 255; Oliver II, supra note 14, at 301, 308. For gifts made within three-year period ending at death, see I.R.C. § 2035(a),(b),(d), discussed in BORIS I. BITTKER & ELIAS CLARK, FEDERAL ESTATE & GIFT TAXATION 195-202 (6th ed. 1990) [hereinafter BITTKER & CLARK]. The inclusion rule of I.R.C. § 2035(c) does not apply because no gift tax is owing on a nonresident alien’s transfer of an intangible.} The possibility that the IRS could
successfully ignore the ownership of U.S. assets by the foreign holding company, under judicially developed principles\textsuperscript{43} or sections 2036 or 2038 of the Code,\textsuperscript{44} appears quite small.

3.2.2. The Burden Of Using The Corporate Form

Use of the foreign holding company device entails "increased initial and ongoing costs" and "more costly and burdensome filing and compliance procedures,"\textsuperscript{45} particularly if the holding company has a U.S. subsidiary.\textsuperscript{46} In addition, the use of a foreign holding company may create more burdensome income tax consequences in the investor's home country,\textsuperscript{47} including the possibility that the U.S. corporate

\textsuperscript{43} See Monte A. Jackel, Taxing U.S Assets Held by a Foreign Holding Company—The Return of Swan and Fillman, 19 TAX MGMT. INT'L J. 263, 263-64 (1990) (suggesting that the IRS has recently attacked such structures using the cases of Estate of Swan v. Comm'r, 247 F.2d 144 (2d Cir. 1957), and Fillman v. U.S., 355 F.2d 632 (Cl. Ct. 1966)). Jackel concludes that "absent special and unusual facts" such a structure should provide protection from U.S. estate tax. Jackel, supra, at 267; see Goldberg, supra note 7, at 38 ("use of foreign holding companies ... has withstood many audits"); BITTKER & LOKKEN, supra note 7, ¶ 134.2.3, 134-10 to 134-11 (stock in foreign corporation has foreign situs except "in cases of sham (e.g., a deathbed transfer of the shares of a domestic corporation to a foreign personal holding company)"); Ross, supra note 25, at 359 & n.350 ("avoidance technique will ordinarily be successful"); Mene, supra note 7, at 629 ("burden is on the IRS to show that decedent claimed to be ... the beneficial owner of the underlying assets"). See also Bruce N. Lemons et al., Using Foreign Corporations To Avoid U.S. Estate Tax on U.S. Residences—With a Canadian Emphasis, 52 TAX NOTES 947, 949-50 (1991) (discussed infra note 53).

\textsuperscript{44} Lemons states that "[s]ome estate tax examiners have apparently contended that the principles of section 2038(a)(1)" dealing with revocable transfers "should apply" based upon the opinion in Estate of Swan v. Comm'r, 247 F.2d 144 (2d Cir. 1957). Lemons, supra note 43, at 951-52. Lemons rejects this view. Id.; see Jackel, supra note 43, at 264-65. For discussion of the potential applicability of I.R.C. § 2036(a), see Lemons, supra note 43, at 953-54; Jackel, supra note 43, at 265-66.

\textsuperscript{45} Boidman II, supra note 37, at 703; see FLORIDA BAR, supra note 12, at 910 ("inordinate expense is necessary to plan and implement the measures to legally minimize the impact of these taxes").

\textsuperscript{46} See Bell & Shoemaker, TAMRA, supra note 1, at 85. This structure is often recommended to avoid the branch tax. See, e.g., Hudson, Post-1989, supra note 10, at 249-50; Austrian & Schneider, supra note 7, at 431; Bell & Shoemaker, TAMRA, supra note 1, at 83-84.

\textsuperscript{47} See Boidman & Scheine, Corporate Ownership, supra note 1, at 181, 185 (discussing Canadian tax practices).

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tax may not be creditable against a home country tax. An egregious example is the Canadian income tax treatment of a Canadian holding company that owns a U.S. vacation home.

In addition, following the Tax Reform Act of 1986, the U.S. income tax consequences of using the corporate form have often been less beneficial than in the case of direct ownership. This was in part because, after the 1986 Act, the corporate rate of 34% exceeded the top individual rate

48 See Bell & Shoemaker, Foreign Investment, supra note 6, at 266-67; see also Hudson, Post-1989, supra note 10, at 218.
49 See 1990 Hearings, supra note 1, at 67 (Hudson testimony). This structure is used for "[m]any" of the "over 500,000" Canadian-owned U.S. vacation homes. Lemons, supra note 43, at 947; see also Boidman & Scheine, Corporate Ownership, supra note 1, at 180. Of the 51 nonresident estate tax returns filed by Canadian decedents for 1986, all but nine of these returns showed U.S. gross estate of under $250,000; on average 42.5% of the U.S. gross estate consisted of real estate or mortgages. Long, supra note 29, at 58.
50 The shareholder is treated as "receiving a taxable shareholder benefit under the Canadian Income Tax," unless measures are taken to qualify the corporation as a "single purpose corporation." However, taking these measures may jeopardize the shareholder's exemption from U.S. estate tax. See supra notes 43-44; Lemons, supra note 43, at 947-54; Nathan Boidman, Fundamental Problems for the Cross-Border Tax Advisor, 90 TNI 6-63, Dec. 1, 1989, available in LEXIS, Taxana Library, TNI File.
51 For the importance of the income tax changes of the 1980s in this context, see 1990 Hearings, supra note 1, at 61-64 (Hudson testimony); Mushner, supra note 3, at 292-93 (explaining how, prior to 1987, foreign investors could use an Antilles corporation with an election under I.R.C. § 897(i) to achieve a single tax at the 20% individual capital gains rate on sales of U.S. real estate); see also Bell & Shoemaker, TAMRA, supra note 1, at 83-85, 88; W. Donald Knight, Jr. & Richard L. Doernberg, Structuring Foreign Investment in U.S. Real Estate, in FOREIGN INVESTMENT in U.S. REAL ESTATE: A COMPREHENSIVE GUIDE 281, 282-83, 290-91 (Timothy E. Powers ed. 1990); Tillinghast, supra note 42, at 95-100. The relevant changes included, in addition to the rate change: (1) enactment of FIRPTA in 1980; see, e.g., Austrian & Schneider, supra note 7, at 400-07; Llewellyn & Umbrecht I, supra note 10, at 239-41; Mushner, supra note 3, at 292-93; (2) repeal of the General Utilities doctrine, see Bell & Shoemaker, TAMRA, supra note 1, at 83; (3) imposition of the branch tax in 1986, see, e.g., Llewellyn & Umbrecht I, supra note 10, at 241-46; Austrian & Schneider, supra note 7, at 409-16; and (4) enactment of the earnings stripping limitations in 1989, see, e.g., Austrian & Schneider, supra note 7, at 423-26; Don W. Llewellyn & Richard L. Umbrecht, Selecting and Capitalizing a Foreign-Owned Entity for Conducting a U.S. Business (pt. III), 21 TAX MGMT. INT'L J. 372, 373-77 (1992) [hereinafter Llewellyn & Umbrecht III].
52 S corporation status is unavailable if there is a nonresident alien shareholder. IRC § 1361(b)(1)(C).
of 28% (31% pursuant to the 1990 Act). However, under the Revenue Reconciliation Act of 1993 (the "1993 Act"), the federal income tax rate structure is more favorable to corporate ownership, particularly for income ranging from $355,000 to $10 million, where the corporate rate is 34% and the individual rate for ordinary income is 39.6%.

On the other hand, the corporate structure continues to have a disadvantage in that it creates the potential for a second level of U.S. income tax in the form of a 30% withholding tax on dividends or a 30% branch tax. This second level of tax, if not reduced or avoided by treaty or

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53 See Bell & Shoemaker, TAMRA, supra note 1, at 84; Hudson, Post-1989, supra note 10, at 217-18.

54 State and local corporate taxes may perhaps add an additional "4 to 8" percentage points. See Tillinghast, supra note 42, at 94; see also Knight & Doernberg, supra note 51, at 285-86 (combined federal and state corporate rate may be 33 to 42 percent). State or local taxes may or may not apply to income from individually owned assets. See Tillinghast, supra note 42, at 94 ("depending on the location, there may be no local tax"); Doernberg & Knight, supra note 51, at 286 (local taxes may add 3 to 5 percentage points).

55 See Pub. L. No. 103-66, §§ 13201(a)-(b), 13221(a), 107 Stat. 312, 458-59 (1993) (amending I.R.C. §§ 1 and 11). A new 36% rate applies to income of an unmarried individual in excess of $115,000 ($70,000 for a married individual filing separately); a 39.6% rate applies to income in excess of $250,000 ($125,000 for a married individual filing separately). Id. A nonresident alien individual who is married is ordinarily required to file separately. I.R.C. § 6013(a)(1). As under prior law, corporate income between $335,000 and $10 million is taxed at a rate of 34%. Under the 1993 Act, a new 35% rate applies to income of corporations in excess of $10 million; a 3% surtax applies to income in the range of $15 million to $18.33 million to recapture the benefit of the 34% rate. Pub. L. No. 103-66, § 13221(a), supra (amending I.R.C. § 11); Michael S. Long & Ileen E. Malitz, Tax Changes, Structural Shifts and Future Tax Receipts: The Case of Closely Held Firms, at 12-13 and Table 9, March 17, 1993 (preliminary working paper on file with the University of Pennsylvania Journal of International Business Law).


57 See I.R.C. §§ 871(a)(1), 881(a)(1), 1441(a), 884(a)-(b).

58 The withholding rate on dividends paid by a U.S. subsidiary to its foreign parent is often reduced by treaty to 5%. See Llewellyn & Umbrecht II, supra note 39, at 323; see also Musher, supra note 3, at 290. Branch tax is eliminated by many treaties and applied at reduced rates under others.
otherwise, often would more than offset the benefit of the favorable corporate rate schedule unless corporate earnings are realized and then accumulated for lengthy periods.

In addition to treaties, there are some techniques for avoiding double U.S. taxation of corporate income. Earnings of a foreign holding company, or its U.S. subsidiary, escape corporate taxation if they are paid out (even to a shareholder) in the form of interest or salary. Moreover, interest


Cf. Schmedel, supra note 56, at B2 (S corporation should not revoke status unless, inter alia, it “plans to reinvest most of its earnings in growth.”); Long & Malitz, supra note 55, at 13 (analysis showing that when income is in range of $355,000 to $10 million “[f]irms paying less than 21% dividends will gain from C Corporation taxation”). Long & Malitz concluded that “[f]or the firm needing to retain funds the change in relative rates definitely encourages a move back to corporate taxation.” Id.

For example, assume that a nonresident alien individual invests $1000 in a directly-held U.S. business, which earns an annual pre-tax return of 10%. If the earnings are reinvested each year (and ignoring any foreign tax effects), the amount accumulated after the end of “n” years, assuming a U.S. individual tax rate of 39.6%, will be: 1000[1+.10(.604)]n. If the business is held in a U.S. subsidiary of a foreign corporation, and the earnings are accumulated in the subsidiary until year “n”, and then distributed as dividends to the foreign parent, the amount to be received (after U.S. tax) in year “n” (assuming a tax-free return of the original investment, a corporate rate of .34, and a dividend withholding rate of .30) is 1000[1+.10(.66)]n(.70) + 300. Cf. DAVID J. SHAKOW, THE TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS 21-23 (1991) (comparing results of direct ownership and corporate ownership with earnings accumulation).

If n=20 years, the accumulation in the case of direct ownership would be $3,231.43. The accumulation in the case of the corporate structure would be $2,813.29, or 13% less. If n=50 years, then the accumulation in the case of direct ownership would be $18,770.94; the accumulation in case of the corporate structure would be $17,398.51, or 7.3% less. If the pre-tax rate of return is 20%, and n=20 years, the accumulation in the case of direct ownership would be $9,785.04, and the accumulation in the corporate form would be $8,656.54, or 11.5% less; if n=50 years, the accumulation in the case of direct ownership would be $299,506.40; the accumulation in the case of corporate ownership would be $344,982.62, or 15% more.

See Llewellyn & Umbrecht I, supra note 10, at 234; Llewellyn & Umbrecht III, supra note 51, at 372-73, 377; see also Austrian & Schneider, supra note 7, at 225-26; Knight & Doernberg, supra note 51, at 291, 300-03.
payments to a foreign recipient are subject to a reduced or zero rate of withholding tax under most treaties, if the recipient is a related person, however, the earning stripping rules may limit the amount of the corporate interest deduction. These results may be quite advantageous.

A second level of tax may also be avoided if the earnings of a foreign holding company are reinvested in its U.S. business until the business is completely terminated or if earnings of a U.S. subsidiary are accumulated until the stock in the subsidiary is disposed of by sale or liquidation. This may, 

Knight & Doernberg note that home country taxes on dividends and interest should be taken into account. Id. at 300. Austrian & Schneider point out that where "interest received by the lending foreign parent is taxed at a higher rate in the lender's home country than the applicable U.S. rate ... leveraging might not be beneficial." Austrian & Schneider, supra, at 423 n.206.

If the salary is for services performed abroad, no U.S. tax will be imposed upon the nonresident alien employee-shareholder either. See Llewellyn & Umbrecht I, supra note 10, at 234.

See Llewellyn & Umbrecht III, supra note 51, at 323-24; see also Austrian & Scheider, supra note 7, at 390 n.10. For treaty-shopping issues, see Knight & Doernberg, supra note 51, at 301-05.

These limitations apply only when the debt-to-equity ratio exceeds 1.5 to 1 and only to the extent that net interest expense exceeds 50% of the payer's adjusted taxable income. See I.R.C. § 163(j)(1)(A),(2)(A)-(B); discussion in Austrian & Schneider, supra note 7, at 423-25; Llewellyn & Umbrecht III, supra note 51, at 373-77. The 1993 Act extends these limitations to debt guaranteed by a related person. Omnibus Budget Reconciliation Act, Pub. L. No. 103-66, § 13228(a), 107 Stat. 312, 494 (1993).


The sale of the holding company's stock by the foreign shareholder would not be subject to U.S. tax. Yet, "buyers are often wary of buying foreign stock for non-tax reasons and may insist on a discounted price to reflect the inherent FIRPTA tax liability inside the corporation." Musher, supra note 3, at 292. If, instead, the foreign holding company's assets are sold and the company is liquidated, the branch tax does not apply. See Treas. Reg. § 1.884-2T (as amended in 1992), discussed in Musher, supra note 3, at 293 n.79; Llewellyn & Umbrecht I, supra note 10, at 246; Hudson, Post-1988, supra note 42, at 9-10.

Apart from FIRPTA, no U.S. tax applies to a disposition of stock in a U.S. subsidiary by a foreign holding company. See I.R.C. §§ 865(a),(g)(1), 864(c)(4), 881(a); Musher, supra note 3, at 293; Hudson, Post-1989, supra note 10, at 253; Hudson, Post-1988, supra note 42, at 9. But cf. Knight & Doernberg, supra note 51, at 294 (earnings and profits of U.S. subsidiary could on liquidation carry over to foreign parent, causing dividends paid by it to be "subject to U.S. tax") (citing I.R.C. §§ 861(a)(2)(C), 897(c)(1)(B)(ii)(I)). If the U.S. subsidiary has been a United States real property holding

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however, involve complex planning where separate parcels of U.S. real estate are to be disposed of at different times.\textsuperscript{68} Unless barred by treaty, a legislative proposal introduced in 1992 as House Bill 5270\textsuperscript{69} would have imposed a tax on capital gains from the disposition of stock in a U.S. corporation\textsuperscript{70} held by a 10%-or-more foreign shareholder. In the case of a foreign parent, these capital gains would have been taxable at a rate of 34\%.\textsuperscript{71} It is still possible that this proposal may be enacted.

A further disadvantage of the corporate form is that the step-up in basis provided to assets held by a decedent at death

corporation at any time in the preceding five-year period, the foreign holding company is taxable on the disposition of stock in the subsidiary, unless the disposition is pursuant to the subsidiary's liquidation following a taxable sale of all the subsidiary's U.S. real property interests. \textit{See} I.R.C. § 897(c)(1)(A)(ii), (B); Musher, \textit{supra} note 3, at 293 & n.70.

\textit{\textsuperscript{68} See} Bell & Shoemaker, TAMRA, \textit{supra} note 1, at 84-85 & n.24; Austrian & Schneider, \textit{supra} note 7, at 431-32. The advantages of consolidation and of using I.R.C. § 453 may be lost. \textit{See} Bell & Shoemaker, TAMRA, \textit{supra}, at 84-85.

\textit{\textsuperscript{69} See} H.R. 5270, 102d Cong., 2d Sess. § 301(a) (1992) (adding I.R.C. § 899). Under the bill, the new tax is not to be applied if to do so would be contrary to any treaty already in effect, provided that any foreign entity claiming a treaty benefit is a qualified resident of the treaty country. H.R. 5270, § 302 (amending I.R.C. § 894). However, where a treaty prevents application of the tax on gains, the bill treats the gain that would be taxable, apart from the treaty, from either a liquidating distribution or redemption made by the U.S. corporation as a dividend to the extent of earnings and profits attributable to the stock. H.R. 5270, § 301(a) (adding I.R.C. § 899(e)); \textit{see also} H.R. 5270, § 302(a) (treaty benefits denied to foreign entities that are not qualified residents).

Thus, a foreign parent that was a qualified resident of a country with a treaty barring the capital gains tax would avoid tax on a sale of stock in a U.S. subsidiary if the stock is not a USRPI. If, instead, the U.S. subsidiary sold its assets and was liquidated, the foreign parent would incur the dividend withholding tax to the extent of the subsidiary's earnings and profits including those created on the sale. If the investment was held directly by a foreign corporation that was a qualified resident of a country with a treaty barring the branch tax, the second level of tax could, apparently, be avoided if the foreign corporation sold its assets and was liquidated.

\textit{\textsuperscript{70} The proposal would also have resulted in imposition of the 30\% branch tax on reinvested earnings upon termination of a branch. \textit{See}} JOINT COMMITTEE ON TAXATION, EXPLANATION OF H.R. 5270, THE FOREIGN INCOME TAX RATIONALIZATION AND SIMPLIFICATION ACT OF 1992 JCS-11-92 (May 29, 1992), \textit{reprinted in} 25 HIGHLIGHTS & DOCUMENTS 2774 (1992) [hereinafter 1992 JCT REPORT].

\textit{\textsuperscript{71} See} Musher, \textit{supra} note 3, at 290 & n.36.
does not apply to assets held by a corporation. Thus, to the extent that profit from U.S. assets takes the form of unrealized appreciation, the corporate form results in an eventual corporate tax at a rate of up to 35%, whereas direct ownership results in complete forgiveness of the income tax if death precedes the sale of the assets. The use of a foreign holding company may also result in complications if the alien shareholder is or later becomes a resident for U.S. income tax purposes, for example, under the 183-day test. Additional U.S. or foreign tax problems may arise when existing individual ownership is shifted to corporate ownership.

Thus, in some cases, foreigners may find that the use of a foreign holding company to avoid U.S. estate tax liability results in less advantageous income tax treatment. This is considerably less likely after the 1993 Act changes in the income tax rate structure. However, it would become much more likely with the enactment of a capital gains tax on foreign shareholders as provided by House Bill 5270. Prior

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72 Hudson, Post-1988, supra note 42, at 12; see also Bell & Shoemaker, TAMRA, supra note 1, at 86-87 & nn.32-33; Knight & Doernberg, supra note 51, at 285-86 (explaining that after the General Utilities repeal, a step-up for the shares in the foreign corporation is “less meaningful”).

73 Cf. Schmedel, supra note 56, at B2 (S corporation should not consider revoking election unless “it lacks appreciated assets, including ... goodwill ... that are subject to double taxation when regular corporations are sold.”).

74 See Mene, supra note 7, at 628 (application of 35% excise tax); I.R.C. §§ 367(a), 551(a), 951(a), 1291(a); see also COMMITTEE ON TAXATION OF INTERNATIONAL TRANSACTIONS, The Effect of Changes in the Type of United States Tax Jurisdiction Over Individuals and Corporations: Residence, Source and Doing Business, 46 THE REC. OF THE ASS'N OF THE BAR OF THE CITY OF N.Y. 914, 924 (1991) [hereinafter COMMITTEE ON TAXATION OF INT'L TRANSACTIONS].

75 For discussion of the circumstances in which use of the corporate form is or is not desirable under pre-1993 Act law, see Llewellyn & Umbrecht I, supra note 10, at 234; Llewellyn & Umbrecht II, supra note 39, at 314; Knight & Doernberg, supra note 51, at 285-88.

76 See I.R.C. § 897(e)(1),(j); Treas. Reg. § 1.897-6T(a)(1) (1988); FLORIDA BAR, supra note 12, at 911 (qualification under I.R.C. § 351 may be blocked by I.R.C. § 897). However, an election under I.R.C. § 897(i) may make I.R.C. § 351 nonrecognition treatment available. See Llewellyn & Umbrecht II, supra note 39, at 330-31; see also Boidman II, supra note 37, at 706; Boidman & Scheine, Corporate Ownership, supra note 1, at 181 n.5.

77 See Mushor, supra note 3, at 287-90, 293-94; see also id. at 294 (arguing that if this tax is imposed, the U.S. estate tax on U.S. real estate holdings of a nonresident alien decedent should be reassessed); 1990
to the 1993 Act, some commentators on U.S. estate-planning for foreigners have emphasized techniques that avoid the use of the corporate form, such as a limited partnership, a limited liability company, a "split-interest" partnership structure, or a trust. Others have advised that investors provide for U.S. estate tax liability by obtaining insurance. But this advice may be rejected by foreigners who fear estate tax exposure or who find advantages to the corporate form regardless of the U.S. tax cost, such as avoidance of filing a U.S. individual income tax return, limited liability, and anonymity, which may be an overriding concern for residents of developing countries.

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Hearings, supra note 1, at 64 (Hudson testimony).


78 See Lee A. Sheppard, The Dark Side of Limited Liability Companies, 55 TAX NOTES 1441, 1441-43 (1992) (suggesting that foreigners may be attracted to this form because of "limited liability" and resemblance to "their own GMBHs and SARLS," but noting uncertainties); see also Tillinghast, supra note 42, at 119 ("the status . . . for estate tax purposes is not clear").

79 See Hudson, Post-1989, supra note 10, at 227-38; see also Robert F. Hudson, Jr. et al., Use of Split-Interest Partnerships for Foreign Investment in U.S. Real Estate, 17 TAX MGMT. INT'L J. 275 (1988); see also Boidman II, supra note 37, at 704 (noting possible loss of basis in United States and Canada for amount paid by parent); Musher, supra note 3, at 291 n.52.

80 Hudson, Post-1989, supra note 10, at 218, 238-41; Hudson, Post-1988, supra note 42, at 17-18; see also Tillinghast, supra note 42, at 119-20; Austrian & Schneider, supra note 7, at 426, 431 n.248.

81 See Knight & Doernberg, supra note 51, at 289. The insurance proceeds would be exempt in the United States. Id.

82 See, e.g., Bell & Shoemaker, TAMRA, supra note 1, at 79 (stating that "estate tax risk of an NRA's making a significant investment in U.S. real estate through a partnership has become prohibitive").

83 Musher, supra note 3, at 293 n.69 (noting that "home country considerations" should also be taken into account); Austrian & Schneider, supra note 7, at 431; Hudson, Post-1988, supra note 42, at 12; Hudson, Post-1989, supra note 10, at 218; see also Knight & Doernberg, supra note 51, at 284; FLORIDA BAR, supra note 12, at 911; Bell & Shoemaker, Foreign Investment, supra note 6, at 289 ("an NRA's desire for anonymity is often viewed as a major justification for enduring the expense and complexity of a corporate structure").
By contrast, there is no U.S. income tax disadvantage to using a foreign holding company to hold portfolio stock interests in U.S. corporations. As in the case of direct ownership of the portfolio interests by the nonresident alien individual, the only U.S. tax would be the U.S. withholding tax on dividends. No capital gains tax would be imposed on disposition of portfolio interests even under House Bill 5270. Similar results may be achieved by foreigners who invest in U.S. companies through a mutual fund organized in the form of a foreign corporation.

3.3. Noncompliance With The U.S. Estate And Gift Taxes

The potential difficulties of applying U.S. transfer taxes to foreigners have long been known to Congress. Thus, in 1966, when Congress repealed the rule imposing a gift tax on the transfer of intangible property by a nonresident alien donor engaged in a U.S. trade or business, the House Committee

their own governments. Bell & Shoemaker, Foreign Investment, supra note 6, at 269-70.

