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US TRANSFER TAX PLANNING FOR NON-RESIDENTS

by Randy Spiro

- I. US citizens and US residents are treated the same way for income taxation, estate taxation, gift taxation and generation skipping transfer taxation purposes.
 - A. Exception— Estate Tax Marital Deduction rules where the surviving spouse is a resident or a non-resident alien: The deduction is denied unless the assets pass to a Qualified Domestic Trust. IRC § 2056A.
 1. At least one trustee must be a US citizen or a domestic corporation; the US Trustee must have the right to withhold tax on corpus dissolutions; the trust must meet security requirements (Treasury Regulation 2056-A-2(d) and Rev Proc 96-54) and the Executor must make an irrevocable election on the estate tax return.
 2. Election must be made on the first timely filed return, but if it is not timely filed, it must be made no later than one year after the due date (including extensions).

3. If the assets pass directly to the surviving spouse, she may transfer them to a Qualified Domestic Trust, so long as she does so before the filing of the federal estate tax return. IRC § 2056(d)(2)(B).
4. A Qualified Domestic Trust is not necessary where the assets pass to a spouse and before the federal estate tax return for the deceased spouse is filed the surviving spouse becomes a US citizen, but only if the surviving spouse was a resident at all times between the decedent's death and the date the surviving spouse became a US citizen. IRC § 2056(d)(4).
5. Proceedings to reform a trust to make it a Qualified Domestic Trust must be instituted before the extended due date of the estate tax return. IRC § 2056(d)(5)
6. A US citizen trustee or a domestic corporation trust must be given the right to withhold from distribution the estate tax imposed. It is imposed on distributions from the Qualified Domestic Trust to the non-citizen spouse, of the trust on the value on the non-citizen spouse's death, and on the value of the trust at the time the Trust ceases to meet the trustee or collection of tax requirements. The tax is equivalent to the tax that would have been imposed had the property involved in

the taxable event been included in the deceased spouse's estate.

- a. Income distributions to the surviving spouse and hardship distributions to the surviving spouse are exempted from the tax.

B. Exception—Gift Tax Marital Deduction rule where the surviving spouse is a resident or a non-resident: The deduction is denied except for the first \$100,000 (adjusted for cost of living) per year of gifts to the spouse. IRC § 2523(i)

1. These gifts can be made to a Qualified Terminable Interest Property Trust. This is particularly desirable if the donor is concerned about divorce.

II. Non-residents are taxed differently from citizens and residents for income taxation, estate taxation, gift taxation and generation skipping transfer taxation purposes. But, there are different tests of residency for income taxation (on one hand) and collectively for estate taxation, gift taxation and generation skipping transfer taxation (on the other hand).

A. For income tax purposes, under IRC § 7701(b) an alien is considered a US resident if either of the following is true:

1. Green Card Tax—The individual has been accorded the privilege of residing in the US as an immigrant in accordance with the immigration laws and that status

has not been revoked or administratively or judicially deemed to have been abandoned.

2. Substantial Presence Test—The individual was present in the US for at least 183 days during the calendar year at issue and for an average of 122 days in each year during the during the current and preceding two years (using days present in current year plus one third ($1/3^{\text{rd}}$) of the days present in preceding plus one sixth ($1/6^{\text{th}}$) of the days present in second preceding year.

B. For estate tax, gift tax and generation skipping transfer tax purposes, an alien is a resident if at the time of his death, he was domiciled in the US. A person is domiciled in the US if he lives in the US, even for a brief period, with no definitive present intention of moving therefrom. This is a subjective test. Treasury Regulation 20.0-1(b)(1), 25.2501-1(b).

1. A person can be a US resident for income tax purposes and a non-resident for estate, gift and generation skipping transfer tax purposes. Estate of Nienhuys v Com, 17 TC 1149, 1161, acq. 1952-1 CB 3.

III. Non-Resident Alien (decedent) Estate Tax Issues

- A. The gross estate only includes property situated or deemed situated in the US at his death (per situs rules).

1. In contrast, US citizens and US residents are subject to estate tax on that worldwide assets.
 2. The Executor files form 706 NA with the IRS Service Center, Philadelphia, PA 19255.
- B. Rates are the same as those imposed on estates of deceased US citizens and US residents.
- C. A \$13,000 credit is allowed, which exempts the first \$60,000 of the estate.
- D. Special use valuation under IRC § 2032A is not available.
- E. Community property rules are respected in determining the decedent's gross estate. Rev Rul 72-443, 1972-2 CB 53
- F. The situs of a partnership is determined by where the partnership conducts its business. Rev Rul 55-701, 1955-2 C.B. 836
- G. The IRC § 2040(b) rule that only 50% of a spousal joint tenancy is includable in the first spouse to die's estate is inapplicable where the surviving spouse is a non-citizen. IRC § 2056(d)(1)(B).
- H. The deductions for expenses, losses, indebtedness and taxes are determined by a fraction the numerator of which is the value of the gross estate situated in the US and the denominator of which is the value of all property included in the gross estate. Treasury Regulation 20.2106-2(a)(2)
1. Only a proportionate part of a recourse note secured by a mortgage on US situs property is deductible even

though the mortgaged property is fully includable in the decedent's estate. Where the property is subject to a non-recourse mortgage, only the value of the equity is includable and thus the mortgage is in effect fully deductible.

a. Non-resident aliens should make sure their mortgages on US real estate are non-recourse.

