Chapter 20

NON U.S. PERSONS IN THE ESTATE PLAN

WHAT IS IT?

Special planning opportunities and problems are present where at least some family members are not U.S. citizens. Techniques will depend largely on the following:

(1) The extent to which these individuals have property situated in the U.S.

(2) Whether they are classified as either resident or nonresident aliens.

(3) Whether they were U.S. citizens who have renounced their citizenship through expatriation to other nations.

(4) Whether the spouse of the client is a citizen of the U.S.

Any planning in this area will be contingent on whether or not there is a treaty with the country in question which covers tax issues. The practitioner must always determine if such treaty provisions exist. As of January 1, 2006, the U.S. had estate/gift tax treaties with 17 countries. Most of the treaties are many years old and may not entirely apply because of changes in the tax laws of the U.S. or the other respective countries. For example, the U.S.-Australia tax treaty was executed in 1954. Australia no longer imposes an estate tax.

WHEN IS THE USE OF SUCH A PLAN INDICATED?

Special planning will be required in the following situations:

1. Where the client or family member is an alien who is considered to be a resident in the U.S. The tests for determining if an alien is a U.S. resident is different for federal income tax law than it is for federal estate tax law. Under the income tax rules, the test is objective, i.e., is the alien physically present in the U.S.?[1] If so, the alien is, subject to a complex set of tests and rules, usually treated as a resident. The federal estate tax regulations define a U.S. resident as a person who, at the time of his death, is "domiciled" in the U.S. Under these regulations, a non U.S. citizen is not domiciled in the U.S. unless he intends to remain here indefinitely.[2] Thus, in the case of the estate tax, the test is a subjective test relating to the "intent" of the person. This section will focus on estate, gift, and generation-skipping transfer tax planning issues.

   If the alien is treated as a resident for estate tax purposes, it follows that the alien's lifetime transfers are subject to gift and estate taxes in essentially the same manner as U.S. citizens resident in the U.S. The basic gift tax law is that the tax applies to all transfers by any individual, whether resident or nonresident.[3] There is an exception for the transfer of intangible property by a nonresident noncitizen.[4]

2. Where the client or family member is not a citizen or resident of the U.S., but is subject to federal estate tax because his taxable estate includes property situated in the U.S.[5] Property situated in the U.S. includes any stock issued by a domestic corporation (i.e., a U.S. corporation); any property which was situated in the U.S. when it was transferred by the decedent, but which would be included in his estate under IRC Sections 2035 to 2038; and debt obligations of a U.S. person, the U.S., or a state or any political subdivision thereof.[6] It does not include life insurance, certain bank deposits, and other specified debt obligations.[7]

3. Where a surviving spouse is not a U.S. citizen, regardless of such spouse's domicile. The issue is the availability of the gift or estate tax marital deduction for transfers of assets to or in trust for the spouse.[8]

4. Where the client is a U.S. citizen not residing in the U.S. The estate and gift taxes are imposed on all U.S. citizens, regardless of where they live.[9] The generation-skipping transfer tax statutes do not specifically cover this, but since the tax is triggered by a taxable transfer for gift or estate tax purposes, the same rule should apply.

WHAT ARE THE REQUIREMENTS?

Subject to the foregoing rules, the goal of estate planning for clients in this category is to minimize the impact of U.S. taxes.

1. To avoid federal income tax, an alien who does not hold a permanent U.S. visa can avoid being considered a resident by not being physically present in the U.S. for more than 30 days during the current year or for more than 182 days during the three calendar year period ending with the current year. The 182 day threshold is calculated by multiplying the number of days the individual was in the U.S. in each of the 3 years by an applicable multiplier, which is 1 for the current year, 1/3 for the 1st preceding year, and 1/6 for the 2nd preceding year, and adding those 3 numbers together.[10] For example, an alien who does not hold a permanent U.S. visa can avoid being considered a resident in the current year by not being physically present in the U.S. for more than 120 days in each of the two preceding years and the current year [120 x 1 = 120; 120 x 1/3 = 40; 120 x 1/6 = 20; 120 + 40 + 20 = 180]. This of course will be impossible for most aliens who are actively engaged in business in the U.S., or maintain a home here. If, however, the alien can limit his presence in the U.S. to no more than 182 days in any year, U.S. income tax may be avoided during such year if:

   a. The alien has a tax home in a foreign country, and

   b. An annual declaration is filed with the IRS with information that shows a "closer connection" with such foreign country than with the U.S.[11]