See 1990 Hearings, supra note 1, at 64 (Hudson testimony that investments "in U.S. equity and debt securities . . . can easily be arranged through a foreign holding company"); id. at 61 (stating that it is "relatively easy to arrange portfolio investments by foreigners so as to avoid U.S. estate and gift tax").

The holding company is not subject to a branch profits tax since there is no U.S. business. See 1990 Hearings, supra note 1, at 64 (Hudson testimony). Dividends paid by the holding company would be from foreign sources, and thus not taxable. See I.R.C. §§ 861(a)(2)(B), 871(a)(1). The personal holding company tax would not apply. See I.R.C. § 542(c)(7). Likewise, the accumulated earnings tax would not apply. See Treas. Reg. § 1.532-1(c) (1959); see also AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION, 164-65 (1987) [hereinafter A.L.I.].

Moreover, if the foreign corporation is a resident in the same country as the individual investor, it would be entitled to the same treaty benefits, if any, or possibly greater benefits (as a corporate parent). See supra note 58.

See supra note 67; I.R.C. § 897(c)(3).


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Report explained: "[i]n practice this rule has proved to be impossible to enforce, since there is no practical way for the Internal Revenue Service to find out when these gifts are made. Moreover, it does not occur to many nonresident aliens that these transfers are subject to U.S. gift tax."91

3.3.1. Impediments To Voluntary Compliance

If a foreigner's investment in the United States is small, and particularly if it consists of assets held for personal use, the foreigner may lack adequate tax advice which would inform him of the need to file U.S. gift or estate tax returns.92 Moreover, an absence of clear guidance regarding the application of the U.S. estate tax to nonresidents may contribute to aggressive reporting positions.93 For example, a nonresident estate holding an interest in a partnership with U.S. assets may claim a foreign situs for that interest and fail to report it.94 There is also uncertainty regarding commonly

91 1966 HOUSE REPORT, supra note 25, at 1002.

92 For example, one commentator has noted that in many cases Canadian couples who made a "pre-TAMRA" purchase of a U.S. vacation home as jointly held property may not have contemplated the U.S. gift and estate tax consequences and that in many cases taxes may be past due with respect to transfers upon the creation of the joint tenancy or upon the death of the first or second to die. See Lawrence F. Gilberti, Pre-TAMRA Purchases of U.S. Realty by Canadian Couples: Unpaid U.S. Tax Liabilities (pt. I), 20 TAX MGMT. INT'L J. 451 (1991) [hereinafter Gilberti I]; Lawrence F. Gilberti, Pre-TAMRA Purchases of U.S. Realty by Canadian Couples: Unpaid U.S. Tax Liabilities (pt. II), 20 TAX MGMT. INT'L J. 514 (1991) [hereinafter Gilberti II]. Gilberti states that the failure to pay tax is due "in some cases [to] oversight, in others the receipt of bad tax advice . . . , and in others clearly malice aforethought . . . ." Gilberti I, supra, at 452.

93 See Hudson, Direct Ownership, supra note 78, at 314 (stating that "the lack of IRS clarification on a number of the uncertain issues in the area and the generally perceived laxity of IRS enforcement probably serves to encourage" noncompliance).

94 This may be based upon one of various plausible theories proposed in the tax literature, see supra notes 12-13, such as the theory based upon Rev. Rul. 55-701, see supra note 13, that the partnership is not engaged in a U.S. trade or business. See Bell & Shoemaker, TAMRA, supra note 1, at 80-82. They note that "most well-informed practitioners advise their NRA clients that investing in U.S. real property through a partnership . . . will subject the investment to U.S. estate taxation." Id. at 82. They conclude, however, that "[t]he lack of clear authority," other than Rev. Rul. 55-701, supra note 13, "leaves an opening to ethically sanction the exclusion of partnership interests . . . [and] [o]ne suspects that, more often than not, the result is that no U.S. estate tax return is filed at all." Id. at 81-2.
occurring issues such as (1) whether a partnership interest is an intangible asset for gift tax purposes,\textsuperscript{95} and (2) the situs of tangible personal property.\textsuperscript{96}

Aggressive tax reporting may also be fostered by a perception that the IRS will not vigorously enforce the estate tax on nonresident estates.\textsuperscript{97} This perception may arise from the fact that the IRS has not been issuing much guidance in this area.\textsuperscript{98} Although the IRS issued a ruling in 1991 specifying the U.S. income tax consequences for a nonresident alien on the disposition of a partnership interest,\textsuperscript{99} it has not provided guidance regarding the treatment of a partnership interest for gift and estate tax purposes. In fact, since 1982 the IRS has issued only one Revenue Ruling relating to transfer taxation of nonresident aliens.\textsuperscript{100} There may also be a perception that even vigorous enforcement efforts by the IRS may be largely ineffective.\textsuperscript{101}

\textsuperscript{95} See supra note 10 and accompanying text.
\textsuperscript{96} See, e.g., Delaney v. Murchie, 177 F.2d 444 (1st Cir. 1949) (jewelry and personal effects of individual who stopped in the United States while traveling from Canada to Nassau), discussed in Troxell, supra note 14, at A-24.
\textsuperscript{97} See Hudson, Direct Ownership, supra note 78, at 314. Hudson suggests that some foreigners have the "expectation that the U.S. estate and gift taxes will not, in fact, ever be enforced (since less is heard about the IRS endeavoring to assure proper compliance in this area)."
\textsuperscript{98} The IRS has, however, recently issued proposed regulations dealing with the 1988 Act estate and gift tax provisions, including the provisions relating to the marital deduction and joint ownership of property when the surviving spouse is a noncitizen and the provisions changing the rate schedule for nonresident estates. See Notice of Rulemaking, supra note 17. In addition, the IRS has issued proposed regulations under the generation-skipping tax, including regulations dealing with the treatment of transfers by nonresident aliens. See supra note 9.
\textsuperscript{100} See Troxell, supra note 14, at C-1 (bibliography), C&A-1. The two most recent Revenue Rulings in this area are: Rev. Rul. 82-193, 1982-2 C.B. 219 (dealing with situs of reversionary interests in a trust holding certificates of deposit) and Rev. Rul. 90-101, 1990-2 C.B. 315 (dealing with proportional credit under treaties).
\textsuperscript{101} See Hudson, Direct Ownership, supra note 78, at 314 (stating that "in a limited number of cases," foreigners may have "an expectation that transfers of otherwise U.S. estate taxable interests may be made offshore without knowledge of the IRS (even if the IRS were endeavoring to be more diligent in their compliance efforts in this area)"); see also infra notes 105-16.
The risk of personal liability\(^{102}\) would seem to be a very powerful stimulus to voluntary compliance in the case of an independent U.S. fiduciary. However, the stimulus would be much less for a foreign fiduciary or perhaps even for a U.S. fiduciary who is also a beneficiary.\(^{103}\)

### 3.3.2. IRS Detection And Enforcement

Some means do exist for the IRS to detect and to enforce estate and gift taxation of transfers by nonresident aliens. In many cases, however, transactions may fall outside the reach of the IRS's enforcement tools.

Required income tax filings\(^{104}\) with respect to income-producing property or business assets held individually or in a partnership\(^{105}\) may alert the IRS to a transfer of property at death. If, however, a nonresident alien owns non-income producing real property (e.g., raw land or a vacation home), directly or through a partnership, there may be no required income tax filings,\(^{106}\) except as required by regulations that

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\(^{102}\) See Gilberti I, supra note 92, at 459-60; Gilberti II, supra note 92, at 526-27. The executor will become personally liable under 31 U.S.C. § 3713(a)(1)(B), (b) "if the executor pays from the estate's assets debts of inferior priority before satisfying those due the United States." Gilberti I, supra note 92, at 460. This assumes that the executor "had some notice of the outstanding tax liability." Gilberti II, supra note 92, at 527. The IRS may "assess and collect any such liability of a fiduciary" pursuant to I.R.C. § 6901(a)(1)(B). Gilberti I, supra note 92, at 460.

\(^{103}\) In some cases, there may be no U.S. fiduciary although the estate includes U.S. situs assets. This may be because property passes by right of survivorship or through a trust, or because the estate is probated entirely in a foreign country.

\(^{104}\) The new regulations under I.R.C. § 374, penalizing a failure to file a timely income tax return by denying allowance of deductions, provide an incentive for such filing. Treas. Reg. § 1.874-1(a) to (b) (as amended in 1990); see also Bell & Shoemaker, Foreign Investment, supra note 6, at 263 (the regulations "encourage estate tax compliance by forcing the NRA to file U.S. income tax returns during his lifetime").

\(^{105}\) But cf. Bell & Shoemaker, TAMRA, supra note 1, at 82 (noting that "unlike the passage of title to a direct interest in U.S. real property, a partnership interest "is typically not evidenced by a recorded conveyance or recorded evidence of probate").

\(^{106}\) See id. ("If the partnership is not engaged in a U.S. trade or business, the lack of U.S. reporting requirements during the NRA's lifetime makes it entirely possible that the IRS would not even have known of the NRA's existence.").
might be issued under I.R.C. section 6039C.\textsuperscript{107} One possible avenue for detection arises when a title insurance company checks for estate tax liens upon the transfer of the property by the heirs to an unrelated party.\textsuperscript{108} Another is an exchange of information pursuant to a treaty, but this avenue may be more useful for policing transfers by U.S. citizens.

A nonresident alien’s transfer at death of stock\textsuperscript{109} in a U.S. corporation becomes subject to IRS scrutiny if the corporation, its transfer agent, or a custodian of the stock fulfills the requirement under the regulations that it obtain a transfer certificate prior to making any transfer.\textsuperscript{110} It is not clear, however, how this requirement would be enforced if the stock were held by a foreign bank or brokerage firm as a nominee.\textsuperscript{111}

Collection by the IRS of unpaid estate taxes is facilitated by the presence of a U.S. fiduciary, a U.S. beneficiary,\textsuperscript{112} or

\begin{footnotes}

\textsuperscript{107} The IRS has not exercised its authority under this provision to require annual information reporting by foreign individuals not engaged in a U.S. trade or business who hold direct investments in U.S. real property interests worth at least $50,000. See Hudson, \textit{Direct Ownership}, \textit{supra} note 78, at 359.

\textsuperscript{108} See Gilbert II, \textit{supra} note 92, at 528.

\textsuperscript{109} Corporate stocks and bonds constituted 45% of the U.S. assets reported on nonresident estate tax returns for 1986. Long, \textit{supra} note 29, at 53, fig. B.


\textsuperscript{111} Cf. Allaire U. Karzon, \textit{International Tax Evasion: Spawned in the United States and Nurtured by Secrecy Havens}, 16 \textit{VAND. J. TRANSNAT'L L.} 757, 769-73 (1983) (discussing use by U.S. corporations of “address method” to determine applicability of reduced treaty income tax withholding rates for dividends). Karzon notes that U.S. payors “can and do rely on the address of record of ... foreign nominees” without inquiring into the address of the beneficial owners of the stock. \textit{Id.} at 771. At the same time, “Switzerland and Belgium ... appear to be the only treaty countries that effectively require their financial institutions acting as nominees” to collect any additional tax due. \textit{Id.} at 773.

\textsuperscript{112} For personal liability of fiduciary, see \textit{supra} note 102. For liability of beneficiary, see I.R.C. § 6524(a)(2), discussed in Gilbert II, \textit{supra} note 92, at 526. Gilberti notes that the beneficiaries may also be subject to transferee liability in equity. \textit{Id.} at 525-26.

\end{footnotes}
assets remaining in the United States.\(^{113}\) In other cases, collection of unpaid estate taxes seems unlikely. Generally, the IRS could not expect a foreign court to assist in the enforcement of a tax claim in the foreign country.\(^{114}\) Estate tax treaties generally would not be helpful either.\(^{115}\) In fact, one distinguished practitioner has written that he has "settled estate tax cases favorably, primarily on the ground of lack of enforceability of a judgment."\(^{116}\)

3.4. Unfavorable Effects Of Present Law

3.4.1. Unfairness

The fact that only a relatively small number of foreigners investing in the United States incur and pay U.S. gift or estate taxes casts doubt on the fairness of the taxes. It is unfair that some foreign investors avoid the taxes by taking aggressive or clearly erroneous positions that are not detected, while others either simply pay the taxes, or incur the inconvenience and extra tax and other costs associated with various legal avoidance techniques.\(^{117}\)

\(^{113}\) See I.R.C. § 6324(a)(1) (estate tax is "a lien upon the gross estate of the decedent for 10 years after the date of death"); Gilberti II, supra note 92, at 528. In the case of probate assets, the lien is apparently not discharged by a sale for adequate consideration. See id. at 528 & n.85.

\(^{114}\) See Troxell, supra note 14, at A-31 to A-32; see also U.S v. Harden, 63-2 U.S. Tax Cas. (CCH) ¶ 9768 (Can. 1963) (dismissing U.S. government's appeal to enforce collection of U.S. taxes in Canadian courts); AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II - PROPOSALS OF THE AMERICAN LAW INSTITUTE ON UNITED STATES INCOME TAX TREATIES 121-24 (1992) [hereinafter A.L.I. TREATIES] (stating that "[t]raditional objections to enforcement of tax claims are based on concerns relating to extraterritorial enforcement, lack of reciprocity, and both substantive and procedural due process"); Goldberg, supra note 7, at 60-61 (citing Her Majesty the Queen in Right of the Province of British Columbia v. Gilbertson, 597 F.2d 1161 (9th Cir. 1979)).

\(^{115}\) See Goldberg, supra note 7, at 62 (estate tax treaties rarely "have effective enforcement provisions").

\(^{116}\) Id. at 62 & n.152.

\(^{117}\) A recent commentary voiced the complaint that the current system penalizes the "honest and well-informed NRA" while providing a "de facto amnesty for dishonest NRAs who simply do not file estate tax returns." Bell & Shoemaker, TAMRA, supra note 1, at 87-89; id. at 82-83 ("Ill-informed or intentionally tax-evading NRAs who invest in U.S. real estate through partnerships will continue to illicitly escape U.S. estate taxation" while "well-informed and honest NRAs [must] endure[e] the income tax
In addition, it is unfair that those foreigners who do pay a tax and who cannot credit it fully against their home country tax likely will have failed to obtain sophisticated legal advice due to the small size of their U.S. investments. Alternatively, they may have consciously forgone legal avoidance techniques because of home country tax considerations, because the small size or the nature of their U.S. investments made such techniques too inconvenient or expensive, or because they find such tax planning distasteful.

3.4.2. Distortion Of Behavior And Disrespect For The Law

The current system for gift and estate taxation of foreigners distorts their behavior by encouraging the use of complicated corporate structures and the seeking out of sophisticated tax advice to avoid the tax. The costs of avoidance may be quite significant in relation to the revenue collected. Moreover, Congress' toleration of the fact that many foreigners investing in the United States escape the U.S. gift and estate taxes by legal or illegal means calls into question the seriousness of Congress' purpose in imposing the tax and may lead to "disrespect" for the law.

 disadvantages of corporate investment structures in order to legitimately avoid U.S. estate taxation.

118 Ross found Congress' decision in 1966 to retain the estate tax on foreigners with respect to intangibles "puzzling", stating that: "[P]ortfolio investors abroad can readily avoid United States estate taxes by use of a holding company. . . . The estate tax will probably be paid by very few aliens, in most cases by those who blunder into its provisions." Ross, supra note 25, at 359-60. Cf. Aaron & Munnell, supra note 32, at 138 (arguing that, in general "wealth transfer taxes . . . are penalties imposed on those who neglect to plan ahead or who retain unskilled estate planners").

119 Cf. Aaron & Munnell, supra note 32, at 138 (arguing that the "compliance costs of the transfer tax system [in general] must amount to a sizable fraction of the total yield of $6 billion"). They note that "[f]or the most part . . . tax avoidance consists of hiring skilled legal talent to arrange property rights in appropriate ways." Id. at 137.

120 A similar argument was made in favor of providing a statutory exemption for portfolio interest received by foreigners rather than requiring U.S. issuers to utilize Netherlands Antilles finance subsidiaries. See STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984: EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984 420 (Comm. Print 1984). The report stated that "if tax-free access to the Eurobond market is important, such access should be direct." Id.

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3.4.3. Comparison To Taxation Of U.S. Citizens

It is worth noting that the defects that inhere in the U.S. estate tax on nonresidents are also present, though perhaps to a lesser extent, in the estate taxation of U.S. citizens and residents. For example, Aaron & Munnell have criticized "the estate and gift taxes in the United States [because they] raise little revenue . . . impose large excess burdens [and] are unfair."

The fact that these defects are shared does not make them any less serious. It may suggest, however, that estate tax reform should not be adopted piecemeal for nonresident estates only.

3.4.4. Trade-off

The defects of U.S. transfer taxation of nonresident aliens may be somewhat mitigated by the fact that many foreigners who avoid U.S. estate taxation by use of a corporate structure do so only at a cost of higher fees and other expenses, as well as potentially less favorable income tax consequences.

Although the current rules may be a "trap for the unwary," at least those who fail to use a corporate structure and who pay U.S. estate taxes do not suffer the potential income tax disadvantages of that structure. However, for some foreigners

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131 Cf. Aaron & Munnell, supra note 32, at 133. They explain that "[i]f the mechanisms [for avoiding transfer taxes] are inexpensive, the result may only be disrespect for the taxing authority", but if not, "then the ratio of excess burdens to revenues generated may be quite large." Id.

132 Ross has stated that "[t]here is something basically undesirable about a tax law which is not susceptible of evenhanded and consistent application, and which encourages taxpayers to adopt avoidance techniques as a standard method of operation." Ross, supra note 25, at 360; see also FOWLER REPORT, supra note 41, at 24 (stating that the fact that "U.S. estate taxes are avoidable through complicated and expensive procedures, while for other foreign investors they are likely to result in a considerable tax penalty . . . is an unsound situation which . . . significantly worsens the overall image of this country as a desirable place to invest").

133 See Aaron & Munnell, supra note 32, at 132-39 (For quotations from these pages, see supra notes 32, 118, 119, 121, and text accompanying infra note 124.); Dodge, supra note 32, at 252 ("principal argument for repealing the federal transfer taxes is that the attendant administrative and transaction costs approach or exceed the revenue yield"); Galvin, supra note 30 (recommending repeal); infra note 345 and accompanying text.

134 Aaron & Munnell, supra note 32, at 138.
who can obtain treaty benefits or who reduce their tax liability by accumulating earnings or by leveraging, the income tax consequences of the corporate structure may not be less favorable than those associated with direct ownership. Such a result is even more likely after the revision of the corporate and individual income tax rates in 1993. On the other hand, there is always the possibility of future rate changes and of enactment of a capital gains tax on foreign shareholders, as under House Bill 5270.

The fact that legal avoidance of U.S. estate taxation may involve a trade-off in the form of a greater income tax burden may also temper disrespect for the law. The tempering of disrespect for the law may, however, only occur if Congress has deliberately established this trade-off. This does not appear to be the case.125

Thus, in 1954, when Congress amended I.R.C. section 2104(b) to treat stock in a foreign corporation as having a foreign situs despite location of the stock certificates in the United States, or when Congress in 1966 implicitly tolerated the use of foreign holding companies,126 the income tax consequences of the corporate form would not have been considered as burdensome as they are after the 1980s income tax changes. Nor has Congress made clear an intention to impose a U.S. estate tax when a noncorporate structure (e.g., a partnership) is being used.127

Finally, the existence, at least in some situations, of the trade-off means that the current estate tax rules for

125 See Bell & Shoemaker, TAMRA, supra note 1, at 88 (inferring from the 1988 estate tax increase that "Congress does not fully appreciate the relationship between the NRA's income tax position and his estate tax position," i.e., that "TAMRA forces the NRA into a corporate investment structure without recognizing that [the Tax Reform Act of 1986] made [it] intolerable from the NRA's income tax perspective.").

126 The 1954 change was justified as "conform[ing] to the tax conventions the United States has entered into with many countries and remov[ing] any deterrent to the use of United States bank and trust companies as depositories." S. REP. No. 1622, 83d Cong., 2d Sess. 126 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. 92 (1954); for the 1966 legislative history, see supra note 41.

127 In addition, there is no additional income tax burden when portfolio stock investments in U.S. companies are held in a foreign holding company (and, in fact, Congress assured this by amending I.R.C. § 542(c)(7) in 1966).

See Mene, supra note 7, at 628 & n.135.
nonresidents may indirectly raise revenue in the form of higher income taxes from those legally avoiding the tax. This makes it less likely that the costs of avoiding the tax exceed the total revenues collected as a result of its existence. Moreover, the existence of the trade-off might put pressure on other countries to negotiate favorable income or estate tax treaty provisions with the United States for the benefit of their residents.

The existence of this trade-off intensifies feelings about the estate tax and its future status. For some nonresident aliens who avoid U.S. estate taxation through the use of a holding company, particularly nontreaty investors, the estate tax is not merely a small nuisance. For the United States, it may not be meaningless as a revenue raiser, despite the fact that it raises little direct revenue. In contrast, to the extent that income tax changes are enacted which reduce the relative income tax disadvantage of the corporate form, such as those passed in 1993, the justification for the estate tax on foreigners and also the opposition to it will decrease.

The question becomes whether the estate tax on foreigners should be retained and, if retained, how might it be improved.

4. CHOICES FACING CONGRESS

4.1. Broadening The Application Of The Estate Tax

In order to eliminate the inequity, the encouragement of sophisticated tax planning, and the disrespect for the law that is engendered by the current estate tax on foreigners, it would be necessary to close the loophole allowing foreigners to escape U.S. estate taxation by utilizing foreign holding companies. This would necessitate the adoption of a rule

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128 See, e.g., Bell & Shoemaker, Foreign Investment, supra note 6, at 267 (arguing that "[t]o individual investors from nontreaty countries . . . , U.S. policymakers have hung out a giant 'Not Welcome' sign"); 1990 Hearings, supra note 1, at 64 (Hudson testimony, arguing that "a foreign investor desiring to purchase U.S. real estate or other direct interest in a U.S. business enterprise is faced with an array of U.S. income tax and estate and gift tax hurdles that substantially inhibit the desirability of investing in the United States").

129 But cf. 1990 JCT REPORT, supra note 4, at 84 (suggesting the possibility of replacing the current rules with "a more mechanically enforceable system, designed to collect approximately the same amount as
which would require looking-through the assets of a foreign corporation controlled by a nonresident alien decedent. Even assuming that Congress does not want to allow an easy escape route from the estate tax, adoption of such a look-through rule does not seem advisable.

First, the likelihood of broad enforcement of such a rule seems remote. If a nonresident alien dies owning no U.S. assets other than those held through a foreign holding company, there would seem to be no way for the IRS to become aware of his death and his indirect U.S. holdings, except in highly publicized situations such as the death of Robert Maxwell or when the annual filing of a Form 5472 is required pursuant to I.R.C. sections 6038A(b) or 6038C(a)(1). The holding company might be organized in a "tax haven" country with which the United States has no treaty or other information-exchange agreement. Although such a look-through rule already applies under I.R.C. section 2107 to estates of expatriates found to have had a tax avoidance motive for recently abandoning U.S. citizenship, it is not clear whether this rule is effectively enforced.

the estate and gift tax would collect if imposed on a broader base than that under present law").

For the view that Congress wished to provide such an escape route without the need to repeal the tax, see Bell & Shoemaker, TAMRA, supra note 1, at 88; see also Mene, supra note 7, at 632 (arguing that "[t]he 1966 Act reduced the entire system . . . to a facade"). Congress' objective was to "avoid the appearance that the United States was a tax haven, while acknowledging that any alien who was willing to pay for some tax advice should be able to substantially reduce" his transfer tax burden. Id.; Ross, supra note 25, at 360 (noting that in the 1966 Act, Congress was "[c]aught in the dilemma of not wishing to impose tracing rules to prevent tax avoidance and thereby discourage foreign investment, and yet not wanting to look too favorably disposed to aliens").

See Ross, supra note 25, at 360 n.351 (stating that "[i]t is not clear that [tracing] rules could be effectively enforced in the context of aliens").

In any year in which a domestic corporation that is 25% foreign-owned, or a foreign corporation engaged in a U.S. trade or business, has any reportable transactions with a related party, a Form 5472 must be filed, which would identify any foreign individual owning at least 25% of the stock, actually or constructively, including through a foreign holding company. See Treas. Reg. §§ 1.6038A-2(a)(1), (b)(1),(2),(f)(1)(1991); 1.6038A-1(c)(1),(2) (1991).