I. The charitable deduction is limited where the donee is a corporation (must be domestic) or is a trust (must be used within US). IRC § 2106(a)(2)(A)

IV. Non-Resident Alien (donor) Gift Tax Issues.

A. Only gifts of real property and tangible personal property situated in the US at the time of the gift are subject to the tax. IRC § 2511(a)

1. The transfer of funds in a US Bank is subject to gift tax because the cash is treated as tangible personal property.

B. No gift splitting (with a spouse) is allowed if either spouse is a non-resident. IRC § 2513(a)(1)

C. No lifetime gift tax credit is available.

D. Rates are the same as the rates imposed on gifts by US citizens and US residents.

E. The \$11,000 per donee annual gift tax exclusion is allowed. IRC § 2503(b).

F. The charitable deduction is limited where the donee is a corporation (must be domestic) or is a trust (must be used within US). IRC § 2522(b).

V. Generation Skipping Transfer Tax

A. Non-residents are allowed to claim the same generation skipping transfer tax exemption as do US citizens and residents and are subject to the statutory automatic allocation of exemption to certain transfer rules. The tax applies where the transferred property is situated in the US for purposes of estate tax laws (transfer at death) or for purposes of the gift tax laws (transfers during life).

Subsequent taxable terminations and taxable distributions are subject to the tax if the original transfer to the trust by the non-resident alien was subject to the tax. Treasury Regulation 26.2663-2.

VI. Special Rules

A. A US person creating or transferring money or property to a foreign trust must report the transfer on IRS form 3520. IRC § 6048(a)

1. A foreign trust is a trust that is not required to include in gross income any income from sources without the US which is not effectively connected with a US trade or business IRC § 7701(a)(31).

2. Transfers for fair market value are exempted (except where there is appreciated property and the transferor

does not immediately recognize the built in gain or
where the transferor is a grantor or a beneficiary of the
trust or is related to the grantor or to the beneficiary).

IRC § 1494, IRC § 643(i)(2).

3. The penalty for failure to report by April 15 of the
calendar year after the transfer is 35% of the amount of
the gross reportable amount.
 4. Offshore trusts must report a US person's gratuitous
transfer on IRS form 3520-A and must furnish the US
grantor and the beneficiaries with forms equivalent to K-
1s by the 15th day of the 3rd month after the end of the
trust's taxable year.
 5. The grantor trust rules will no apply to a non-resident
grantor of a foreign trust even if there is a US citizen or
US resident beneficiary and even if the grantor
becomes a US citizen or resident after the transfer. IRC
§ 679.
- B. US persons receiving distributions from foreign trusts after 8/20/96
who fail to report them on form 3520 must pay a penalty of 35% of
the gross amount of the distribution. IRC § 6677(a)
- C. US persons receiving gifts from non-resident aliens after 8/20/96
must report them on IRS from 3520. IRC § 6039F.

1. But only if the fair market value exceeds \$100,000 in the aggregate during the taxable year. Gift must be aggregated only when they are received from family members. The penalty for late filing is 5% per month, capped at 25%.
2. Gifts to US persons from foreign partnerships or corporations must be reported if in the aggregate they exceed \$10,000 per year.

D. Non-resident aliens should consider making gifts before establishing a US domicile.

1. If the gift is in trust, it should be made more than five (5) years before establishing the US domicile.

VII. Situs rules for Estate, Gift and Generation Skipping Transfer Tax Purposes.

- A. Deposits with domestic banks are treated as situated outside the US unless they are effectively connected with a US trade or business. IRC § 2106(b), IRC § 871 (i)
- B. Portfolio debt obligations issued by US obligors after 7/18/84 and debt instruments of issuers who realize less than 20% of their income from US sources are deemed situated outside the US. IRC § 2105(b)(3).
- C. Life insurance policy proceeds on the life of the non-resident

1. For estate tax purposes they are deemed to be property situated outside the US whether the insurer is domestic or foreign. IRC § 2105(a).
 2. For gift tax purposes they are considered intangible personal property and thus are not subject to gift tax.
- D. Life insurance owned by the non-resident on the life of another.
1. Is includable in the owner's gross estate if the policy was issued by a US insurer.
- E. Annuity contracts have a US situs if the contract rights are enforceable against a US company. Guaranty Trust Co. of New York, 16 BTA 314(1925)
- F. Works of art in the US solely for exhibition, loaned to a non-profit public gallery or museum and on exhibition at the time of the non-resident alien's death are deemed situated outside the US. IRC 2105(c), Treasury Regulation 20.2105-1(b). But if a corollary lifetime gift of such artwork were made, it would be subject to gift tax.
- G. The situs of real property is determined by its physical location. Treasury Regulations 20.2104-1(a), 20-2105-1(a)(1), 25.2511-3(b)(1)
1. US real estate held in a foreign corporation (other than as an agent) is not deemed to be situated in the US,

even if the shares of the foreign corporation are located in the US.

2. Gifts of interests in foreign partnerships or corporations owning US real estate are not subject to gift tax unless the transfer of the real estate to the entity and the gift of the interest in the entity is treated as a step transaction.
- H. The situs of tangible personal property (except as discussed in paragraph F above) is determined by its physical location at the time of the owner's death. Treasury Regulations 30.2105-1(a)(2), 20.2104-1(a)(2) and 25.2511-3(a)(1)
- I. Stock of a domestic corporation is deemed situated within the US and stock of a foreign corporation is deemed situated outside the US. Treasury Regulations 20.2104-1(a)(5), Rev Proc 54-407 1954-2 CB 657