Inbound Tax Planning:

What Your Clients Need To Know Before Immigrating

Part 2 – Wealth Transfer Tax Planning

By John R. Strohmeyer, J.D., LL.M.

Any person who is considering spending more time in the United States should be aware of the two tax systems that affect individuals: the federal income tax and the federal "wealth transfer" taxes – the estate tax, the gift tax and the generation-skipping transfer tax. Part 1 of this series, published in the January/February 2017 issue of *Today's CPA*, addressed the income tax aspects of the immigration process. In this Part 2, we will address planning for the estate tax, gift tax and generation-skipping transfer tax.

Because of the complexity involved in planning for any one of these taxes, both articles only provide a cursory introduction to the concepts involved in immigration tax planning. And beyond the rules outlined in both parts of this article, the United States is a party to over 50 bilateral income tax treaties, and several bilateral estate and gift tax treaties, each of which creates a unique taxing regime between the two countries. For these reasons, many concepts have been abbreviated or left out entirely to provide a brief overview.

As with income tax, U.S. citizens and residents are subject to worldwide taxation by the three wealth transfer taxes: the estate tax, gift tax and generation-skipping transfer tax. Nonresidents are only subject to wealth transfer taxation on their U.S.-situs assets. So, while these taxes are different from the income tax, the principle that nonresidents are taxed only on assets that are located in the United States is similar to the principal in income taxation that the United States only taxes income that is connected with the United States.

Domicile, Not Residence

Although the income tax uses an objective test to determine residence, the domicile test for the wealth transfer taxes is subjective and can produce a different result. The test is satisfied if a person is domiciled in the United States at the time of either his/her death or transfer by gift. A person acquires U.S. domicile by residing in the United States for any period of time, no matter how brief, with no definite present intention of leaving.[1] Absent that intention, a person will not acquire domicile for the purposes of wealth transfer taxation. As a result, the determination of domicile for wealth transfer tax purposes requires a determination of an individual's state of mind at the requisite moment. Once determined to be a resident under this subjective test, a resident is required to file

Forms 709 to report lifetime gifts, or the resident's estate must file a Form 706 if required to do so.

A person who is not a U.S. citizen or who does not have a U.S. domicile is a "nonresident not a citizen of the United States" for wealth transfer tax purposes.[2] For simplicity in this article, a "nonresident not a citizen of the United States" will be referred to as a "nonresident." Because this test is different than the residence test for income tax, it is possible for an individual to be a resident for income tax purposes without being a resident for wealth transfer tax purposes and vice versa.

Generally, a person's domicile continues to be the place of birth until it is affirmatively shown that the person acquired a different domicile. A person who resides in the United States without knowing when he/she will return home will not acquire a U.S. domicile. For example, a person who moved to the United States in 1940 from The Netherlands to escape the Nazis and intended to return home when it was safe did not acquire a U.S. domicile.[3] If doubt exists as to whether a new domicile has been acquired, it is likely that the person's domicile has not changed.[4]

Estate Tax

The United States only imposes the estate tax on U.S.-situs assets of nonresidents, though the estate tax is computed in the same manner as U.S. citizens and residents. As a result, the nonresident's estate tax will be equal to the excess of the taxable estate plus any adjusted taxable gifts over the tentative tax on the amount of the adjusted taxable gifts.[5] Two important differences in this calculation (but not the only differences) for the nonresident are the assets included in the estate and the availability of deductions.

A nonresident's estate will be subject to the estate tax only on U.S.-situs assets. For example, real property and tangible personal property located in the United States are included in the nonresident's estate.[6] But leases are generally not included in the gross estate.[7] Stock in corporations organized under U.S. law, but not the underlying assets, are included in the nonresident's estate.[8]

