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Estate Planning Involving Resident and Non-Resident Aliens

Navigating Estate, Gift and GST Tax Rules; Leveraging Estate and Lifetime Gifting Opportunities

WEDNESDAY, MARCH 16, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Section I

Estate, Gift and Generation-skipping Transfer Tax Rules

Basic Rules Applicable to Resident and Nonresident Aliens

- The application of US transfer tax rules generally depends on whether the transferor is a US citizen or US resident ("US Person"), or a non-US citizen who is also a non-US resident ("Non-US Person")

Definition of Resident

- **A resident for transfer tax purposes is one who is domiciled in the United States**
  - Domicile is acquired by living in a country, even for a brief period of time, with no definite present intention of moving at a later time (Treas. Reg. § 20.0-1(b) (estate tax) and § 25.2501-1(b) (gift tax))
- **A resident individual for all other purposes is determined under IRC § 7701(b) of the Code**
  - Substantial Presence Test
  - Green Card Test
  - First Year Election

US Transfer Tax Rules Applicable to US Persons

- **US Persons are generally subject to US Federal estate, gift and GST tax on taxable transfers of property, wherever located, at a 40% rate**
- **US Persons are generally entitled to an exemption from each transfer tax. The gift and estate tax exemptions are unified. In 2016, the maximum exemption for each transferor is $5,450,000 for Federal estate, gift and GST tax purposes**
- **All US Persons can**
  - make annual exclusion gifts ($14,000 in 2016)
  - elect to use portability and
  - split gifts

US Transfer Tax Rules Applicable to Non-US Persons

- **Estate Tax**
  - Non-US Persons are subject to US estate tax on assets situated in the US
  - Non-US Persons have a $13,000 credit (which equates to a $60,000 exemption) from US estate tax; however US estate tax treaties may provide a greater exemption
- **Gift Tax**
  - Non-US Persons are subject to U.S. gift tax on real and tangible property situated in the US
    - Unless the donor expatriated, intangible property given by a non-US resident is not subject to the gift tax
    - The IRS takes the position that Treasury Bills located in the US are tangible assets (PLR 8138103)
    - Annual exclusion for gifts ($14,000 in 2016) is allowed, but gift-splitting is not allowed

US Transfer Tax Rules Applicable to Non-US Persons (cont'd)

- **Generation Skipping Transfer Tax**
  - Determined under estate and gift tax principles
  - Although the Regulations provide that Non-US Persons are entitled to an exemption of $1 million, the GST exemption for nonresidents is the same as for residents and citizens under Section 2631 of the Code

Special US Transfer Tax Rules Applicable to Non-US Citizen Spouses

- **Estate Tax**
  - The estate of a decedent (regardless of whether a resident or non-resident) is allowed an unlimited marital deduction for assets passing to a US citizen spouse
  - No such deduction is allowed for transfers to a non-US citizen spouse unless the assets are transferred to a qualified domestic trust ("QDOT")
- **Gift Tax**
  - Gifts to US citizen spouses are entitled to an unlimited marital deduction
  - No such deduction is allowed for gifts to a non-US citizen spouse
  - However, larger annual exclusion gifts can be made to non-US citizen spouses than to other individuals ($148,000 in 2016)

US Bilateral Estate and Gift Tax Treaties

- **Estate and gift tax treaties are designed to avoid double taxation of transfers:**
  - when an individual is a citizen or resident of one country but owns, or is transferring, property located in another country
  - when an individual is resident of multiple countries under local laws
- **A treaty generally will permit each country to tax property located within its borders, and also may allow an increased credit or exemption to a Non-US Person**

Bilateral Estate and Gift Tax Treaties

- **The U.S. currently has estate and/or gift tax treaties with the following countries:**
  - Australia*
  - Austria
  - Canada*
  - Denmark
  - Finland
  - France
  - Germany
  - Greece
  - Ireland
  - Italy
  - Japan
  - Netherlands
  - Norway
  - South Africa
  - Switzerland
  - United Kingdom

Bilateral Estate and Gift Tax Treaties

- **Special note: Some countries (two notable examples being Canada and Australia) do not have an estate or gift tax, but do have a deemed capital gains tax ("CGT") on death. Because CGT is not an estate tax, a bilateral estate tax treaty may not provide relief from double taxation**

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Section II

Sample Estate Planning Scenarios

US Legal Permanent Resident (Green Card Holder) Married to US Citizen

- **Assume they live in the US**
- **Some questions to ask:**
  - How long has LPR had green card (to determine whether expatriation tax would apply if he/she gives up green card)?
  - Is the LPR a US domiciliary for US estate and gift tax purposes? If not, only $60,000 exemption available unless treaty applies.
  - Does LPR's country of citizenship have an estate or gift tax? If so, does a treaty apply?
  - Does LPR own property in country of citizenship?
  - Do children have dual citizenship?
  - Does LPR need Will in his/her home country, and does forced heirship apply to any assets?

