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Inbound Estate Planning for Nonresident Aliens

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INTRODUCTION

The U.S. tax laws are plenty complicated when advising U.S. citizens and residents on planning with regard to their estate and gift taxes (also referred to as the ''transfer taxes''). We have overlapping tax regimes (income, gift, estate, and generation-skipping transfer) that can apply simultaneously — and work in opposition to one another — in a single transaction.

When we expand U.S. estate and gift tax planning beyond U.S. borders, either for a U.S. person with foreign connections (''outbound planning'') or for a foreign person with U.S. connections (''inbound planning''), the complications rise to another level.

This article will focus on the unique U.S. transfer tax rules that apply to individuals who are not citizens or residents of the United States, referred to as ''nonresident aliens.'' However, before we delve into the U.S. taxation of nonresident aliens, we should first review the rules for determining whether a non-citizen individual is indeed a nonresident alien for U.S. transfer tax purposes, or whether the individual is actually a U.S. resident.

TRANSFER TAX RESIDENCY

Determining residency for income tax purposes generally involves objective criteria through the use of one of three tests: (1) the green card test; (2) the substantial presence test; or (3) the first-year election.[1] In contrast, residency for U.S. transfer tax purposes (i.e., estate and gift taxes) involves a subjective inquiry regarding the individual's domicile. It is possible for a person to be a resident for income tax purposes and not to be a resident for transfer tax purposes, and vice-versa.

''Domicile'' is a common-law term meaning a person's fixed and permanent place of abode where the person intends to remain indefinitely or to where the person intends to return.[2] A person can have multiple homes, but a person can have only one domicile. A person may be considered a resident of the country in which he currently lives for income tax purposes but still be considered domiciled in another country if he intends to return to that country. Once domicile is established in a particular country, it can be difficult to lose because original domicile remains until the taxpayer demonstrates the requisite intent to establish a

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[1] For a more detailed discussion of income tax planning for nonresident aliens, see our prior article, *Inbound Essentials: Estate and Income Tax Planning for Nonresident Aliens*, 39 Tax Mgmt. Est., Gifts and Tr. J. 190 (Sept. 11, 2014); *see also* 907 T.M., *U.S. Income Taxation of Nonresident Alien Individuals*.

[2] *See* Black's Law Dictionary 558–59 (9th ed. 2009); *see also* Rev. Rul. 80-209, 1980-2 C.B. 248.

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new domicile. The Treasury regulations provide the following general definition of ''domicile'':

> A person acquires a domicile in a place by *living there*, for even a brief period of time, with no definite present *intention* of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[3]

Thus, for U.S. tax purposes, to be characterized as a U.S. domiciliary, a person must (1) live in the United States; and (2) have no intention of leaving.[4] Because of the subjective intent factor, there are no hard and fast rules as to the required length of physical presence to establish transfer tax domicile like there are for income tax residency.[5] This subjective inquiry looks to many factors, including:

- the length of time spent in the United States and abroad, and the amount of travel to and from the United States and between other countries;
- the value, size, and locations of the person's homes, and whether he owned or rented them;
- whether the person spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.;
- the situs of valuable or meaningful tangible personal property;
- where the person's close friends and family are situated;
- the locales in which the person has religious and social affiliations or in which he partakes in civic affairs;
- the locales in which the person's business interests are situated;
- the person's visa status;
- the places where the person states in legal documents where he resides;
- the jurisdiction where the person is registered to vote;
- the jurisdiction that issued the person's driver's license; and
- the person's income-tax filing status.[6]

Generally, no one factor is determinative. Rather, the courts look to the totality of the circumstances to determine a person's domicile. Facts supporting the conclusion that the taxpayer has not abandoned his prior domicile may also lead to a conclusion that the taxpayer has not established a new one elsewhere. Also, claiming privileges based on residency (e.g., by filing a Form 1040NR instead of a Form 1040) may be considered evidence that the taxpayer has not abandoned his domicile in his home country.

Also, because domicile requires a permanent and fixed place of abode, a person can continue to be domiciled in a country he left long ago if he has not yet established a new permanent residence elsewhere. A person who sells his home in one country to move abroad but does not become a permanent resident of the new country may still be a domiciliary of the country that he left. In any case, the burden of proof is generally on the taxpayer to establish that his domicile has, or has not, changed.

In the face of conflicting evidence as to an individual's domicile, U.S. choice-of-law rules favor the retention of the original domicile.[7] The Supreme Court has held that domicile is a question of state law, rather than federal law, such that an individual could demonstrate the requisite intent to establish domicile in a U.S. state under that state's rules regardless of the individual's federal immigration status.[8]

TREATY CONSIDERATIONS

If a nonresident alien is considered a tax resident of a country with a highly developed tax regime (e.g., the United Kingdom, France, Canada), it is paramount to obtain tax advice in that other country to ensure that any U.S. planning does not have negative tax consequences in the other country. If the other country is a treaty partner with the United States, U.S. taxation of the individual can be reduced or eliminated by treaty.

Currently, the U.S. has income tax treaties with over 60 countries and estate and gift tax treaties with

[3] Reg. §20.0-1(b)(1), §20.0-1(b)(2) (for estate tax); Reg. §25.2501-1(b)(1) (for gift tax) (emphasis added). All section (''§'') references are to the U.S. Internal Revenue Code (''the Code'') or the Treasury regulations thereunder, unless otherwise indicated.

[4] *Id.*

[5] *Restatement (Second) of Conflict of Laws* §16, Comment (b).

[6] *See* Heimos, 837 T.M., *Non-Citizens — Estate, Gift, and Generation-Skipping Taxation*, III.C.4.

[7] *E.g., Margani v. Sanders*, 453 A.2d 501 (Me. 1982).

[8] *Elkins v. Moreno*, 435 U.S. 647 (1978) (holding that federal law did not bar an individual present in the United States under a G-4 diplomatic visa from establishing a domicile in Maryland for the purposes of qualifying for in-state tuition rates at the state university).

