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Estate & Gift Tax Treatment for Non-Citizens

It goes without saying that the laws governing the U.S. estate and gift tax system are complex. When you then consider the additional complexities of the rules governing non-U.S. citizens ("non-citizens"), the U.S. estate and gift tax system is even more onerous and requires a much higher degree of awareness. This piece will help outline the most important estate and gift planning differences between U.S. citizens, U.S. resident aliens and nonresident aliens.

Residence & Domicile

To start, the first question for any non-citizen client (and his/her advisor) is to determine if the client is a resident alien or a nonresident alien for transfer tax purposes. Note: different rules may apply for income tax purposes.

The Code imposes estate and gift taxes on a worldwide basis on transfers by an individual who is a citizen or "resident" of the United States. For gift tax purposes, an individual is a resident if that person is domiciled in the U.S. at the time of the gift transfer. For estate tax purposes, a person is a "resident decedent" if the person is domiciled in the U.S. at the time of his or her death.

The U.S. Treasury Regulations defines "domicile" as follows:

"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."

Because the question of domicile depends on the intention of the individual, there is no bright-line test to determine if an individual has become a U.S. resident for gift and estate tax purposes. However, some of the factors considered when making a determination of residency include:

1) Length of time spent in the U.S and abroad
2) Size, cost and nature of the decedent's houses or other residence — whether owned or rented
3) Location of the decedent's family and close friends
4) Visa status
5) Location of decedent's business interests and voting records
6) Declaration of residence in one's wills, trusts, deeds, etc.

U.S. citizens who reside in U.S. possessions: In determining whether an individual is a resident alien or a nonresident alien for the purposes of the estate and gift tax rules, it is important to note that special rules apply to certain persons residing in U.S. possessions.

Internal Revenue Code Section 2209 provides that a decedent who is a U.S. citizen and resident of a possession at the time of his death shall be considered a nonresident alien for estate tax purposes, but only if such person acquired U.S. citizenship solely by reason of 1) being a citizen of the U.S. possession, or 2) being born or residing within such possession.

These rules are also applicable for the purposes of determining any gift or generation-skipping tax liability of a person residing in a U.S. possession. The term "possessions" means Puerto Rico, Guam, American Somoa, the Northern Mariana Islands, and the U.S. Virgin Islands.

Resident Aliens

Resident aliens are generally subject to the same gift and estate tax laws applicable to U.S. citizens. However, there are a few key distinctions when planning for a client who is a resident alien or is married to a resident alien, which are outlined below.

1. APPLICABLE CREDIT AMOUNT AVAILABLE

The full applicable credit amount against U.S. estate tax is available to resident aliens the same as it is with U.S. citizens. This amount starts at a $5,000,000 base (for 2011) and is indexed every year for inflation. For 2014, the current applicable credit amount is $5,340,000. Under current law, the estate and gift tax applicable credits are unified so that resident aliens also have a $5,340,000 (for 2014) gift exemption available during their lives.

Transfers by a resident alien are also subject to the Generation Skipping Transfer Tax (GSTT) in the same manner as applicable to U.S. citizens. The current exemption for GST taxes is $5,340,000 (for 2014).

2. TAXATION OF WORLDWIDE PROPERTY

All property of resident aliens, whether it is located in the U.S. or in another country, is subject to U.S. estate and gift tax. If a foreign death tax is owed to another country by a decedent's estate, the estate will receive a credit for the foreign death tax. However, there is no credit available against the U.S. gift tax for foreign gift taxes, which may lead to multiple gift taxation on gifts of foreign property. Some countries may have tax treaties with the U.S., which may affect the estate tax on citizens of those countries.

3. GIFT TAX EXCLUSIONS

Gifts made to a non-citizen spouse: Gifts to a spouse who is not a U.S. citizen (whether a resident alien or a nonresident alien) do not qualify for the unlimited gift tax marital deduction that is available for gifts to a U.S. citizen spouse (IRC Section 2523). However, a spouse can make a "present interest" gift to a non-citizen spouse that should qualify for a larger annual exclusion amount under Section 2523(i)(2) (this amount is $145,000 in 2014).

Gifts made by a non-citizen: Resident aliens can make present interest gifts to anyone in the U.S. that will qualify for the standard annual gift tax exclusion (the annual exclusion amount is $14,000 in 2014).

Both of these exclusion amounts are indexed annually for inflation.

4. MARITAL DEDUCTION/QUALIFIED DOMESTIC TRUST (QDOT)

The unlimited estate tax marital deduction that is presently available to U.S. citizens is not available to estates where the surviving spouse is not a U.S. citizen. The only exceptions to this rule are: 1) if the surviving spouse becomes a U.S. citizen before the estate tax return is filed, or 2) the property passing to the surviving spouse passes in a qualified domestic trust (QDOT).