2. To avoid federal estate tax, the alien's estate will have to establish the alien's "intent," i.e., that the alien's permanent home is outside the U.S. For example, if the alien has a bigger or better residence in the U.S. than in the alien's home country, this will be difficult. Also, the conduct of business and investment affairs should, to the extent possible, be located outside the U.S. Obviously, the alien should avoid signing documents in which the alien is described as a U.S. resident.

3. Where it appears U.S. residency will be unavoidable for either income or transfer tax purposes, the alien should seek to make gifts of assets to non U.S. persons, such as adult children living in foreign countries, before becoming a U.S. resident. This could be done with irrevocable foreign situs trusts, and limited liability companies (LLCs) discussed in Chapter 44. Many foreign countries recognize LLCs. This may be particularly useful to reduce the size of the alien's taxable estate.

4. Whether or not the alien is deemed a resident under U.S. tax laws, foreign situs trusts may be particularly useful to mitigate tax consequences. It will be essential that such a trust be irrevocable and have an independent trustee. However, the alien could retain some powers over the trust to the extent these powers do not cause the alien to be considered the "owner" of the trust for federal income or estate tax purposes. See in particular the discussion of the Income Taxation of Estates and Trusts in Chapter 19.

5. Where the alien can avoid U.S. residency, the use of foreign situs revocable trusts and foreign corporations may be indicated.

6. Where the client is a resident or U.S. citizen, but the client's spouse is not a U.S. citizen, the planner must concentrate on the federal gift and estate tax marital deduction. In general, the gift tax annual exclusion/marital deduction is limited to $120,000 (in 2006) per year where the donee spouse is not a U.S. citizen. If the surviving spouse is not a U.S. citizen, the estate tax marital deduction is only available if the bequest ends up in a qualified domestic trust (QDOT). This is a trust that meets the requirements for the marital deduction discussed in Chapter 24, but which must include a series of special provisions relating to the trustee and how the trust is administered. If such a trust is used, the decedent's estate can claim the estate tax marital deduction for transfers to it, but most distributions to the surviving spouse, as well as the value of the assets remaining in the trust at the death of the surviving spouse, will be subject to federal estate tax. Moreover, this estate tax is computed by assuming such assets are added to the estate of the predeceased spouse.

   The basis in a taxable distribution from a QDOT is computed as though the transfer was made by gift. In other words, the initial basis is carried over and increased (but not above fair market value) by the amount of gift tax allocable to the growth in the value of the property occurring after the first spouse's death.

For example, assume property worth $1,000,000 is placed into a QDOT. It grows to $1,300,000 and is paid out to the surviving spouse and taxed at that time as a distribution. An upward adjustment is allowed in the recipient's hands to account for the gift tax paid on the $300,000 of appreciation.

7. There are also special rules relating to distributions from foreign situs trusts to U.S. beneficiaries. For example, there is an interest charge if such a trust accumulates income and then distributes the accumulation.[12] If a U.S. person makes an inter vivos gift of property to a foreign situs trust that has at least one U.S. beneficiary, the trust income is taxed to the grantor.[13]

8. The unified credit and state death tax credit are allowed to the estates of those considered U.S. residents for estate tax purposes, even if they are not U.S. citizens.[14]

9. *Foreign Death Tax Credit:* Foreign death taxes are often imposed on property owned by a resident noncitizen where the property is situated outside the U.S. A credit is allowed for estate, inheritance, legacy, or succession taxes paid to a foreign country (or to a U.S. possession). The foreign death tax credit is allowed to the estate of a resident alien. The credit is allowed only for taxes actually paid to the foreign country or U.S. possession.[15]

HOW IT IS DONE – AN EXAMPLE

The client is the citizen of a foreign country who is not a resident of the United States. He is considering making a substantial investment in real estate in Hawaii. If he makes this investment directly, he will be subject to federal income tax on all of the income since it is U.S. source income. Further, upon his death, the value of the real property will be subject to U.S. estate tax.