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only 17 countries. Further information can be found on the IRS website at the following URLs:

- http://www.irs.gov/Individuals/International-Taxpayers/Tax-Treaties
- http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estate-&-Gift-Tax-Treaties-(International)

U.S. TRANSFER TAXATION OF NONRESIDENT ALIENS

Gift Taxation of Nonresident Aliens

Property Transfers Subject to Gift Tax

The U.S. gift tax generally applies to gratuitous transfers of property made during the donor's lifetime. For U.S. citizens and residents,[9] the gift tax applies to gratuitous transfers of any property, wherever situated.[10] But for nonresident aliens, the gift tax applies only to gratuitous transfers of U.S.-situs real and tangible personal property.

Gifts of intangible property by nonresident aliens are not subject to U.S. gift tax.[11] Unfortunately, ''intangible property'' is not exhaustively defined in the Internal Revenue Code or the Treasury regulations, an omission that has led to a great deal of uncertainty for nonresident aliens and their U.S. tax and estate planning counsel. However, it is clear that the following types of property are intangible property, and are therefore not subject to gift tax:

- stock in a U.S. corporation;[12] and
- debt obligations, including bank deposits, issued by a U.S. borrower.[13]

Physical currency (bank notes and coins, i.e., ''cash'') is considered tangible personal property for gift tax purposes.[14] Therefore, advisors should caution their nonresident alien clients about transfers that could be construed as cash gifts, including the transfer of a U.S. safe deposit box holding cash[15] and writing a check from a U.S. bank account.[16]

The guidelines for wire transfers from a U.S. bank remain muddy. Though some commentators believe that a wire transfer is intangible property because it involves an obligation of the bank to electronically shift the deposit from one bank to another, with no physical transfer from the donor to the donee, it would be less risky to use another method to transfer ownership of a bank's obligations, for instance, by transferring an actual certificate of deposit in-kind to the donee.[17] It is also unclear whether transferring ownership of a bank deposit account, which is definitively intangible property, will be characterized as a taxable transfer. This is because the bank, rather than simply changing the name on the account, might instead move the funds into a newly created account in the name of the donee, inadvertently converting the ''bank deposit'' into cash en route. Generally, it would be safest to have the nonresident alien move funds to an offshore account and wire the funds to the donee from there.

With regard to partnership interests, the IRS has stated that it will not rule on the issue of whether they should be treated as intangible property for gift tax purposes.[18]

Finally, it should be noted that otherwise nontaxable intangible property gifts will be subject to tax if they are ''covered gifts'' from a covered expatriate to a U.S. recipient.[19]

Gift Tax Exclusions, Unified Credit, and Imposition of Tax

Nonresident aliens can make tax-free transfers of U.S.-situs real estate and tangible personal property up to the applicable annual exclusion amount of $10,000 per donee, per year, indexed for inflation ($14,000 for 2015). Gifts of U.S. real estate and tangible personal property by a nonresident alien in excess of the annual exclusion amount will be subject to current gift taxation because nonresident aliens do not receive the benefit of the unified estate and gift tax credit that allows U.S. citizens and residents to avoid paying gift tax during life through the ''pre-use'' of

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[9] Although the test for transfer tax purposes is one of ''domicile,'' rather than ''residence,'' as described above, we will refer to ''residence'' here for ease of discussion. And the term ''nonresident alien'' herein will mean an alien who is a non-U.S. domiciliary.

[10] §2501(a), §2511(a).

[11] §2501(a)(2).

[12] Reg. §25.2511-3(b)(3).

[13] Reg. §25.2511-3(b)(4); *see also Citizens Bank of Md. v. Strumpf*, 516 U.S. 16 (1995); *Estate of Gade v. Commissioner*, 10 T.C. 585 (1948); *Estate of Fabbricotti Fara Forni v. Commissioner*, 47 BTA 76 (1942).

[14] *Blodgett v. Silberman*, 277 U.S. 1, 48 S. Ct. 410 (1928).

[15] Rev. Rul. 55-143, 1955-1 C.B. 465.

[16] GCM 34845 (Apr. 17, 1972); GCM 36860 (Sept. 24, 1976).

[17] *See* Arturo Aballi, *Gifts of Certain Intangible Property by Foreign Persons — Principles, Pitfalls, and Planning Opportunities*, 37 Tax Mgmt. Est., Gifts and Tr. J. 160 (Mar. 8, 2012).

[18] Rev. Proc. 2003-7, 2003-1 I.R.B. 233, §4.01(26).

[19] For a more detailed discussion of the taxation of covered expatriates and covered gifts and bequests, see our prior article, *Inbound Essentials: Estate and Income Tax Planning for Nonresident Aliens*, 39 Tax Mgmt. Est., Gifts and Tr. J. 190 (Sept. 11, 2014); *see also* 845 T.M., *Gifts*, and 806 T.M., *Immigration and Expatriation Law for the Estate Planner*.

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their estate tax exemption via lifetime gifting. However, nonresident aliens can make unlimited charitable gifts and gifts on behalf of donees directly to educational and medical institutions.[20]

If gift tax is imposed during the donor's lifetime, the tax is calculated based on a progressive rate schedule, and gifts are accumulated over the lifetime of the taxpayer.[21] The calculation of the gift tax requires computing a tentative tax on the aggregate sum of the taxable gifts for that year and for each of the preceding calendar periods, and subtracting a tentative tax on the aggregate sum of the taxable gifts for the preceding calendar periods.[22] Taxable transfers by nonresident aliens are subject to gift tax at rates ranging from 18% to a maximum 40%, and the result of the cumulating lifetime gifts means that taxable gifts made in subsequent years will be taxed at increasingly higher rates up to the maximum rate of 40%.

Gifts to Spouses

In general, there is an unlimited deduction for gift tax purposes of transfers made to spouses. However, this does not apply to gifts made to a spouse who is not a citizen.[23] Instead, gifts to spouses who are non-citizens are limited to a special ''super annual exclusion'' amount of $100,000 per year, indexed for inflation ($147,000 for 2015).[24] Note that the taxation of gifts of U.S.-situs property between spouses depends entirely on the *citizenship* of the *donee* spouse (not the domicile of the donor). Thus, a nonresident alien spouse could make unlimited gifts of U.S.-situs real and tangible personal property to a citizen spouse, but not the other way around.

