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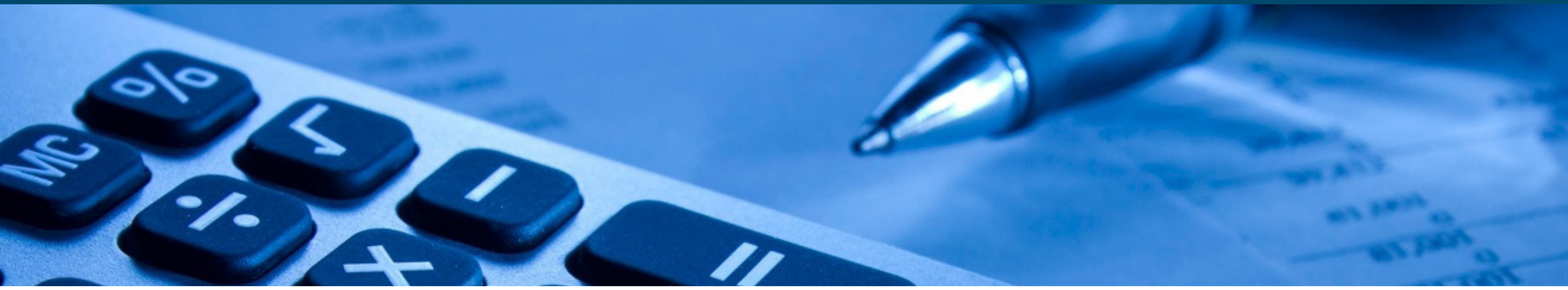

Transfer Tax Basics for Noncitizens

Situation: Over the past few months, there has been a renewed interest in estate planning topics. The increased interest is likely due to the combination of the daily coverage of deaths due to COVID-19, historic high federal exemption amount, and low interest rates. Recently, some of my calls involved the application of U.S. estate tax laws to clients who are not citizens of the United States, but either reside or own property in the U.S. Individuals who reside in the U.S., but are not citizens, could face significant estate and gift tax problems. Advisors can help their clients avoid tax traps by knowing the rules and appropriate life insurance planning techniques. The purpose of this Counselor's Corner is to provide you with a general understanding of the special estate and gift tax rules that apply to noncitizens. This article also contains life insurance planning techniques.

Solution: Before we begin, we need to clearly understand the basic rules and terminology. U.S. transfer taxes are triggered by one of two things – jurisdiction over the person, or jurisdiction over the property.

Jurisdiction over a person arises when the individual is a U.S. citizen or a noncitizen resident (resident aliens). The United States treats noncitizen residents similar to U.S. citizens for transfer tax purposes. This means the U.S. transfer taxes apply, regardless of where the property is located.

On the other hand, if a person is not a U.S. citizen or a U.S. resident, then the only exposure to U.S. transfer taxes is over property that has "situs" within the U.S. In general, U.S. situs includes property that is physically located in the United States and certain property deemed by the Internal Revenue Code to have U.S. situs, regardless of its location. Noncitizen nonresidents (nonresident aliens) will be subject to U.S. transfer taxes only on property that is situs in the U.S. and deemed to have a U.S. situs. Furthermore, nonresident aliens are subject to different U.S. transfer tax rules from those applicable to U.S. citizens and resident aliens.

Since the transfer tax system that applies depends on whether the noncitizen is a resident or nonresident (technically whether the person considers his/her "domicile" to be the U.S.), the first step in any transfer tax planning scenario is to determine whether there is a U.S. domicile for transfer tax purposes. For transfer tax purposes, "domicile" is defined as a "physical presence in the United States coupled with the intention of remaining in the U.S. permanently."

It should be noted that the transfer tax test for residency is not the same test applied for U.S. income tax purposes. Whether a noncitizen will be classified as a resident for transfer tax purposes is subject to a "facts and circumstances" test.

Evidence of being a domiciled U.S. resident can include:

- Location of principal residence and tangible personal property.
- Social, civic and religious membership.
- Place of business.
- Voting registration.
- Time spent in the United States.
- Driver's license.
- Green card application.
- Financial dealings.

It is important to note that for transfer tax purposes, domicile can be established in a short period of time provided there is no current intention of moving.