Planning Note: The deceased individual's citizenship does not affect whether the marital deduction is available; only the citizenship of the spouse due to inherit needs to be considered.

For example, in a situation where a husband is a U.S. citizen and a wife is not a U.S. citizen, the husband's will or living trust should contain QDOT provisions, whereas the wife's will or trust can provide for a typical Qualified Terminable Interest Property (QTIP) trust. The requirements for a QDOT trust are set forth in Internal Revenue Code Section 2056A. The QDOT must have at least one U.S. trustee (a U.S. citizen or a U.S. corporation), and must be administered under the jurisdiction of a U.S. state or the District of Columbia. The QDOT trust must also satisfy the general marital deduction requirements of U.S. estate tax law (e.g., the qualified terminable interest rule of Section 2056), and the election for treatment as a QDOT trust must be made on the decedent's estate tax return (Form 706). Income distributions to the surviving spouse from the QDOT trust are not subject to estate tax, but distributions of principal to the surviving spouse are subject to estate tax, unless the distributions are made on account of hardship.

If a couple are preparing an estate plan and they are planning to become U.S. citizens in the future, they may not need to have QDOT provisions in their living trusts; if they die before they actually become U.S. citizens, their executor can elect post-mortem for their marital trusts to qualify as QDOTs.

Planning Note: For insurance planning purposes, if one or both of the spouses is a non-citizen, and they need life insurance for estate liquidity, they may consider getting single life policies, rather than a survivorship policy.

5. JOINTLY OWNED PROPERTY

For U.S. citizens, when the first spouse dies, the estate will include only 50% of jointly owned property, regardless of who contributed funds to the property's purchase or maintenance. However, for non-citizen spouses, the entire value of a joint interest will be included in the estate of the first spouse to die, reduced by contributions which the estate can prove were supplied by the surviving spouse. As a result, it may be a good idea to "undo" joint ownership of assets during both spouses' lives, if it is expected that they will have a taxable estate (the annual exclusion for gifts to spouses or the lifetime gift exemption may be used for this purpose).

6. RETIREMENT PLANNING

Since assets passing to a non-citizen surviving spouse will receive the marital deduction only if they are included in the QDOT trust, the best option for a non-citizen surviving spouse who receives qualified plan or IRA assets is to roll over the plan benefits into an IRA-QDOT trust. The IRA-QDOT will allow the surviving spouse to continue deferring income tax on the retirement assets that remain in the IRA and receive income from the IRA estate tax free. However, distributions of principal to the surviving spouse will be subject to both estate and income tax, as with a standard QDOT.

Nonresident Aliens (NRAs)

Unlike U.S citizens and resident aliens, who are subject to estate and gift tax on their worldwide assets, nonresident aliens are subject to estate and gift tax only on assets that are considered U.S. situs property (see page 5 for examples). Moreover, when a nonresident alien is subjected to transfer taxes, the exemptions against such tax differ from the exemptions afforded to citizens and resident aliens. Below are some of the key factors to be aware of when planning for a nonresident alien.

1. APPLICABLE CREDIT AMOUNT AVAILABLE AT DEATH

Nonresident aliens can generally transfer up to $60,000 of assets at death without being subject to U.S. estate tax (the actual credit amount is $13,000, which translates into an exemption amount of $60,000). The exemption amount is not expected to change in the next few years.

Treaties with Other Countries: Note that U.S. treaties with other countries may allow for a larger exemption. For example, Canadian citizens who are nonresident aliens with U.S. situs property receive a prorated estate tax exemption up to $5,000,000 based on a ratio of U.S. sited assets to worldwide assets (U.S./Canadian Tax Protocol, Article XXIXB). Advisors will need to also review the possibility and impact of existing tax treaties between the U.S. and other countries to determine potential estate and gift tax liability.

Treaty countries include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland and the United Kingdom.[1]

2. ESTATE TAXATION OF U.S. SITUS PROPERTY

Nonresident aliens are subject to U.S. estate tax only on "U.S. situs property," which is defined in Internal Revenue Code (IRC) Sections 2103-2105 and the applicable regulations. U.S. situs property generally includes, but is not limited to, the following types of assets:

1) Real estate and tangible property located in the U.S.
2) Stock in a U.S. corporation & mutual funds
3) Certain U.S. bank deposits
4) Debt obligations of a U.S. person, the U.S., a State, or any political subdivision thereof, or Washington, D.C.
5) Certain intangible personal property, if issued by or enforceable against a U.S. resident, domestic corporation, or governmental unit[2]
6) A retained interest and/or beneficial interest in a trust-owning property situated in the U.S. (even a foreign trust)
7) U.S. life insurance cash surrender value or replacement value of a policy owned by the decedent on the life of another
8) Deferred compensation and pension benefits paid by a U.S. employer

Real estate: If U.S. real estate owned by a nonresident alien is subject to a non-recourse mortgage, then only the equity in the residence will be subject to U.S. estate tax, whereas if the residence has a recourse mortgage on it, the full fair market value of the property will be included in the taxable estate.