Spousal Gift Splitting

As mentioned above, for gifts to non-spouses, a nonresident alien is limited to the regular annual exclusion amount of $10,000 per donee, per year, indexed for inflation ($14,000 for 2015).[25] Typically, spouses are allowed to ''split'' gifts of non-community property made to third parties, which means that both annual exclusions are applied to a single gift, thereby doubling the total annual exclusion available per donee.[26] However, gift-splitting is not available where one of the spouses is a nonresident (unless a gift tax treaty provides otherwise).[27] Gift-splitting is available if either (or both) of the spouses is a non-citizen, but both spouses must be U.S. residents for transfer tax purposes.[28]

Creation of Jointly Owned Property

General Rule: Joint Ownership with Non-Spouse

The general rule with regard to the creation of a joint tenancy in property where one party provides all or a disproportionate share of the consideration for that property is that the donor will have made a gift to the donee to the extent that the donee did not provide full consideration for his interest.[29] If the laws of the jurisdiction where the property is located allow a joint tenant to unilaterally sever his interest, the value of each person's interest in the property is his proportionate share; otherwise, value is determined on an actuarial basis (i.e., each joint tenant's likelihood of surviving the other joint tenant). As with any other gift, the value of the transfer of an undivided interest in property is reduced, for gift tax purposes, by the annual exclusion amount.

For example, assume that a father purchases real property for $100,000 and titles it in the names of himself and his daughter, as joint tenants. Daughter does not furnish any consideration for the purchase of the property. If the jurisdiction allows unilateral severance of each tenant's interest, the interests are valued on a pro-rata basis (50%) rather than on an actuarial basis. Thus, Daughter has received an undivided one-half interest in the property, valued at $50,000 at the time of the transfer. The father may exclude the annual exclusion amount ($14,000 for 2015) from the value transferred ($50,000), so the taxable gift is $36,000.

Joint Ownership with Non-Citizen Spouse

The gift tax treatment for the creation of joint tenancies differs when the joint tenants are spouses. Prior to the enactment of the unlimited gift tax marital deduction by the Economic Recovery Tax Act of 1981,[30] the creation of a spousal joint tenancy with right of survivorship or a tenancy by the entirety had gift tax consequences in accordance with the general rules above. But with the enactment of the unlimited gift tax marital deduction, such transactions between citizen spouses have no gift tax consequences, and so the Internal Revenue Code sections that provided guidance on spousal joint tenancies were repealed.[31] However, gifts to non-citizen spouses remain subject to gift tax, and so we must look for guidance to Treasury regulations that refer to these repealed statutes.

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[20] §2503(b), §2503(e), §2522(b).

[21] §2001(c).

[22] §2502(a).

[23] §2523(i)(1).

[24] §2523(i)(2); Reg. §25.2523(i)-1(a), §25.2523(i)-1(c)(2).

[25] §2503(b).

[26] §2513.

[27] §2513(a)(1).

[28] *Id.*

[29] Reg. §25.2511-1(h)(5).

[30] Pub. L. No. 97-34.

[31] Reg. §25.2523(i)-2, promulgated under former §2515, §2515A (repealed) (the current §2515 is a generation-skipping transfer tax provision).

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Real Property. For joint tenancies in real estate, where the donee spouse is a non-citizen, the *creation* of the joint tenancy (and additional improvements to the property) is not a taxable gift, regardless of the proportion of the consideration furnished by each spouse.[32] However, if the joint tenancy *terminates*, other than by reason of the death of a spouse (which may have estate tax consequences, discussed below), a taxable gift occurs to the extent that the non-citizen donee spouse receives proceeds that are not proportionate to the amount of the consideration that such spouse furnished.[33]

Consider the following example: A non-citizen Husband and his non-citizen Wife take title to U.S.-situs real property, creating a joint tenancy with right of survivorship. If Husband paid $300,000 for the real property and took title in the names of both Husband and Wife as joint tenants, there will be no gift tax upon the purchase. If, however, the couple sells the property for $400,000, and the proceeds are distributed equally to both Husband and Wife, Husband is deemed to have made a gift of one-half of the proceeds ($200,000) to Wife. The annual exclusion amount ($147,000 for gifts to a nonresident alien spouse in 2015) will be excluded from the proceeds for purposes of calculating the gift tax, assuming that the exclusion has not already been used for prior gifts to Wife that year. Thus, $53,000 of Wife's proceeds will be subject to gift tax, and Husband must report the gift on a Form 709.

As a result, a joint tenancy or tenancy by the entirety cannot be used as a disguise to transfer property to a non-citizen spouse on a tax-free basis because gift tax will arise if the tenancy is terminated before the death of the donor spouse. If the tenancy terminates due to death, there may be estate tax consequences, described in more detail below.

Personal Property. Whereas spousal joint tenancies in real property are subject to gift tax on the termination (rather than the creation) of the joint tenancy, the rules differ for the creation of spousal joint tenancies with a non-citizen spouse in personal property (for example, for shares of stock, mutual funds, certificates of deposit, and miscellaneous household property).

The Treasury regulations state that the creation of a spousal joint tenancy with a non-citizen spouse in personal property results in each spouse retaining a one-half interest in the property.[34] Treating each spouse as retaining a one-half interest in the property avoids the need to calculate the actuarial value of each spouse's interest; instead it is just treated as a gift of one-half of the consideration furnished by the donor spouse, and taxed accordingly (after application of the annual exclusion amount). At termination of the joint tenancy (other than by death), no gift tax is imposed as long as the proceeds are distributed 50/50.

Estate Taxation of Nonresident Aliens

Imposition of Estate Tax

While U.S. citizens and residents enjoy a $5 million estate tax exemption, indexed for inflation ($5,430,000 for 2015), in addition to an unlimited estate tax marital deduction that allows spouses, with proper planning, to avoid estate tax on $10 million of assets ($10,860,000 for 2015), nonresident aliens are allowed a mere $60,000 exemption, which is not indexed for inflation and has not been increased in decades. For this reason, nonresident aliens must plan carefully around the U.S. estate tax for U.S.-situs property held at death.

