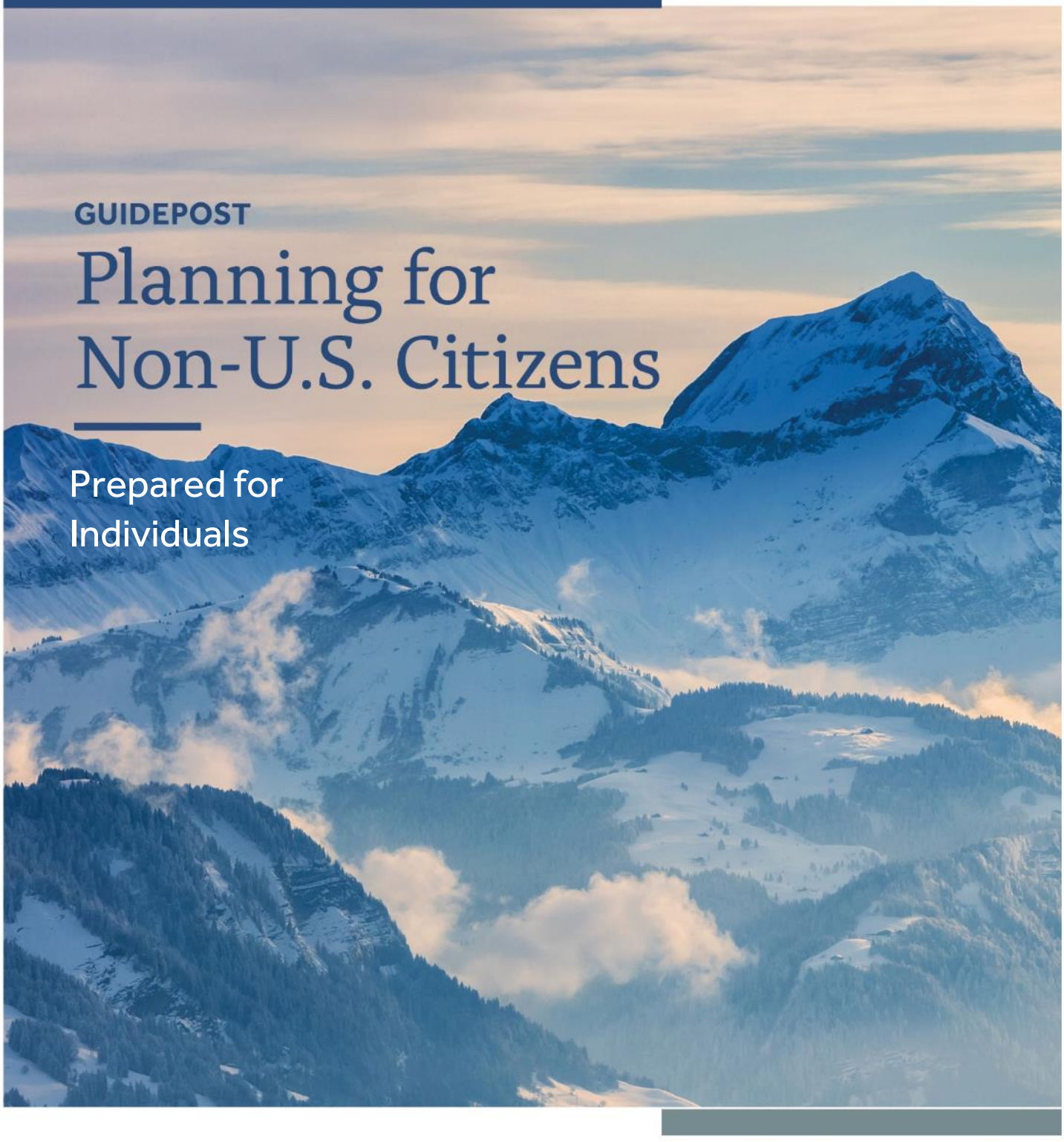

GUIDEPOST

Planning for Non-U.S. Citizens

Prepared for Individuals

Planning for Non-U.S. Citizens

The world that we all inhabit is becoming increasingly complex and interwoven. Some persons live and work in more than one country, and many families have family members who reside in multiple countries around the world. Individuals are choosing to work outside of their home country for economic, political and quality-of-life reasons. Businesses and investors are also diversifying their holdings around the globe. Persons who are not U.S. citizens, such as permanent Resident Aliens (e.g., green card holders and their immediate family members) and Nonresident Aliens, are faced with a challenging estate tax planning environment when they acquire assets in the U.S. Many non-U.S. citizens falsely believe that assets owned outside of the U.S. are not subject to U.S. federal estate tax at their death. In fact, most non-U.S. citizens will be subject to not only U.S. federal estate tax but also estate taxes of one or more foreign nations. Therefore, it is critical for non-U.S. citizens to understand their situation.