Equities: If the nonresident alien is a citizen of a country that has an estate tax treaty with the U.S., then U.S. equities may be exempt from estate tax, and other tax provisions may vary for citizens of that country, depending on the terms of the treaty.

U.S. bank deposits: Personal bank deposits (e.g. cash and certificates of deposit) within the U.S. are normally not considered U.S. sited property under §2105(b), unless such accounts are considered connected to a trade or business in the U.S. operated by the decedent. However, deposits with a domestic branch of a foreign corporation will be considered U.S. situs property if such branch is "engaged in the commercial banking business."[3] Alternatively, deposits with a foreign branch of a domestic corporation or partnership engaged in the banking business generally are not deemed situated in the U.S (even if they were effectively connected to a U.S. trade or business).[4]

Note that when a bank deposit is held by a U.S. bank as the trustee or custodian acting in a fiduciary capacity, those deposits will likely be considered U.S. sited property.[5]

Other cash deposits: Cash deposits with U.S. brokers, money market accounts with U.S. mutual funds and cash in U.S. safe deposit boxes are generally considered U.S. situs property.[6]

Trusts: In general, trust assets are included in the taxable estate of a nonresident alien if they would be included in the taxable estate of a U.S. resident or citizen, under the U.S. estate tax rules (IRC Sections 2033-2038), but only to the assets that are comprised of U.S. situs property (determined at the time of transfer or at the death of the nonresident alien). If the assets are owned by an irrevocable trust created by the nonresident alien decedent, then such assets generally will be exempt from U.S. estate tax, although the three-year "look-back" rule does apply to transfers of U.S. situs assets.

U.S. partnership interests: Neither the Code nor the Regulations specifically address the situs of partnership interests for estate tax purposes (or for gift tax purposes, see below), and the case law and rulings are inconclusive. It is generally accepted that an interest in a partnership that is organized outside the U.S., holds no U.S. assets, and conducts business outside the U.S. is not a U.S. situs asset. However, it also seems reasonable to conclude that a nonresident alien's interest in a U.S. partnership, especially one that owns U.S. situs property or is engaged in a U.S. trade or business, will likely be subject to U.S. estate tax.

Filing Requirement: If a nonresident alien has a gross U.S. estate exceeding $60,000, a U.S. executor will have to file a Form 706NA within nine months of the date of death.

3. NON-U.S. SITUS PROPERTY

Only U.S. sited property owned by a nonresident alien decedent is subject to U.S. estate tax. Code Section 2105 and supporting regulations provide a list of property that is generally considered non-U.S. situs property, including, but not limited to:

1) Life insurance proceeds on the decedent's life
2) Personal bank deposits at a U.S. bank and certain other bank deposits (see page 5)
3) Stock in companies incorporated outside the U.S.
5) Art work on loan for an exhibition
6) Some U.S Treasury debt obligations

Proceeds from life insurance on the nonresident alien decedent's life: Amounts received as insurance on the life of a nonresident alien decedent are not subject to U.S. estate taxes at death. However, if a nonresident alien decedent owns a policy on the life of another, and that policy is a U.S. situs asset, the policy's value will be includible in the nonresident alien's gross estate. If the policy owned by the decedent on another's life is issued by a U.S. company, the policy will likely be includible in the gross estate as either a debt of a U.S. person under the debt obligation rules or as intangible personal property enforceable against a U.S. corporation.

Planning Consideration: Unlike the proceeds of a life insurance policy owned by a U.S. citizen or resident, the proceeds of a policy on the life of the decedent nonresident alien are not included in the decedent's U.S. gross estate, regardless of who owns the policy. Accordingly, a nonresident alien may own the policy on his/her life directly rather than having to transfer ownership of the policy to an irrevocable trust, as is often done for U.S. citizens and residents.

4. GIFT TAX TREATMENT

Unlike the estate tax rules described above, a gratuitous transfer by a nonresident alien of property is subject to U.S. gift taxes only if the property being transferred is real estate or tangible personal property located within the U.S. Consequently, gifts of any intangible property by a nonresident alien, whether or not situated in the U.S. and regardless of its value, would not be taxable.

Gifts of cash & currency: The Internal Revenue Service and the courts have generally taken the position that U.S. or foreign currency or cash situated within the U.S. at the time of the gift will be treated as a tangible asset.[7] Accordingly, a gift by a nonresident alien in the form of a check drawn against a U.S. bank account or a wire transfer of funds into a U.S. account to a U.S. donee may be treated as a transfer of currency.