Transfer Taxation of Resident Noncitizens

If an individual is a citizen or resident noncitizen of the United States, U.S. transfer tax rules will be applied to their worldwide assets (i.e., all property owned by the individual regardless of its location). This is why many individuals attempt to avoid resident status. Resident noncitizens are generally taxed under the same transfer tax rules as U.S. citizens. However, there are special rules relating to the marital deduction and jointly owned property that are explained further below.

Rates

Resident noncitizens are subject to the same estate and gift tax rates applied to U.S. citizens.

Exclusion Amount

Resident noncitizens are treated the same as U.S. citizens with respect to the exclusion amount used to shelter assets from gift and estate taxation.

Annual Exclusion

Both the gift tax annual exclusion ($15,000 in 2020, indexed for inflation) and the ability to split gifts with a spouse are available to resident noncitizens.

Jointly Owned Property

For marriages where one spouse is a noncitizen, jointly owned property is not treated as if each spouse provided equal consideration. If the surviving spouse is a noncitizen, the entire value of the property is presumed to be included in the decedent spouse's gross estate for estate tax purposes. An exclusion is allowed only to the extent that the noncitizen survivor can demonstrate that he/she contributed to the property.

The Marital Deduction

No marital deduction is allowed for gifts to a noncitizen spouse. However, there is a limited exemption if the transfer would otherwise qualify for the marital deduction to a U.S. citizen. For the 2020 calendar year, a maximum of $157,000 per year (indexed for inflation) of spousal gifts can be made to a noncitizen spouse without being subject to gift tax. Furthermore, at death, if a citizen or resident alien spouse leaves property to a surviving spouse who is a noncitizen, the decedent's estate does not receive the marital deduction for the property unless the property passes into a qualified domestic trust (QDOT) or the surviving spouse becomes a U.S. citizen prior to the due date of the estate tax return. (The QDOT provisions and requirements are discussed in detail in a separate section.)

A U.S. citizen decedent with a noncitizen spouse is a common situation. Without proper planning, there can be serious negative tax consequences. Lifetime gifts to a noncitizen spouse are limited by an annual basis ($157,000 in 2020, indexed for inflation). Because of that limitation, shifting assets to a less affluent spouse for the maximum use of the gift tax applicable exclusion amount is a slower process than with a couple where both spouses are U.S. citizens. This fact needs to be considered when designing a gifting plan involving a noncitizen spouse. In addition, gifting is more difficult because the gift tax is applied to "worldwide assets." Therefore, gifts of foreign property from a resident alien to a U.S. citizen, even if made abroad, will be subject to gift taxes. This fact is often a costly surprise to many resident aliens.

The status of a surviving spouse is also an important consideration when designing an estate plan. Transfers at death to a noncitizen need to be planned carefully. A bypass trust is often used for a married couple with significant wealth. The remaining portion of the decedent spouse's estate can avoid taxation at the first death through use of the marital deduction.

Transfer Taxation of Noncitizens Who Are Not Residents

A nonresident noncitizen is generally taxed only on property which has *situs within the United States.* This is a key difference from taxation for resident noncitizens. U.S. situs generally includes property that is physically located in the United States and certain property deemed by the tax law to have U.S. situs, regardless of its location. The application of situs rules depends on the type of property that's transferred and the transfer tax system that's applied.

Situs for Gift Tax Purposes

While nonresident noncitizens are subject to the same gift and estate tax rates applicable to U.S. citizens and resident aliens, **only gifts of real and tangible personal property situated in the United States at the time of the transfer will be taxed for gift tax purposes.**

Nonresident noncitizens can therefore make unlimited gifts of real and tangible property, even to U.S. citizens, as long as this property is deemed to have situs outside the United States at the time the gift is made. Be careful: cash, whether in U.S. dollars or foreign currency, is treated as tangible property, and a nonresident alien will incur gift tax on gifts of cash made within the United States.

Significantly, no gift taxes are imposed on transfers of intangible personal property, even if such property is actually located in the United States. Common examples would include: stock, mutual funds, insurance contracts, and debt obligations. Debt obligations can include deposits with banks, savings and loans, or insurance companies. Capitalizing on these provisions can lead to significant wealth transfer without taxation. Since intangible property is not subject to U.S. gift tax, but subject to U.S. estate tax if located in the United States, a nonresident alien should maximize lifetime gifts of U.S. situs intangible property. In addition, tangible personal property should first be removed from the United States before it is gifted to avoid imposition of U.S. gift tax.