Who is Subject to the U.S. Estate and Gift Tax?

The federal gift and estate tax laws that apply to U.S. citizens also apply to non-U.S. citizens, who are further categorized as either Resident Aliens or Nonresident Aliens. Whether a non-U.S. citizen is a resident for transfer tax purposes depends on his or her "domicile." The domicile test considers several subjective factors, including how long the non-U.S. citizen has been in the U.S., how frequently he/she travels abroad, and especially his/her intent to remain in the U.S., often tied to where the non-U.S. citizen's immediate family is located. (This test is different from the "green card" and "substantial presence" tests that are used to determine residency for income tax purposes.)

- A **U.S. Citizen** is an individual born or naturalized in the U.S. and subject to its jurisdiction. The unified estate and gift tax is imposed on a citizen's taxable estate, which includes all assets wherever situated in the world.[1]
- A **Resident Alien** is an individual who is not a citizen of the U.S. but is a lawful permanent resident[2] of the U.S. The unified estate and gift tax is imposed on a Resident Alien's taxable estate, which (like a U.S. citizen) includes all assets wherever the property is situated in the world.
- A **Nonresident Alien** is an individual who is not a citizen of the U.S. and whose domicile is outside the U.S. The rules differ considerably for Nonresident Aliens.
    - **Estate tax** — Estate tax may apply to transfers of both tangible and intangible property situated or deemed situated within the U.S. upon a Nonresident Alien's death. Certain intangible assets, however, are not considered as having a U.S. situs, such as stock in foreign corporations and proceeds from a life insurance policy insuring the life of a Nonresident Alien.
    - **Gift tax** — Nonresident Aliens are subject to gift tax on gifts of property situated in the U.S. and generally are not taxed on gifts they make of intangible property, even though it may be considered located in the U.S. Intangible U.S. property for gift tax purposes includes U.S. bank accounts (provided the account is not connected with a U.S. trade or business), cash in U.S. brokerage accounts, bonds issued in the U.S. and stock in domestic corporations. Categorization of interests in partnerships or LLCs is unclear.[3]

U.S. Gift and Estate Tax Exclusions

The following tables summarize the amounts in 2019 that can be transferred gift and estate tax-free. When engaging in transnational planning, it is important to consider not only the status of the transferor, but also the status of the transferee.

1 IRC§2001;Treas.Reg.§20.2031-1.
2 Treas. Reg. §20.2031-1 (includes green card holders and individuals who satisfy the substantial presence test).
3 IRC §2105.

Gift Tax	To a U.S. Citizen	To a Resident Alien or a Nonresident Alien
From a Citizen or a Resident Alien	• Spouse: Unlimited marital deduction • Non-Spouse: Annual exclusion–$15,000 Lifetime exclusion amount–$11,400,000	• Spouse: Annual exclusion–$155,000 Lifetime exclusion amount–$11,400,000 • Non-Spouse: Annual exclusion–$15,000 Lifetime exclusion amount–$11,400,000
From a Nonresident Alien (U.S. situs property)	• Spouse: Unlimited marital deduction • Non-Spouse: Annual exclusion–$15,000 Lifetime exclusion amount – N/A	• Spouse: Annual exclusion–$155,000 Lifetime exclusion amount – N/A • Non-Spouse: Annual exclusion–$15,000 Lifetime exclusion amount – N/A

Estate Tax	To a U.S. Citizen	To a Resident Alien or a Nonresident Alien
From a Citizen or a Resident Alien	• Spouse: Unlimited marital deduction • Non-Spouse: Basic exclusion amount–$11,400,000	• Spouse: Basic exclusion amount–$11,400,000 • Non-Spouse: Basic exclusion amount–$11,400,000
From a Nonresident Alien (U.S. situs property)	• Spouse: Unlimited marital deduction • Non-Spouse: Exclusion amount–$60,000[4]	• Spouse: Exclusion amount–$60,000[4] • Non-Spouse: Exclusion amount–$60,000[4]

Estate Planning Strategies for Non-U.S. Citizens

Pre-Permanent Resident Planning Opportunities

Permanent Resident Aliens of the U.S. are treated essentially the same as U.S. citizens. Such will be liable for U.S. estate and gift tax on their entire worldwide assets (and may pay U.S. income tax on their worldwide income per an objective test based on number of days within the U.S. over a three-year period).

Once a U.S. person for tax purposes, it is difficult to avoid U.S. estate and gift tax. There are standard estate planning techniques available to U.S. citizens to reduce and minimize such taxes, but these pale in comparison to the estate planning available before one becomes a permanent resident. The most significant estate planning technique involves pre-immigration planning. At its core, pre-immigration estate planning involves retitling assets and/or moving assets into limited liability companies, trusts or other estate planning structures where the assets are not subject to U.S. estate or gift tax.