Property Taxed

While nonresident aliens are subject to gift tax only on transfers of U.S.-situs real estate and tangible personal property, all property situated in the United States and owned at the death of the nonresident alien is included in the nonresident alien's U.S. taxable estate.[35] For estate tax purposes, U.S.-situs property includes the following, subject to a few exceptions where indicated.

U.S. Tangible Personal Property

Any tangible personal property (automobiles, furnishings, jewelry, etc.) physically located in the United States will be subject to estate tax.[36] Cash and currency are considered tangible personal property and will thus be taxable if located in the United States at the decedent's death.

U.S. Intangible Property

While intangible property transferred by a nonresident alien during lifetime is not subject to gift tax, intangible property owned by a nonresident alien at death is generally subject to U.S. estate tax.[37]

The following U.S. intangible assets are included in a nonresident alien's U.S. estate:

- funds in bank or other brokerage accounts that are used in a U.S. trade or business;
- qualified retirement plans held in the United States;

[32] Reg. §25.2523(i)-2(b)(1).

[33] Reg. §25.2523(i)-2(b)(2). The rules differ for pre-July 1988 transfers. *See* Reg. §25.2523(i)-2(ii).

[34] Reg. §25.2523(i)-2(c) (but see exception for property in which the fair market value cannot be determined without reference to the life expectancy of one or both spouses).

[35] §2103; Reg. §20.2103-1.

[36] Reg. §20.2104-1(a)(2).

[37] Reg. §20.2104-1(a)(4).

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- stock in U.S. corporations;
- life insurance policies held by the decedent on the life of another person, issued by a U.S. insurance company; and
- annuities on the life of another person, issued by a U.S. insurance company.

However, the following U.S. intangible assets are not included in a nonresident alien's U.S. estate:[38]

- savings accounts, checking accounts, or certificates of deposit with a U.S. bank (if not used in a U.S. trade or business);
- funds held in a U.S. bank custody account;
- funds deposited in a foreign branch of a U.S. bank;
- proceeds of a life insurance policy on the life of the nonresident alien, owned by the nonresident alien and issued by a U.S. insurance company; and
- debt obligations and certain short-term OID obligations of a U.S. person that qualify for the portfolio interest exemption under §871(h).

U.S. Real Property

U.S. real property held directly by the nonresident alien is included in the nonresident alien's U.S. estate and includes land, buildings, fixtures, and improvements on the property.[39]

Certain Retained Interests [40]

U.S.-sitused property that is gratuitously transferred by a nonresident alien decedent while he is alive, by trust or otherwise, is includible in the decedent's estate if:

- the nonresident alien decedent retained for his life (or for a period that cannot be ascertained without reference to his death) some type of possession, control, or enjoyment of the property or its income, or the right to designate who will possess or enjoy the property;[41]
- possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest in the property that exceeds 5% of the value of the property at the time of the decedent's death;[42]
- the property was, on the date of the nonresident alien decedent's death, subject to his right to alter or revoke the transfer (or such a power was relinquished by the nonresident alien decedent within three years of the date of his death);[43] or
- the decedent transferred within the three-year period prior to his death an interest in property that would have been included in his estate under any of the foregoing rules, *and the property so transferred was situated in the United States at the time of the transfer or at the time of the decedent's death*. For this reason, it is best to transfer only non-U.S. assets to a trust structure and to ensure that the structure never acquires U.S. assets.[44]

Partnerships and Limited Liability Companies

Much debate exists concerning the determination of the situs of a partnership or LLC interest for U.S. estate tax purposes. This debate is rooted in the history of partnership law. Partnerships originated in ancient Roman law, and when they appeared in English statutory law over a century ago, partnerships were viewed as aggregate-ownership vehicles (where each partner owns a pro-rata interest in the partnership's operations and assets). This is referred to as the ''aggregate theory'' of partnerships. But as limited partnerships and limited liability companies emerged as more evolved versions of general partnerships over the next century, partnership statutes also evolved to treat these entities as separate from their owners, and interests in the entity were treated as personal property (known as the ''entity theory'' of partnerships).

Thus, the U.S. estate taxation of a nonresident alien's interest in a partnership or LLC can be summarized under each of these theories as follows.

- Aggregate Theory. Because this approach views a partnership interest as pro-rata ownership of the partnership's underlying assets, the place of organization of the partnership is irrelevant, and we must look to the situs of the partnership's property.
- Entity Theory. Because this approach treats the partnership as an entity separate from its partners, we must look to: (1) the location where the partnership conducts its business; or (2) the residency of the partnership for income tax purposes (i.e., its place of organization) to determine the situs of a partner's interest in the entity.

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[38] Reg. §20.2105-1.

[39] Reg. §20.2104-1(a)(1).

[40] §2104(b).

[41] *See* §2036.

[42] *See* §2037.

[43] *See* §2038.

[44] *See* §2035.

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Generally, a partnership interest is deemed to be a U.S.-sitused asset if: (1) the partnership does not qualify as a separate legal entity under the law of the jurisdiction where it was established, or is dissolved on the death of one partner, and the underlying assets of the partnership are situated in the United States; or (2) the partnership is a separate legal entity under the laws of the jurisdiction where it was established, it survives the death of a partner, and the partnership carries out its business in the United States.[45]

In the past, the IRS has not suggested that the aggregate theory should be applied to the question of the situs of a partnership interest for purposes of applying transfer taxes to a gift or to the estate of a nonresident alien. However, very little guidance is available to instruct advisors on how the interests will be characterized, and therefore caution must be taken when planning. Some very outdated pronouncements indicate that the IRS seems to favor the use of the entity theory to determine the situs of the partnership interest based on where the entity itself is engaged in business.[46] However, the location of a partnership's business is a facts-and-circumstances determination. And still other authorities seem to prefer a look-through theory to determine the situs of the partnership interest based on the location of the assets.[47]

Because uncertainty exists with regard to partnership interests (and interests in LLCs that are taxed as partnerships), a nonresident alien should plan conservatively by assuming that any U.S. connection will cause the partnership or LLC interest to be considered a U.S.-situs asset.