See COMMITTEE ON TAXATION OF INT'L TRANSACTIONS, supra note 74, at 917 (stating that "the current provisions as to expatriates . . . are difficult to police").

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Moreover, if Congress were to enact a look-through rule, it would conflict with all but one of the sixteen existing estate tax treaties entered into by the United States, as well as with the OECD Model Double Taxation Convention. A unilateral override of such treaties, although effective for domestic law purposes, would damage our relationships with our treaty partners and our ability to negotiate future treaties. In addition, if the means for imposing the U.S. estate tax was to override an estate tax treaty, our partner under such a treaty would almost certainly be unwilling to cooperate in providing information necessary for enforcement, absent renegotiation of the treaty. The chances for renegotiating this aspect of treaties, particularly with


155 OECD COMMITTEE ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON ESTATES AND INHERITANCES AND ON GIFTS, (1983) [hereinafter OECD MODEL]. The Model Convention permits the nonresidence country to impose its estate or gift tax only on "immovable property" situated therein or "movable property . . . which is the business property of a permanent establishment situated" therein. Id. arts. 5-7, at 27-28.


157 The commentary to the OECD Model Convention explains that permitting source-based taxation of securities would have "involved sacrifices only by the States" that do not, by internal law, seek to tax securities on the basis of situs. OECD MODEL, supra note 135, at 67. The commentary also states that "the balance of concessions would not be equal if different treatment were accorded to registered shares and bearer shares," because in some states registration is required and in others bearer certificates are common. Id.

The Commentary states further that the country of residence "is best, and sometimes the only one, equipped to" monitor donative transfers of securities, particularly "bearer securities", which are generally used in Continental Europe. The Commentary points out that even if registration is required, "shares owned by foreigners are very often registered . . . in the name of nominees." Id. at 67. Finally, the Commentary suggests taxation based upon the domicile of the transferor is "more practical from the point of view of the taxpayer" because it avoids "dispersal of liability to tax amongst [several] States," where the securities may "originat[e]" but "with
European countries where bearer shares are prevalent, may be slim. Finally, even if a look-through rule were adopted for transfers at death, taxpayers could still rely, except in cases of sudden death, on the exclusion from gift tax for transfers of intangibles unless this loophole were also closed. The enforcement of a rule imposing a gift tax upon transfers of securities, with a look-through rule for foreign holding companies, may be even more difficult than the enforcement of a look-through rule for transfers at death. Thus, it seems unrealistic to expect that the major loophole in the U.S. estate taxation of foreign investors can be effectively closed.

4.2. Possible Repeal Of The Tax

The existence of this unclosable loophole in the U.S. estate taxation of foreign investors might suggest the desirability of the tax's repeal. Whether this is advisable depends on the rationale for the limited U.S. estate taxation of foreigners “can be found in a combination of historical legal precedent, notions of territoriality, international law, comity, foreign policy, economics, and a sovereign's taxing power”).

If the estate tax for U.S. citizens and residents were repealed, as proposed by Galvin, supra note 30, this would likely result in repeal of the estate tax for foreigners as well. This article, however, assumes that the U.S. estate tax will continue to apply to citizens and residents.

See 1990 JCT REPORT, supra note 4, at 84 (suggesting that “the effect of current law could be achieved more simply by exempting nonresident alien decedents’ estates”); Fowler REPORT, supra note 41, at 24 (recommending repeal of the tax as applied to intangibles); Ross, supra note 25, at 359, 360 (calling Congress' rejection of recommendation “puzzling”

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upon the soundness of the justifications for the imposition of the tax and whether these justifications are undermined by the existence of the loophole.

4.2.1. Justifications For The Estate Tax On Nonresidents

a. Introduction

The estate tax, like other taxes, is a means of raising revenue. Although the amount to be raised is necessarily small, the importance of the revenue is enhanced by the and arguing that “[i]t might have been desirable for the United States, which has long been one of the leading advocates of a free flow of capital internationally, to remove estate taxes on nonresident aliens”). Ross also suggests that there are “substantial arguments” for repeal based upon “social policy and proper nexus for tax.” Id. See FLORIDA BAR, supra note 12, at 912 (recommending repeal of the tax as applied to intangibles); 1990 Hearings, supra note 1, at 65 (Hudson testimony, recommending “[c]reation of a new pass-through corporate vehicle . . . affording estate tax protection”); see also Galvin, supra note 30, at 1413, 1418-19 (recommending repeal of the estate tax for all decedents); Gerald P. Moran, Estate and Gift Taxation: The Case for Repeal, 13 TAX NOTES 339, 343 (1981) (arguing that “the federal transfer tax has been repealed sub silentio”); cf. COMMITTEE ON TAXATION OF INT’L TRANSACTIONS, supra note 74, at 918 (noting that one alternative to the current income and estate tax rules relating to expatriates would be “to except gifts or inheritances from expatriates from the provisions of section 102”).


145 See BITTKER & CLARK, supra note 40, at 1-2; Michael J. Graetz, To Praise the Estate Tax, Not to Bury It, 93 YALE L.J. 259 (1983). Revenues from estate and gift taxes amounted to $7.78 billion in 1988, “or only a little over eight-tenths of 1 percent” of total federal tax revenues. BITTKER & CLARK, supra note 40, at 1. Moreover, “[o]utright confiscation” of gross estates in excess of $1 million would have yielded “less than 10 percent of total federal revenues.” Id. at 2. Another commentator has estimated that “$150 billion pass at death each year” and that his proposal to impose a tax of 100% on property passing at death, with six exemptions, would raise about $25-$30 billion annually. Mark L. Ascher, Curtailing Inherited Wealth, 89 MICH. L. REV. 69, 72, 91 (1990). Aaron & Munnell state that “[n]o developed industrial country derives significant revenues from wealth transfer taxes.” Aaron & Munnell, supra note 32, at 133. This is consistent with the fact that “the wealth of decedents in any one year is not a large percentage of GDP.” Id.; see also OECD NET WEALTH, supra note 144, at 27-28 (charts showing revenues in OECD countries); Moran, supra note 143, at 341 (such taxes now produce “less-than-significant revenues”).
likelihood of continuing budget shortfalls.\footnote{Ascher, supra note 145, at 92 ("[A] country with a government that insists on consistently spending substantially more than it takes in ought to consider seriously any proposal with reasonable prospects for raising any significant amount of revenue."); see also id. at 73 & n.15; Willard H. Pedrick, Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia, 35 TAX L.W. 113, 127 (1981) (stating that death taxes "raise significant amounts . . . for budgets hard pressed to cover the costs of social programs designed to ameliorate the plight of those unfortunate who have no wealth and little income"). But see Graetz, supra note 145, at 270 (stating "we must look elsewhere than the production of revenues if we are to justify strengthening, rather than eliminating, the estate tax"); OECD NET WEALTH, supra note 144, at 20-21 (noting that the "contribution of . . . wealth transfer taxes to revenue is invariably very small and revenue yield is unlikely to be the dominant consideration in their introduction or retention").}

One traditional justification for the tax has been its role in "break[ing] up large concentrations of wealth."\footnote{S. REP. NO. 144, 97th Cong., 1st Sess. 124 (1981) [hereinafter 1981 SENATE REPORT]. The report uses this as justification for expansion of the unified credit so as "to provide estate and gift tax relief to smaller estates." Id.}

This rationale has been criticized, however, on the grounds that (1) the tax is not well suited to the function\footnote{Ascher, supra note 145, at 93-96; see also Aaron & Munnell, supra note 32, at 121 ("[G]reat concentration of wealth holdings can produce adverse social or political outcomes.").} and may or may not be effective,\footnote{See Aaron & Munnell, supra note 32, at 138 (arguing that an inheritance tax would do more to "encourage the dispersion of large estates"); see also OECD NET WEALTH, supra note 144, at 79-81 (discussing possible advantages of inheritance tax over estate tax); Dodge, supra note 32, at 249 (The estate and gift taxes do "little . . . to encourage the dispersion of wealth among various individuals . . . [a]nd there is nothing . . . that bears on the acquisition by a recipient of wealth from multiple sources.").} and that (2) the function of the tax should not be
viewed so narrowly.\textsuperscript{151}

Rather, some supporters emphasize the tax's broader role as at least potentially "contributing an important element of progressivity to the federal tax system,"\textsuperscript{152} thereby promoting fairness\textsuperscript{153} and the "equalization of inherited wealth."\textsuperscript{154} Some argue that the tax is particularly suited to measuring "ability to pay" because its burden falls on the beneficiaries, for whom an inheritance is a "windfall."\textsuperscript{155} Some view the tax as compensating to some extent for the failure to impose a current income tax on unrealized appreciation and its exemption from income tax at death,\textsuperscript{156}

\& CLARK, supra note 40, at 7. However, they note that the "taxable estate' ... may be only a small fraction of the wealth that passes from one generation to another." \textit{Id}.

\textsuperscript{151} Graetz, supra note 145, at 271. Graetz argues that "[t]he narrowing of the estate tax base that accompanies political acceptance of this myth necessarily defeats the contribution of this tax to the progressivity of the federal tax system." \textit{Id}.

\textsuperscript{152} See Graetz, supra note 145, at 271. Graetz wrote in 1983 that "the estate and gift taxes ... contributed nearly one-third as much to the progressivity of our tax structure as did rates in excess of the average individual income tax" for 1970; however, for 1980, the figure was reduced to 12%, and the 1981 estate tax changes were expected to reduce it further. \textit{Id.} at 272-73; see Harry L. Gutman, \textit{Federal Wealth Transfer Taxes After the Economic Recovery Tax Act of 1981}, 35 \textit{NAT'L TAX J.} 253, 261-62 (1982).

\textsuperscript{153} See Graetz, supra note 145, at 278 ("There is quite a strong case to be made for the fairness of substantial and progressive taxes on bequests."); BITTKER & CLARK, supra note 40, at 6 (Some argue that because "estate and gift taxes are paid only by the super-rich" they can be justified on the grounds of "fairness and the desirability of taxing in accordance with ability to pay."); Pedrick, supra note 146, at 126-27 (Death taxes "represent an application of the ability to pay principle of taxation by requiring that large aggregations of wealth contribute to the cost of governance.").

\textsuperscript{154} BITTKER & CLARK, supra note 40, at 6; see Ascher, supra note 145, at 88 (noting that treatment of "accumulated wealth at death is ... a critical determinant of our degree of equality of opportunity succeeding generations will enjoy"); OECD NET WEALTH, supra note 144, at 17 (noting that wealth transfer taxes "may contribute importantly to vertical equity as in most countries inheritance is a major source of inequality in the distribution of wealth").

\textsuperscript{155} BITTKER & CLARK, supra note 40, at 6; see also Ascher, supra note 145, at 93; OECD NET WEALTH, supra note 144, at 17 (explaining that capital transfer tax "may be more acceptable [than annual wealth tax] because of the feeling that an inheritance is unrelated to the efforts of the heir").

\textsuperscript{156} BITTKER & CLARK, supra note 40, at 10 ("[I]t seems likely that, as long as the income tax laws continue to leave the door open to substantial accumulations, the estate and gift taxes will have a task to perform.");
as well as for other gaps in the income taxation of income from capital. Moreover, wealth “may well provide utility above and beyond the ability to consume,” such as “power or social standing” or “security.” Finally, it has been argued that an estate tax is less likely than an income tax to interfere with incentives to work or to save.

The justification for the gift tax depends upon the existence of an estate tax. Given an estate tax, a gift tax is necessary primarily to prevent lifetime gifts from being used to avoid imposition of an estate tax.

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Gutman, supra note 152, at 257-60 (noting that after ERTA only 15% “of the unrealized appreciation in estates of decedents dying will be subject to any tax at all”). However, Professor Galvin cites the unequal income tax treatment of realized and unrealized appreciation as a reason to replace the estate tax with a rule of constructive realization. Galvin, supra note 30, at 1417 & n.29.

157 See Aaron & Munnell, supra note 32, at 120-21, 138.

158 Id. at 121.

159 OECD NET WEALTH, supra note 144, at 16 (explaining that capital provides “advantages confer[ring] additional taxable capacity,” i.e., “an income independent of the health of the owner and attainable without any current sacrifice of leisure . . . [and] independence, security, and the opportunity for advantageous purchase or for a spending spree”).

160 See Graetz, supra note 145, at 280 (noting that some economists have observed that “death time taxes on capital, such as estate taxes, are likely to have smaller disincentive effects than lifetime income taxes”). Graetz finds the evidence “inconclusive” as to whether estate taxation has a significant “adverse impact . . . on capital formation.” Id. at 278, 283. See OECD NET WEALTH, supra note 144, at 18 (“A death duty . . . may have less of a disincentive effect on the supply of labour or work effort than an equivalent addition to [the] income tax.”); id. at 19 (discussing potentially contradictory effects on savings); Ascher, supra note 145, at 100-02 (discussing the effect on the incentive to work of his proposal to “curtail inheritance” by providing a tax of 100% above the amount of certain exemptions). Ascher states that “[w]hatever the disincentive effects of an increase in taxes at death, the authorities are all but unanimous that such effects are smaller than those of an increase in the income tax.” Id. at 102 & n.180; see also id. at 102-10 (discussing whether his proposal would cause shift from savings to consumption).

161 BITTKER & CLARK, supra note 40, at 12-13; see OECD NET WEALTH, supra note 144, at 78 (noting that the gift tax was justified by OECD members as “a measure to support the death duty”). In addition, the gift tax “discourages, or compensates for, loss of income tax revenue from transfer of income-producing assets from one owner to another in lower income tax brackets.” ABA TASK FORCE, supra note 28, at 396.

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b. Applicability Of Justifications To Nonresident Estates

The justification for situs-based jurisdiction over foreigners under the estate tax is that the accumulation and retention of wealth within a country's borders is facilitated by government-provided services and protection, and government support of the infrastructure and economy. Thus, it is fair for the situs country to make a claim to a portion of that wealth.162 This claim may be strongest for assets permanently situated in the country, such as real estate. The fact that a holding company, or a partnership, has been interposed between U.S. real estate or business assets and the nonresident alien does not weaken that claim.163

The primary role of the estate tax in achieving a progressive distribution of the tax burden, with regard to ability to pay, is quite consistent with a source-based, as well as a residence-based, imposition of tax. In light of this, the imposition of a U.S. estate tax on foreigners with U.S. assets, including those assets held through holding companies, may be viewed as important in achieving equity with U.S. investors.164

It is less obvious that the objectives of breaking up large concentrations of wealth and of promoting equality of opportunity in American society are furthered by the exercise of situs-based jurisdiction. These objectives seem to be important primarily if the inherited wealth were to remain in the hands of a U.S. citizen or resident, who may be presumed to play a larger role in U.S. society and politics than a

162 Cf. Ascher, supra note 145, at 86-87 (arguing that "society has a major stake in all accumulated wealth" because "[s]ociety plays a crucial role in every individual's acquisitive activities" as it "determines the rules by which individuals acquire property, ... educates (to one extent or another) every individual ... [and] enacts and enforces laws that protect individuals' enjoyment of what they acquire"); A.L.I., supra note 87, at 18-19 ("[G]overnmental services and protections" are relevant in determining source of income.); id. at 63 (Secondary dividend rule of I.R.C. § 861(a)(2)(B) is based upon the view that dividends have their source in the country under whose "governmental protections... the income-producing activities" generating the earnings took place.).

163 However, as discussed supra notes 134-39, where a holding company is interposed, such a claim would generally not be recognized by other countries.

164 As discussed below, the goal of equity was the stated rationale for the 1988 Act's increase in the estate tax rates applicable to nonresident estates.
foreigner. However, even though the decedent is a nonresident alien, his beneficiary may be a U.S. citizen or resident, or may, perhaps as a result of inheriting U.S. assets, become a U.S. citizen or resident. In addition, a nonresident alien with substantial U.S. assets may often play an important role in U.S. society. Examples include Rupert Murdoch and the late Robert Maxwell, two individuals having large U.S. media holdings.

The possible role of the estate tax in compensating for the failure to tax unrealized appreciation may also be viewed as consistent with a situs-based imposition of the estate tax, for example, on U.S. real estate. However, in the case of holdings of stock in U.S. corporations, other than real estate holding companies, the failure of the United States to tax even realized gains of nonresident aliens may undermine this argument. This would no longer be true, however, if a tax were enacted on capital gains of 10%-or-more foreign shareholders, as under House Bill 5270.

The availability of a holding company structure as a means to avoid a U.S. estate tax does not necessarily undermine these justifications for the imposition of a situs-based tax on foreigners. First, foreign investors who utilize a corporate structure to hold U.S. real estate or business assets may, at least in some cases, incur greater income tax burdens than if individual ownership or a partnership were used. Thus, the existence of the estate tax increases the overall U.S. tax burden of such foreigners even if they do not incur U.S. estate tax liability. Second, the small number of foreigners who do not use the corporate structure do incur a U.S. estate tax. Thus, the continued existence of U.S. estate taxation of foreigners furthers, rather than detracts from, equity between U.S. citizens and foreigners, although not achieving equity among foreign investors.

Without regard for the practical consequences, repeal of the estate tax only for foreigners might be perceived by American voters as inequitable, even though the estate tax in

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165 Avoidance can be achieved with a foreign holding company or, alternatively, with a U.S. holding company where there is treaty protection, or where an inter vivos gift is made.

166 See 1965 Hearings, supra note 25, at 64 (statement of the Treasury describing reasons for rejecting the repeal of the estate tax on intangibles.
general does not have great public support. \textsuperscript{167} At the same time, Americans might be expected to view the achievement of tax equity among wealthy foreign investors as fairly unimportant. \textsuperscript{168} Therefore, it might be difficult to convince American voters that using a relatively ineffective tool to subject foreign investors to a tax burden comparable to that imposed on U.S. citizens or residents is worse than abandoning the effort entirely.

A different conclusion might be drawn with respect to the U.S. estate tax on portfolio stock interests in U.S. companies held by foreigners. Use of a foreign holding company to avoid U.S. estate taxation on such investments is apparently simple and results in no adverse U.S. income tax consequences. Thus, no \textit{quid pro quo} is extracted for avoidance of the U.S. estate tax. Whatever the inequity in not imposing a U.S. estate tax on such assets held by foreigners, repeal might be accepted as merely recognizing a \textit{fait accompli}. \textsuperscript{169}

After the 1993 Act's change in the income tax rate structure, the same argument for repeal might be made for the entire estate tax on foreigners, assuming that the capital gains held by nonresident estates. The Treasury stated that "[a]lthough we receive only $5 million in revenue annually from our estate tax on nonresident aliens, it would appear inequitable to completely relieve nonresident aliens holding U.S. intangible property from estate tax when U.S. citizens are subject to an estate tax." \textit{Id.} Similarly, Stanford Ross stated that Congress, in failing to exempt foreigners from the U.S. estate tax in 1966, "was probably concerned that a statutory exemption would look like it was unduly favoring aliens over United States citizens." Ross, \textit{supra} note 25, at 360.

\textsuperscript{167} Graetz, \textit{supra} note 145, at 284-85 (commenting that "the American people do not seem to like heavy taxes on bequests"). Graetz also states that strengthening of the estate tax is blocked by "objections of owners of small businesses and farms." \textit{Id.}

\textsuperscript{168} Cf. Bell & Shoemaker, TAMRA, \textit{supra} note 1, at 87 (noting that "[p]assage of the across-the-board increase in estate taxation of NRAs was made all the easier because NRAs in the abstract have no representation in Washington").

\textsuperscript{169} However, IRS data shows that corporate stocks and bonds constituted 45\% of the total U.S. gross estate shown on returns of nonresident estates for 1986. \textit{See supra} note 109. It is not clear whether direct investments in U.S. corporations are included. The Staff of the Joint Committee uses an argument similar to that in the text to support complete repeal of the U.S. estate tax on foreigners. 1990 JCT REPORT, \textit{supra} note 4, at 84 (described \textit{supra} note 28).
tax on foreign shareholders proposed in House Bill 5270 is not eventually enacted. Under the 1993 Act, the likelihood that adverse income tax consequences would result from the use of a foreign holding company structure for U.S. real estate or business assets is greatly diminished. Recent history suggests, however, that the 1993 reversal in the relationship between individual and corporate tax rates may not last long. At the same time, it may be difficult in terms of relationships with our trading partners to reinstate the estate tax on foreigners once it has been completely repealed. Thus, it may not be wise to repeal the estate tax on foreigners in response to a possibly temporary decision by Congress to increase individual rates over corporate rates.

c. International Acceptance

Repeal by the United States of the estate tax on nonresident estates may be viewed as an overly generous unilateral act in light of the wide international acceptance of such a tax. Many other countries impose a tax on transfers of property at death, although the tax often takes the form of an inheritance tax imposed on the beneficiary rather than an estate tax. Under accepted international practice, a country may assert jurisdiction to impose an estate and gift tax on the basis of the situs of property within its borders, as well as on the basis of the residency of the transferor.

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170 Twenty out of 23 OECD countries reporting in 1986 had "death taxes and gift taxes at the central or federal level." The three that did not were Australia, Canada and Switzerland (where "most ... cantons" have such taxes). OECD NET WEALTH, supra note 144, at 77. Of the 20 countries, 3 have estate taxes, 16 have inheritance taxes and one has a combination of these taxes. Id. at 77-78. For a more comprehensive survey, see II JEFFREY A. SCHOENBLUM, MULTISTATE AND MULTINATIONAL ESTATE PLANNING 441-534, app. H, (1982 & 1990 Supp.). For a discussion of the repeal of death taxes in Australia and Canada, see Pedrick, supra note 146 (criticizing repeal in Australia); George E. Carter, Federal Abandonment of the Estate Tax: The Intergovernmental Fiscal Dimension, 21 CAN. TAX J. 232, 246 (1973) (criticizing the repeal as a "retrograde step").

171 See OECD NET WEALTH, supra note 144, at 79-81 (discussing the relative merits of estate and inheritance taxes).

172 See OECD NET WEALTH, supra note 144, at 108 ("Generally speaking, death taxes are charged on all the property of deceased persons who were resident or domiciled in the country imposing the tax, while in the case of non-residents the charge is limited to property situated in the taxing country"); see also OECD Model, supra note 135, arts. 5-7 (permitting a

https://scholarship.law.upenn.edu/jil/vol14/iss4/1
However, situs taxation of intangibles is less well-established, and a look-through rule for foreign entities may have no precedent. To avoid overlapping taxation by residence and situs countries, the country of residence is expected to provide relief by exempting the property having its situs in another country or by allowing a credit for the tax imposed by the situs country.

Most countries that impose death taxes, including many of the major trading partners of the United States, do impose these taxes on property owned by nonresidents and situated within their borders. Thus, U.S. citizens investing abroad will often be subject to foreign estate or inheritance taxes. Such foreign taxes are eligible to be credited against U.S. estate tax liability pursuant to I.R.C. section 2014.

Given this international practice, there is no barrier to the United States imposing its estate and gift tax on the basis of situs as well as residence, although there may be limits to acceptance of U.S. taxation of intangibles. In fact, this international practice may suggest that the United States

situs country to tax immovable property and movable property of a permanent establishment, but not other property; Burnet v. Brooks, 288 U.S. 378 (1933) (upholding inclusion in a nonresident decedent’s gross estate of stock in a foreign corporation and bonds of foreign governments and corporations that were physically held in the U.S.). The Supreme Court explained that the United States, “as a nation with all the attributes of sovereignty,” had jurisdiction to impose the U.S. estate tax “without violating any established principle of international law.” Id. at 396.

See supra notes 134-39 and accompanying text.


According to the OECD Committee on Fiscal Affairs, “most [member] States . . . tax transfers of all or certain property situated within their territory,” even in the absence of other bases for tax, such as residence of the donor or donee. OECD MODEL, supra note 135, at 15, 64. These countries include, for example, Denmark, Luxembourg, and Belgium (all three countries limit the tax to immovables), Germany (where the tax also includes business property, an invention registered there, and shares in a German company in the case of a 25% or more owner), and Sweden (where immovable property, business property, and all shares in a Swedish company are taxed), as well as the United Kingdom, and Ireland. OECD NET WEALTH, supra note 144, at 108.