There are two major pitfalls to becoming a permanent U.S. resident. The first is that, for a married couple both of whom are U.S. citizens, assets can be moved freely between spouses without paying gift tax (during life), and without paying estate tax (on the death of the first spouse). The U.S. estate tax grants an unlimited marital deduction for these gifts and transfers

4 The unified credit for the estate of a nonresident alien is $13,000, which translates to an applicable exclusion amount of $60,000.

between spouses. If the spouse receiving the assets is not an actual U.S. citizen, the tax-free amount that can be transferred is not an unlimited amount but rather only $155,000 (for 2019, indexed to inflation for subsequent years). This is true even if the surviving spouse is a permanent resident.

The second major pitfall involves any decision to leave the U.S. There exists an expatriation tax (commonly referred to as the exit tax) that a permanent resident must pay upon surrendering the permanent resident status. This tax essentially is a capital gains tax on the appreciation of any assets owned by the permanent resident,[5] including any appreciation that occurred prior to becoming a permanent U.S. resident. It is basically the same tax that applies to U.S. citizens who renounce U.S. citizenship.

Nonresident Alien Planning Opportunities

Generally, only a Nonresident Alien's assets that are considered located in the U.S. will be subject to federal estate tax and they only get to shelter $60,000 from U.S. estate tax. Federal estate taxes are taxed on a graduated scale for Nonresident Aliens beginning at 26 percent and reaching the maximum tax rate of 40 percent on U.S.-based assets in excess of $1,000,000. Nonresident Aliens with substantial U.S.-based assets face significant estate tax liability on transfers of this property upon death.

A Nonresident Alien is only subject to gift tax when gifting either real property or tangible personal property located in the U.S. at the time of the gift. Therefore, the physical location of the property at the time the gift is made determines whether or not the property is subject to U.S. gift taxes. Examples of tangible personal property include cash, jewelry, paintings and automobiles. However, a gift of intangible property by a Nonresident Alien is not subject to U.S. gift taxes even if the property is situated in the U.S.[6]

Though annual gift tax exclusions of $15,000 (in 2019) are allowed for non-spousal gifts made by Nonresident Aliens, they cannot gift split.[7] Gift splitting is only allowed if both spouses are either U.S. citizens or permanent resident aliens. Furthermore, since the unlimited marital deduction is not available, an increased annual exclusion amount—sometimes referred to as a "super" annual exclusion—is provided for present interest gifts to a non-U.S. citizen spouse who otherwise would have qualified for the marital deduction.[8] For 2019, the exclusion amount is $155,000 (adjusted annually for inflation).[9]

For Nonresident Aliens, U.S. gift and estate taxes only apply to property situated in the U.S. However, gift tax situs rules are different than estate tax situs rules, meaning there are types of properties that are deemed to be U.S. situs property for estate tax purposes, but not for gift tax purposes. The disparities among these situs rules provide unique planning opportunities for the nonresident alien.

Qualified Domestic Trusts

The use of a Qualified Domestic Trust (QDOT) may be appropriate for a married couple when one of the spouses is a non-U.S. citizen. A QDOT allows a decedent's estate to **defer estate tax** on property passing to a non-U.S. citizen spouse until the non-U.S. citizen spouse's death. Accordingly, it ensures that QDOT property will eventually be subject to federal estate tax.

A QDOT must meet the following requirements:

- The executor must make an irrevocable election by attaching a statement to the estate tax return. The election cannot be made on any return filed more than one year after the due date (including extensions).
- The trust must be created per the laws of the Unites States, a state, the District of Columbia, or a foreign jurisdiction.
- The trust must require at least one of the trustees to be a U.S. citizen or domestic corporation.
- The U.S. trustee must be able to withhold tax from principal distributions to the non-citizen spouse.
- Property passing to the **QDOT** must separately qualify for the marital deduction under Internal Revenue Code (IRC) §2056. This means that it must be included in the surviving spouse's estate.

5 IRC § 877A(a)(1)
6 IRC §2501(a)(2)
7 IRC §2503(b); IRC §2513(a)(1)
8 IRC §2523(i)(2)
9 Rev. Proc. 2018-57, Section 3.43(2)

- A "small QDOT" (with assets of $2 million or less as of the decedent's date of death) may not have more than 35 percent in real property located outside the U.S. as of the last day of its tax year.
- A "large QDOT" (with **more** than $2 million in assets as of the decedent's date of death) must have a "bank" as at least one of its trustees. A U.S. branch of a foreign bank may qualify if at least one U.S. co-trustee is there always. If U.S. co-trustee is an individual, he/she must furnish a bond equal to 65 percent of the trust's value at decedent's death.