Bequests to Nonresident Alien Spouses Using a QDOT

An important estate-planning tool for married U.S. citizens and residents is the unlimited estate tax marital deduction for bequests to a surviving spouse. In other words, the value of property transferred to a surviving spouse is deducted from the deceased spouse's gross estate to arrive at the deceased spouse's taxable estate.

However, the marital deduction is available only for transfers to surviving spouses who are U.S. citizens. If the surviving spouse is not a U.S. citizen, it is available only for transfers to a ''qualified domestic trust'' for the spouse's benefit (commonly referred to as a ''QDOT''). A U.S. citizen or resident who uses a QDOT to leave property to a non-citizen spouse is permitted an estate tax marital deduction for the value of the property transferred to the trust. A QDOT defers estate tax in the deceased spouse's estate by imposing estate tax on: (1) distributions of capital from the trust to the surviving spouse during his or her lifetime; and (2) the value of the property remaining in the trust on the date of the surviving spouse's death.

QDOTs are available only for testamentary transfers, not for lifetime gifts. A QDOT can be established via the deceased spouse's will or revocable management trust, but if the non-citizen spouse received a spousal bequest outright, he or she can transfer the property to a QDOT prior to the filing of the decedent's estate tax return.[48]

In general, to qualify as a QDOT, a trust must: (1) have at least one trustee who is a U.S. citizen or U.S. corporation; and (2) provide that no distribution (other than a distribution of income) may be made from the trust, unless the trustee who is a U.S. citizen or U.S. corporation has the right to withhold from such distribution the estate tax described in the paragraph above. The deceased spouse's executor must also make an election on the estate tax return to treat the trust as a QDOT.

A ''large QDOT'' (one funded with assets having a value of more than $2 million on the U.S. spouse's date of death) carries with it more cumbersome administrative requirements than a ''small QDOT.''[49] This is because the Code requires additional assurance that the IRS will be able to collect the tax from a large QDOT as compared to a small QDOT. These collection assurances are provided by requiring a large QDOT to satisfy one of the following three so-called ''Security Requirements'': (1) a U.S. bank must serve as a trustee; (2) the trustee must furnish a bond in favor of the IRS equal to 65% of the fair market value of the trust assets; or (3) the trustee must provide the IRS with a letter of credit in an amount equal to 65% of the fair market value of the trust assets. By contrast, a small QDOT can satisfy the Security Requirements by merely containing provisions that prohibit the trust from holding foreign real estate.

Because of the more stringent Security Requirements on large QDOTs, it is preferable to maintain small-QDOT status if possible. For example, if the deceased spouse's estate consists of both U.S. and non-U.S. assets, and the surviving non-citizen spouse is

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[45] *See Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934); Rev. Rul. 55-701, 1955-2 C.B. 836.

[46] Rev. Rul. 55-701, 1955-2 C.B. 836; *see also* GCM 16164, XV-1 C.B. 363 (1936), *rev'd by* GCM 18718, 1937-2 C.B. 476 (later declared obsolete by Rev. Rul. 70-59, 1970-1 C.B. 280, which applied the entity theory to partnership interests).

[47] *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934). *See* Richard A. Cassell, Michael J.A. Karlin, Carlyn S. McCaffrey, and William P. Streng, *U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests*, Tax Notes Int'l (Aug. 11, 2003), p. 563, Doc. 2003-14517, or 2003 *WTD* 154-13.

[48] Reg. §20.2056A-2(b)(2).

[49] Reg. §20.2056A-2(d).

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not domiciled in the United States, it might be desirable to leave only U.S.-situs assets to the QDOT and leave the foreign-situs assets to the surviving spouse outright or in a regular testamentary trust to keep the QDOT below the $2 million limit.

Jointly Owned Property

Joint Ownership with a Non-Spouse

For U.S. citizens who hold property in a non-spousal joint tenancy with right of survivorship, the general ''consideration-furnished rule'' applies a presumption that the value of the entire jointly owned asset is included in the gross estate of the first joint tenant to die unless the surviving tenant or tenants can prove that they provided adequate and full consideration for their share of the joint tenancy.[50] In that case, the value of the joint tenancy that is proportionate to the consideration furnished by the surviving joint tenants will be excluded from the decedent-joint tenant's estate. There is an exception where the entire property was acquired by all of the joint tenants at the same time in the form of a gift, bequest, devise, or inheritance; in that case, the value included in a decedent-joint tenant's estate is his fractional share of the property.[51]

The consideration-furnished rule applies to all non-spousal joint tenancies regardless of citizenship, and if the property is U.S.-situs property, it will be subject to estate tax in the hands of a nonresident alien decedent up to the amount of consideration that the nonresident alien furnished.

Joint Ownership with a Non-Citizen Spouse

For tenancies in which the only two tenants are spouses and U.S. citizens, only one-half of the value of the joint tenancy or tenancy by the entirety is included in the decedent's estate, and the passage of the deceased spouse's interest to the surviving spouse by right of survivorship will be covered by the estate tax marital deduction.[52] This is known as the ''50-50 rule.'' However, if the surviving spouse is not a U.S. citizen, the 50-50 rule does not apply, and the consideration-furnished rule will apply.[53]

Consider how to plan with regard to the marital assets of Wife who is not a U.S. citizen and Husband who is a U.S. citizen. If the non-citizen spouse (Wife) were to die first, the 50-50 rule would apply, and one-half of the value of assets held jointly with Husband would be included in Wife's estate, regardless of who provided the funds for such assets. However, if the citizen spouse (Husband) is the first to die, leaving a non-citizen surviving spouse, the default consideration-furnished rule applies, meaning that Wife would have to prove the source of funds for any jointly held assets to determine the portion of those assets to be included in Husband's gross estate. Furthermore, Husband's share of the joint property passing to Wife will not be eligible for the marital deduction.