The amount of U.S. tax that may be offset by the credit is limited by the ratio of the value of the property includible in the gross estate that is situated in the foreign country and subjected to the foreign tax to the entire gross estate (reduced by both the deduction for charitable transfers and the marital deduction).
should not forego an opportunity to raise revenue in a manner utilized by other countries.\textsuperscript{177} In addition, it may be undesirable for the United States to permit itself to be used as a tax haven, where residents of countries that impose an estate or inheritance tax can shield assets from exposure to either home country or situs-based taxation.

d. Revenues

For 1986, the IRS collected only about $6.5 million in estate taxes from nonresident estates. The gift taxes collected from nonresident alien donors in 1982 amounted to only about $400,000.\textsuperscript{178} Some have contended that “the current U.S. estate and gift tax on foreigners” is not “defensible as” a “significant revenue measure.”\textsuperscript{179} These figures may not, however, fully reflect the large increase in U.S. investments by foreigners during the 1980s or the higher estate tax rates imposed by the 1988 Act.\textsuperscript{180} Nor do they reflect the revenues that could potentially be generated by more vigorous enforcement of the tax. Even with these adjustments, however, the revenue generated by estate taxation of nonresident estates probably would not be a significant percentage of estate tax revenues from all sources.

These revenue figures may tell an incomplete story. A significant increase in income tax revenues may have been generated indirectly by the existence of the estate tax, which induces foreigners to use holding company structures for

\begin{itemize}
\item \textsuperscript{177} See Ross, supra note 25, at 359 (Congress’ decision not to repeal estate tax on intangibles in 1966 was based in part on “[t]he fact that most advanced countries of the world do have statutes on their books which seem to impose some amount of death tax on assets owned by aliens.”).
\item \textsuperscript{178} See Long, supra note 29, at 51, 54, 58 (estate tax); FLORIDA BAR, supra note 12, at 910 n.1 (gift tax). The estate tax collected for 1982 was “nearly $4 million.” Skelly & Hobbs, supra note 29, at 15.
\item \textsuperscript{179} 1990 Hearings, supra note 1, at 65 (Hudson testimony); see also FLORIDA BAR, supra note 12, at 910 (“U.S. estate and gift taxes on nondomiciled aliens are not significant sources of revenues.”); Mene, supra note 7, at 633 (“Nonresident alien tax provisions are not designed as a revenue measure at all, but are an interplay of politics and foreign relations.”).
\item \textsuperscript{180} It is interesting to note that prior to the reduction in rates under the 1966 Act, the estate tax on nonresidents was raising $5 million annually. 1965 Hearings, supra note 25, at 64 (statement of Treasury). This was more than the $4 million raised in 1982. See supra note 178.
\end{itemize}
investments. This assumes that a corporate structure is more expensive than direct ownership from an income tax standpoint. As noted, this is not always true, particularly for treaty investors and particularly after the 1993 Act's income tax rate changes. If, however, a capital gains tax on 10%-or-more foreign shareholders is enacted, the corporate structure would become more expensive than direct ownership in many more cases. This would increase income tax revenues, assuming that foreigners are not thereby induced to invest elsewhere.

Attribution of greater income tax revenues to the existence of the estate tax further assumes that a foreign holding company would not be utilized by foreigners for other reasons (e.g., to avoid the need to file a U.S. individual income tax return or to achieve anonymity or limited liability), even if the U.S. estate tax on foreigners were repealed. 181 This assumption is difficult to verify.

In any event, in light of the current prospects for the U.S. budget deficit, no revenue source, however small, assuming that revenue exceeds the cost of collection, is readily sacrificed.

e. Effect That Repeal Of Estate Taxation Of Foreigners Would Have On Estate Taxation Of U.S. Citizens

i. Treaty Benefits For U.S. Citizens

Retention of the estate tax on nonresidents may be necessary to permit the U.S. Treasury Department to negotiate new or revised 182 estate tax treaties with other countries in which U.S. citizens or U.S. domiciliaries may reside or have

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181 Robert F. Hudson, Jr. recognized that foreigners may prefer to use the corporate form in his proposal that the burden imposed on foreigners by U.S. estate taxation be ameliorated by permitting nonresident aliens to form S corporations and to exempt the stock in such corporations from U.S. estate tax. 1990 Hearings, supra note 1, at 65-66 (Hudson testimony).

182 Currently, the United States does not appear to be seeking to greatly expand or modify its estate tax treaty network. Apparently, the only countries with which the United States currently has active estate tax treaty negotiations are Germany and France, with whom the United States already has estate tax treaties. See Fogarasi, supra note 14, at 507-08. However, income tax treaty negotiations with Canada also include estate tax issues. See infra note 186.
assets. Without such a tax, or perhaps a replacement tax, such as a tax on gains constructively realized at death, the United States would have no leverage in such negotiations or would have to use unrelated tax provisions, such as income tax provisions, as its bargaining chips. In fact, the current estate tax on nonresident estates may help the U.S. Treasury to negotiate income tax reductions with other countries. Of course, the 1993 Act's income tax rate changes, if not eventually followed by enactment of a capital gains tax on foreign shareholders, greatly diminish the income tax disadvantages of a corporate structure and, as a result, the bargaining leverage of the United States in estate tax treaty negotiations.

Retention of the estate tax on nonresidents might also be necessary to ensure the continuation of existing estate tax treaties. The U.S.-Canada treaty was eventually terminated after Canada repealed its estate tax. However, negotiations are currently underway for a treaty provision coordinating the U.S. estate tax with the Canadian income tax on constructively realized gains. In addition, the U.S.-Australia treaty has

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183 See COMMITTEE ON TAXATION OF INT'L TRANSACTIONS, supra note 74, at 922 ("Since the estate and gift taxes can be avoided by owning United States assets through a foreign corporation, logical justification for their retention lies in part on the ability to obtain benefits and information through treaties with other countries."); cf. 1965 Hearings, supra note 25, at 64 (statement of Treasury noting that repeal of the estate tax on intangibles held by foreigners would hamper information exchange under treaties).

184 See infra notes 345-69 and accompanying text.

185 Cf. 1968 HOUSE REPORT, supra note 25, at 1001 (Congress was concerned that "unilateral reduction of estate tax rates ... by statute may have the effect of making it more difficult to negotiate estate tax treaties.").

186 Concern about the 1988 estate tax rate increase for nonresident estates was a factor leading to income tax negotiations with Canada, which include discussion of overlapping death taxation. See Nathan Boidman, Cross-Border Death Taxes: Current Issues and Developments (pt. III), 2 TAX NOTES INT'L 822, 826 (1990) [hereinafter "Boidman III"] (noting that "controversy stirred up for Canadians by the radical increase in U.S. estate tax rates in 1988 has been seen as the major reason for treaty renegotiations that commenced in January of [1990]"); see also Fogarasi, supra note 14, at 508 (status of treaties); Gary J. Gartner, Canada—United States Treaty Renegotiations Postponed, 21 TAX MGMT. INT'L J. 91, 103 (1992) ("U.S. treaty negotiators undoubtedly have used the opportunity to seek a reduction in the withholding rates.").

187 See Troxell, supra note 14, at A-16 (discussing termination of treaty);
not been terminated despite Australia's repeal of its estate tax in 1979.\textsuperscript{188}

If repeal of the U.S. estate tax on nonresidents hampers the ability of the United States to negotiate or retain estate tax treaties with other countries, this may have adverse effects on the U.S. Treasury or on U.S. citizens and residents. A loss of treaty provisions limiting source-based taxation might reduce the revenues of the United States in its capacity as a residence country because increased foreign taxes imposed on U.S. persons would result in their claiming increased credits against U.S. estate taxes pursuant to I.R.C. section 2014. This loss of U.S. tax revenue would be in addition to the loss of revenue resulting from the United States' voluntary relinquishment of jurisdiction to tax foreigners on a source basis.\textsuperscript{189} On the other hand, if the increased foreign taxes were not creditable pursuant to I.R.C. section 2014 (e.g., because the United States considers the property taxed by the foreign country to have a U.S. situs), the loss of treaty benefits would be borne by the U.S. citizens incurring the foreign taxes.

Of course, the importance of such effects created by a reduced treaty network depends on certain assumptions. First, it must be assumed that, in the absence of a treaty, a foreign country would collect a significant amount of estate or inheritance tax from U.S. citizens or residents (thus, for example, it would not be practical for U.S. citizens or residents to avoid the tax by use of a foreign holding company).\textsuperscript{190} A

\textit{supra} note 186 and \textit{infra} note 350.

\textsuperscript{188} Troxell, \textit{supra} note 14, at A-16.

\textsuperscript{189} It is not clear that the positive revenue effect for the United States of existing treaties (i.e., reduction of credits against U.S. estate tax claimed by U.S. residents) is not partly or fully offset by a negative revenue effect of such treaties (i.e., reduction of U.S. situs-based taxation of nonresidents, mandated by the treaties). However, if the choice is between (a) retention of the status quo and (b) repeal of the U.S. estate tax on nonresidents with resulting elimination of U.S. estate tax treaties, then the latter course can be seen as only reducing revenues, because the revenue from nonresidents that the United States forgoes under treaties would not be claimed by it.

\textsuperscript{190} See, e.g., Rene de Monseignat, \textit{The Estate Planning Environment in France, in INTERNATIONAL ESTATE PLANNING, supra} note 7, at 549, 558-59. The author suggests that foreigners can avoid French succession taxes upon French real estate by holding it in a “societe civile,” owned individually or by “non-French limited liability companies.” \textit{Id.} For use of a non-Canadian holding company to avoid the Canadian income tax on deemed dispositions at death, see \textit{infra} note 351.
second assumption is that a significant portion of the tax otherwise collected would be eliminated by treaty provisions (e.g., because the tax was imposed on intangibles). If these assumptions are true, then it might be useful for the United States to study the methods used by other countries to enforce their death taxes.

If the only objective of the United States in imposing its estate tax on nonresidents is as a bargaining tool for reduction or elimination of situs-based taxation of U.S. citizens or residents by other countries, this might be accomplished without applying the U.S. estate tax so broadly. The objective is not served by imposing the estate tax on residents of countries that do not, under domestic law, impose any death taxes on nonresidents. The U.S. tax would impose an unnecessary burden on residents of such countries, who would have little prospect of treaty relief being negotiated for them. Congress could instead adopt a provision analogous to I.R.C. section 883 providing for a complete estate tax exemption for residents of any country that either has no situs-based estate tax or agrees to exempt U.S. residents from estate tax.¹⁰¹

This approach, however, ignores other functions that an estate tax treaty might perform, such as providing procedures for mutual agreement and exchange of information. In addition, a treaty benefits U.S. citizens and residents by resolving conflicting claims made by the United States and another country to impose residence-based taxation, albeit sometimes to the detriment of the U.S. Treasury.¹⁰²

¹⁰¹ An alternative is to extend the approach of I.R.C. § 2108, which authorizes the President to proclaim that pre-1967 provisions apply to decedents of any countries imposing more burdensome taxes on U.S. citizens than the United States applies to residents of such countries. See 1966 HOUSE REPORT, supra note 25, at 1001. That is, the United States would reduce or eliminate its estate tax on nonresident estates, but give the Treasury authority to reimpose the tax on residents of countries that do not reciprocate.

¹⁰² If, for example, a treaty classified a particular U.S. citizen or resident as a resident only in the other country, U.S. jurisdiction to tax would be limited to U.S. situated assets, and, thus, the United States would lose revenue. If, on the other hand, the treaty resolved the conflict in favor of the U.S. claim, the United States would not be gaining anything beyond what it would have claimed absent the treaty, because the tax on U.S. assets that the other country would be precluded from imposing would not have been creditable, in any event, under I.R.C. § 2014.
ii. Exchange Of Information

As noted above, one function of estate tax treaties is to provide for an exchange of information that will facilitate the enforcement of estate taxation. Under these treaty provisions, information, presumably obtained from estate tax returns, regarding decedents who are residents of a treaty country is provided to that country, either routinely or upon request.

It has been argued that repeal of the estate tax on nonresidents would prevent the United States from acquiring information about U.S. assets held by nonresident estates. Thus, the United States would have little information to swap with its treaty partners for information about estates of U.S. citizens who reside in the treaty country or have assets therein. Clearly, enforcement of the U.S. estate tax with respect to foreign assets of U.S. citizens is essential both in terms of equity vis-a-vis U.S. citizens whose assets are entirely in the United States and to avoid creating an incentive for U.S. citizens to invest abroad.

The exchange of information argument for retaining the estate tax on nonresidents may not be as strong as it first appears. The small number of nonresident estate tax returns currently filed, e.g., only 110 for 1986 apart from the 51 filed for Canadian decedents, may provide the United States with very little information about U.S. or foreign assets of nonresident alien decedents that can be offered to treaty

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183 Most exchange of information provisions are not specific about the information to be provided. An exception is the treaty with Norway, which requires the United States routinely to provide "information disclosed by [U.S.] estate tax records relative to estates of deceased persons who were domiciled in, or citizens of, Norway," as well as "such information as is available" regarding assets located in Norway of U.S. citizens or residents. Convention for the Avoidance of Double Taxation, June 13, 1949, U.S.-Nor., art. 8, para. (1)(a), 2 U.S.T. 2353, 2358.

184 See, e.g., Convention for the Avoidance of Double Taxation, U.S.-Fr., supra note 15, art. 15, para. 4, at 1957 (providing that "[t]he furnishing of information shall be either on a routine basis" as agreed by the competent authorities of the two countries, "or on request with reference to particular cases"); Convention for the Avoidance of Double Taxation, July 15, 1969, U.S.-Neth., art. 14, para. 3, 22 U.S.T. 247, 265.

185 See 1965 Hearings, supra note 25, at 64 (statement of Treasury); COMMITTEE ON TAXATION OF INT'L TRANSACTIONS, supra note 74, at 922 & n.29 (quoted supra note 183).

186 See Long, supra note 29, at 58.
partners. In addition, the small amount of information obtained by the IRS regarding U.S. assets of nonresident estates casts doubt on the ability of our treaty partners to provide the United States with valuable information about assets that belong to U.S. citizens or to U.S. residents unless they are also citizens of the treaty partner.

Even if the estate tax on nonresidents were repealed, the IRS nevertheless might be able to obtain considerable information (perhaps as much as it obtains currently) about U.S. assets of nonresident decedents through its income tax enforcement mechanisms.\(^{197}\) With this information obtained for income tax purposes,\(^{198}\) it seems likely that the United States could enter into an information exchange agreement under which it would be provided with information pertinent to collecting estate taxes from U.S. citizens or residents.\(^{199}\) Nor is it necessary that an agreement for exchange of information relating to estate taxes be contained in an estate tax treaty. In some U.S. income tax treaties, the article on the exchange of information already applies to the U.S. estate tax.\(^{200}\) Moreover, in 1984, the United States began to enter

\(^{197}\) For penalties under I.R.C. § 874 for failure to timely file an income tax return, see \emph{supra} note 104. For Treasury's authority under I.R.C. § 6039C to require information reporting, see \emph{supra} note 107. A partnership may be required to withhold income tax with respect to a nonresident alien partner. \emph{See} I.R.C. §§ 1441(b), 1445(e)(1), 1446. For filing requirements prescribed by regulations pursuant to I.R.C. §§ 6038A and 6038C, see \emph{supra} note 132. In addition, the IRS obtains information regarding U.S. source dividends, interest or royalties received by foreign persons through Form 1042S filed by withholding agents. \emph{See} Richard A. Gordon et al., \emph{An Analysis of Tax Information Agreements Concluded by the U.S.}, 20 TAX MGMT. INT'L J. 187, 193 (1991). This information is "automatically" provided to the residence country pursuant to information exchange provisions in income tax treaties. \emph{Id.} at 193.

\(^{198}\) One existing estate tax treaty makes clear that the United States is required to supply information in its possession even though such information pertains to assets of nonresidents exempted from U.S. estate tax by the treaty. Convention for the Avoidance of Double Taxation, U.S.-Fr., \emph{supra} note 15, art. 15, para. 2(b); Technical Explanation of the U.S.-Fr. Convention on Taxes on Estates, Inheritances and Gifts, 1980-2 C.B. 405, 411.

\(^{199}\) The United States might even want to conclude such an agreement with a country that does not impose its estate tax on U.S. citizens, provided that such a country (like the United States) has other means of obtaining information pertinent to assets of U.S. citizen or resident decedents.

\(^{200}\) There are at least 11 such treaties. \emph{See} Convention on Avoidance of Double Taxation, Aug. 29, 1989, U.S.-F.R.G., art. 26, para. 6, 2 Tax Treaties
into tax information exchange agreements separate from income or estate tax treaties, and these agreements generally apply to estate taxes.\textsuperscript{201} In addition, the United States is a signatory of the Convention on Mutual Administrative Assistance in Tax Matters of the Council of Europe and the OECD.\textsuperscript{202} Repeal of the U.S. estate tax on nonresidents would apparently not preclude the United States from obtaining information under this Convention with respect to estate taxation of U.S. citizens and residents, if the United States were willing to provide reasonable assistance in enforcing other countries' estate taxes.\textsuperscript{203}

Finally, if repeal of the estate tax would prevent the United States from negotiating exchange of information agreements regarding estate taxes owed by U.S. citizens or residents, Congress could authorize the IRS to impose the estate tax only on residents of countries with which the IRS has not obtained a satisfactory agreement. A similar provision was enacted in connection with the repeal of income taxation of interest received from portfolio debt, but it has not been invoked by the IRS.\textsuperscript{204}

In conclusion, retaining an estate tax on nonresident estates does facilitate receipt by the U.S. Treasury of information from other countries regarding estates of U.S. citizens and residents. However, it is not clear how valuable the information obtained pursuant to estate tax treaties has been.

\textsuperscript{201} See Gordon, supra note 197, at 187. For a current listing of these agreements, see Fogarasi, supra note 14, at 510.

\textsuperscript{202} This was ratified by the United States, with reservations relating to recovery of tax claims, state and local taxes, and service of documents. See U.S. Presents Instrument of Ratification to OECD Multilateral Treaty, 91 TNT 41-29, Feb. 21, 1991, available in LEXIS, Taxana Library, TNT File. However, the Convention is not yet in force. See Treas. Dept., Treasury Issues Update of Treaty Talks, 92 TNT 124-90, June 16, 1992, available in LEXIS, Taxana Library, TNT File.


\textsuperscript{204} I.R.C. §§ 871(h)(5), 881(e)(5); see Gordon, supra note 197, at 189 & n.8.
Nor is it clear that repeal of the estate tax on nonresident estates would leave the United States without adequate alternatives to obtain such information.

f. Discouragement To Investment In The United States

Situs-based estate taxation has an important disadvantage not shared by residence-based taxation: it may distort decisions regarding where to invest. The concern that situs-based taxation had discouraged investment in the United States figured prominently in decisions to reduce the rates of the estate tax in 1966. Commentators Bell and Shoemaker argued in 1991 that Congress' 1966 objective of not discouraging investment in the United States by foreigners had been "indirectly and inadvertently repealed by Code changes that have made investment through a foreign corporation unattractive from an income tax perspective."

Investment in the United States will be discouraged only with respect to assets other than those eligible for exemption by statute (e.g., portfolio debt) or by treaty (e.g., intangibles, such as investments in stock in U.S. corporations). Such discouragement will occur only if the following assumptions are correct: (1) tax considerations are a significant factor in a foreigner's decision to invest in the United States; (2) the U.S. estate tax would not be fully creditable against an estate or inheritance tax imposed by the residence country; the

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205 See 1990 JCT REPORT, supra note 4, at 84 (noting as a "policy consideration ... the effect that broad imposition of U.S. estate and gift tax might have on decisions to invest inside or outside the United States").

206 See supra notes 20 & 25. During the legislative deliberations, the Treasury stated that "[i]t is generally believed that high estate taxes on foreign investors are one of the most important deterrents in our tax laws to foreign investment in the United States." 1965 Hearings, supra note 25, at 19. For discussion of the Congressional objective in 1966, see Mene, supra note 7, at 632-33.

207 See Bell & Shoemaker, Foreign Investment, supra note 6, at 268; Bell & Shoemaker, TAMRA, supra note 1, at 88.

208 See 1965 Hearings, supra note 25, at 19 (The Treasury recommended lower estate tax rates and an increased exemption as "bring[ing] U.S. effective estate tax rates on nonresident aliens to a level ... substantially below those imposed on resident estates in the United Kingdom, Canada, and Italy" so that "U.S. investment from these latter countries bears no higher estate tax than local investment because of foreign tax credits or exemptions provided in such countries."); Knight & Doernberg, supra note
foreigner is not willing to use aggressive or fraudulent return positions as a means to avoid U.S. estate tax; (4) if the foreigner were to use a holding company to avoid U.S. estate tax, he would suffer unfavorable U.S. income tax or foreign tax consequences or considerable inconvenience or expense, and he would not have used a holding company, e.g., as a device to achieve anonymity, absent concern about the U.S. estate tax; and (5) estate taxation is more burdensome in the United States than in other potential host countries. Thus, for example, because the U.S. estate tax on foreigners’ portfolio holdings of stock in U.S. companies is easily avoided at little cost, it provides little disincentive to such investments. Particularly under the 1993 Act, this may often be true for investments in U.S. business assets or real estate.

The rapid expansion of foreign investment in the United States in the 1980s seems to have slowed in the 1990s, and the United States must consider whether it desires to take new steps to attract such investment. In that regard, the United States must consider whether investment by foreign individuals (through whatever form) is a major source of foreign investment in this country. The United States must also consider whether it could attract such investment merely by adjusting the level of tax, for example, through the rate schedule, the unified credit or the marital deduction. In

51, at 288-89 (In light of 1988 rate increases, U.S. estate tax incurred by German investor in U.S. real estate would “in many cases . . . far exceed the German inheritance tax.”).

309 In 1965, the Treasury, in supporting an “increase in exemption and reduced rates” but retention of the estate tax on intangibles for nonresidents, noted that “[t]he proposed tax treatment . . . is substantially similar to the treatment accorded the estates of nonresidents by Canada, whose rates on the estates of its citizens are comparable to our own.” 1965 Hearings, supra note 25, at 64-65 (Treasury statement).


311 See 1965 Hearings, supra note 25, at 64 (statement of Treasury) (recommending an “increase in [specific] exemption and reduced rates” instead of repeal of the tax as applied to intangibles, in order to avoid discouragement of investment in the United States by foreigners); see also Ross, supra note 25, at 358 (“Congress wanted to impose some measure of
this way, it could seek to insure that the U.S. tax does not exceed the tax level in other likely host countries or at least in likely residence countries assuming the U.S. situs-based tax would be creditable.\(^{212}\)

4.2.2. Conclusion

Despite the limited effectiveness of the U.S. estate tax with respect to nonresident estates and its possible discouragement of foreign investments in the United States, there are arguments for retaining it if the estate tax for U.S. citizens and residents is retained. Simple repeal of the estate tax for foreigners would represent a voluntary relinquishment of the revenues, however small, collected from the tax to other countries without any expectation that those countries would take reciprocal action. Repeal would also mean relinquishment of the additional income tax revenues that may be generated, although of a lesser amount under the 1993 Act, when the desire to avoid U.S. estate tax induces foreigners to utilize a holding company. Moreover, repeal for nonresidents but not for residents would detract somewhat from equity between U.S. citizens and foreigners, even though retention of the tax does not by any means yield complete equality of treatment, and would likely be viewed by the public as clear discrimination in favor of foreigners. Limited effectiveness with resulting unfairness is a defect of the U.S. estate tax even as applied to U.S. citizens. Thus, it may be inappropriate to limit repeal to the estate tax on nonresidents.

Repeal for nonresident estates might also disrupt the network of U.S. estate tax treaties and information exchange thereunder, although information exchange could probably be maintained, perhaps with additional effort on the part of the U.S. Treasury. This might lead to: (1) excessive situs-based taxation of U.S. citizens or residents who invest abroad or duplicative claims of residence taxation, resulting in double taxation; or (2) a loss in U.S. estate tax revenues from U.S.

taxation on aliens with substantial U.S. property, while recognizing that aliens should not be subject to as high estate tax burdens as citizens.\(^{213}\). As discussed infra notes 352 et seq. and accompanying text, some have proposed reducing the level of tax by limiting the tax to the element of appreciation in property passing at death.

\(^{212}\) See supra notes 208, 209.
citizens or residents investing abroad due to increased foreign death tax credits or lack of information required by the IRS for enforcement.

These arguments should be sufficient to convince Congress to retain the tax unless the U.S. estate tax is repealed for U.S. citizens and residents as well. However, if the tax is to be retained, its limitations should be taken into account in the tax’s design.

4.3. Design Of An Imperfect Tax

If the U.S. estate tax on nonresidents is to be retained despite its limited effectiveness, at what level and upon what base should the tax be imposed? In order to retain a meaningful role for the estate tax on nonresidents, the base should not be narrowed further, and uncertainties regarding application of the tax, which contribute to evasion, should be resolved. To add, enforcement mechanisms should be strengthened.