Example

Mr. C is a resident and citizen of England. He has an estate valued at over five million dollars. Two million dollars of this value is in shares of stock in U.S. corporations. If Mr. C dies today, his U.S. stock will be subject to U.S. estate tax because the shares of U.S. stock will be treated as having U.S. situs for estate tax purposes. Significant transfer tax savings could have been realized had Mr. C made a gift of those U.S. shares of stock to his daughter prior to death. Gift tax would not have been applied and the value of the shares would not have been included in his estate at his death.

Life Insurance Planning Pointers

Policy Transfer: Since a life insurance policy is an intangible, a nonresident alien can gift a life insurance policy insuring himself or another without incurring a U.S. gift tax. In addition, since a gift tax does not apply, transferors do not have to worry about the "three-year pullback rule."

Premium Payment: Care must be taken when gifting premium payments. Gifts of cash made within the United States must be limited to the gift tax annual exclusion per donee to avoid the imposition of gift tax. A nonresident noncitizen wishing to assist another in the payment of life insurance premiums may choose to gift the cash to the owner of the policy outside the jurisdiction of the United States, thus avoiding the imposition of U.S. gift tax.

Situs for Estate Tax Purposes

The following is a short summary of some of the major property categories and general situs rules that are applied under the estate tax law related to nonresident noncitizens.

Real Property: Physical location determines situs.

Tangible Personal Property: The situs is determined by its physical location. However, temporary presence is not enough to cause U.S. situs. Currency is deemed to be tangible property, although most forms of monetary instruments are intangible property (stock, bank deposits, life insurance, etc.).

Intangible Personal Property: Includes securities, life insurance, accounts receivable, and debt obligations. Debt obligations include: deposits with banks, savings and loans, or insurance companies.

- *Stock:* Stock issued by a U.S. corporation is deemed to be sitused in the United States. Stock of a foreign corporation has foreign situs, regardless of the location of the stock certificates.
- *Deposits:* Funds held by U.S. banks or U.S. savings and loan associations or deposits with domestic branches of foreign banks are treated as having foreign situs, unless they are effectively connected with a U.S. trade or business. However, deposits in a foreign branch of a U.S. bank will always have foreign situs and the business rule does not apply.
- *Debt Obligations:* Generally, the debt obligations of a U.S. person or a U.S. governmental entity has U.S. situs. There is an exception for all portfolio debt obligations issued by U.S. persons or governmental entities after July 18, 1984, and debt instruments of issuers who realize less than 20% of their income from U.S. sources. Therefore, most U.S. bonds do not have U.S. situs. Debt obligations of non-U.S. persons or governments do not have U.S. situs, even if they are physically located in the United States.
- *Amounts Held by Domestic Life Insurance Companies:* Deposits (including prepaid premiums) held by an insurance company under an agreement to pay interest are deemed to have a foreign situs as long as the amount is not effectively connected to a U.S. trade or business.
- *Life Insurance Proceeds:* Insurance proceeds on the life of a nonresident noncitizen who owned the policy at death are deemed to be property sitused outside the U.S., regardless of the insurance company's country of origin. However, this rule does not apply to a life insurance policy on the life of another person issued by a U.S. carrier and owned by a nonresident noncitizen at death. Such a policy is deemed to have U.S. situs.

Life Insurance Planning Pointers

Wealthy U.S. citizens and noncitizen residents who have insurance policies on their lives must give up "any incidents of ownership" over their policies to ensure the exclusion of the policy's death benefit from their estates. This is usually accomplished through the use of an irrevocable life insurance trust (ILIT) that imposes restrictions on the insured's ability to access the cash value, choose investment options, name beneficiaries, etc. In contrast, a nonresident noncitizen does not have to establish an ILIT to ensure that the policy proceeds will escape U.S. estate taxation. U.S. Code specifically excludes life insurance insuring his/her life from estate tax when he/she holds the policy at death. This additional flexibility makes life insurance an invaluable planning tool for nonresident noncitizens because they have the best of both worlds – access to the policy cash values and no U.S. estate tax. An ILIT would be an appropriate planning tool if a nonresident noncitizen might relocate to the United States in the future.