If the real property were held through a foreign corporation, there would be little if any income tax advantage, but this would afford complete protection from federal estate and gift taxes. He may also consider holding the real estate through an irrevocable foreign situs trust, which will also avoid federal estate and gift taxes, and will not avoid federal income tax. The trust may be a more flexible arrangement. Further, a combination of the corporation and trust may be considered, with a corporation holding the real estate, and the corporate stock held in the irrevocable trust.

If the property is to be held by a foreign corporation, it is important to be certain the entity will be recognized as a corporation under U.S. law. Some foreign countries have entities which may nominally be classified as corporations, but which may not be recognized as such in this country. Further, the best procedure to follow is for the alien to transfer the consideration for the purchase of the U.S. real property to the foreign corporation in exchange for stock, and then have the corporation purchase the land. There should always be consideration for the transfer of assets to a foreign corporation.

WHAT ARE THE TAX IMPLICATIONS?

As discussed above, where a noncitizen becomes a resident of the U.S. under either the income or estate tax definitions, that person will be subject to taxes in essentially the same manner as a U.S. citizen. The critical first step is to determine whether or not the alien is a resident under either tax. If so, the domestic planning options discussed in this book are generally available.

If the alien is not a resident, then the first step is to avoid U.S. gift and estate taxes by structuring the ownership of assets to avoid direct ownership by the alien of U.S. property or business interests. From the income tax standpoint, nonresident aliens are only taxed on income from sources within the U.S. The U.S. source income rules are detailed and complex (see, in general, IRC Sections 871 and following).

If the nonresident alien does own U.S. situs property, then the federal estate tax will apply under the rules discussed in IRC Sections 2101 and following and the unified credit available is reduced to a maximum of $13,000.[16]

Under the Foreign Investment in Real Property Tax Act, various provisions have been added to the law to insure collection of income tax on the transfer of U.S. real property by nonresident aliens, including withholding.[17]

In addition, property situated in the U.S. is subject to the generation-skipping transfer tax regardless of the fact the transferor is a nonresident alien.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Most countries in the world, other than those that follow the English common law system, such as most of the United States, do have community property laws. It is very likely assets acquired by noncitizens are community property, and planning should proceed accordingly. In addition, if the alien is a resident in a community property state, that state may seek to impose its community property rules on assets or earnings received while domiciled in the state.

QUESTIONS AND ANSWERS

Question – What is a controlled foreign corporation, and what is its significance?

Answer – A controlled foreign corporation is a foreign corporation in which either more than 50% of the total combined voting power of all classes of stock or more than 50% of the total value of the stock is owned by United States shareholders.[18] The net effect of such status is that any income earned by the corporation will be attributed to and taxed to any shareholders who are U.S. residents.[19] This rule will apply even if the corporate stock is owned through a revocable trust. There are complex rules and exceptions.

Question – Is the partnership or LLC a viable form of entity for aliens to hold investments or business interests?

Answer – The partnership has the same advantages to aliens as to other taxpayers in avoiding two levels of taxation on its income. However, if the partnership is making U.S. investments, or carrying on a U.S. trade or business, it is subject to stringent withholding requirements. If a nonresident alien owns an interest in a partnership that is carrying on U.S. business, it appears that the partnership interest will be subject to U.S. estate tax.

Question – Is an irrevocable foreign trust a viable form of business entity for aliens to hold U.S. investments or business interests?

Answer – Such a trust may be a good planning vehicle, particularly when combined with other entities, such as the foreign corporation or partnership. Again, there are strict withholding requirements on distributions from such trusts. An important advantage of the trust is the potential avoidance of federal estate and gift tax by nonresident aliens. The trust is preferable to any form of direct ownership of U.S. real estate.