At the same time, the United States should not be overzealous in its application of this necessarily imperfect tax. In a domestic context, Congress has been very generous in exempting the small and medium-sized estate (far too generous, one might argue). To deny this generosity to foreigners undercuts the U.S. claim that it seeks equal treatment of foreigners and U.S. citizens. Of course, strict equality is an elusive goal in light of the differing considerations relevant to the taxation of nonresident decedents. Fairness to nonresident aliens would seem to require that where strict equality is unattainable, Congress should not choose the alternative more burdensome to nonresident aliens. A heavy-handed approach tends to undermine international acceptance of the estate tax on foreigners, which is an important justification for its retention.

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213 See Bell & Shoemaker, TAMRA, supra note 1, at 81-82 (treatment of partnership interest); supra notes 93-101 and accompanying text.
214 See supra note 151; infra notes 324-25.
4.3.1. Tax Base

a. Partnership Interests

If the estate tax on nonresidents is to be retained despite its imperfections, then uncertainties and inconsistencies in the definition of the tax base should be resolved. Congress should establish clear rules\(^{215}\) for determining the situs of a partnership interest for estate tax purposes and for classifying a partnership interest for gift tax purposes.\(^{216}\) As noted above, uncertainty on this issue has probably contributed to aggressive reporting positions taken by taxpayers, which serve to anger more responsible taxpayers.\(^{217}\) Since the statute is silent on this issue, and given that it goes to the heart of the current estate tax regime for foreigners, Congress should resolve the uncertainty.

A major criticism of the current estate tax treatment of foreigners is that the application of the tax is very narrow in light of the potential for avoidance by use of a foreign holding company. As noted, this loophole must be tolerated because a look-through rule for foreign holding companies would present difficulties involving enforcement and international acceptance. In contrast, there is no similar justification for allowing U.S. real estate or business assets held in a partnership to escape U.S. estate or gift taxation. Therefore, a look-through rule\(^{218}\) for partnership interests should be adopted for estate and gift tax purposes.\(^{219}\)

Enforcement of the estate tax or even the gift tax under a look-through rule for partnerships should not be difficult in

\(^{215}\) Cf. Bell & Shoemaker, TAMRA, supra note 1, at 81 (The look-through rule should be "incorporated in a clear pronouncement by the IRS.").

\(^{216}\) For a discussion of the uncertainty under the current law, see supra notes 10, 12-13 and accompanying text.

\(^{217}\) See supra notes 93, 94 and 117.

\(^{218}\) Cf. Rev. Rul. 91-32, 1991-1 C.B. 107, supra note 99 (adopting such a rule for income taxation of dispositions of partnership interests).

\(^{219}\) See Bell & Shoemaker, Foreign Investment, supra note 6, at 268-69 (proposing look-through rule be adopted with respect to partnerships for estate tax purposes); FlÓRIDA BAR, supra note 12, at 912, 916 (proposing that "property held by partnership, trust, or estate" be "treated as held proportionately by its partners or beneficiaries" for gift or estate tax purposes); see also Bell & Shoemaker, TAMRA, supra note 1, at 81 (stating that "[f]rom a policy standpoint," a look-through rule should be used).
the case of a partnership engaged in a U.S. business or holding U.S. real estate. Such a partnership would already be required to identify foreign partners for income tax purposes and to withhold income tax.\textsuperscript{220} As suggested by one commentator, the partnership could also be required to assist in withholding the estate or gift tax whenever a donee or beneficiary was to be admitted as a new partner.\textsuperscript{221} Another possible enforcement technique for the estate tax would be to deny the benefits of the I.R.C. section 754 election absent an IRS waiver.

Congressional action classifying a partnership interest under a look-through approach would not conflict with well-established international rules.\textsuperscript{222} For example, the OECD Commentary on its Model Convention notes the possibility of divergent characterizations of a partnership interest and suggests as one solution a treaty provision reserving to the nondomiciliary state "a right to tax the partnership interest to

\textsuperscript{220} See supra notes 105, 197.

\textsuperscript{221} See Bell & Shoemaker, TAMRA, supra note 1, at 82. They note the withholding rules for income tax owed by a nonresident alien partner, under I.R.C. §§ 1441, 1445, and 1446, and argue that "it would certainly be possible to collect U.S. estate taxes through some mechanism since the partnership... will have assets within the United States." Id.; see also Bell & Shoemaker, Foreign Investment, supra note 6, at 269.

\textsuperscript{222} Among the pre-1970 treaties, only that with Australia contains an explicit situs rule for partnerships (i.e., the place where the partnership business is carried on). Troxell, supra note 14, at A-30; Convention For the Avoidance of Double Taxation, U.S.-Austl., supra note 134, art. 3, para. 1(g), at 96. Among the post-1970 treaties, the treaty with Germany explicitly adopts a look-through approach. See Troxell, supra note 14, at A-29; Convention For the Avoidance of Double Taxation, U.S.-F.R.G., supra note 15, art. 8, at 10; see also Bell & Shoemaker, Foreign Investment, supra note 6, at 268 n.40. The treaties with France and the Netherlands provide only that U.S. taxation of a partnership interest is permitted to the extent that the partnership is engaged in a U.S. trade or business through a U.S. permanent establishment. See Convention For the Avoidance of Double Taxation, July 15, 1969, U.S.-Neth., supra note 194, art. 7, at 255; Convention For the Avoidance of Double Taxation, U.S.-Fr., supra note 15, art. 6, at 194. The treaties with Sweden and Austria leave the classification of a partnership interest to the law of the nondomiciliary state, and "[t]he U.K. and Danish treaty are silent." See Troxell, supra note 14, at A-29 n.305; Convention For the Avoidance of Double Taxation, June 13, 1983, U.S.-Swed., art. 7, T.I.A.S. No. 10,826, at 10; Convention For the Avoidance of Double Taxation, U.S.-Aus., supra note 15, art. 7, para. 2, at 3609; see also Model Estate and Gift Tax Treaty of November 20, 1980, art. 7 (Treas. Dep't 1980), reprinted in 1 Tax Treaties (CCH) ¶ 209 (similar to Swedish provision).
the extent that the underlying assets would be taxable under the Model treaty.223

Adoption of a look-through rule for partnerships would not be merely an empty gesture. Currently, many foreigners may utilize a partnership to own U.S. real estate or business assets without their estates filing a U.S. estate tax return upon death. This practice would be discontinued. By eliminating the option of obtaining the income tax treatment associated with a partnership (i.e., pass-through treatment with a stepped-up basis) while also avoiding the estate tax, some revenue would likely be raised.224

b. Stock In U.S. Corporations

A more difficult question is the proper treatment of stock in a U.S. corporation. On nonresident estate tax returns filed for 1986, corporate stocks and bonds represented an average of 45% of the U.S. gross estate, or a total of about $27.8 million.225 A thoughtful study of the estate taxation of nonresidents prepared by the Florida Bar Tax Section in 1988 proposed that stock in a U.S. corporation and other intangibles be excluded from the scope of the estate tax on nonresidents. One rationale was that “the estate tax should not foster [the use of foreign holding companies] unnecessarily.” A further justification was to bring the gift and estate tax rules into conformity.226

223 OECD Model, supra note 135, at 71; see also id. at 68-70.

224 By contrast, if Congress were to provide clearly that a partnership interest was an intangible with its situs at the residence of the partner, many foreigners, more than under current law, would likely take advantage of this opportunity, thereby decreasing revenues, although to a lesser extent under the 1993 Act. This new advantage associated with a partnership might put even greater pressure on the issue of entity classification. See Troxell, supra note 14, at A-29. Troxell suggests that in applying treaty provisions that arguably exempt from U.S. tax an interest in non-business U.S. real estate if held through a partnership, “[t]he existence of a partnership might be denied either on grounds of sham or failure to engage in an active business.” Id.

225 See Long, supra note 29, at 53, 58. The average percentage was only 36% where the U.S. gross estate was in the range of $60,000 to $100,000, but was 56% where the U.S. gross estate was over $1 million. Id. It was not indicated whether the corporate stocks and bonds constituted solely portfolio investments.

226 See FLORIDA BAR, supra note 12, at 911-12. The report proposes a
The strongest case for exemption would be one for passive investors in publicly-traded U.S. corporations. As noted above, the use of a foreign holding company is apparently simple and results in no adverse income tax consequences so that no quid pro quo is extracted for avoidance of the U.S. estate tax. Repeal of the tax would not prevent the United States from collecting information about the stock to share with the country of residence; such information would be obtained in connection with income tax withholding on the dividends. One favorable side-effect of repeal might be that, for foreigners making small U.S. investments, U.S. estate tax considerations would no longer favor investing in mutual funds organized as foreign entities over investing in mutual funds not catering specifically to foreigners. Paradoxically, the ease of avoiding the tax on such stock investments, and thus the lack of discouragement to making such investments, reduces the urgency of providing a statutory exemption.

A similar argument could be made for allowing an exemption from the estate tax for a foreign investor with a major stake of 10% or more in a U.S. corporation (even though investing in U.S. real estate or business assets). The seven post-1970 estate tax treaties already exempt such stock from the U.S. estate tax. Other investors can easily avoid the tax by placing the stock in a foreign holding company. Since the corporate form is being used in any event, interposition of a foreign holding company does not increase the income tax burdens associated with the investment.

However, it would not seem wise for Congress to grant a statutory exemption for this case. The granting of such an estate tax exemption might be followed by calls for repeal of  

"comprehensive revision" of the U.S. estate and gift taxation of nonresident aliens. Id. at 910. It "stresses ease of administration, simplification of the tax, and fairness to nondomiciled aliens through treatment more like that of U.S. persons." Id. at 912.

227 See supra notes 87-90 and accompanying text. It is not clear why such a large percentage of the gross U.S. estate shown on 1986 returns consisted of corporate stock and bonds. See supra notes 109, 169 and accompanying text.


229 See supra notes 14, 38 and accompanying text.
the rule preventing nonresident aliens from being shareholders in S corporations, and Congress might find it difficult at that point to reinstate the estate tax with respect to S corporation stock. To allow a combination of S corporation treatment and the U.S. estate tax exemption would make avoidance of the U.S. estate tax much less burdensome from a U.S. income tax standpoint for some investors, and would likely reduce revenues for the federal Treasury.

There would seem to be no reason for the United States to make this concession unilaterally. Enforcement of estate or gift taxes with respect to stock in an S corporation would be feasible just as in the case of a partnership. While the seven more recent U.S. estate tax treaties exempt stock from situs-based taxation, it is not unlikely that the U.S. Treasury could negotiate a provision in an estate tax treaty adopting a look-through approach for an S corporation or partnership. If the United States were to instead agree to exempt S corporation stock from the estate tax by treaty, it could at least obtain reciprocal concessions with respect to estate taxation of U.S. citizens.

4.3.2. Improving Compliance

A number of approaches could be used to reduce illegal avoidance of U.S. estate taxation by foreigners. Voluntary compliance would be enhanced if uncertainties in the transfer taxation of foreigners were resolved (e.g., by greater IRS guidance). In particular, adoption of look-through treatment for partnership interests and the imposition of a withholding requirement upon partnerships with respect to donative transfers of partnership interests by nonresident aliens would improve compliance.

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230 In 1990, the Chairman of the Florida Bar Tax Section proposed that a nonresident alien be allowed "to make a direct investment in the United States through an otherwise qualified S corporation" without subjection to U.S. estate tax. 1990 Hearings, supra note 1, at 66 (Hudson testimony).

231 See generally A.L.I. TREATIES, supra note 114, at 13 (noting that "a country may be prepared to modify its domestic law rules only when satisfied that it is (and its taxpayers are) deriving appropriate reciprocal concessions from the foreign country concerned").

232 See supra note 129.

233 See Bell & Shoemaker, TAMRA, supra note 1, at 81-82.
Congress might prevent some tax evasion by conditioning the use of a date-of-death basis under I.R.C. section 1014 (or an I.R.C. section 754 election) upon a showing\textsuperscript{234} that any U.S. estate tax owed by a nonresident estate has been paid.\textsuperscript{235} In addition, perhaps compliance could be enhanced by more vigorous enforcement of penalties against a U.S. corporation that authorized a transfer of its own stock held by a nonresident alien decedent without first obtaining a transfer certificate.\textsuperscript{236}

Finally, the IRS might devote greater resources to auditing and enforcing the U.S. estate tax liability of foreigners\textsuperscript{237} (e.g., by spending more time reviewing probate records or investigating situations where a stepped-up basis is claimed by an heir). However, it is not clear that the extra revenue collected from the use of greater IRS resources would be sufficient to justify their use.\textsuperscript{238}

4.3.3. Marital Deduction

Under the 1988 Act, Congress for the first time granted the estate and gift tax marital deduction with respect to transfers by nonresident aliens. However, Congress simultaneously imposed restrictions on the marital deduction allowed to any transferor with respect to a transfer made to a noncitizen spouse.\textsuperscript{239} There is little existing treaty relief from these

\textsuperscript{234} Alternatively, the heir might be required to make a timely notification to the IRS that the property was inherited from a nonresident alien decedent.

\textsuperscript{235} Cf. COMMITTEE ON TAXATION OF INT'L TRANSACTIONS, supra note 74, at 918 (noting, as one alternative to the current income and transfer tax rules regarding expatriates, a new provision that would provide a zero basis for property inherited from a person who had renounced U.S. citizenship).

\textsuperscript{236} See supra notes 109-11 and accompanying text.

\textsuperscript{237} See 1990 JCT REPORT, supra note 4, at 84 (stating that some “may suggest the devotion of more resources to enforcement of the current system as applied to a broader base”).

\textsuperscript{238} See FLORIDA BAR, supra note 12, at 912 (stating that “it is not believed that increased enforcement efforts would significantly improve collections in the area”). Instead, they suggest greater “fairness” in the law as possibly improving compliance. Id.

\textsuperscript{239} See supra notes 17-18. For criticism of these rules, as passed by the House, and before the addition of the QDT mechanism, see Myron C. Grauer, Xenophobia, Estate Taxes, and the Miscellaneous Revenue Act of 1988, 40 TAX NOTES 1199 (1988).
restrictions.\textsuperscript{240} Germany\textsuperscript{241} and France\textsuperscript{242} have negotiated with the United States to obtain further relief through treaties.

These new rules deny the estate tax marital deduction for a transfer to a noncitizen spouse unless the property passes at death to a qualified domestic trust ("QDT"). The gift tax marital deduction is replaced by a $100,000 annual exclusion in the case of transfers made to a noncitizen spouse.\textsuperscript{243} Moreover, if there is a noncitizen surviving spouse, jointly owned property\textsuperscript{244} not passing to a QDT is included in its entirety in the gross estate of the spouse first to die, except to the extent of the contribution shown to be made by the

\begin{footnotesize}
\begin{enumerate}
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\item[243] See I.R.C. § 2523(a), (i)(2); see also Jackel, supra note 17, at 113.
\item[244] In addition, creation of a joint tenancy in personal property with a noncitizen donee spouse may be considered to involve a gift. See Prop. Treas. Reg. § 25.2523(i)-2, 58 Fed. Reg. 321 (1993); Notice of Rulemaking, supra note 17, at 39; Jackel, supra note 17, at 111-12; see also Plaine & Siegler, supra note 18, at 383-90 (noting ambiguities in statute and legislative history); id. at 436-37 (chart). If the donor is a nonresident alien, only U.S. situs tangible property is potentially subject to gift tax. For treatment of joint tenancy in real property, see Gilberti I, supra note 92, and Gilberti II, supra note 92.
\end{enumerate}
\end{footnotesize}
surviving spouse.\textsuperscript{245}

Distributions of corpus from the QDT to the surviving spouse and the value of the property remaining in the QDT when the surviving spouse dies are subject to U.S. estate taxation at rates determined as if the amounts were includible in the transferor spouse’s estate.\textsuperscript{246} To avoid double taxation, the estate tax liability so incurred with respect to the QDT, or the estate tax liability incurred upon the death of the first spouse to die where no QDT is created, is creditable against the estate tax liability incurred upon the inclusion of the same property in the estate of the surviving spouse.\textsuperscript{247}

a. Rationale For Restrictions

The rationale for these restrictions was Congress’ concern that the marital deduction should not be a vehicle for permanent tax avoidance. Congress considered the proper role of the deduction as “defer[ring] the estate tax on the

\textsuperscript{245} See I.R.C. § 2056(d)(1)(B), which is an exception to the general rule that only one-half of the jointly-held property held by a married couple is included in the estate of the first to die. See also I.R.C. § 2040(a)-(b); Prop. Treas. Reg. § 20.2056A-8(a)(1), 58 Fed. Reg. 318 (1993); Notice of Rulemaking, supra note 17, at 38; Jackel, supra note 17, at 111 & n.13; Goldberg, supra note 7, at 54-55; William P. Streng, Estate Planning, 11-11th Tax MGMT. (BNA), at A-91 & n.844. This rule makes it necessary for “the decedent’s executor to trace the consideration provided by each spouse.” Plaine & Siegler, supra note 18, at 337-38; see also id. at 405-06; U.S. Estate Taxation of Non-Resident Alien Staff of the World Bank and Other International Organizations, Memorandum prepared by World Bank, introduced into Congressional Record by Senator Moynihan (Aug. 2, 1991), 91 TNI 34-35, Aug. 21, 1991, available in LEXIS, Taxana Library, TNI File [hereinafter World Bank Memo] (tracing rule “places an unrealistic premium on record-keeping for the ordinary household”).

\textsuperscript{246} I.R.C. § 2056A(b)(1),(2),(3)(A),(7).

\textsuperscript{247} I.R.C. §§ 2056(d)(3), 2013. See Jackel, supra note 17, at 115; Prop. Treas. Reg. § 20.2056A-7, 58 Fed. Reg. 318 (1993); Notice of Rulemaking, supra note 17, at 40-41. The statutory language may give rise to a technical argument that the credit is unavailable if the spouse dying first is a nonresident alien. See Goldberg, supra note 7, at 53 & n. 113; I.R.C. §§ 2056(a)(first clause), 2106(a)(first clause), 2106(a)(3). But this argument is unconvincing. See Goldberg, supra note 7, at 53 (concluding that “[t]here does not . . . appear to be any reason for depriving such spouses of a credit and it may, therefore, be possible that the reference to section 2056(a) includes a reference to section [sic] 2016(a)(3)”). Letter from Susan F. Klein to Monte Jackel, Treasury Dept., (Nov. 2, 1993), 93 TNI 232-6, Dec. 3, 1993, available in LEXIS, Taxana Library, TNI File (suggesting that final regulations make availability of credit clear).
assumption that the deductible property if not consumed will ultimately be includible in the surviving spouse’s estate.”

If the surviving spouse is not a citizen, this assumption would often not be correct “since to avoid taxation on the worldwide estate, the spouse need only give up U.S. residence.” Congress’ concern is perhaps most pertinent in the case of a U.S. citizen transferring property to a resident alien or nonresident alien spouse. However, the concern is also relevant where both spouses are nonresident aliens (even though the marital transfer does not change the nature of the jurisdiction asserted over the marital property). If a nonresident alien decedent were granted the marital deduction without the QDT limitation, nonresident alien couples could adopt a strategy of avoiding the U.S. estate tax by holding U.S. assets until immediately after the first spouse’s death; the surviving spouse could then sell the asset with a new date-of-death basis and replace it with a foreign-situs asset. This strategy for avoiding the U.S. estate tax, as well as the U.S. income tax on appreciation, would break down only in the rare case where both spouses died in close proximity (e.g., together in an accident).

b. Burdens Of The QDT Mechanism

Ostensibly, the QDT regime is merely a mechanism to insure that the deferral allowed by the marital deduction in a domestic context does not become an exemption in the case of an alien surviving spouse. However, this mechanism subjects the couple to a significant burden not experienced where the survivor is a citizen. This burden, viewed realistically, has a greater impact on alien decedents than on U.S. citizen decedents because the former group is much more likely than the latter to be married to alien spouses. Complaints about

248 1988 HOUSE REPORT, supra note 2, at 592.

249 Id. The $100,000 annual gift tax exclusion for transfers to an alien spouse was intended “to avoid imposing a gift tax upon common financial arrangements between spouses.” Id.

250 See, e.g., Letter from Richard W. Skillman to Peter Barnes, Acting Deputy International Tax Counsel (July 16, 1990), reprinted in 18 HIGHLIGHTS & DOCUMENTS 1174 (July 31, 1990) [hereinafter Skillman]. He describes the “inequities and practical problems . . . created for families of relatively modest wealth.” Id.
this burden were recently voiced by the World Bank on behalf of its employees.\textsuperscript{251} 

First, there is the inconvenience and expense of setting up and maintaining the QDT structure, including fees for sophisticated tax advice and for the trustee.\textsuperscript{252} This may be of particular concern when the amount of assets passing through the QDT is small.\textsuperscript{253} In many cases, this may be an inconvenient form of ownership for property such as a personal residence,\textsuperscript{254} furniture,\textsuperscript{255} or a family business to be managed by the surviving spouse.\textsuperscript{256} While the alien spouse

\textsuperscript{251} See Letter from Lewis T. Preston, The World Bank, to Nicholas F. Brady, Secretary of the Treasury (Dec. 18, 1991), 92 TNI 3-33, Jan. 15, 1992, available in LEXIS, Taxana Library, TNI File (seeking relief from I.R.C. § 2056(d) and the new estate tax rates for nonresidents); see also World Bank Memo, supra note 245.

\textsuperscript{252} See Skillman, supra note 250, at 1175 (stating that “for estates of moderate size, the administrative burdens and costs ... would be significant”). He argues that a “friend or relative” would likely not agree to be trustee, and that “ongoing professional assistance would be needed to determine the tax liability of the trust.” Id. Under the proposed regulations, if the assets in the QDT exceed $2 million, at least one U.S. trustee must be a bank or the U.S. trustee must provide a bond in an amount equal to at least 65% of the assets. Prop. Treas. Reg. § 20.2056A-2(d)(1)(i), 58 Fed. Reg. 312 (1993). If the assets do not exceed $2 million, the same requirement must be met or the trust document must require that 35% or less of the trust assets consist of foreign real estate. Prop. Treas. Reg. § 20.2056A-2(d)(1)(ii), 58 Fed. Reg. 312 (1993).

\textsuperscript{253} See supra note 252; World Bank Memo, supra note 245 (stating that QDT’s “are cumbersome and expensive for the typical estate of a World Bank staff member, where the principal assets are illiquid, i.e., the family residence and the pension”).

\textsuperscript{254} See Bissell, supra note 18, at 81 (stating that “there may be practical constraints against placing property such as the family home into a QDT”). He suggests the possible loss of benefits under I.R.C. §§ 1034 or 121. See id.; see also Plaine & Siegler, supra note 18, at 404 (noting that “the portion of the home held in the [QDT] will have” a new basis at death); Skillman, supra note 250, at 1175 (lender might restrict transfer). This concern would be less likely to be relevant if the survivor was a nondomiciliary of the United States.

\textsuperscript{255} See Skillman, supra note 250, at 1175 (arguing that “[t]angible personal property, such as cars and furniture and other items to be used by the surviving spouse during her lifetime, presumably could not be transferred to a QDT”).

\textsuperscript{256} See Plaine & Siegler, supra note 18, at 401 (“real estate and business interests that the noncitizen spouse may wish to retain control over rather than having to share control with the United States trustee, should be transferred” outside the QDT); id. at 360 (possibility that if “active business” is “significant portion of the QDT,” classification as association may result).
can be a trustee of the QDT, there must also be a U.S. citizen or U.S. corporation as trustee who has the right to withhold estate tax from any distribution of the corpus.\textsuperscript{257} Assets in a QDT would not meet a surviving spouse's need for liquid assets at his immediate disposal.\textsuperscript{258}

Second, the QDT structure may have the effect of broadening the base of the estate tax. In a fully domestic context, assets passing under the marital deduction including appreciation after the death of the first to die will permanently escape estate taxation to the extent that they are consumed by the surviving spouse or transferred by gift pursuant to the $10,000 annual per donee exclusion.\textsuperscript{259} By contrast, when assets are placed in a QDT, withdrawal of the principal including capital gains\textsuperscript{260} for consumption or gifts by the surviving spouse will trigger the estate tax thereon unless the withdrawal qualifies for an exemption as a distribution "on account of hardship."\textsuperscript{261}

The effect of the QDT mechanism is particularly harsh for an estate that is relatively small (taking into account worldwide assets), where perhaps all or a large part of the

\textsuperscript{257} See I.R.C. § 2056A(a); Adams, supra note 18, at 760 (1989 and 1990 changes insured that surviving spouse "may serve as a co-trustee").