Summary of Significant Transfer Tax Differences

GENERAL OVERVIEW OF ESTATE, GIFT AND GENERATION SKIPPING SITUS RULES			
Type of Property	**U.S. Citizen**	**Resident Noncitizen**	**Nonresident Noncitizen**
Gift Tax	Worldwide gifts subject to U.S. gift tax.	Worldwide gifts subject to U.S. gift tax.	• Gifts of real and tangible personal U.S. situs property subject to U.S. gift tax. • Gifts of intangible U.S. situs property (e.g., stock, certain deposits and life insurance) and gifts of non-U.S. situs property not subject to U.S. gift tax.
Estate Tax	Worldwide property owned by decedent subject to U.S. estate	Worldwide property owned by decedent subject to U.S. estate tax.	U.S. situs property owned by decedent subject to U.S. estate tax.
GST Tax (generation skipping tax)	Generation skipping gifts or bequests subject to U.S. GST tax.	Generation skipping gifts or bequests subject to U.S. GST tax.	Generation skipping gifts or bequests subject to U.S. gift or estate tax are subject to U.S. GST tax.

SUMMARY OF ESTATE & GIFT TAX RULES BY CITIZENSHIP STATUS					
Decedent/ Surviving Spouse	**Decedent's Exclusion Amount[1]**	**Estate Tax Marital Deduction**	**Decedent's Interest in Property held Jointly with Spouse[2]**	**Annual Marital Gift Tax Exclusion[3]**	**Availability of Gift-Splitting to a Third Party**
U.S. Citizen/ U.S. Citizen	$11,580,000	Unlimited	50%	Unlimited	Available
U.S. Citizen/ Resident Noncitizen	$11,580,000	Only with a QDOT	100%	$157,000	Available
U.S. Citizen/ Nonresident Noncitizen	$11,580,000	Only with a QDOT	100%	$157,000	Not Available
Resident Noncitizen/ U.S. Citizen	$11,580,000	Unlimited	50%	Unlimited	Available
Resident Noncitizen/ Resident Noncitizen	$11,580,000	Only with a QDOT	100%	$157,000	Available
Resident Noncitizen/ Nonresident Noncitizen	$11,580,000	Only with a QDOT	100%	$157,000	Not Available
Nonresident Noncitizen/ U.S. Citizen	$60,000	Unlimited	100%	Unlimited	Not Available
Nonresident Noncitizen/ Resident Noncitizen	$60,000	Only with a QDOT	100%	$157,000	Not Available
Nonresident Noncitizen/ Nonresident Noncitizen	$60,000	Only with a QDOT	100%	$157,000	Not Available

[1] Applicable for 2020.
[2] Unless consideration can be substantiated for the noncitizen surviving spouse portion.
[3] Rates for 2020. Amounts are indexed for inflation.

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Qualified Domestic Trust (QDOT)

As discussed previously, the biggest step that most married couples can take to reduce estate taxes at their death is to qualify property for the marital deduction. By using the marital deduction, a decedent can leave all of his/her property to the surviving spouse and avoid federal estate taxes. However, this process becomes more complex if the surviving spouse is a noncitizen. The U.S. estate tax law requires that a surviving spouse be a U.S. citizen in order to qualify for the unlimited marital deduction. The reason for doing this? Congress does not want a surviving noncitizen spouse to leave the United States with property that has never been taxed. The citizen spouse's estate still benefits from the exclusion amount. However, estate tax will be imposed on everything over this estate tax amount unless the surviving noncitizen spouse is the beneficiary of a special marital trust, called a qualified domestic trust (QDOT).

The qualified domestic trust is essentially a substitute for the marital trust, but with some additional restrictions and covenants. Like a marital trust, a QDOT requires mandatory distribution of the trust's income and allows distribution of principal for "needs." The qualified domestic trust ensures that at the death of the noncitizen spouse, the assets placed in the trust will incur federal estate taxation. Basically, the estate tax is imposed at the surviving spouse's death as if the property had been included in the first spouse's gross estate.

Basic Features of a QDOT Trust

The executor of the decedent's estate must make an irrevocable election on the decedent's U.S. federal estate tax return.