Although U.S.-situs property is included in a nonresident's gross estate, several classes of assets are excluded from the gross estate. For example, real property and tangible personal property located outside the United States are excluded from the gross estate.[9] To encourage nonresidents to loan works of art to U.S. museums, works of art owned by a nonresident are excluded if they are, at the time of death, on loan or exhibition in the United States, even though they are located in the United States.[10] Shares of stock in a corporation organized and incorporated under the laws of a foreign country are excluded.[11] The proceeds of a life insurance policy on the life of a nonresident are also excluded from the gross estate, regardless of the situs of the company that issues the policy.[12] Also exempted are debt obligations issued by a U.S. corporation and deposits with a U.S. bank if the interest would be treated as foreign source income, or would be exempt from tax as portfolio interest or the rules applicable to interest paid on deposits with U.S. banks.[13] And deposits with a foreign branch of a U.S. commercial bank will be excluded from the gross estate.[14]

Because fewer assets are included in the nonresident's gross estate for estate tax, a nonresident decedent only receives a $13,000 estate tax credit (effectively a $60,000 exemption amount),[15] as opposed to the $5,490,000 estate tax exclusion amount available for U.S. citizens and residents in 2017.[16] The nonresident decedent estate tax credit is not adjusted for inflation.

A NONRESIDENT'S ESTATE WILL BE SUBJECT TO THE ESTATE TAX ONLY ON U.S.-SITUS ASSETS.

Beyond a limited estate tax credit, nonresidents may only claim limited deductions for estate tax purposes. For example, a nonresident may deduct general expenses of administration, debts, taxes, funeral expenses and losses of the worldwide estate as a U.S. citizen or resident would.[17] However, the amount of the deduction is limited to the ratio of U.S. taxable property to worldwide assets. Additionally, it does not matter if the amounts to be deducted were incurred or expended within or without the United States.[18] To obtain these deductions, the nonresident's estate must disclose the decedent's worldwide estate on the estate tax return. No deduction will be allowed unless the value of the decedent's entire gross estate is disclosed in the estate tax return.[19] Thus, an estate must balance the ability to claim these deductions against the need to disclose.

So, if a nonresident decedent had a worldwide gross estate valued at $10,000,000, of which the U.S. gross estate is valued at $1,000,000, only 10 percent of their debts, taxes, and funeral and administration expenses would be deductible, regardless of whether they are directly attributable to the administration of the U.S. estate. Before claiming any deductions, the estate would need to report the entire $10,000,000 estate, even though only $1,000,000 would be subject to the estate tax.

Regardless of a decedent's residence, the unlimited marital deduction is not available for assets that pass to a surviving spouse who is not a U.S. citizen.[20] But the marital deduction can be obtained by using a qualified domestic trust (QDOT). An additional estate tax is imposed on distributions of corpus from the QDOT during the surviving spouse's lifetime and on the value of the QDOT corpus on the date of death of the surviving spouse.[21] The additional estate tax is generally equal to the tax that would have been due if the property had been included in the decedent's estate. The trustees are personally liable for this tax.[22]

A charitable deduction is allowed for the full amount of all bequests, legacies, devises or transfers to certain domestic recipients.[23] Generally, the recipient must be the United States;

continued on next page

any U.S. state or any political subdivision or a U.S. state; the District of Columbia; any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes; or a trustee or trustees, or a fraternal society, order or association operating under the lodge system.[24] Unlike administrative expense and loss deductions under Code § 2106(a)(1), the charitable deduction is not proportionate to the ratio of U.S. and worldwide property. But like deductions under Code § 2106(a)(1), the charitable deduction is only allowed if the executor discloses the worldwide gross estate.[25] Again, the nonresident's executor must choose between disclosing worldwide assets and foregoing the charitable deduction.

Gift Tax

Nonresidents are subject to the gift tax on all transfers.[26] Like the estate tax, the gift tax only applies to a nonresident's gifts of U.S.-situs property and not worldwide transfers.[27] Because fewer assets have a U.S. situs for the gift tax than the estate tax, the gift tax presents less of an issue for nonresidents than the estate tax. Generally, real property and personal property physically located in the United States are subject to the gift tax.[28] So, if a nonresident were to gift $50,000 in jewelry while standing on Miami Beach, the gift would be subject to gift tax. However, if that nonresident and donee boarded a boat and headed into international waters, the same transfer would not be subject to gift tax.

