U. S. Estate and Gift Tax Planning for Non-Citizens

The United States is infamous for its high income tax rates and worldwide taxation of its citizens and residents. As a result, many people with homes or assets in the United States have carefully educated themselves about the U.S. income tax rules. However, the U.S. transfer tax system is less well-known. This is unfortunate. The principles that drive efficient U.S. income tax planning do not necessarily result in efficient estate tax planning.

The U.S. transfer tax system is not an inheritance tax. It is a tax on the assets of the transferor, and it applies either when gifts are made during lifetime or when bequests are made at death. The tax rate is forty percent (40%). However, the tax can often be significantly reduced or even eliminated with proactive transfer tax-focused planning. Lifetime transfers are often a key part of this planning.

Transferor's Domicile

The application of the tax derives from the status of the transferor.

For non-citizen transferors, the key question is whether you are a domiciliary of the United States at the time of the transfer. A person is domiciled in the United States if they live here, for even a brief period of time, with no definite present intention of leaving. They retain that domicile until they establish a new domicile elsewhere under the same test.

A U.S. domiciliary is subject to gift and estate tax on his or her worldwide assets, while a nondomiciliary (often referred to as a non-resident, non-citizen or "NRNC") is subject to tax only on assets that have a situs in the United States. The residence of the recipient is irrelevant for imposition of tax purposes (although it may affect whether reporting is required).

This test is different from the test that applies to determine whether a person is subject to worldwide income tax. With limited exceptions, income tax treaties (which provide exceptions and comfort to other countries' citizens and residents with connections to the United States) do not apply in the gift and estate tax context.

Asset Situs and the Advantage of Gifting

It is often beneficial for NRNCs to transfer U.S.-based assets by lifetime gift. This is because the definition of "U.S. situs" casts a much smaller net with respect to transfers made by lifetime gift than with respect to inheritance left by bequest at death. For example, securities in U.S. corporations may be transferred tax-free by lifetime gift, but would be subject to U.S. estate tax if transferred upon death.

Estate planning attorneys with experience in international planning are often able to virtually eliminate U.S. gift and estate taxes by assisting clients with putting in place appropriate structures (often called "blocker entities") to convert U.S. situs property to a nontaxable form. For example, real property or tangible personal property located in the United States, which is always U.S. situs, can be transferred to a corporate entity, which may in appropriate circumstances then be gifted without incurring U.S. gift or estate tax.

Valuation Opportunities

If blocker entities do not fully protect the U.S. assets of an NRNC, lifetime gifting also provides an opportunity to reduce the transfer tax through a planned series of gifts. This is because the U.S. transfer tax valuation principles incorporate discounts for a lack of control and lack of marketability where appropriate. Consider an NRNC who owns an 80% interest in a U.S. corporation that operates a family business; if he holds this entire interest, until death, he is likely to owe estate tax on a value close to 80% of the net asset value of the business. However, if he transfers 40% to his children by lifetime gift, he will obtain two advantages: First, the lifetime transfer will not be subject to U.S. gift tax. Second, the 40% interest remaining in his estate may be valued for estate tax purposes significantly below 40% of the net asset value of the business because the minority share in his estate is not a controlling interest.

With any gifting plan, small details can make a big difference in ensuring that assets have been placed in to tax-efficient structures and that transfers have successfully removed assets from the NRNC's estate. There are a number of principles that can apply to unexpectedly to deem foreign assets to be U.S. situs assets or deem interests that were transferred by gift to still be in the NRNC's estate. Careful, knowledgeable planning is necessary.

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Selection of Beneficiary

If the intended beneficiary of the transfer is a U.S. citizen or domiciliary, or likely to become one, it is often advantageous from a U.S. perspective to place the assets into a trust for the benefit of that individual. A properly written and administered trust can provide the beneficiary with the beneficial enjoyment without subjecting them to taxation in the beneficiary's estate.

Income Tax Planning

In the United States, the transfer of assets by gift or upon death is not a taxable event. However, a careful estate plan will seek to reduce the beneficiaries' income tax on income earned by the transferred asset or upon the sale of the asset.

For example, with proper planning, the assets of an NRNC can receive a "step up" in income tax basis for U.S. purposes at the NRNC's death, thereby effectively eliminating all built-in gain that accrued during the NRNC's lifetime and reducing the beneficiaries' tax bill when they sell the asset. This can be true even where the assets are effectively shielded from the U.S. transfer tax.

It is also necessary to ensure that planning structures that are subject to punitive U.S. income tax regimes – such as foreign corporations owned by U.S. persons or foreign trusts held for the benefit of U.S. persons – do not remain in place after the gift.

Reporting

It is not necessary for an NRNC to report a gift of non-U.S. situs assets. However, in certain circumstances it may be advisable to do so. In addition, the beneficiary may need to report the gift.

Assistance of Experienced U.S. Tax Counsel

For NRNCs with assets or family members in the United States, the assistance of a U.S. estate planning attorney with international tax planning experience is vitally important. An experienced attorney can help evaluate your exposure to the U.S. estate tax, review relevant tax treaties, form "blocker entities" to convert U.S. situs assets to non-U.S. situs assets without running afoul of punitive income tax regimes, form a trust to hold assets for the benefit of U.S. family members, and assist you and your loved ones with properly reporting gifts.

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