With regard to how these rules will apply to U.S.-situs assets versus non-U.S.-situs assets, the answer again differs depending on who dies first, and whether the non-citizen spouse is also a nonresident for estate tax purposes. If the U.S. citizen (Husband) dies first, both U.S.- and non-U.S.-situs assets will be implicated because his gross estate includes worldwide assets. If the non-citizen Wife dies first and she is also a nonresident, the only joint tenancy assets that will be included in her U.S. gross estate are U.S.-situs assets.

Due to the wide variance in the tax treatment depending on which spouse will die first, where the couple's property is located, and whether the non-citizen spouse is a resident or a nonresident for transfer tax purposes, it is not recommended to create joint-tenancy property with a non-citizen spouse.[54]

Generation-Skipping Transfer Taxation of Nonresident Aliens

Generation-skipping transfer (''GST'') tax generally applies to certain transfers to ''skip persons.'' In very general terms, skip persons are those who are assigned to a generation that is two or more generations below the donor, or, if the donor and donee are not closely related, a skip person is a donee who is more than 37½ years younger than the donor.[55] GST tax will not apply to gifts or bequests made by nonresident aliens to skip persons if the gift or bequest is not subject to U.S. gift or estate tax.[56] Therefore, transfers of non-U.S. property from a nonresident alien will not incur GST tax.

To the extent that GST tax applies, nonresident aliens are allowed a $1,000,000 GST tax exemption on GST taxable transfers.[57] The Treasury regulations set the GST tax exemption at $1,000,000 for both residents and nonresidents in 1995; since then, the exemption amount was increased for residents, but the regulations for nonresidents have not been amended.

[50] §2040(a).

[51] *Id.*

[52] §2040(b), §2056(a).

[53] §2056(d)(1)(B), §2040(b)(2)(B).

[54] For further explanation of these complicated rules as they relate to the estate tax consequences of joint tenancies, see PLR 9551014.

[55] §2613, §2651(d).

[56] Reg. §26.2663-2(a).

[57] *Id.*

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Commentators have noted that the Treasury presumably intended for the GST tax exemption for nonresident aliens to track the exemption for residents. Therefore, it is likely that the IRS would recognize a $5,000,000 GST tax exemption, indexed for inflation ($5,430,000 for 2015).[58]

U.S. TAX PLANNING FOR NONRESIDENT ALIENS

Because of the minimal $60,000 estate tax exemption that is available to nonresident aliens, if a nonresident alien owns U.S.-situs property, it can trigger a devastating amount of estate tax. Therefore, the transfer tax considerations tend to drive U.S. planning for nonresident aliens, with federal income tax issues taking the passenger seat. Unfortunately, what is good for transfer tax purposes is not always the best income tax situation, and vice-versa. Additional complications arise when a non-citizen is a resident for income tax purposes and a nonresident for transfer tax purposes, but an analysis of these complications is outside the scope of this article. Therefore, for purposes of this discussion, we will assume that an individual is a nonresident alien for both income and transfer tax purposes.

In this section, we summarize a variety of tax planning structures to enable a nonresident alien to avoid or significantly reduce exposure to U.S. estate tax. However, before undertaking to set up one of the ownership structures described below, the first consideration should be whether a nonresident alien can purchase life insurance that would cover the amount of U.S. estate tax that will be imposed at the nonresident alien's death. Life insurance proceeds on the life of an insured nonresident alien are deemed to be non-U.S. situs property.[59] A life insurance policy may not be affordable depending on the individual's age or health history, but if this option is available, it could be the simplest solution for providing the liquidity needed to pay the U.S. estate tax without implementing a more complex ownership structure.

As will be discussed below, the most widely used solution for a nonresident alien to avoid U.S. estate tax is to place U.S.-situs property in a foreign corporation, because stock in a foreign corporation is not subject to U.S. estate tax in the hands of a nonresident alien. However, this structure does have some disadvantages that must be weighed on a case-by-case basis and compared with the pros and cons of other ownership structures. We will review the various ownership options and their benefits and drawbacks below.

Direct or Pass-Through Ownership by Foreign Individuals

The simplest way for a nonresident alien to invest in the United States is directly in his own name or via a disregarded entity or other pass-through entity. The major advantages of direct or pass-through ownership are: (1) it is simple; (2) it avoids the double income taxation of corporate ownership; (3) individual investors have the benefit of lower capital gains tax rates (where corporate investors do not); (4) the nonresident alien's U.S. beneficiaries will receive a step-up in basis in the assets at the nonresident alien's death (i.e., the basis will not be trapped in a corporation); and (5) if the nonresident alien owns multiple U.S. properties, losses from unprofitable properties can offset income from profitable properties.

If loss of the lower capital gains rates through corporate ownership is not a concern, and if the nonresident alien's assets generate income that is effectively connected with a U.S. trade or business (referred to as ''effectively connected income'' or ''ECI''), then one disadvantage of direct ownership versus corporate ownership is that a higher maximum income tax rate applies to individuals (39.6%) as opposed to the maximum rate for corporations (35%). In addition, if a foreign individual dies while owning property that is considered ''situated in the United States'' for estate tax purposes, and that property exceeds $60,000 in value, estate tax will be incurred. This factor would also weigh in favor of corporate ownership.

As previously mentioned, the situs of an interest in a partnership or LLC for estate and gift tax purposes is a gray area. Although it should be possible under the entity theory of partnerships for a nonresident alien to avoid estate tax on U.S. assets held in a foreign partnership, caution would dictate that a foreign corporation be used instead.

There are certain situations in which a nonresident alien need not own U.S. assets through a corporate vehicle to avoid estate taxation. Assets that are excluded from the nonresident alien's U.S. estate under the Code (i.e., bank deposits and life insurance on the nonresident alien's life) can be held outright or in a pass-through entity. There may also be scenarios in which a treaty provides sufficient relief; for example, the U.S.-Canada Income Tax Treaty allows a Canadian decedent to receive a marital ''credit'' for U.S. property left to a Canadian-resident nonresident alien

[58] Federal Tax Coordinator 2d, ¶R-9528, ''Application of GST tax to transfers by nonresident aliens (NRAs).''