Estate tax is imposed on distributions of principal made during the surviving spouse's lifetime and on the value of all property remaining in the trust on the surviving spouse's death. The tax also is imposed if a person other than a U.S. citizen or domestic corporation becomes a trustee of the trust, or if the trust otherwise ceases to meet requirements of a QDOT. There is an exception allowing for tax-exempt "hardship" distributions, that is, in response to an immediate and substantial need relating to the health, education, maintenance, or support of the spouse or anyone the spouse is legally obligated to support. The amount of estate tax is the additional amount that would have been due had the property been included in the decedent spouse's estate. The estate tax on QDOT distributions is due on the fifteenth day of the fourth month of the calendar year following the end of the calendar year in which the taxable event occurs.

The basis of property is adjusted to the date of death value. However, basis in a taxable distribution is adjusted upward to account for estate tax paid on the growth in value of the property occurring after the first spouse's death. For example, if property worth $1 million is placed in a QDOT and later paid to the surviving spouse when it has appreciated to $1.3 million upon distribution, it will be estate taxed at the increased value of $1.3 million. The recipient will receive a basis adjustment for estate tax paid on the $300,000 value increase from the date of death to the later distribution for a total basis of $1,300,000.

Ownership Interest of Life Insurance Policy on Own Life

Estate Tax

Unlike a U.S. citizen, a Nonresident Alien may individually own a life insurance policy insuring his or her own life and the death benefit will not be subject to U.S. estate tax.[10] This treatment is available regardless of where the issuing insurance company is located and without regard to the location of the beneficiary.

Gift Tax

A life insurance policy owned by and insuring the life of a Nonresident Alien will not be subject to U.S. gift tax. It will also not be subject to a three-year lookback if the donor dies within three years of giving the life insurance policy to another.

Ownership Interest of Life Insurance Policy on Life of Another

Estate Tax

There is no definitive rule regarding a Nonresident Alien's ownership of a life insurance policy insuring the life of another, whether a resident or nonresident. As such, there is a question as to whether the unmatured contract is deemed located in the U.S. for estate tax purposes. The situs rule dictates that the location of the policy for U.S. estate tax purposes will depend on the location of the issuer of the policy. In other words, the answer hinges on whether the insurer is domestic or foreign. The U.S. Internal Revenue Code sets forth those assets that are specifically excluded from estate tax for a Nonresident Alien; it provides that where a deceased Nonresident Alien owned a policy on his/her life, the death benefit will not be considered U.S. situs property and thus will not be subject to estate tax.[11] Thus, where a deceased Nonresident Alien owned a policy on

10 IRC §2105(a); Treas. Reg. § 20.2105-1(g)
11 IRC §2105

the life of another, the fair market value of that policy would be included in the estate of a Nonresident Alien, provided the policy was issued by a U.S. life insurance company.

Gift Tax

Although exempt from gift taxes, a gift by a Nonresident Alien of a life insurance policy on the life of another issued by a U.S. life insurance company made within three years of his/her death may result in the fair market value of the policy on the life of another being included in his/her gross estate for estate tax purposes, same as when a gift is made by a U.S. citizen or resident.

Ownership of U.S.-Based Tangible Personal Property

You will recall that only a Nonresident Alien's U.S. situs property will be subject to gift tax. Therefore, to minimize gift tax, a Nonresident Alien may remove U.S.-based tangible property from the U.S. prior to making a gift of such property. Alternatively, a Nonresident Alien can convert tangible property into intangible property prior to making a gift of such property. For example, a Nonresident Alien can convert tangible property such as cash into intangible property by simply depositing it into a U.S. bank account—which is considered intangible property. Alternatively, a Nonresident Alien can contribute tangible property to a foreign business entity and make gifts of business interests, which are also considered intangible property, that can be transferred free of federal gift taxes. Note that the IRS may collapse these steps if they are undertaken in a short period of time and treat the entire transaction as taxable under the step-transaction doctrine, and therefore some time should elapse while these planning strategies are utilized.[12]

Estate and Gift Tax Treaties

The U.S. has entered into an estate and/or gift tax treaty with a select number of countries. The U.S. has a gift tax treaty with Australia, Austria, Denmark, France, Germany, Japan, Sweden, and the United Kingdom. The U.S. has an estate tax treaty with Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland, and the United Kingdom. Additionally, some countries that lack an estate tax have estate tax provisions in their income tax treaty with the U.S., such as Canada and Israel.

These treaties, in general, allow a citizen of one of the treaty countries who owns property to avoid the possibility of both countries taxing the same asset at the time of death. As far as the U.S. estate tax is concerned, a treaty might reduce or eliminate such tax on the U.S. property of a nonresident alien. Furthermore, a tax treaty with the U.S. may govern where property is considered situated.

12 DeGolshmidt-Rothschild v. Comm'r, 168 F2d 975 (2d Cir. 1948).

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