Question – A nonresident alien who spends a great deal of time in the U.S. intends to take his daughter, also a nonresident alien, on a shopping trip in this country to purchase expensive jewelry. Is this advisable?

Answer – It would be better for the parent to purchase the jewelry and be the owner, return to the foreign country, and then make a gift of it to his daughter. Otherwise, the transfer is subject to U.S. gift tax.

Question – A decedent is a nonresident alien who was an expatriate from the U.S. four years before her death. Is there any estate tax exposure?

Answer – IRC Sections 2107 and 877 (expatriation to avoid tax) provide that if citizenship is lost within 10 years of death, an estate tax will be imposed on the estate of the expatriated individual if the individual meets any of the following criteria: (1) The individual earned above a specified annual income in the years before the expatriation, or (2) the individual had a net worth of at least $2,000,000 as of the date of expatriation. For purposes of the estate tax liability, the expatriate's taxable estate would include not only property situated in the U.S. as defined in IRC Section 2104, but also stock in certain foreign corporations.

Question – A nonresident alien wishes to create a trust for the benefit of U.S. citizens. How can the alien avoid U.S. tax on the trust income?

Answer – If the trust is subject to the grantor trust rules under IRC Sections 671 to 677, the grantor, not the trust or its beneficiaries, will be taxed on the trust income. This also avoids the tax on accumulations discussed above.

Question – What are the requirements of a qualified domestic trust (QDOT)?

Answer – A QDOT has certain requirements.

1. The trust must meet the same requirements for the marital deduction as a trust for the benefit of a citizen spouse (see Chapter 24). Thus, it can be a QTIP trust, a trust over which the surviving spouse has the right to all income and a general power of appointment, or an estate trust. In an estate trust, it is not necessary that all of the income be distributed annually to the surviving spouse, so long as all trust distributions must ultimately be made to the spouse or the spouse's estate. Such a trust is often useful where the trust

assets are not income producing, such as stock in a closely held corporation. Regulations may provide for arrangements other than trusts in jurisdictions where trusts are prohibited.

2. Except as provided in regulations, at least one trustee must be an individual who is a U.S. citizen or a domestic corporation. According to regulations, if the value of the trust assets exceeds $2 million, at least one U.S. trustee must be a bank or the trustee must furnish a bond or irrevocable letter of credit equal to 65% of the value of the trust. If the trust is worth less than $2 million, either a bond must be furnished or the trust must contain a clause that not more than 35% of its fair market value can be invested in non U.S. real property. Also, an individual U.S. trustee must have a tax home in the U.S. Tangible and intangible U.S. property must be in the U.S. or a U.S. brokerage account.

3. No distribution can be made from the trust unless the U.S. citizen or domestic corporation trustee has a right under the trust to withhold from the distribution any tax due on the distribution.

4. The executor of decedent's estate must make a QDOT election. If the qualifying trust is a QTIP, both QTIP and QDOT elections must be made.

5. No marital deduction is allowed unless the property is transferred to a QDOT, or a trust reformed to qualify as a QDOT, or it is transferred to the QDOT by a surviving spouse, or the surviving spouse becomes a citizen, or there is a treaty. There must be an actual transfer or assignment to a QDOT created by the decedent, executor, or surviving spouse.

6. An estate tax is imposed on QDOT assets on the happening of any of the following events:

   (1) When any distribution, other than (a) a distribution of income to the surviving spouse or (b) a distribution to the surviving spouse on account of hardship, is made prior to the surviving spouse's death;

   (2) When the surviving spouse dies. The entire value of the property in the QDOT at that time will be subject to federal estate tax;

   (3) When the QDOT fails to meet any QDOT requirement designed to assure that the IRS will collect the estate tax. The estate tax will be imposed as if the surviving spouse died on the date the trust failed the requirement; or

   (4) When the QDOT pays the tax imposed upon the first of the above triggering events, that tax itself is considered a taxable distribution that sets off yet another tax. In other words the QDOT's payment of the estate tax on a distribution is itself a distribution subject to a further estate tax.