US Legal Permanent Resident (Green Card Holder) Married to US Citizen

- **Planning tips**
  - US citizen's Will/Revocable Trust must contain QDOT for non-citizen spouse; non-citizen spouse's documents need not have QDOTs
  - If LPR does not plan to become domiciliary and/or no treaty applies, avoid having US-situs assets owned by LPR
  - Consider use of insurance to avoid QDOT restrictions
- **Note different definitions of domicile in some countries—theoretically possible for LPR to be domiciled in US for US estate and gift tax purposes and also in home country (e.g., UK)**

Both Spouses are Legal Permanent Residents

- **Similar considerations as previous scenario.**
- **Additional questions to ask:**
  - Are spouses citizens of the same country?
  - Why have they not become citizens—do they plan to leave the US?
- **Planning tips:**
  - Both spouses' documents must contain QDOTs
  - Strongly consider having Wills in home country, because greater chance they may leave US
  - If they plan to leave US, consider having them give up green cards before they become subject to expatriation tax

Non-US Person Married to US Citizen

- **Assume they live outside US**
- **Advantages:**
  - Non-US Person can transfer unlimited non-US assets to US citizen spouse and/or children without estate or gift tax
  - Ability to leave assets in trust for US citizen spouse without restrictions imposed by QTIP trust
- **Planning tips:**
  - Trusts created for US citizen spouse probably should be US trusts (or build in flexibility to change situs from foreign to domestic, depending on whether remainder beneficiaries also are US persons).
  - Non-US Person should be careful not to acquire any assets that could be subject to US estate tax (e.g., real estate).
  - If Non-US Person acquires US situs assets in structure that avoids US estate tax (e.g., through foreign corporation), introduces complexity for US citizen spouse—may need to explain importance of post-death elections on death of Non-US Person

Non-US Person with US Assets

- Treaty provisions are key
- Best to avoid any US-situs assets in the first place, but if not possible, acquire in a manner that will preclude US estate tax
- The equivalent “string” provisions of Code sections 2035-2038 apply to trusts created by Non-US Persons, so a revocable trust will not protect US-situs assets from US estate/gift taxation
- US real estate is toughest to plan for due to FIRPTA — some tax will be paid at some point, so must balance between paying income and estate tax

Section III

Potential Pitfalls

Need to Confirm Relevant Facts and Applicable Law

- **Confirm citizenship and tax residency of all parties, including beneficiaries.**
  - Accidental US Persons?
- **Confirm the applicable marital property regime**
  - Separate or community property?
- **Confirm the applicable inheritance law regime**
  - Forced heirship?
- **Confirm compliance with US and any other applicable tax regimes**

Need to Identify US and Foreign Trusts

- **US or "Domestic" Trust: Any trust satisfying both a "court test" and a "control test"**
  - Court Test: A US court is able to exercise "primary supervision" over the administration of the trust
  - Control Test: One of more US persons (citizens/resident aliens) have authority to control all "substantial decisions" of the trust
- **Foreign Trust: Any trust failing one or both tests**

Need to Consider Consequences of Foreign Trusts

- **Beware potential "exit tax" on US trust that becomes a foreign trust**
- **Beware funding of foreign trust by Non-US Person with US assets**
- **US beneficiaries of foreign nongrantor trusts:**
  - Are taxed on receipt of current income, including gains (distributable net income, DNI)
  - Are taxed on receipt of accumulated income (undistributed net income, UNI) – the "throwback tax" plus an interest charge
  - May be taxed (by attribution) on income arising from non-US corporations owned by the trust

Need to Eliminate Potential US Tax Traps in Investment Structures

- US disfavors US citizens and residents who own investments through non-US companies via the "controlled foreign corporation" (CFC) and "passive foreign investment company" (PFIC) rules
- Liquidate or "check the box" for foreign companies that would be CFCs or PFICs

Need to Comply with US Tax Reporting Requirements

- A US citizen/resident must report gifts or bequests of over $100,000 received in any year from a nonresident alien or foreign estate
- Special rule for gifts through “intermediaries” and for “purported gifts” from non-US corporations and partnerships
- A US citizen/resident must report the receipt of any distribution from a foreign trust (including uncompensated use of trust property)
- Severe penalties for non-reporting

Section IV

Potential Opportunities

Plan for US Persons to Inherit Assets with Stepped Up Tax Basis

- General “basis step up at death” rule applies to appreciated assets owned by decedents who are Non-US Persons
- Basis step up rule for assets in revocable trusts
- Basis step up rule for assets in irrevocable trusts
- Basis step up rule for community property assets
- Basis step up problem for assets held in non-US corporations

Use Dynasty Trusts to Hold Assets Received from Non-US Persons

- **Advantages of a US dynasty trust for US beneficiaries:**
  - Estate, gift and generation-skipping transfer tax benefits of a "dynasty trust" funded with non-US situs assets
  - Income tax trade-off (US trust is taxed on worldwide income but avoids the "throwback tax")
  - Simpler US tax reporting for trust distributions
  - Avoids "deemed distribution" rule for use by US beneficiary of trust-owned property

Potential Advantages of Life Insurance

- **Life insurance proceeds on life of a Non-US Person are not subject to US estate tax**
- **Life insurance on life of a US Person with a non-US citizen spouse may help avoid having to leave assets in a QDOT**
- **Life insurance held in foreign nongrantor trusts may avoid "throwback tax" issues**

Potential Advantages of Expatriation

- **"Covered expatriates" are subject to an "exit tax" on expatriation**
- **US citizens/residents who receive "covered" gifts or bequests from a covered expatriate may be taxed at gift or estate tax rate (40%)**
- **However, there are exceptions to covered expatriate status:**

  (1) Certain dual citizens from birth
    - Not US tax resident (under substantial presence test) for 10/15 years
    - Must continue to be a citizen of, and taxed as a resident of, other country

  (2) Certain minors (under 18 ½)
    - Not US tax resident (under substantial presence test) for last 10 years
- **Neither exception applies to long term resident green card holders**

Thank You

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