\textsuperscript{258} See Skillman, supra note 250, at 1175. Skillman states that "the surviving spouse would want to keep a moderate amount of liquid assets . . . under her direct control without intervention of a QDT." \textit{Id.}

\textsuperscript{259} See 1988 House Report, supra note 2, at 592-93. Bissell points out that a U.S. citizen is "free to 'waste' the principal" on "vacations, day-to-day living expenses . . . clothing" or to use it for excludable gifts. Bissell, supra note 18, at 81; \textit{see also} Letter from Professor Myron C. Grauer to Congressman Dan Rostenkowski, Chairman, House Ways and Means Committee, (May 31, 1989), \textit{reprinted in} 43 Tax Notes 1538 (1989) [hereinafter Grauer 1989 Letter] (Estate tax is avoided by spending principal, except on a "yacht" or other property that will remain in the estate.).

\textsuperscript{260} See Prop. Treas. Reg. § 20.2056A-5(c)(2), 58 Fed. Reg. 316-17 (1993); 1989 House Report, supra note 240, at 1432. Thus, one commentator suggests that if property in a QDT is expected to appreciate greatly, it might be worthwhile to withdraw it from the QDT, sell it after it appreciates, and then "waste" the gain. Bissell, supra note 18, at 84.

\textsuperscript{261} I.R.C. § 2056A(b)(3)(B). Under proposed regulations, this must be "in response to an immediate and substantial financial need relating to the spouse's health, maintenance or support" and does not include cases where "the amount distributed may be obtained from other sources that are reasonably available to the surviving spouse." Prop. Treas. Reg. § 20.2056A-5(c)(1), 58 Fed. Reg. 316 (1993).
inheritance received by the surviving spouse may be consumed during his lifetime.\textsuperscript{262} One specific example of this harshness is where a joint and survivor annuity acquired, for example, as a pension,\textsuperscript{263} by the first to die is placed in a QDT or treated itself as a QDT,\textsuperscript{264} and the annual payments are made available to the surviving spouse. In that case, each annuity payment will be treated as made from the corpus to the extent of the present value of the annuity as of the date of death, divided by the expected annuity term.\textsuperscript{265} Thus, a large part of each annuity payment may be subject to the estate tax in addition to any income tax that may be owing.\textsuperscript{266} By contrast, if the surviving spouse is a citizen, a

\textsuperscript{262} See Plaine & Siegler, supra note 18, at 369. They argue that the limitation of the exemption for principal distributions to “hardship” “is clearly unfair to [those] of moderate wealth who are more likely to have to invade trust property for their support than a wealthy noncitizen surviving spouse whose larger income stream will decrease or eliminate the need for corpus distributions.” Id.; see also Grauer 1989 Letter, supra note 259, at 1538. He states that the QDT “provides equity . . . only where the income generated by the QDT property is sufficient to satisfy all of that spouse’s wants and needs; i.e., where an exceedingly wealthy family is involved.” Id.

\textsuperscript{263} Apparently, the situs of such retirement benefits is determined under the rules for debt obligations under I.R.C. § 2104(c). See Goldberg, supra note 7, at 38 (indicating that survivorship rights under pension and profit sharing plans would be inadmissible under the debt obligation rule unless the services were performed abroad); Troxell, supra note 14, at A-26 (indicating that if a nonresident alien earns a pension from work in the United States, joint and survivor benefits would be taxable to the alien spouse unless placed in QDT).


\textsuperscript{266} See Plaine & Siegler, supra note 18, at 370 (suggesting that “there will be very little left for the surviving spouse”); Skillman, supra note 250, at 1175; see also Prop. Treas. Reg. §§ 20.2056A-4(c)(3)(v), 20.2056A-5(c)(3)(iv), 58 Fed. Reg. 314, 317 (1993) (where spouse avoids deferred tax by “rolling over” corpus payments into QDT, amounts can be withdrawn tax-
joint and survivor annuity would often entirely escape an estate tax.\textsuperscript{267}

Third, under the QDT regime, the tax imposed upon principal distributions from the QDT occurs earlier than would be the case if the surviving spouse were a citizen.\textsuperscript{268} In the latter case, the marital property would not be subject to a transfer tax until either the death of the surviving spouse or an earlier gift outside the annual $10,000 exclusion.

Fourth, the graduated rate brackets and the unified credit, (only $13,000 absent liberalization by a treaty) of a surviving nonresident alien spouse will be wasted except to the extent that he holds, at death, U.S.-situs property not passing through the QDT.\textsuperscript{269} This is because the property passing through the QDT will eventually be taxed as if it were originally included in the estate of the first to die.\textsuperscript{270} A similar waste of benefits occurs with a U.S. citizen couple if the first spouse to die owns all the property and leaves it entirely to the surviving spouse\textsuperscript{271} rather than, for example, creating a bypass trust for part of the estate.\textsuperscript{272} Whether or not the surviving spouse is an alien, the waste of benefits free from QDT to pay income tax on “rolled over” amounts).

\textsuperscript{267} The marital deduction would provide protection on the death of the first spouse. The annuity would likely be “wasted” before the death of the survivor. See Plaine & Siegler, supra note 18, at 370; Skillman, supra note 250, at 1175.

\textsuperscript{268} See Adams, supra note 18, at 769 (noting “acceleration” and also that the credit allowed pursuant to I.R.C. §§ 2056(d)(3) and 2013 is not refundable); Grauer 1989 Letter, supra note 259, at 1540 (suggesting the possibility that I.R.C. § 2013 credit should be enhanced with interest and be made refundable); see also Grauer, supra note 239, at 1201.

\textsuperscript{269} See Plaine & Siegler, supra note 18, at 379, 398 n.228. In a community property state, however, the surviving spouse would “own one-half of the community property assets.” Id.; see also Adams, supra note 18, at 757; Bernard L. Karr, New Planning Required for Surviving Spouses Who Are Not U.S. Citizens, 70 J. TAX’N 140, 142 (1989); Grauer 1989 Letter, supra note 259, at 1540. Grauer argues that treatment of QDT distributions as if included in the estate of the first to die “[i]n many cases . . . unfairly generates revenue by removing from the transferee surviving spouse the benefits of his or her unified credit and fresh start up the tax brackets.” Id.

\textsuperscript{270} See I.R.C. § 2056A(b)(1),(2),(3)(A),(7).

\textsuperscript{271} See Bissell, supra note 18, at 83. He concludes that the “rules for noncitizens in theory cannot be said to be discriminatory.” Id. But see Grauer 1989 Letter, supra note 259, at 1540, discussed at supra note 269.

\textsuperscript{272} See, e.g. Bissell, supra note 18, at 83. However, this planning is disrupted if the spouse without assets dies first.

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could be avoided by *inter vivos* gifts that equalize the spouses’ ownership of property potentially subject to the estate tax, for example, U.S.-situs property in the case of a nonresident alien couple. However, in the case of a nonresident alien couple, these equalizing gifts, if of *tangible* U.S.-situs property, would be subject to the gift tax on the amount in excess of the $100,000 annual exclusion for marital gifts. Gift-splitting, which is another means of using the unified credit and low brackets of a spouse not owning a sufficient amount of his own property, is unavailable where either spouse is a nonresident alien.

Moreover, it is not clear that the statutory purpose necessitates taxation of the QDT property at the rates of the first to die, particularly in the case where the first spouse to die is a nonresident alien. In a case where the first to die is a U.S. citizen or resident, taxation of QDT property as though it were includible in the estate of the first to die is perhaps justifiable under the theory of preserving the application of progressive rates to the worldwide estate. But if the first spouse to die is a nonresident alien, his estate is limited to his U.S-situs assets, as may also be the estate of the surviving spouse.

c. Conclusion

The QDT device should be retained because it is a reasonable way to achieve Congress’ goal of insuring that assets passing to an alien surviving spouse under the marital deduction do not also escape U.S. estate taxation upon transfer at the surviving spouse’s death. However, care should be

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273 *See* Karr, *supra* note 269, at 142; Plaine & Siegler, *supra* note 18, at 398.

274 *See* Bissell, *supra* note 18, at 83. Moreover, there may be “uncertainty” regarding the gift tax consequences of severing a joint tenancy. *See* Plaine & Siegler, *supra* note 18, at 399 (concluding that “careful planning” is needed).

275 *See* I.R.C. § 2513(a); Plaine & Siegler, *supra* note 18, at 400.

276 *See* Plaine & Siegler, *supra* note 18, at 379 (concluding that the legislative goal is merely to insure that U.S. tax jurisdiction is not avoided); Grauer 1989 Letter, *supra* note 259, at 1540 (proposing change); *see also* Adams, *supra* note 18, at 773 (recommending change).

277 Alternatively, Congress could impose a tax upon the surviving spouse if and when giving up residence status, or, if already a nonresident, when
taken to minimize the added burdens imposed upon alien spouses by this mechanism.

To be comparable with the treatment of a surviving citizen spouse, the QDT mechanism should allow an exemption for principal distributions that would permit a reasonable amount of consumption. Thus, for example, Congress should adopt the 1989 House bill exempting principal distributions up to an annual amount of $100,000, reduced by the amount of income distributions, and increased by the amount paid for the surviving spouse’s medical care. To the same end, a disposing of U.S.-situs assets or shifting their situs. See Adams, supra note 18, at 772-73. He suggests that I.R.C. § 2107 could be expanded to reach the case "of a resident noncitizen surviving spouse leaving the United States" with respect to "assets for which the surviving spouse claimed the marital deduction and which are still in existence when the spouse leaves the United States." Id. at 772; Grauer, supra note 239, at 1201 (proposing extension of I.R.C. § 2107 "to impose the same tax in the event of a tax-motivated loss of permanent resident status"); see also COMMITTEE ON TAXATION OF INT’L TRANSACTIONS, supra note 74, at 924-25. The Committee proposed a comprehensive set of income tax rules "taxing assets when they went out of residence or doing business jurisdiction, and correspondingly giving a fair market value basis when assets come into residence or doing business jurisdiction." Id. at 925. The proposal would also provide "an exemption," for estate and gift tax purposes, "for the amount of assets brought into residence jurisdiction." Id. at 925. This is "a logical corollary" of I.R.C. § 2056(d). See id. at 924.

However, in some cases, the QDT rules may be more generous than the rules applied by a trading partner of the United States to U.S. citizens. See Boidman III, supra note 186, at 824 (stating that U.S. resident is "not eligible for a general ‘spousal rollover,’" with respect to Canadian tax on deemed disposition at death); id. at 827 (stating that Canada should consider a treaty provision "to equalize an advantage now enjoyed by Canadian investors under the QDT rules in the U[nnited] S[tates]").

A further proposal has been made that any credit allowed the estate of the surviving spouse for estate tax imposed upon the marital transfer property in the estate of the first to die (or deemed to be so imposed under the QDT rules) be enhanced with interest and be made refundable. See Grauer 1989 Letter, supra note 259, at 1540; see also Grauer, supra note 239, at 1201. This proposal, however, appears to be directed only at a surviving spouse who is a U.S. resident at the time of death (so that there would be assurance that assets received from the other spouse were not removed from the U.S. taxing jurisdiction). Id.

In the case of a nonresident alien decedent, only U.S. situs assets would need to be placed in a QDT. Thus, one could argue that in the case of a nonresident alien decedent the $100,000 figure should be multiplied by the percentage of the worldwide estate with a U.S. situs. However, as discussed below, this percentage would not often be known.

This, however, was replaced with the more limited "hardship"
marital deduction should be provided for qualified pension benefits passing to an alien spouse.\textsuperscript{262}

Further changes should be made to facilitate full utilization of the lower rate brackets and the unified credit of each spouse. At least if the spouse dying first is a nonresident alien for estate tax purposes, the property remaining in the QDT upon the survivor’s death should be subjected to estate taxation only once,\textsuperscript{263} as part of the estate of the surviving spouse\textsuperscript{264} without regard to the situs of the property even though the surviving spouse may be a nonresident alien at death.\textsuperscript{265} In addition, gift-splitting should be allowed even though one or both spouses are nonresident aliens, provided that the gift deemed made by the nonowner spouse is subject

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\textsuperscript{262} See Plaine & Siegler, supra note 18, at 368-69; Adams, supra note 18, at 763-64. Adams explains that the figure of $100,000 was chosen because this amount could have been transferred annually by interspousal transfer if the death had not intervened; Adams endorses the House proposal. See id. at 773; Jackel, supra note 17, at 114. For a similar proposal, see Grauer 1989 Letter, supra note 259, at 1538-39. Grauer proposed an exemption of "up to $75,000 of principal" paid to support the survivor "at the level to which he or she had become accustomed," with a phase-out "for each dollar that the transferee (surviving) spouse's adjusted gross income exceeds $75,000 for the year of withdrawal." Id. at 1539. This phase-out rule would seem to be impractical in the case of a nonresident alien not required to file a U.S. income tax return.

\textsuperscript{263} See supra notes 263-67 and accompanying text.

\textsuperscript{264} Thus, no credit under I.R.C. § 2031 would be available. To insure collection of tax where the surviving spouse holds other U.S. assets at death, the QDT property would have to be viewed as stacked on top of any other property in the estate of the surviving spouse. If the QDT property were stacked on the bottom, the tax on that property might be eliminated by the unified credit, and the tax on the remaining property would have to be collected from the survivor’s estate, rather than from the U.S. trustee of the QDT. However, if the QDT property is stacked on top, this would make it difficult for the U.S. trustee of the QDT to know how much estate tax was owing on the QDT property. Thus, he should be permitted to withhold the maximum that might be owing, with the estate of the surviving spouse having the opportunity to claim a refund for excess tax paid by the trustee.

\textsuperscript{265} See Plaine & Siegler, supra note 18, at 379; Adams, supra note 18, at 773 (suggesting that tax imposed upon distributions from QDT, or upon property remaining in QDT at death of survivor, should be determined as if the property is included in the estate of surviving spouse); Grauer 1989 Letter, supra note 259, at 1540.

\textsuperscript{266} It might be more difficult to treat principal distributions from the QDT as if includible in the estate of the surviving spouse, who would still be alive.
to the U.S. gift tax apart from the $10,000 annual exclusion. These measures would make the failure to utilize the lower brackets and unified credits of both spouses less likely.

It does not seem advisable, however, to repeal the provision requiring tracing of the consideration paid for jointly held property, despite the inconvenience associated with tracing. Such a repeal, along with other ameliorating changes, was proposed by Senator Daniel Patrick Moynihan and Representative Sam Gibbons for application only to noncitizen employees of an international organization. Repeal of this tracing rule would in effect reinstate a marital deduction for 50% of the value of property transferred to a noncitizen spouse without the necessity of utilizing a QDT. While this would bring consistency with the treatment of community property, it would represent a major retreat from the objective underlying the QDT rules.

Finally, it might be desirable to provide an alternative to the QDT regime, particularly for small estates, that would more simply provide results similar to those available when the surviving spouse is a citizen. This is the apparent objective of a provision of House Bill 5270, which would create

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286 The unified credit is not available with respect to inter vivos gifts in the case of a nonresident alien donor. See I.R.C. § 2505(a).

287 See FLORIDA BAR, supra note 12, at 912, 914 (proposing to “allow nondomiciled aliens to split taxable gifts”). The proposal states that by allowing gift-splitting and the marital deduction, “administration of the estate and gift taxes would be improved and the area would be greatly simplified.” Id. at 912.


289 See Adams, supra note 18, at 750-52; Grauer, supra note 239, at 1201; see also Plaine & Siegler, supra note 18, at 379; see, e.g., Estate of Paul M. Vandenhoeck v. Commissioner, 4 T.C. 125 (1944) (stock in domestic corporation held by alien decedent domiciled in France was community property under French law and, thus, only half its value was includable in gross estate).

290 See Skillman, supra note 250, at 1175-76 (proposing that Congress permit a “reasonable marital deduction for estates that cannot sensibly or effectively utilize the QDT mechanism”).
a new "marital transfer credit" for the estate of the first to die where the surviving spouse is a noncitizen. In the case of a resident alien's estate, the credit "effectively exempts a second $600,000, in addition to the amount exempted by the unified credit";\footnote{291} in the case of a nonresident alien's estate,\footnote{292} the credit "effectively exempts $600,000, but reduces that amount by the amount exempted by the unified credit" (i.e., by $60,000 absent liberalization of the credit by treaty).\footnote{293} This provision, however, applies only if\footnote{294} either spouse is employed in the United States by an international organization.\footnote{295} Whether such an approach would be appropriate for all nonresident estates with a noncitizen

\footnote{291}Cf. Grauer, supra note 239, at 1201 (proposing, as an alternative to QDT approach, that the marital deduction be limited to the "greater of $600,000 or one-half of the value of the property that would otherwise qualify for the marital deduction").

\footnote{292}In the case of a nonresident alien couple, the first spouse to die could, for example, transfer $60,000 to her children under the protection of the unified credit and $540,000 to her spouse under the protection of the marital transfer credit. The property transferred to the surviving spouse could be shielded from U.S. estate tax on the death of the surviving spouse to the extent of the $600,000 exempted by the survivor's unified credit plus any further amount either consumed by the survivor or removed from U.S. tax jurisdiction before his death.

\footnote{293}1992 JCT REPORT, supra note 70, at 2784-85; see H.R. 5270, supra note 69, § 404 (providing a "marital transfer credit"). In the case of a decedent subject to estate tax as a nonresident, and assuming no treaty benefits improving upon the $13,000 unified credit and no lifetime gifts, the credit against estate tax is equal to the excess of (i) a tentative tax computed on the sum of the marital transfer amount plus $60,000 (the deduction equivalent of the unified credit) over (ii) a tentative tax computed on $60,000. The marital transfer amount is the amount that would have been allowed as a marital deduction without the QDT limitation but not to exceed the lesser of (i) $540,000 or (ii) the excess of the taxable estate over $60,000. See id. § 404(c), (e)(2); 1992 JCT REPORT, supra note 70, at 2785.

\footnote{294}If the U.S. acknowledges that the current rules impose excessive burdens on international employees, it is hard to justify limiting the relief to them. But see Hearings on H.R. 5270 Before the Committee on Ways and Means, 102nd Cong., 2nd Sess. (1992) (statement of Fred T. Goldberg, Jr., Assistant Secretary, Department of the Treasury) reported at 92 TNT 149-164, July 22, 1992, available in LEXIS, Taxana Library, TNT File (endorsing this provision, based upon "the United States' special role as host to ... international organizations"); and noting that "the Articles of Agreement of the Bretton Woods institutions" prohibited income taxation of the salary of international employees.

\footnote{295}The credit is available only if neither spouse is a citizen or a lawful permanent resident and the benefit of the QDT provisions is waived. See H.R. 5270, supra note 69, § 404(b), (c)(1).
surviving spouse will be addressed in connection with a discussion of the rate schedule and the unified credit.\(^\text{296}\)

**4.3.4. The Rate Schedule And The Unified Credit**

In the 1988 Act, Congress eliminated the separate, lower rate schedule for estates of nonresident aliens and granted such estates a unified credit of $13,000 (unless enlarged by treaty) that offsets the estate tax on the first $60,000 of assets included in the taxable estate.\(^\text{297}\) Congress' stated goal in making these 1988 changes was "that nonresident aliens should be treated more like to [sic] U.S. citizens and resident aliens.\(^\text{298}\) However, some argue that the 1988 changes moved the law further away from this goal.\(^\text{299}\) It may not be possible to achieve perfect equity between citizens and nonresident aliens because of their differing circumstances. Failing that, Congress should probably have erred on the side of greater generosity to nonresident estates.

**a. The Rate Schedule**

If the effects of the unified credit and the marital deduction are ignored, requiring nonresident estates to be subject to the same rate schedule as the estates of U.S. citizens does not appear to be inequitable; in fact, it might be considered favorable.\(^\text{300}\) On the surface, equal treatment would seem to

\(^{296}\) See infra notes 337-43 and accompanying text.

\(^{297}\) See supra notes 22-27 and accompanying text.

\(^{298}\) See 1988 HOUSE REPORT, supra note 2, at 594.

\(^{299}\) See Bell & Shoemaker, TAMRA, supra note 1, at 88-89 (referring to statement in legislative history as "an exercise in unembarrassed superficiality," because "TAMRA, in fact, places the NRA investor at a severe disadvantage vis-a-vis his U.S. counterpart"); see also supra note 3. See generally 1990 Hearings, supra note 1, at 61, 63-64 (Hudson testimony). For concern on the part of Canada, see supra note 186.

\(^{300}\) See FLORIDA BAR, supra note 12, at 912. Prior to passage of the 1988 Act, the Florida Bar proposed that the special lower rate schedule for nonresident estates be eliminated, but that nonresident estates be allowed the same unified credit as estates of U.S. citizens. They noted that the "higher rates . . . would apply only to property situated in the United States . . . and the allowance of a greater unified credit should serve the function of exempting smaller estates from tax." Id. They predicted that "[s]ince many smaller estates probably would be composed principally of U.S. real estate, which can so easily be lawfully removed from the U.S. estate tax base . . . any revenue loss from this change would be minimal." Id. They
require the use of the same rate schedule. However, it might be appropriate to take into account the overall tax burden faced by a nonresident estate on its worldwide assets. Under this view, the United States should arrange its tax rules so that if the U.S. rules, including the credit under I.R.C. section 2014 for foreign death taxes, were also adopted by other countries, the overall tax burden on a nonresident estate would not vary based upon the location of the estate's assets. The overall tax burden would be the same as the tax burden on the estate of a U.S. citizen with the same amount of worldwide assets. (Equity in this sense is hereinafter referred to as "worldwide equity.")

To achieve this form of equity for a nonresident estate, the U.S. rate schedule should be applied to the worldwide estate, and the tax so computed should be multiplied by the fraction of the worldwide estate that has a U.S. situs.

argue that this would be similar to the income tax and gift tax "both of which apply the same rates to foreigners as to U.S. persons after making modifications in the tax base." Id.

Under I.R.C. § 2014, the credit for foreign death taxes is limited to the average rate of tax imposed by the United States as country of residence, after subtracting the unified credit. That is, the allowable credit cannot exceed an amount which bears the same ratio to the tax imposed by I.R.C. § 2001 (after allowance of the unified credit, credit for gift tax, and credit for state death taxes) as the value of the property which is situated within the foreign country and subject to the foreign country's tax (and included in the gross estate) bears to the value of the entire gross estate, reduced by the marital deduction and deduction for charitable contributions. I.R.C. § 2014(b).

Cf. Daniel J. Frisch, The Economics of International Tax Policy: Some Old and New Approaches, 47 TAX NOTES 581, 590 (1990) (suggesting a "harmonizability standard" for assessing U.S. tax rules). To apply this standard, policymakers would "consider what would happen if both an MNC's [multinational corporation] home country and the country hosting its activities had a tax system exactly like the U.S." Frisch concludes that "[i]f any of the MNC's income would be taxed twice or would escape taxation completely, the U.S. tax system would seem to be seriously flawed as a model for other countries to follow." Id. See generally Herman B. Bouma, The Proper Conceptual Foundation for Allocating Deductions, 19 Tax Mgmt. Int. J. 307, 308 (1990) (context of applying section 904).

See Goldberg, supra note 7, at 49. Goldberg notes that "[n]otwithstanding that the federal taxable estate is limited to assets situated in the United States, the rate is based only on those assets." He notes that, in contrast, "New York taxes a nonresident's estate on its proportionate share of a tax on worldwide assets, i.e., taxation with progression." Id. at 49 and n.101.