7. The estate tax on the QDOT is computed as follows:

   Step 1: State the amount involved in the taxable event

   Step 2: Add all previous taxable events

   Step 3: Compute the federal estate tax on the estate of the first spouse to die as if the total of #1 and #2 above were included in the decedent's gross estate

   Step 4: Compute the federal estate tax on the estate of the first spouse to die as if only the amount of the previous taxable events were included in the decedent's gross estate

   Step 5: Subtract the tax computed in step #4 from the tax computed in step #3. This is the tax imposed as a result of a current taxable event.

8. If the surviving noncitizen spouse becomes a U.S. citizen before the decedent's estate tax return is filed, and the surviving spouse was a resident of the U.S. at all times after the decedent's death and before becoming a citizen, the usual marital deduction is available to the surviving spouse (i.e., a QDOT is not required). If the surviving spouse becomes a U.S. citizen after the QDOT is established, the spouse may still be able to treat the balance of the QDOT assets as a conventional marital deduction, as long as the other requirements of IRC Section 2056A(b)(12) are met.

9. If the estate otherwise qualifies, various tax elections are available upon the death of the surviving spouse, such as stock redemptions under IRC Section 303, valuation elections under IRC Sections 2032 and 2032A, and deferred payment of federal estate tax under IRC Section

6166. Also, a charitable deduction under IRC Section 2055 may be available.

Question – What are the planning advantages of gift transfers to a noncitizen spouse?

Answer – Lifetime transfers of up to $120,000 (in 2006) per year to a noncitizen spouse qualify for the gift tax marital deduction. The noncitizen spouse could leverage this gift by purchasing life insurance on the life of the citizen spouse. Such insurance would not be included in the estate of the citizen spouse, and through the use of an irrevocable life insurance trust, discussed in Chapter 31, could be excluded from the estate of the noncitizen spouse in the event such spouse is subject to federal estate tax.

Lifetime gifts to a surviving spouse are particularly useful where the surviving spouse is a U.S. resident subject to federal gift or estate taxes. In this case, cumulative gifts of up to $1,000,000 can be used to take full advantage of the noncitizen spouse's unified credit. Even gifts in excess of that amount, given at the rate of $120,000 (in 2006) per year, can be used to take advantage of the lower estate tax brackets of the noncitizen spouse. This clearly has advantages over the use of a QDOT trust, where the trust assets will eventually be taxed at the probably higher estate tax brackets that would be used in computing the tax in the estate of the predeceased spouse.

Question – What is the impact of joint tenancy forms of title holding where one spouse is not a citizen?

Answer – Under IRC Section 2040(a), the entire value of the joint tenancy property is included in the estate of the spouse who contributed to the joint tenancy. Note that IRC Section 2040(b), which provides that joint tenancies between husband and wife are deemed owned 50% by each for estate tax purposes, does not apply if the surviving spouse is not a citizen.[20]

CHAPTER ENDNOTES

1. IRC Sec. 7701(b).
2. Treas. Reg. §20.0-1(b).
3. IRC Sec. 2501(a)(1).
4. IRC Sec. 2501(a)(2).
5. IRC Sec. 2103.
6. IRC Sec. 2104.
7. IRC Sec. 2105.
8. IRC Secs. 2056(d), 2056A, 2523(i).
9. IRC Secs. 2001(a), 2501(a).
10. IRC Sec. 7701(b)(3)(A).
11. IRC Sec. 7701(b)(3)(B).
12. IRC Sec. 668.
13. IRC Sec. 679.
14. IRC Secs. 2010, 2011.
15. IRC Sec. 2014.
16. IRC Sec. 2102(b).
17. IRC Secs. 897, 1445.
18. IRC Sec. 957.
19. IRC Sec. 954.
20. IRC Sec. 2056(d)(1)(B).