[59] §2105(a). But note that §2105(a) applies only to the *proceeds* of insurance on the life of a nonresident alien. If, at death, a nonresident alien decedent owns insurance on the life of a surviving U.S. resident or another nonresident alien, the value of the policy can be included in the nonresident alien decedent's gross estate if it is situated in the United States. Reg. §20.2105-1(g).

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surviving spouse, as long as the bequest would otherwise qualify for the marital deduction.[60]

Ownership by a Foreign Corporation

As mentioned above, owning U.S. assets through a foreign corporation is the most common way for a nonresident alien to block U.S. estate taxation. This is because the nonresident alien's estate will consist of shares in a foreign corporation (which are not includible in the nonresident alien's estate for estate tax purposes), rather than the underlying U.S. assets. Furthermore, during the nonresident alien's lifetime, he can gift shares of the foreign corporation free of gift tax, and sell shares of the foreign corporation free of U.S. income tax. Finally, dividends from the foreign corporation are not subject to U.S. income tax in the hands of a nonresident alien.

All of that sounds quite ideal, but the negative implications of this ownership structure must be considered as well. Although the foreign corporation will not be taxed on the sale of any U.S. stock that it owns, the sale of U.S. real estate held by the foreign corporation will be deemed to be ECI under FIRPTA, thereby subjecting the gain to the additional 30% branch profits tax on top of the regular corporate tax.[61]

Another downside of corporate ownership is that, upon the nonresident alien's death, the shares in the corporation will receive a step-up in basis, but the assets owned by the entity will not. This means that U.S. beneficiaries who inherit shares of the foreign corporation will also acquire the assets' built-in gain, causing a gain event if the assets are later sold or if the corporation is liquidated. However, the income tax on the built-in gain will typically be less than the estate tax on the gross value of the corporation's U.S.-situs assets, and so using a foreign corporation to avoid estate taxation may be preferable.

Foreign Investment Through a U.S. Corporation

A nonresident alien may choose to hold U.S.-situs assets through a U.S. corporation. Utilizing a U.S. corporation will avoid the branch profits tax that arises on a foreign corporation's ECI. In addition, gifts of domestic stock by a nonresident alien are not subject to gift tax. And, as with foreign corporations, the maximum tax rate on the corporation's income will be 35% as opposed to the highest individual rate of 39.6%.

However, unlike a foreign corporation, the stock of the U.S. corporation will be subject to estate tax since it is a U.S.-situs asset. In addition, like the foreign corporate structure, a U.S. corporation carries with it the same built-in gain problem for U.S. beneficiaries, mentioned above.

Foreign Corporation (Parent) / U.S. Corporation (Subsidiary) Structure

Utilizing a tiered structure consisting of a U.S. corporation to hold the U.S. assets and a foreign corporation to hold the shares in the U.S. corporation may provide the best of all worlds. The foreign parent/U.S. subsidiary structure results in no U.S. gift or estate tax if stock in the foreign corporation is gifted during the nonresident alien's lifetime or owned at death. If the U.S. corporation is a USRPHC under FIRPTA, the branch profits tax will not apply to gain on the disposition of the foreign corporation's interest in the U.S. corporation.[62]

Although the tiered structure provides many income and transfer tax savings, certain issues cannot be avoided. For example, the U.S. corporation will be taxed on its worldwide income, so the U.S. corporation's holdings should be limited to only U.S. assets to avoid incurring U.S. tax on foreign income. Also, corporations do not receive the benefit of lower capital gains rates. In addition, double taxation will occur if earnings and profits are distributed to the foreign parent via a dividend. However, the amount of the taxable dividend can be controlled by reducing the corporation's earnings and profits with expenses at the corporate level. It is also possible to reduce the double taxation by paying the nonresident alien a salary, which will be taxed at graduated individual rates and deducted at the corporate level.

Another potential disadvantage of this structure is that a liquidating distribution of a U.S. subsidiary corporation to a foreign parent will not qualify for the non-recognition treatment that would otherwise apply in a wholly U.S. structure.[63] Thus, upon liquidation of the U.S. subsidiary, any appreciated property will be subject to regular corporate tax and branch profits tax

[60] Art. XXIX(B).

[61] §897(a)(1)(B), §884. The Foreign Investment in Real Property Tax Act of 1980 (''FIRPTA'') created an exception to the general rule that nonresident aliens are not subject to tax on U.S.-source capital gains. FIRPTA treats a nonresident alien's gain (or loss) from the sale or exchange of a U.S. real property interest as if the nonresident alien were engaged in the conduct of a trade or business in the United States and the gain (or loss) was effectively connected with such trade or business. *See* Pub. L. No. 96-499.

[62] §884(d)(2)(C).

[63] §367(e)(2).

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in the hands of the foreign parent.[64] However, if the foreign corporation uses the distributed property in a U.S. trade or business for at least ten years after the liquidation, no recognition of gain on the appreciated assets of the U.S. subsidiary is required.[65]

Finally, there is also a potential issue with this structure where the nonresident alien shareholder intends to use the U.S. subsidiary corporation's property for personal use. The IRS has stated that personal use of corporate property is a constructive dividend equal to the amount by which the fair market rental value of the U.S. property exceeds the amount that the shareholder actually pays in rent.[66] The result is that the U.S. subsidiary will be deemed to pay a dividend to the foreign parent (subject to a 30% withholding tax to the extent of earnings and profits), which then pays a deemed dividend to the nonresident alien shareholder. Thus, with this structure, the nonresident alien should pay fair rental value for any personal use of the corporation's property.

All things considered, the foreign parent/U.S. subsidiary structure is usually the recommended way for nonresident aliens to acquire U.S. property, especially if the property generates ECI. In the case of U.S. real estate, the nonresident alien should first form the foreign corporation, which will then form the U.S. corporation, which will then be used to acquire the U.S. property. To avoid a deemed disposition under FIRPTA, U.S. real estate that is already owned by the nonresident alien should not be transferred to a corporate structure.[67]

Ownership Through a Foreign Trust

The final ownership option for a nonresident alien's U.S. assets is through a foreign trust. There are two types of trusts for U.S. income tax purposes: grantor trusts and non-grantor trusts.