- A QDOT must qualify for the marital deduction.
- At least one of the trustees must be a U.S. citizen or a domestic corporation.
- No corpus (principal) distribution can be made from the trust, unless the U.S. trustee has the right to withhold any federal gift or estate taxes imposed on the trust. Any distribution of principal from the QDOT during the surviving spouse's lifetime will result in the immediate imposition of estate or gift taxes on the amount distributed, unless the distribution is made because of hardship. The additional gift or estate tax is calculated as if the distributed property had been included in the taxable estate of the first spouse to die.
- Additional estate taxes are due at the death of the surviving spouse or sooner if the trust ceases to qualify as a QDOT.
- A QDOT with assets less than $2 million must either meet one of the requirements for a trust exceeding $2 million (see below) or provide that no more than 35% of the fair market value of assets consists of real property located outside the U.S. In addition, all other QDOT assets must be physically located within the U.S. at all times.
- If the fair market value of the assets in the QDOT exceeds $2 million, then the QDOT must provide one of the following:
    1. One of the trustees is a U.S. bank.
    2. At least one trustee is a U.S. branch of a foreign bank and another trustee is a U.S. trustee.
    3. The U.S. trustee must furnish a bond, a security deposit or line of credit equal to 65% of the fair market value of the QDOT principal.

If the surviving spouse is not a U.S. citizen and a QDOT was not created at the death of the first spouse, there are two ways in which this can be rectified:

1. A trust that was created by the decedent spouse and that otherwise qualifies as a marital trust may be revised to satisfy the QDOT requirements. This revision must be completed before the due date of the decedent spouse's federal estate tax return. Or, if it is a judicial revision, action must be taken before the due date.
2. If the surviving spouse receives the property outright, the surviving spouse can create a QDOT and transfer the property to the trust before the decedent's estate tax return is filed.

In addition, the QDOT rules do not apply if the surviving spouse becomes a U.S. citizen before the estate tax return in filed.

What You Need to Know to Underwrite Nonresident Noncitizens

If it is decided that life insurance is needed to complete an estate plan, you need to know how a nonresident's policy will be underwritten. Many factors are taken into account when deciding whether a nonresident may qualify for life insurance in the United States. One of the primary factors is the insured's country of residence.

Sometimes other countries restrict their citizen residents from purchasing life insurance outside of their native country. If so, a U.S. policy is not an option. There may also be U.S. government restrictions regarding life insurance sales to residents of particular countries. Other countries may not have any legal or government restrictions preventing the sale of life insurance to their residents, but the risks presented by those countries (i.e., crime, health and safety standards, political or economic instability, etc.) are considered too significant to price. Thus, carriers will decline to offer coverage.

However, there are many countries whose residents may be underwritten in the United States. The underwriting category for individuals who reside in these countries will vary depending on the risks involved. You will need to make an inquiry or phone call to determine the particular underwriting considerations for a resident country.

You can expedite the underwriting process by understanding the process and providing the needed information. All aspects of the insurance transaction, including solicitation, completion of the application, medical exams, inspection reports, and delivery, must be completed in the U.S. Make sure to allow adequate time to complete the underwriting process and deliver the policy in the U.S. Here is a list of key information the proposed-insured may need to provide:

- What are the insured's "meaningful ties" to the United States? These ties may include, but are not limited to: property ownership, business interests, employment in a U.S. based company, U.S. investments, etc.
- All nonresident must be medically examined and have an inspection report done. Blood tests, motor vehicle reports, EKGs, and chest x-rays will be required based on the carrier's age/amount rules. In addition, all nonresident must provide attending physician statements (APS records).
- The insured will need to provide proof of tax certification. If a social security number can't be provided, a Form W-8 will usually be required.
- Premiums must be paid annually in U.S. currency.
- The insured may not be a candidate for life insurance if currently active in the military, police, government, or judicial services within their resident country. Those with political or union ties may be excluded as well.
- The carrier will ask the insured to provide information on his or her past and future travel patterns. Additional ratings may be assessed.
- Policies owned by third-party foreign persons or entities will seldom be acceptable. With most carriers, all aspects of the insurance transaction must be completed in the United States.

In Summary: Transfer tax planning for noncitizens is a complex area that requires familiarity with many U.S. estate and gift tax rules. In addition, agreements between the United States and the noncitizen's home country may alter or replace the general rules discussed in this article. Legal and tax professionals that are experienced in planning for international citizens should be consulted before implementing any planning strategy.

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