For example, if a resident of country X had a worldwide estate of $1.3
Thus, if only one third of the assets of the worldwide estate are in the United States, only one third of the benefit of the lower brackets would be available. Because the United States has not adopted this approach (which would be impractical), its rate schedule for nonresident estates\(^{305}\) can be considered more generous than necessary to achieve equity with U.S. citizens.\(^{306}\) Not only does the United States allow nonresident estates the full benefit of the graduated rate schedule, but it also does not begin a phase-out of the benefits of graduated rates and the unified credit pursuant to I.R.C. section 2001(c)(3) until U.S. assets exceed the $10 million

\[^{305}\] Under the income tax, the difficulty of determining worldwide income is similarly avoided by disregarding the possible existence of foreign-source noneffectively connected income (or U.S. source noneffectively connected income taxed under I.R.C. § 871) in the application of the rate schedule to effectively connected income. Thus, the effectively connected income of a nonresident alien is allowed the full benefit of the lower brackets of the rate schedule for citizens and residents. See A.L.I., supra note 87, at 13 (defending this approach). However, only one personal exemption is generally permitted, the standard deduction is denied, and itemized deductions are limited to deductions connected with effectively connected income, a personal casualty loss deduction for property located within the United States, and the deduction for charitable contributions. See I.R.C. §§ 63(c)(6), 873(b). Thus, in effect, the benefit of the zero bracket amount created by personal exemptions for dependents and the standard deduction is denied.

\[^{306}\] See 1988 HOUSE REPORT, supra note 2, at 594-95 (explaining that "the provision gives [nonresident estates] the benefits of the progressive U.S. estate tax rates on a basis at least as favorable as estates taxed in the United States on a world-wide basis"); see also Musher, supra note 3, at 291 n.46. Musher states that under the 1966 Act "[t]he lower exemption [for nonresident estates] was ... meant to roughly compensate for determining the applicable progressive marginal rates without regard to a nondomiciliary's worldwide estate." Id.
threshold established for the estates of citizens.\(^{307}\)

However, the overall effect of the estate tax system on nonresident aliens depends also on the application of the marital and other deductions and of the unified credit. It is in these respects that the U.S. system may be considered inequitable to foreigners.

b. The Unified Credit

i. Proportional Credit

To achieve "worldwide equity" in the sense described above, the United States should grant to nonresident estates a unified credit equal to the $192,800 credit allowed to estates of U.S. citizens, multiplied by the fraction of the worldwide estate that has a U.S. situs (a "proportional credit").\(^{308}\) Under this approach, the 5% surtax imposed by I.R.C. section 2001(c)(3), which phases out the credit and the benefit of graduated brackets for very large estates, would apply as soon as the worldwide estate reaches $10 million, although it would be applied only to the U.S. estate.\(^{309}\) The validity of this approach was apparently recognized by Congress, when in 1988 both the House and Senate initially approved a proportional credit for nonresident estates.\(^{310}\) The same

\(^{307}\) Under the "worldwide equity" approach, the phase-out would begin when the worldwide estate exceeds $10 million; however, since only a fraction of the benefits of the graduated rates (and unified credit) would have been allowed, only that same fraction would be recaptured.

\(^{308}\) The result is the same whether the full unified credit is first subtracted and then the tax, less the unified credit, is multiplied by the fraction, or whether, alternatively, the tax (without credit) is multiplied by the fraction and then the result is reduced by the credit multiplied by the fraction.

\(^{309}\) Assuming that the estate were allowed a proportional unified credit and only a proportional allowance of the benefit of the graduated brackets (contrary to current law), this would insure that the amounts recaptured by the surtax would not exceed the benefits actually granted. Moreover, the recapture would occur over the same phase-out range (based upon worldwide estate) as for a U.S. citizen with the same worldwide estate. If the estate were granted the full benefit of the graduated brackets, the surtax would have to be adjusted further. See infra text following note 336.

\(^{310}\) See 1988 HOUSE REPORT, supra note 2, at 594-95; 1988 CONFERENCE REPORT, supra note 18, at 116. The Committee on Ways and Means explained that "the credit is reduced only in proportion that the estate of a foreign person is in a different situation than the estate of a U.S. person."
approach is mandated in U.S. treaties with seven countries.\textsuperscript{311} However, the conferees approved the proportional credit only in cases where required by treaty so that "the worldwide estate is easily determinable." By granting only a flat $13,000 credit in other cases, it sought "to eliminate the need to determine the . . . worldwide estate."\textsuperscript{312}

It is hard to disagree with Congress' conclusion that a determination of the worldwide assets of a nonresident estate is not practical, except perhaps where this is facilitated by a treaty, in light of the difficulties of identifying even the U.S. assets of a nonresident estate. If a proportional credit were granted, some nonresident estates might decline to claim the credit (probably out of concern for the effects disclosure might have in the home country),\textsuperscript{313} as already happens when the proportional credit is granted by treaty.\textsuperscript{314} Of the 161 nonresident estate tax returns filed for 1986, 89 showed the worldwide estate.\textsuperscript{315} Insuring that the credit is claimed would not, however, be the United States' responsibility provided that the United States had not discouraged such claims by sharing information about worldwide assets with unscrupulous foreign governments. Much more worrisome for the United States is the likelihood that some nonresident estates would claim the proportional credit but make an incomplete disclosure of their worldwide assets, thereby inflating the amount of the credit claimed. In this case, the

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\item[311] These are the treaties with Australia, Finland, Greece, Italy, Japan, Norway, and Switzerland. Rev. Rul. 90-101, 1990-2 C.B. 315.
\item[312] 1988 Conference Report, supra note 18, at 116; see I.R.C. § 2102(c)(1),(3)(A).
\item[313] See Florida Bar, supra note 12, at 910 ("[T] nondomiciliary estates often must choose to forego otherwise allowable U.S. deductions because of the requirement that the estate report its worldwide assets and liabilities."); Krauthamer, supra note 12, at 255 (stating that "[N] onresident aliens (and their representatives) are usually reluctant" to reveal the worldwide estate so as to claim prorated deductions under I.R.C. § 2106(a)(1) "because of tax or exchange control laws in the home country or simply out of fear of confiscation of those assets").
\item[314] See Troxell, supra note 14, at A-18. Troxell states that non-Americans "may not only be willing to forego" the proportional credit "but are suspicious of U.S. attorneys or accountants who try to elicit the information necessary to prepare a claim for the larger credit." Id.
\item[315] Long, supra note 29, at 53.
\end{enumerate}
\end{footnotesize}
IRS would have little ability to detect unreported assets located outside the United States.

ii. Harshness Of The $13,000 Credit

At the same time, limiting the credit to $13,000 has harsh results. The $13,000 credit would be less than the more equitable “proportional credit” in every case in which U.S. assets represent more than 6.7% of the worldwide estate, although the lower credit may be partially or fully compensated for by the full allowance of the graduated tax brackets.\(^{316}\) It seems likely that U.S. assets would often exceed 6.7% of the worldwide estate.\(^{317}\)

The $13,000 credit has a particularly harsh effect on nonresident estates where the worldwide estate is relatively small and U.S. assets comprise a relatively large fraction of the estate. For example, if the worldwide estate is $600,000 or less, then no U.S. estate tax should be owing, based upon the approach of “worldwide equity.” However, if the U.S. assets represent 100% of a $600,000 worldwide estate, the U.S. tax liability will be $179,800 (i.e., $192,800 less $13,000); if the U.S. assets represent one third (or $200,000) of the worldwide estate, the U.S. estate tax will be $41,800

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\(^{316}\) For example, in a case where U.S. situs assets are $200,000 and comprise only 1/10 of the worldwide estate (totalling $2 million), the $41,800 actual U.S. tax will be less than the $58,800 tax computed under the “worldwide equity” approach (i.e., the tax on $2 million, or $780,800, less the full unified credit of $192,800, leaving $588,000, to be multiplied by 1/10). A favorable outcome is achieved in this case (even though the $13,000 credit is less than 1/10 of the $192,800 credit allowed U.S. citizens) due to the generous rule allowing nonresidents full utilization of the graduated rate brackets.

\(^{317}\) Of the 161 nonresident estate tax returns filed for 1986, only 89 showed the worldwide estate. See Long, supra note 29, at 53. In the case of these 89, the U.S. gross estate constituted on average 23.3% of the worldwide gross estate. Id. IRS statistics for nonresident estate tax returns filed for 1982 show that “[t]hese estates had $148 million of worldwide assets, of which 32 percent” were U.S. situs. Skelly & Hobbs, supra note 29, at 15. It is not clear that these figures are representative of all nonresident estates that are potentially subject to U.S. estate tax. The 6.7% figure would likely be exceeded by nonresident employees of international organizations or multinational corporations who are employed in the United States for a period of years; the bulk of their assets (e.g., a residence, pension, and modest investments) are likely to be in the United States. Similarly, the figure may be exceeded by Canadians or Mexicans of relatively modest wealth who have a U.S. vacation home, e.g., in Florida.
(i.e., $54,800 minus $13,000); only if the U.S. assets represent one-tenth or less of the worldwide assets will U.S. tax liability be zero.

As the worldwide estate increases, this harsh effect is somewhat mitigated. Thus, if the worldwide estate is $2 million, the U.S. tax liability exceeds the "theoretically correct" tax only if U.S. assets are more than 30% of the worldwide estate.\footnote{If U.S. assets are 30\% of the worldwide estate, or $600,000, actual U.S. tax liability is $179,800, and the theoretically correct tax is $176,400. If U.S. assets are 25\% of the worldwide estate, or $500,000, the actual U.S. tax liability is $142,600 and the "theoretically correct" tax is $147,000.} If the assets of the worldwide estate are in excess of $10 million, it becomes more likely that the actual U.S. tax liability will be less than the tax computed under the "worldwide equity" approach.\footnote{For example, if worldwide assets were $20 million and U.S. assets were $10 million, the actual U.S. tax liability for 1993 would be $5,127,800. (Applying the rate schedule to the U.S. assets only would yield a tax of $5,140,800, which would be reduced by the $13,000 credit.) However, the tax under the "worldwide equity" approach would be $5,474,000. Under this approach, the tax on the worldwide assets of $20 million would be $10,948,000, i.e., $10,640,800, increased by the surcharge of $500,000 (on the $10 million which is in the surtax range of $10 million to $21,040,000), and then reduced by the unified credit of $192,800. Since the U.S. assets represent one-half of the total, the U.S. tax would be 50\% of $10,948,000, or $5,474,000. If there was no phase-out requirement, the tax under the "worldwide equity" approach would be $5,224,000 (i.e., $10,640,800 less $192,800, multiplied by .5), just slightly more than the actual U.S. tax liability.} This is because, under the "worldwide equity" approach, the phase-out of the unified credit and the graduated brackets would begin at $10 million of worldwide assets, whereas under the Code the phase-out begins only when U.S. assets exceed $10 million.\footnote{The surtax imposed to phase-out the unified credit is of course limited to the $13,000 credit actually permitted a nontreaty nonresident estate. See I.R.C. § 2101(b)(last sentence).}

Moreover, it can be argued that the $13,000 credit is too small even for cases where a proportional credit would be no greater than $13,000. The policy behind the unified credit in a domestic context may support use of the credit to completely exempt nonresident estates with a small amount of U.S. assets regardless of the size of the worldwide estate. For example, a nonresident estate with worldwide assets of $5 million might hold stock, in a U.S. company, valued at $65,000. Although the estate would have access to
sophisticated legal advice to facilitate the filing of a U.S. estate tax return, the expense and complexity associated with filing a U.S. return seems out of proportion to the size of the investment and the amount of the tax liability (i.e., $1,300). Requiring a return may require excessive effort from both the taxpayer and the IRS, which must monitor the return.\textsuperscript{321} This concern motivated Congress to increase the specific exemption for nonresident estates from $2,000 to $30,000 in 1966, a level that was one-half of that provided to U.S. citizens or residents.\textsuperscript{322}

The lack of greater relief for nonresident estates with small U.S. holdings seems particularly unfair in light of the fact that foreign investors with large U.S. holdings would generally utilize a foreign holding company to avoid the U.S. estate tax. By contrast, a foreign investor with small U.S. holdings often would not find it worthwhile to incur the expense and inconvenience of using a foreign holding company. Moreover, if the holdings consist of personal use assets, such as a vacation home or car, the holding company structure might not be feasible. Thus, the current rules may have the perverse effect of imposing little or no estate tax on nonresident estates with large U.S. holdings, while generally imposing an estate tax on nonresident estates with small holdings. The fact that the average U.S. gross estate shown on the 161 nonresident estate tax returns filed for 1986 was $385,201 may support this theory.\textsuperscript{323}

\textsuperscript{321} See 1966 HOUSE REPORT, supra note 25, at 999. The committee explained that the fact that “nonresident aliens ... typically have only a portion of their estate in the United States ... justifies a lesser exemption for” them. Id. The report concluded, however, that “the minimal ... exemption presently allowed is so low as to place an unreasonable and inequitable tax burden on” them, and that $30,000 “is high enough to make filing of returns unnecessary in the case of relatively small investments here.” Id.

\textsuperscript{322} See id.

\textsuperscript{323} See Long, supra note 29, at 53. The U.S. gross estate was below $100,000 on 34 returns, was between $100,000 and $249,999 on 66 returns, was between $250,000 and $499,999 on 29 returns, was between $500,000 and $999,999 on 25 returns, and was $1 million or more on only 7 returns.

\textit{Id. at 58.}
iii. Conclusion

In conclusion, the choice of a $13,000 credit gives too little weight to the strong domestic policy of "provid[ing] estate and gift tax relief to small estates." Although this policy is certainly susceptible to criticism, it does not seem fair to abandon it only in the case of nonresident estates.

One might argue in support of the 1988 changes that Congress' harsh approach has provided the U.S. Treasury with an effective bargaining tool in treaty negotiations. By offering a proportional credit only by treaty, the U.S. Treasury may be in a position to enter into new estate and gift tax treaties, or to negotiate more favorable provisions in existing estate and gift or income tax treaties. However, in many cases there may be no prospect of a treaty solution because many foreign countries do not have an estate or inheritance tax including some countries that are not considered tax havens. More fundamentally, it seems inappropriate for the United States to rely on treaty negotiations to remedy statutory provisions that produce inequitable treatment of foreigners.

Taking the treatment of marital transfers into account reinforces the conclusion that the $13,000 unified credit for nonresident estates is too meager. A nonresident estate is

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[324] 1981 House Report, supra note 26, at 154 (discussing expansion of unified credit that increased the amount effectively exempted from $175,000 to $600,000); see also S. Rep. No. 938, 94th Cong., 2d Sess. pt. 2 at 13 (1976) [hereinafter 1976 Senate Report] (new unified credit was designed to "confer more tax savings on small- and medium-sized estates").

[325] See Graetz, supra note 145, discussed at supra notes 151-53; Gutman, supra note 152, at 253 (stating that "ERTA significantly reduces the scope and impact of the federal wealth transfer taxes").

[326] There are a number of important U.S. trading partners that impose a death or gift tax, with which the United States has no estate or gift tax treaty, for example: Belgium, Bolivia, China, Egypt, Hungary, India, Indonesia, Israel, Korea, Luxembourg, New Zealand, Pakistan, Philippines, Poland, Portugal, Rumania, Spain and Venezuela.

[327] Thus, for example, the following countries have no estate or inheritance tax at the national level: Argentina, Australia, Bahamas, Bermuda, Brazil, Cayman Islands, Liechtenstein, Mexico, Netherlands Antilles, Saudi Arabia, Sierra Leone, Switzerland (by canton), Thailand and Uruguay. See Schoenblum, supra note 170, app. H, at 441-541.

[328] But cf. A.L.I. Treaties, supra note 114, at 13. ALI notes that "some tax administrators have explicitly acknowledged the practice of adopting domestic law rules designed to be modified by treaty (most frequently by imposing withholding tax rates higher than deemed appropriate)."

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entitled to the marital deduction on the same terms as the estate of a U.S. citizen. But, as a practical matter, a nonresident estate is much more likely than the estate of a U.S. citizen to be subject to the special restrictions on the marital deduction applicable to transfers to a noncitizen spouse. As discussed above, these restrictions, though justified in theory, can have harsh effects. In particular, even if a QDT is used, the opportunity for principal to be consumed by the surviving spouse on a tax-free basis is eliminated except in the case of hardship. Moreover, if a QDT is not used, the tax on principal is accelerated to the death of the first spouse so that the income earned during the surviving spouse's lifetime is reduced. In addition, tax-free inter vivos transfers of U.S. situs tangible property to an alien spouse are limited to $100,000 annually. In light of this, the impact of the small unified credit for nonresident estates may affect not only the estate's heirs, but also and most directly the surviving spouse if the estate is relatively modest. By contrast, Congress in the Tax Reform Act of 1976 sought to insure that “a decedent with a small- or medium-sized estate should be able to leave sufficient property directly to the surviving spouse for support during the lifetime of the spouse without the imposition of an estate tax.”

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239 The Ways and Means Committee’s explanation in 1988 of its elimination of the separate rate schedule for nonresident estates referred to the fact that such estates were being granted the marital deduction for the first time. See 1988 HOUSE REPORT, supra note 2, at 594-95. However, it did not explicitly draw a connection between elimination of the separate rate schedule and granting of the marital deduction. See id. The separate, lower rate schedule adopted for nonresident estates in 1966 (with the expanded specific exemption) was designed to yield a tax “in an amount which is generally equivalent to the tax imposed on an estate of similar value of a U.S. citizen with the maximum marital deduction.” 1966 HOUSE REPORT, supra note 25, at 996.

234 This assumes no liberalizing amendment, e.g., permitting $100,000 in annual tax-free distributions from a QDT. See supra notes 279-81.

231 1976 SENATE REPORT, supra note 324, at 14; 1976 HOUSE REPORT, supra note 25, at 17; see Adams, supra note 18, at 753 n.22; see also 1976 JCT REPORT, supra note 21, at 527, 530-31, 533 (giving an explanation of provisions). This was the rationale for Congress in 1976 to increase the allowable marital deduction from one-half of the decedent's adjusted gross estate to the greater of that amount or $250,000. Id.
c. Proposals For Liberalization

Some liberalization of the current rules seems warranted. One commentator has suggested that Congress reinstate the separate, lower rate schedule for nonresident estates,\footnote{332} except in the case of investors who under various treaties are eligible for the proportional credit.\footnote{333} However, such a reduction in rates for nontreaty investors is not a precise substitute for granting a larger credit. In particular, a rate reduction does not eliminate the need for filing by an estate with a small amount of U.S. assets, and it may provide greater benefits to larger estates than to smaller ones. In addition, a denial of the benefit of the lower rates to treaty investors entitled to a proportional credit would seem to require either treaty renegotiation or treaty override.\footnote{334}

Another proposal is to continue to apply the rate schedule for resident estates to nonresident estates, but to allow nonresident estates the full $192,800 unified credit.\footnote{335}

\footnote{332} See Bell & Shoemaker, Foreign Investment, supra note 6, at 267-68 & n.38. This proposal was combined with a further proposal that the estate tax for nonresident estates be limited to appreciation, and was based on the assumption that the proposed maximum 30% estate tax rate for nonresident aliens would be "roughly the same as their maximum income tax rate." Id. at 268. See infra notes 352 et seq. and accompanying text.

\footnote{333} One reason offered in the House report under the 1988 Act for the new higher rate schedule was concern about court decisions granting treaty investors the simultaneous benefit of the lower rate schedule for nonresident estates and the proportional credit. See 1988 HOUSE REPORT, supra note 2, at 594 ("differential rates and credit of present law do not achieve" equal treatment with U.S. citizens "particularly ... where a treaty allows aliens the benefit of both the unified credit and the lower rates"); see also Bell & Shoemaker, Foreign Investment, supra note 6, at 268 & n.38. Bell & Shoemaker note that the United States has an income tax treaty with all the countries (except South Africa) with which it has an estate tax treaty. Id. Thus, they conclude that treaty investors eligible for the proportional credit are also beneficiaries of income tax treaties that reduce the income tax burden of a corporate structure used to avoid U.S. estate tax on U.S. real estate. Id.

\footnote{334} But see Bell & Shoemaker, Foreign Investment, supra note 6, at 267-68. They suggest that "Congress could repeal the across-the-board increase in the NRA estate tax rates passed in 1988, and instead target the increase to the narrow situation that was cited to justify the increase." Id. They state further that "Congress could easily tailor a provision to this specific concern." Id. at 268 n.38. They note that the United States currently has only 16 estate tax treaties. Id. See also Bell & Shoemaker, TAMRA, supra note 1, at 89 n.39.

\footnote{335} See FLORIDA BAR, supra note 12, at 912, discussed supra note 300.
Under this proposal, if the U.S. assets represent anything less than 100% of the worldwide estate, the credit would be more than the proportional credit. This seems unduly generous, especially given that worldwide assets are not taken into account in applying the rate schedule and in determining the phase-out range.

It might be an appropriate compromise for Congress to grant a credit of $87,800 (which would effectively exempt approximately $300,000 of U.S. assets). This credit, which is about 45% of the unified credit of $192,800 allowed for U.S. citizens, could be viewed as based upon an implicit assumption that U.S. assets comprise 45% of the worldwide estate. The estate of a treaty resident would still be able to claim the proportional credit if more than 45% of the assets of the estate were situated in the United States.

As a corollary to this rule, the phase-out of the graduated rate brackets and the unified credit for nonresident estates would be determined based upon the same assumption. Thus, the phase-out would begin with a U.S. taxable estate of $4.5 million (rather than the current $10 million). The surtax rate would be 5% until the benefit of the $87,800 unified credit was recaptured (i.e., until the U.S. taxable estate reached $6,256,000). Thereafter, the surtax rate would be increased to 11.18% in order to recapture the $359,200 benefit of the graduated brackets (allowed fully to nonresident estates) by the time the U.S. taxable estate reaches $9,468,000, i.e., 45% of $21,040,000, the top of the phase-out range for U.S. citizens.

d. The Marital Transfer Credit

A further suggestion is to provide a nonresident alien decedent having a noncitizen surviving spouse with a means
to achieve results somewhat comparable to those available when the surviving spouse is a citizen, without the need to utilize a QDT. When the surviving spouse is a citizen, a marital transfer results in deferral of the estate tax. This deferral becomes a permanent tax exemption to the extent that the transferred property is consumed by the surviving spouse or such property absorbs any part of the unified credit of the surviving spouse that would not otherwise be utilized. Thus, to achieve somewhat comparable results for the nonresident estate with a noncitizen spouse, an exemption could be granted for marital transfers up to the amount that would be protected by the unified credit of the surviving spouse.337

Thus, under this proposal, a nonresident estate that waives the privilege of forming a QDT would be granted a marital transfer credit. In effect, this would exempt from taxation an additional $300,000 of property (which is transferred to the surviving spouse) beyond the amount exempted by the estate's unified credit.338 The $300,000 is intended to be the exemption equivalent of the unified credit of the surviving spouse,339 based upon the assumption that

337 This exemption would be overly generous to the extent that the surviving spouse had his own U.S. situs property which would have served to utilize his unified credit. On the other hand, the amount of this exemption would not explicitly take account of the fact that a citizen spouse could avoid tax on transferred property by consuming it.

338 Compare H.R. 5270, supra note 69, § 404(a), adding I.R.C. § 2210(c)(1)(B)(i),(c)(2)(A) (marital transfer amount for nonresident estates may not exceed $600,000 less the deduction equivalent of the unified credit allowed to the estate); John Turro, Germans Trying to Raise Ante on Treaty, Treasury Complaints, 50 TAX NOTES 1193, 1194 (1991) (The Treasury, in January, 1991, proposed to German negotiators “an additional” unified credit, so as to assist “those persons who are over the $600,000 unified credit but for whom making a [QDT] would be administratively too costly.”). The effect of this provision of H.R. 5270 is to permit a total of $600,000 to be shielded from tax by a combination of the unified credit of the first spouse to die (which would shield $60,000 absent enlargement by treaty) and the marital transfer credit. See supra notes 290-95 and accompanying text. The proposal in the text would have the same overall effect if the unified credit of the first to die is not enlarged by treaty: $300,000 of property would be exempted by the unified credit of the first to die and $300,000 by the marital transfer credit.

339 Somewhat similarly, under H.R. 5270, the marital transfer credit for a resident estate would, in effect, exempt an amount equal to the unified credit of the surviving spouse if he is also a resident alien at death. In the case of a nonresident estate, however, the amount of property in effect exempted by the marital transfer credit is not based upon the amount of the
the surviving spouse will also be a nonresident\textsuperscript{340} alien at
dead and that treaty benefits will not be available to enlarge
the survivor’s unified credit.\textsuperscript{341}

The marital transfer credit would provide a tax deferral,
but would not in itself protect the transferred property from
estate taxation upon the death of the surviving spouse, any
more than does the marital deduction. However, assuming
that the spouse first to die places $300,000 of property in a
credit shelter trust, another $300,000 of property could be
permanently shielded from the estate tax by first using the
marital transfer credit for the estate of the first to die and
then using the unified credit in the estate of the surviving
spouse.\textsuperscript{342} This assumes that the unified credit of the
surviving spouse would not have been utilized in any event to
offset estate tax liability with respect to separately-held, U.S.
situs property of the surviving spouse, including property
received from the spouse first to die by \textit{inter vivos} transfer. At
the same time, either separately-held property or the property
received from the spouse first to die, which would have a new
basis under I.R.C. section 1014,\textsuperscript{343} could be consumed by the
surviving spouse or withdrawn from U.S. tax jurisdiction

\textsuperscript{340} This assumption has to be made because even if the surviving spouse
is a resident when the first spouse dies, such residence might later be
abandoned.