Grantor trust status will retain the positive income tax benefits of direct or pass-through ownership because all of the trust's income is treated as owned by the nonresident alien grantor. However, a grantor trust will not accomplish estate tax avoidance because in order for it to be classified as a grantor trust, the trust must either be: (1) revocable; or (2) the grantor or the grantor's spouse must be the sole beneficiaries during the grantor's life.[68] Both of these traits are impermissible retained interests which cause estate taxation on U.S. assets in the trust as described above.

A non-grantor trust will also avoid corporate double taxation because trusts are taxed like individuals, albeit at compressed rates.[69] In addition, a non-grantor trust will achieve estate tax savings so long as the grantor relinquishes all impermissible retained interests, meaning that the trust must be used for actual gifting and must be truly irrevocable.[70] A foreign non-grantor trust will not be desirable if the current or future beneficiaries are or may become U.S. citizens or residents due to the throwback tax regime applicable to accumulated income of foreign non-grantor trusts; to avoid the throwback tax, all income of the trust, even foreign-source income, must be distributed out of the trust each year.[71] For this reason, if a nonresident alien has U.S. beneficiaries, it is usually best to utilize a U.S. non-grantor trust for lifetime gifting or for testamentary transfers to those beneficiaries.

Basis Considerations

Gifted property takes a carryover basis; that is, the basis of the property in the hands of the donee will equal the donor's basis in the property.[72] In addition, if there is a gift of property subject to debt in excess of the donor's basis in the property, a deemed sale will be triggered, which may be subject to U.S. income tax if the gain is deemed to be U.S.-source income (such as with U.S. real estate or interests in partnerships that own U.S. real estate).[73]

In contrast, property transferred at death receives a step-up in basis equal to the fair market value at the decedent's date of death.[74] Therefore, property received by devise or bequest will have less taxable gain upon subsequent disposition than property received by gift. However, if a nonresident alien decedent leaves stock in a foreign holding company to a U.S. beneficiary, the stock itself will receive a basis step-up, but the underlying assets will not (see above). Therefore, if it is anticipated that U.S. persons may inherit or otherwise receive the stock of a foreign holding company, the nonresident alien should consider periodically selling and repurchasing appreciated assets held by the company to increase the underlying assets' bases, thereby reducing the built-in gain to future U.S. recipients.

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[64] §367(e)(2), §882, §884.

[65] Reg. §1.367(e)-2(b)(2).

[66] T.C. Memo 2012-327. *See also* Rev. Rul. 58-1; FSA 199945017 (advising that rent-free use of an S corporation's corporate asset by the majority shareholder was a constructive dividend to the majority shareholder in the amount of the fair rental value of the asset).

[67] §897(e).

[68] §672(f).

[69] §1(e), §1(f)(1) (for 2015, a non-grantor trust's taxable income over $12,300 is taxed at 39.6%).

[70] §2035–§2038, §2104(b).

[71] §668.

[72] §1015(a).

[73] Reg. §25.2512-8.

[74] §1014(a).

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Inheritance of Shares in a Foreign Corporation by U.S. Beneficiaries; CFCs

As mentioned above, when establishing an entity structure to plan around transfer taxes and income taxes, a nonresident alien must consider long-term tax ramifications upon the ultimate disposition at the nonresident alien's death. If a foreign corporation is used as an estate tax blocker to hold U.S.-situs assets and the shares in the foreign corporation are inherited by U.S. descendants or held in a trust for the benefit of U.S. beneficiaries, then these U.S. shareholders may find themselves subject to special U.S. income tax ''anti-deferral'' regimes applicable to foreign corporations. Although U.S. anti-deferral regimes are not applicable to nonresident aliens, a nonresident alien with U.S. beneficiaries must be aware of them due to the adverse income tax consequences to the U.S. beneficiaries who will receive shares of the foreign corporation.

The primary anti-deferral regime applicable to closely held foreign corporations is known as the ''Subpart F'' regime, which is applicable to ''controlled foreign corporations'' or ''CFCs.''[75] In a nutshell, the Subpart F rules provide that certain types of passive income and related-party income earned by a CFC (''Subpart F income'') will be deemed to be distributed to the company's U.S. owners and taxed as ordinary income in the U.S. owners' hands, even if it is not actually distributed to them.

If a U.S. person receives interests in a CFC, whether directly or indirectly (e.g., if a beneficiary of a trust that holds a CFC), such person must report ownership of the CFC to the IRS on Form 5471, even though it may be indirectly owned through a trust. All of the CFC's Subpart F income (interest, dividends, capital gains, etc.) will flow through to the beneficiaries each year and must be reported on their personal income tax returns, even if the income is not actually distributed to them.

A CFC is generally defined in the Code as any foreign corporation where more than 50% of the total value or voting power of the stock is owned by United States shareholders on any day during the taxable year of such foreign corporation. A ''United States shareholder'' is a U.S. person who owns, or is considered to own, 10% or more of the total combined voting power of all classes of the corporation's stock. For purposes of determining U.S. share ownership, constructive ownership rules apply, meaning that stock of a foreign corporation that is owned by corporations, partnerships, and trusts is treated as owned proportionately by the shareholders, partners, or beneficiaries, and certain family members are treated as owning each other's stock.

A U.S. person's ownership of shares in a CFC that owns U.S. assets is a tax-inefficient structure. At a minimum, it has the detrimental effect of converting capital gain income into higher-taxed ordinary income, and the U.S. reporting requirements can be burdensome. Therefore, the U.S. beneficiaries will likely want to either liquidate the foreign corporation or elect pass-through treatment for the foreign corporation at the nonresident alien's death.

CONCLUSION

Estate planning is already a very complicated practice area that requires proficiency in multiple tax regimes that work in opposition to one another. When planning for a nonresident alien, the complexity increases exponentially, and the unique tax rules contain many traps for the unwary. We hope that this article helps you to better navigate the minefield of U.S. inbound estate planning for nonresident aliens.

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[75] §951 *et seq.*

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