However, the Service has also ruled that a transfer of cash by a check drawn on a foreign bank and payable by a U.S. bank is not subject to gift tax because it is considered an asset outside the U.S.[8]

Intangible property: Property which is considered intangible personal property and is therefore not subject to federal gift tax when given by a nonresident alien includes: 1) shares of stock issued by a U.S. or foreign corporation, and 2) debt obligations, including a bank deposit, the primary obligor of which is a U.S. person, the U.S., a State, or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government.[9]

Planning Note: Seeing as the gift tax rules compare favorably next to the estate tax rules in the area of intangible property, nonresident aliens may want to consider gifts of intangible property (e.g., stock in a U.S. company) to U.S. citizens, residents or other nonresident aliens rather than holding these assets until death.

Annual exclusion gifts: Nonresident aliens, just like U.S. persons, may avail themselves of the annual exclusion for gifts of present interests. However, unlike U.S. persons, nonresident aliens are not eligible for any lifetime gift tax exemption amount for gifts in excess of the annual exclusion limit.

For 2014, the annual exclusion gift limit per donor is $14,000 to each donee in a calendar year. This threshold increases to $145,000 for gifts to a non-citizen spouse. Note that a nonresident alien cannot use the gift tax marital deduction unless the spouse/donee is a U.S. citizen as of the date of the gift. Where the gift is to a non-citizen spouse, no marital deduction is available (even if the transfer is to a trust that qualifies as a QDOT).

Reporting obligations for donor & U.S. donees: If a nonresident alien makes a taxable gift of U.S. real or tangible personal property that exceeds (or does not qualify for) the annual exclusion amount, the gift must be reported on a Gift Tax Return (Form 709) by April 15 of the following year. In addition, the nonresident alien donor would be responsible for paying any gift tax associated with the transfer. If the Service is unable to collect the required gift tax from the nonresident alien, the onus may be transferred to the donee, as the recipient of the gift.

For U.S. recipients of gifts and bequests that exceed $100,000 in value, the recipient (including trusts) must report the gift/bequest to the IRS on a Form 3520 no later than the date the recipient's income tax return is due (including extensions) for the same tax year as the gift is made.

In determining whether a U.S. person has received gifts during the taxable year from a particular foreign donor in excess of $100,000, the U.S. donee must aggregate gifts from foreign persons that he/she knows or has reason to know are related, within the meaning of § 643(i)(2)(B). For instance, if a nonresident alien mother and father each give their U.S. son $60,000, the gifts are aggregated, the $100,000 reporting threshold is exceeded and the son must report both gifts. Once the $100,000 threshold has been met, the donee must separately identify each gift in excess of $5,000.

Form 3520 is merely a reporting obligation; however, the penalty for failure to report could be severe — 5% of the gift value for each month for which the failure to report continues (not to exceed a total of 25%). No penalty will be imposed if the gift recipient can demonstrate his/her failure to file was due to reasonable cause and not willful neglect. Ignorance of the law is not reasonable cause.

5. GENERATION-SKIPPING TRANSFER TAX (GSTT)

A transfer by a nonresident alien will be subject to GST tax only if it is also subject to U.S. estate or gift tax, which only occurs if it consists of U.S. situs property.[10]

Based on current regulations, nonresident aliens have a $1,000,000 exemption for GST taxes.

6. UNDERWRITING REQUIREMENTS

John Hancock requires that all policy premiums be paid from a pre-existing U.S. bank account and billing address. The premium paying account must exist for purposes other than/in addition to funding life insurance. The policyowner must have a valid U.S. Tax ID (TIN or SSN) or must complete an IRS Form W-8BEN. All solicitation and requirements gathering must occur in the United States. Solicitation is defined as the entire new business process, e.g., illustration, application, completion of underwriting requirements including examinations and policy delivery. All cases are subject to U.S. connection guidelines, which address the need for both the physical and financial U.S. presence for foreign national business. For complete details, please consult our *Seller's Guide to the Global High Net Worth Market (Life-5198)* or visit the Field Underwriting Guide on your firm's John Hancock producer website.

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1. Many of the treaties that exist are many years old and may not apply because of changes in the tax laws of either the respective country or the U.S.
2. Treas. Reg §20.2104-1(a)(4)
3. IRC §2104(c)
4. IRC §2105(b)(2)
5. Rev Rul 69-596
6. IRC §2104(c)
7. Treas. Reg. §25.2511-3
8. PLR 8210055; PLR 200340015
9. IRC §2511(b); Treas. Reg. §25.2511-3
10. Treas. Reg. § 26.2663-2

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