\textsuperscript{341} This assumption has to be made because even if the surviving spouse
is a resident of a treaty country, the amount of the proportional credit could
not be predicted in advance.

\textsuperscript{342} The surviving spouse would also be entitled to a credit under I.R.C.
§ 2013 for estate tax paid by the estate of the first to die (after allowance of
the unified credit and marital transfer credit) with respect to property
transferred to the surviving spouse. The surviving spouse’s credit would be
limited to an amount which bears the same ratio to the estate tax paid by
the estate of the first to die as the value of the property transferred and not
shielded by the marital transfer credit bears to the taxable estate. \textit{Cf.} I.R.C.
§ 2013(b).

\textsuperscript{343} One might argue that, to the extent of the marital transfer credit
claimed by the first to die, the surviving spouse’s unified credit should be
available for use only against the property received from the spouse first to
die. However, such a limitation would involve complicated tracing rules,
and its effect would be merely to encourage the surviving spouse to retain
the property received from the first to die and to consume or withdraw from
the United States, instead, other U.S. property held by the surviving spouse
(although this property would not have a stepped-up basis).
assuming the spouse is a nonresident alien. As a result, in many cases, the eventual estate tax liability of the survivor’s estate would not be increased by the receipt of property under the protection of the marital transfer credit. Given such circumstances, the use of the marital transfer credit would achieve a permanent tax reduction.

Use of the marital transfer credit would likely be preferred by estates with small U.S. holdings, for which the QDT mechanism may be expensive and cumbersome. If the estate of the first to die does not exceed $600,000, the marital transfer credit would insure that there would be no estate tax liability on the death of the first to die, so that at the very least, the tax would be deferred. As described above, there often would be no tax on the death of the survivor either.

By contrast, the estate of a nonresident alien which passes sizeable U.S. assets to a surviving alien spouse with a considerable life expectancy might find it more advantageous to forego the marital transfer credit and to utilize a QDT. A QDT would permit deferral of estate tax liability on unlimited amounts transferred to the QDT until the death of the surviving spouse. Moreover, assuming the adoption of the proposal to tax QDT property in the estate of the surviving spouse, $600,000 of property of the first to die could be permanently exempted from the estate tax, as under the marital transfer credit strategy. Thus, the first to die could place $300,000 in a credit shelter trust and the rest in the QDT. $300,000 of QDT property could be shielded from estate tax on the death of the surviving spouse by use of his unified credit. Separately-held assets of the surviving spouse, including assets received from the first to die by inter vivos transfer, could be consumed or withdrawn from U.S. tax jurisdiction prior to the death of the surviving spouse.

The proposed expansion of the unified credit and the proposed marital transfer credit, combined with the proposed exemption for survivorship rights under a pension plan and the existing exemption for life insurance proceeds on the life of a nonresident alien, would largely remove the burden of the U.S. estate tax for nonresident alien decedents with small U.S. estates without seriously compromising the goal of equity between U.S. and foreign investors. As noted, nonresident estates with small U.S. holdings are the ones particularly burdened by the current rules because the use of QDT’s and
foreign holding companies may be impractical for them. The above proposal would in many cases remove the need for the use of such devices by estates with small U.S. holdings.\textsuperscript{344} At the same time, estates with larger U.S. holdings would not unfairly benefit. These estates might not find the marital transfer credit to be beneficial, nor would they receive greater benefits than smaller estates from the enlarged unified credit. Moreover, the proposal would also provide for a phase-out of the unified credit and graduated rate brackets to begin at lower levels than under current law.

4.4. Limiting The Estate Taxation Of Foreigners To Asset Appreciation

If, as has been proposed,\textsuperscript{345} the United States were to

\textsuperscript{344} If a QDT were used, the proposed exemption for QDT distributions of up to $100,000 annually would assist surviving spouses who found it necessary to invade the QDT principal.

\textsuperscript{345} Beginning in 1972, Canada replaced its estate tax with a rule imposing income tax on gains deemed realized from disposition of assets by gift or at death, but allowing deferral with respect to spousal transfers. See Boidman I, supra note 1, at 579-80. Professor Galvin has recently proposed repeal of the U.S. estate tax entirely and its replacement with a requirement that gains be constructively realized at death for income tax purposes (possibly combined with repeal of section 103). See Galvin, supra note 30, at 1418-19; Charles O. Galvin, Burying the Estate Tax: Keeping Ghouls out of the Cemetery: A Reply to Professor Smith, 56 TAX NOTES 951 (1992) [hereinafter Galvin II] (suggesting that “gift time and death time recognition of gain, standing alone, would probably make up the lost revenue”). \textit{Cf.} COMMITTEE ON TAXATION OF INT’L TRANSACTIONS, supra note 74, at 918 (suggesting that the special income, gift, and estate tax provisions applicable to expatriates could be replaced with a rule providing a zero basis for heirs or by repeal of section 102). \textit{But cf.} Robert B. Smith, Burying the Estate Tax Without Resurrecting Its Problems, 55 TAX NOTES 1799 (1992) (criticizing Galvin’s proposal for constructive realization at death); Lawrence Zelenak, Taxing Gains at Death, 46 VAND. L. REV. 361, 374-75 (1993) ("[A]ssuming revenue neutrality," the Galvin proposal would be “regressiv[e]” because the exemption amount would have to be “much lower . . . than the $600,000 transfer tax exemption created by the unified credit."). Zelenak suggests that in lieu of eliminating the estate tax, “the revenue raised from the new capital gains tax” could be used to “reduce the transfer tax burden” and that Congress could “key[ ] the exemption to the new capital gains tax to the transfer tax exemption.” Zelenak, supra, at 375. For earlier proposals recommending constructive realization of gains at death, see President’s 1963 Tax Message: Hearings on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress January 24, 1963 Before the House Comm. on Ways and Means, 88th Cong., 1st Sess., pt. 1, at 54-56, 128-40 (1963) (statement of C. Douglas
replace its transfer tax system with an income tax on gains constructively realized at death, equity considerations would strongly suggest extending that approach to nonresident estates as well. A more difficult question is whether it would be appropriate to replace the estate tax in this way for nonresident estates only.

Under such a system, constructive realization would presumably apply to gains from the same type of property that is currently subject to the U.S. estate tax for nonresident estates, and the constructively realized gains would be taxable as effectively connected gains under I.R.C. section 871(b). An exemption level might be established similar to that under the current estate tax for nonresident estates (i.e., $60,000).\textsuperscript{346} A carryover basis might be provided for spousal transfers.\textsuperscript{347}

The potential advantage of such an approach would be to reduce the burden of U.S. death taxation on directly-owned U.S. investments of nonresidents by a reduction of the tax base\textsuperscript{348} and of the tax rates\textsuperscript{349} for death taxation.

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\textsuperscript{346} See Dillon Statement, supra note 345, at 129-30, 132 ($15,000 lifetime exclusion so as to permanently exempt relatively small estates); Zelenak, supra note 345, at 416-20 (proposing use of “minimum basis method” and that the exemption be the same as under the estate tax); Galvin II, supra note 345, at 953 (suggesting a $600,000 exemption level for U.S. citizens); see also Dillon Statement, supra note 345, at 129-30 (discussing exclusion for personal and household effects, not including jewelry, antique furniture or furs of unusual value); Zelenak, supra note 345, at 428 (suggesting either “$5,000 . . . as an asset-by-asset exemption” or “$100,000 as an aggregate exemption”).

\textsuperscript{347} See Dillon Statement, supra note 345, at 130-31 (marital exclusion from constructive realization for up to one half of appreciation in decedent’s property); Galvin, supra note 30, at 1419; supra notes 278 & 345 (Canadian system); see also Zelenak, supra note 345, at 395-401 (suggesting ways to make this “workable”).

\textsuperscript{348} The base would be limited to the appreciation in assets.

\textsuperscript{349} The applicable tax rates would be the individual income tax rates, including the maximum capital gains tax rate of 28%. Under the 1993 Act, the maximum rate applicable to ordinary gain is 39.6%. This still compares favorably with the top estate tax rate of 55% (reinstated by the 1993 Act).
However, constructive realization would involve three disadvantages not present under the current system. First, foreign countries that prevent double death taxation of their residents by allowing a credit for estate or inheritance taxes imposed by other countries would not likely credit the new U.S. income tax on gains constructively realized at death, absent negotiation of new treaty provisions. Second, the replacement of the estate tax for nonresidents with an income tax at death might lead to the termination of existing estate tax treaties and might complicate the negotiation of new treaties. Third, the adoption of any system of taxation for nonresidents that is different than that for U.S. citizens and residents would be viewed by foreigners with suspicion and might be criticized as discriminatory even though the system would be less burdensome than the current law. In addition, a system of constructive realization at death for nonresidents would appear to be no easier to enforce than the current estate tax for nonresidents.

See supra notes 23-24 & 55.

350 For U.S. denial of an I.R.C. § 2014 credit for the Canadian income tax on deemed disposition of assets at death, see Estate of Ballard v. Comm'r, 85 T.C. 300 (1985); Rev. Rul. 82-82, 1982-1 C.B. 127; see also Boidman III, supra note 186, at 825. In Ballard, the court stated that "[t]he nature and character of an estate tax is that of an excise tax upon the privilege of transferring property of the decedent at death," whereas in the case of the Canadian tax the "focus ... is the recognition of gain or loss." 85 T.C. at 304, 306 (citation omitted). The IRS stated that "[t]he common element in estate, inheritance, legacy, and succession taxes is that they are all taxes imposed on the value of the property transferred from a decedent to an heir." Rev. Rul. 82-82, supra, at 127. Boidman calculates that the maximum combined rate of U.S. and Canadian tax that could apply to appreciation in Canadian assets transferred at death by a U.S. citizen is 70%. Boidman III, supra note 186, at 825. The current negotiations between the United States and Canada may result in provisions ameliorating this problem. See id. at 827.

351 Imposing a withholding requirement upon the transferee of the property from the decedent would add little to the obligations of the donee, executor, and heirs under the current transfer tax system. Foreigners could avoid constructive realization at death, just as they currently avoid the U.S. estate tax, by interposing a foreign holding company between themselves and the U.S. asset. See Boidman III, supra note 186, at 825 (footnote omitted) (noting that, for Americans, "[t]he single most effective method of avoiding exposure to Canadian death taxes is ownership of Canadian investments through a U.S. or other non-Canadian resident corporation"). Any attempt to look-through those foreign companies would face the same obstacles (e.g., enforceability and treaty conflicts) as a look-through rule
Commentators Bell and Shoemaker have proposed instead that the United States revise the current estate tax for nonresidents so that it resembles a system of constructive realization at death.\textsuperscript{352} Under this proposal, the estate tax on nonresidents would apply only to unrealized appreciation,\textsuperscript{353} and the pre-1988 Act rate schedule, which ranges from 6\% to 30\%\textsuperscript{354} for estates in excess of $2$ million, would be reinstated, but not for investors entitled by treaty to use the proportional unified credit. This proposal would be even more favorable to foreign investors than constructive realization, particularly under the 1993 income tax rates, because the pre-1988 estate tax rates are “extremely graduated and [do] not reach 30\% until the taxable estate [is] in excess of $2$ million.”\textsuperscript{355} In addition, the above described

under the estate tax. However, under a system of constructive realization, there may be less incentive for foreigners to avoid U.S. death taxation by use of a foreign holding company, provided that constructively realized gains would be eligible for capital gains treatment.

\textsuperscript{352} See Bell & Shoemaker, Foreign Investment, supra note 6, at 267-68 & n. 38.

\textsuperscript{353} Somewhat similarly, some have proposed that the estate tax be adjusted for all taxpayers so as to impose a heavier burden on unrealized appreciation. See ABA TASK FORCE, supra note 28, exhibit G at 446-48 (suggesting “equaliz[ing] the tax treatment of those who sell during life and those who hold until death” by providing “a 10-point credit against the estate tax” with respect to the portion of property transferred at death not representing unrealized appreciation); Galvin, supra note 30, at 1417 & n.29; Zelenak, supra note 345, at 407 (criticizing ABA TASK FORCE’S Exhibit G as “us[ing] the credit proposal as a disguised way of reducing death tax rates”); see also Graetz, supra note 145, at 262 & n.24 (referring to “the quite simple and fair proposal for an additional estate tax on appreciation, which had been developed in the 1970s by the Trust Division of the American Bankers Association” (citing Covey, supra note 345, at 843-49)).

\textsuperscript{354} See Bell & Shoemaker, Foreign Investment, supra note 6, at 268. They note (prior to the passage of the 1993 Act) that the maximum rate of 30\% would be “roughly the same as their maximum income tax rate,” and suggest that their proposal “would again properly integrate the income and the estate tax.” Id. They explain that “[o]wing to the basis step-up provided by [I.R.C.] § 1014, an NRA would pay either a maximum 30 percent marginal estate tax rate or a maximum 31 percent (28 percent on capital gains) marginal income tax rate on the appreciation in U.S. real property investments, but not both.” Id. at n.39.

\textsuperscript{355} See Bell & Shoemaker, TAMRA, supra note 1, at 87 n.33. If, as under the pre-1988 law, the unified credit was sufficient to eliminate the tax on the first $60,000, amounts between $60,000 and $100,000 would be taxed at a rate of 6\%. By contrast, there is much less graduation in the individual income tax rates. See id. at 86-87 (describing pre-1990 rates).
problems associated with constructive realization would be avoided, provided that the proposed “hybrid” estate tax\textsuperscript{356} were not viewed by our trading partners as a disguised income tax.\textsuperscript{357}

Bell and Shoemaker have argued that because the current estate tax is not limited to appreciation, it creates “an almost insurmountable disincentive to foreign direct investment in U.S. real estate,” at least by nontreaty investors.\textsuperscript{358} The objective of their proposal is to mitigate the burden of the U.S. estate tax on nonresidents so that the estate tax (or the costs associated with avoiding it through a foreign holding company) would not deter them from making U.S. investments.\textsuperscript{359} Thus, the proposal seeks to make direct ownership of U.S. assets a more attractive alternative than the use of a foreign holding company, which has been rendered “unattractive from

Shoemaker note that prior to the 1988 increase in estate tax rates, it was not necessarily disadvantageous for a nonresident alien to invest in U.S. real estate through a partnership and incur estate tax (at graduated rates that only reached the maximum of 30\% for estates in excess of $2 million) while achieving a step-up in basis that avoided income tax at a maximum rate of 28\% (with very little income eligible for the lower bracket). \textit{Id.} at 87.

\textsuperscript{356} The current estate and gift taxes are constitutional as excise taxes. \textit{See Bittker & Lokken, supra} note 7, ¶ 120.1.2, at 120-3 to 120-6 (citing Knowlton v. Moore, 178 U.S. 41 (1900) (legacy tax) and New York Trust Co. v. Eisner, 256 U.S. 345 (1921)); Dodge, \textit{supra} note 32, at 252 & n.42; \textit{id.} at 249 & n.32 (noting that by contrast, an annual wealth tax “would probably be unconstitutional” due to U.S. Const. art. I, § 9, cl. 4, which “prohibits an unapportioned direct tax that is not an income tax” permitted by the 16th Amendment). It appears that the proposed tax described in the text would be constitutional.

\textsuperscript{357} \textit{See supra} note 350; \textit{cf.} Treas. Reg. § 1.901-2 (as amended in 1991).

\textsuperscript{358} Bell & Shoemaker, \textit{Foreign Investment, supra} note 6, at 268; \textit{see also id.} at 267 (“To individual investors from nontreaty countries . . . U.S. policymakers have hung out a giant ‘Not Welcome’ sign.”); Musher, \textit{supra} note 3, at 290 (stating that “[f]rom the foreign investor’s perspective the U.S. estate tax is confiscatory”). Musher notes that “in its nature as a transfer tax the U.S. estate tax where applicable is imposed without regard to whether an investment has appreciated, and is imposed on the base of value rather than simply gain.” \textit{Id.} at 291. He concludes: “[u]nderstandably, a nondomiciliary, who unlike a U.S. domiciliary is not automatically within the U.S. estate tax net, is very hesitant to make an economic decision to invest in U.S. real property, if that decision involves a significant risk of being caught in that net.” \textit{Id.} (footnote omitted).

\textsuperscript{359} \textit{See Bell & Shoemaker, Foreign Investment, supra} note 6, at 267-69.
an income tax perspective. This would have further salutary effects of (1) eliminating the complications, inefficiency, and disrespect for the law associated with the use of a foreign holding company to avoid U.S. estate tax, (2) eliminating unfairness to foreigners for whom use of a foreign holding company is impractical, and (3) possibly reducing the incentive for tax evasion.

The proposal would, in fact, provide more favorable overall U.S. tax consequences for direct ownership than for corporate ownership apart from the higher rates of tax on ordinary income of individuals under the 1993 Act. In a foreign holding company, the corporate tax would eventually be applicable to all appreciation in corporate assets since there would be no step-up in basis at death. In addition, there would be the potential for a second level of tax on corporate income from appreciation or operations, particularly if the tax on the capital gains of foreign shareholders proposed in House Bill 5270 is enacted. Under direct ownership, the tax on unrealized appreciation would be accelerated to the date of death, but it would likely be at rates significantly below the corporate rate (particularly because the pre-1988 estate tax rate schedule is very “graduated”), and there would be only one level of tax. However, the top individual income tax rate of 39.6% under the 1993 Act for operating income or gains that are not capital gains would be a disadvantage of individual ownership.

Bell and Shoemaker acknowledge that to make direct ownership of U.S. real estate an attractive option, foreigners’ desire for anonymity would also have to be considered. They suggest that the IRS could address this

360 See id. at 268; see also supra note 207.
361 See Bell & Shoemaker, Foreign Investment, supra note 6, at 267. They note the “morass of complexity, economic inefficiency, and noncompliance” generated by the current rules. Id. They further note that “[t]he ignorant and the unethical simply avoid U.S. estate taxation altogether by not filing a return,” while “[t]hose who are able to afford (and willing to put up with) tiered corporate structures dedicate otherwise productive resources to multiple layers of accountants, lawyers, and foreign governments.” Id. (footnote omitted).
362 See supra note 355.
363 See supra notes 84-85 and accompanying text.
364 See Bell & Shoemaker, Foreign Investment, supra note 6, at 269-70.
concern for many residents of developing countries by "affirmatively publiciz[ing] to [nonresident aliens]" that tax return information will be disclosed only pursuant to a "tax treaty or information exchange agreement," and by avoiding such agreements with foreign governments that have "restrictive investment policies and exchange controls."365

On the other hand, there is no intrinsic logic to limiting the base of the estate tax to appreciation for nonresident estates only, nor to providing a separate, lower rate schedule for nonresident estates. These proposals would be a step away from equality in the tax treatment of U.S. citizens and nonresident aliens.366 Any inequity toward foreigners in the current rules does not stem from the rate schedule or from the taxation of amounts not representing appreciation, but rather from the rules for the unified credit and marital deduction, which could be rectified, as discussed above. In fact, Bell and Shoemaker appear to acknowledge that treaty investors entitled to the proportional credit should not also benefit from the pre-1988 rate schedule.367

Equality in the treatment of U.S. citizens and nonresident aliens would be achieved most completely by retaining the current estate tax on foreigners (but liberalizing the unified credit and marital transfer rules, as described above), while adding a look-through requirement with respect to foreign holding companies. Since this is impractical, the next most "equitable" system is the current one, with liberalized unified credit and marital transfer rules. This system requires foreigners to choose between (1) utilizing a direct form of ownership, with the same tax consequences as for U.S.

365 Id. at 270 & n.44.
366 But cf. Musher, supra note 3, at 294 (noting that U.S. persons are "subject to estate tax risk under both corporate and individual ownership structures"). However, he argues that "[s]ince U.S. individuals for better or worse are within the U.S. worldwide estate tax net, that tax is not a marginal cost which they must consider in making their choice of investment vehicle," and thus they typically... select individual ownership structures for real estate investments "and thereby achieve single income taxation of their real estate gains." Id. He argues that "[b]y contrast, for foreign investors the U.S. estate tax may frequently constitute a very real and drastic marginal cost," making use of a foreign holding company "a necessity." Id.
367 See Bell & Shoemaker, Foreign Investment, supra note 6, at 267-68 & n.38. See supra notes 359-55 and accompanying text.
citizens, i.e., a single level of income tax at individual rates and an estate tax at rates of up to 55%, or (2) utilizing a foreign holding company structure, thereby avoiding the U.S. estate tax but in some cases (much fewer under the 1993 Act) incurring less favorable income tax consequences, which U.S. citizens would ordinarily avoid by utilizing direct ownership. The fact that U.S. citizens have many opportunities to avoid U.S. transfer taxation does not justify liberalizing the estate tax treatment of foreigners who own U.S. assets by direct ownership. Foreigners' opportunities for avoidance are generally the same or greater.

It is quite possible that the Bell and Shoemaker proposal could result in some loss of revenues, particularly if a tax on the capital gains of foreign shareholders had already been enacted. Whether there would be such a revenue loss might depend upon how many new U.S. investments were made by foreigners who previously would be deterred by the U.S. estate tax. Any shift on the part of existing foreign investors in the United States from corporate ownership to direct ownership would presumably lose more income tax revenues than the new estate tax revenues thereby gained or else the shift would not be made. Moreover, there would be some decline in estate tax revenues from foreigners who have made direct investments in the United States and who would have paid estate tax under current law.

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568 If the capital gains tax on foreign shareholders in H.R. 5270, supra note 69, is enacted, then the income tax consequences of the foreign holding company structure will more often be unfavorable. Thus, the holding company structure would be less of a refuge from the tax burden ordinarily imposed on U.S. citizen decedents.

569 See supra notes 30-44 and accompanying text. Thus, foreigners are entitled to an exclusion for life insurance proceeds (even if retaining the incidents of ownership at death) and for portfolio debt. In addition, they can make tax-free lifetime gifts of intangible property in unlimited amounts or of tangible property to the extent of the annual $10,000 per donee exclusion. Foreigners, like citizens, can utilize favorable valuation techniques and can sell property for a private annuity. There are, however, some exceptions, even apart from the restrictions on the estate and gift tax marital deduction and the lesser amount of the unified credit. Thus, nonresident aliens cannot use gift-splitting or use the unified credit to offset gift tax. For the generation-skipping transfer tax exemption under I.R.C. § 2631 in the case of a nonresident alien transferor, see Prop. Treas. Reg. § 26.2663-2(f), 57 Fed. Reg. 61356 (1992); Harry F. Lee, GST and the Nonresident Alien, 57 TAX NOTES 265, 270-71 (1992).
Thus, Congress, in assessing the Bell and Shoemaker proposal, must consider, on the one hand, whether the current system, even with liberalized rules for the unified credit and marital transfers, is too discouraging to investment in the United States by nonresident alien individuals (or would be too discouraging if House Bill 5270 is enacted). Congress must also consider the distastefulness and inefficiency in the current use of the holding company structure as a tax avoidance device, and the inequality among foreign investors stemming from the unsuitability of that device for some foreign investors. Congress should adopt the Bell and Shoemaker proposal only if these concerns are important enough to depart from the goal of equal treatment of U.S. citizens and nonresident aliens by easing the estate tax rules for nonresident aliens only (and even for treaty investors who also obtain the benefit of the proportional credit). Moreover, the United States should act unilaterally to reduce its estate tax jurisdiction only if it seems unrealistic that the U.S. Treasury could broaden its network of estate tax treaties and thereby achieve a quid pro quo for estate tax relief offered to nonresident aliens.

5. CONCLUSION

Major unclosable loopholes in the U.S. estate tax on nonresident estates narrowly limit its application in practice. This has led to suggestions that the tax should be repealed. The arguments favoring its retention should, however, prevail. The United States should do what it can to broaden application of the tax by clearly asserting jurisdiction over assets held through partnerships, resolving other uncertainties, and tightening compliance measures. The United States should also provide more equitable treatment of nonresident estates by liberalizing the unified credit and marital transfer rules. Further liberalizations, which would provide more favorable treatment for nonresident estates than for estates of U.S. citizens, can be justified only by a pressing need to promote investment in the United States by foreign individuals.