A nonresident is not subject to U.S. gift tax on a transfer of property not located in the United States. Transfers of intangible property by a nonresident are not subject to the gift tax.[29] Bank deposits or Treasury bills are generally considered intangible property for gift tax purposes.[30]

Although a nonresident is not granted any lifetime exemption from gift tax, a nonresident gets many of the same deductions and exemptions as a U.S. citizen or resident. A nonresident receives the same per donee annual exclusion ($14,000 per donee in 2017) that is granted to U.S. citizens and residents on transfers of U.S.-situs assets.[31] As with U.S. citizens and residents, the payment of qualified educational and medical expenses by a nonresident is excluded from the gift tax.[32]

Generation-Skipping Transfer Tax

In addition to the estate tax and gift tax, nonresidents are generally subject to the generation-skipping transfer tax (GST tax) if the transfer is otherwise subject to the estate tax or gift tax.[33] The GST tax serves as a backstop to the estate tax and the gift tax by taxing transfers that "skip" a generation (e.g., a gift from a grandparent to a grandchild) if the transfer is subject to either the estate tax or gift tax. Although nonresidents receive GST exemption, it is not clear if that amount is $1,000,000[34] or $5,490,000 (the amount granted to U.S. citizens and residents in 2017).

Avoiding the Tax Traps

Even this brief introduction to the wealth transfer taxes shows the varied rules, exceptions, requirements and exemptions that apply to both U.S. residents and nonresidents. When combined with the income tax planning discussed in Part 1 of this series, a complex web of rules presents many traps for the unwary. The increased amount of investment in the United States by foreign citizens looking for a safe haven for their investments presents opportunities for these tax traps to be sprung. The tax planning needed to avoid these tax traps will take on a greater importance in the coming years as it becomes easier to transfer money and property into the United States. ■

Footnotes

1. Code § 2001(a); Treas. Reg. §§ 20.01-1(b); 25.2501-1(b).
2. Code §§ 2101(a), 2511(a).
3. *Estate of Nienhuys v. Comm'r*, 17 T.C. 1149, 1159 (1952).
4. *Estate of Khan v. Comm'r*, T.C. Memo 1998-22 (citing *Weis v. Comm'r*, 30 B.T.A. 478, 487 (1934)).
5. Code § 2101(b)(1)-(2).
6. Treas. Reg. § 20.2104-1(a)(1)-(2).
7. *Estate of de Perigny v. Comm'r*, 9 T.C. 782 (1947).
8. Code § 2104(a).
9. Treas. Reg. §§ 20.2105-1(a)(1), (2).
10. Code § 2105(c).
11. Treas. Reg. § 20.2105-1(f).
12. Code § 2105(a).
13. Code §§ 2104(c); 2105(b)(1) and (3).
14. Code § 2105(b)(2).
15. Code § 2102(b)(1).
16. Code § 2010; Rev. Proc. 2016-55, Sec. 3.35, 2016-45 IRB.
17. Code § 2106(a)(1).
18. Treas. Reg. § 20.2106-2(a)(2).
19. Treas. Reg. § 20.2106-2(b).
20. Code § 2056(d)(1).
21. Code § 2056A(b).
22. Code § 2056A(b)(6).
23. Code § 2106(a)(2).
24. Code § 2106(a)(2)(A)(i)-(iii).
25. Treas. Reg. § 20.2106-1(b).
26. Code § 2501(a)(1).
27. Code § 2511(a).
28. Treas. Reg. § 25.2511-3(b)(1).
29. Code § 2501(a)(2).
30. Treas. Reg. § 25.2511-3(b)(4).
31. Code § 2503(b)(1); Rev. Proc. 2016-55, Sec. 3.37(1), 2016-45 IRB.
32. Code § 2503(e).
33. Treas. Reg. § 26.2663-2(b)(1).
34. Treas. Reg. § 26.2663-2(a).

John R. Strohmeyer is an associate at Crady, Jewett & McCulley LLP in Houston. His practice focuses on estate planning and estate administrations for high-net-worth individuals, including a developing international focus. He is also the co-chair of the International Tax Committee of the tax section of the State Bar of Texas. He may be contacted at jstrohmeyer@cjmlaw.com.