<u>ESTATE TAX CONSEQUENCES OF INTERNATIONAL TRANSACTIONS</u>:

by

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1. INTRODUCTION AND OVERVIEW

In most foreign countries, wealth transfer taxes imposed upon the recipient are in the form of an inheritance tax. The United States estate tax, however, is “neither a property tax nor an inheritance tax. It is a tax imposed upon the transfer of the entire taxable estate and not upon any particular legacy, devise, or distributive share.” Regs. § 20.0-2. It is a tax on the privilege of transferring wealth not on a particular property interest, even though fair market value is the basis upon which the estate tax is imposed. Consider the following example from the Regulations.

In the case of a burial plot, the plot has value immediately before death, but only that portion of the burial plot in which the decedent is not buried has value for purposes of the estate tax since the portion in which the decedent is buried is non-transferable.

2. JURISDICTION

The United States estate tax applies to the following:

- <u>citizens</u> of the United States, no matter where they live and no matter which other citizenships they may have; and

- to all who are <u>residents</u> of the United States, including certain illegal immigrant aliens.

In addition, the estate and gift tax applies to any transfer of assets by a nonresident, not a citizen, deemed to be situated in the United States, as determined by the United States. IRC § 2101(a)

<u>PLANNING NOTE</u>:
In determining the assets which are subject to estate taxation under the United States tax system, please note the word "includibility," does not necessarily mean taxable since there are deductions and exemptions that are to be discussed later.

(a) CITIZENSHIP AND RESIDENCY

IRC § 2001 provides:

"A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States."

The term "citizen" is not defined in the Internal Revenue Code nor does the Internal Revenue Code define the term "resident" in the estate tax sections.

Under the estate tax regulations, the term "resident" means domiciliary as opposed to a resident.

<u>PLANNING NOTE</u>:
The estate tax will apply in the case of any citizen of the United States, even if the citizen has never lived in the United States and none of the decedent's property is located in the United States.

(b) WHO IS A U.S. CITIZEN?

Under 8 USC § 1101, provides the following:

A person is a citizen of the United States at birth if the person was born (a) in the United States and subject to the jurisdiction thereof; (b) in the United States to a member of an Indian, Eskimo, Aleutian, or other aboriginal tribe; (c) outside of the United States and its outlying possessions of parents, both of whom are citizens of the United States and one of whom has a residence in the United States or one of its outlying possessions prior to the birth of such person; (d) outside of the United States and its outlying possessions of parents, one of whom is a citizen of the United States, who has been physically present in the United States or one of its outlying possessions for a continuous period of one year prior to the birth of such person and the other of whom is a national, but not a citizen of the United States; (e) in an outlying possession of the United States of parents, one of whom is a citizen of the United States who has been physically present in the United States or one of its outlying possessions, for a continuous period of one year at any time prior to the birth of such person; (f) of unknown parentage found in the United States while under the age of five years, until shown, prior to his attaining the age of 21 years not to have been born in the United States; (g) outside the geographical limits of the United States and its outlying possessions of parents, one of whom is an alien and the other a citizen of the United States who, prior to the birth of such person, was physically present in the United States or its outlying possessions, for a period or periods totaling not less than five years, at least two of which were after attaining the age of 14 years. In addition, 8 U.S.C. § 1431 converts automatic citizenship upon a child under the age of 18 who was born outside the United States to one citizen parent and one alien parent which the child is living and (legal and physical custody), the citizen parent in the United States having obtained lawful admission for permanent residency.

(c) RESIDENCY

The Internal Revenue Code does not contain a definition of resident, but the Regulations provide the following definition:

"A resident decedent is a decedent who, at the time of his death, had his <u>domicile</u> in the United States… 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 affect such a change unless accompanied by absolute removal." Regs. 20.0-1(b)(1)

<u>PLANNING NOTE</u>:
This is a subjective test based upon "intent."

(d) GREEN CARD HOLDERS

The holder of a so-called green card will generally be considered a domiciliary of the United States since one of the requisites to obtaining a green card is the "intention to reside permanently in the United States."

(e) ILLEGAL ALIENS

An illegal alien can be a domiciliary subject to the estate tax rules. In Rev. Rul. 80-209, the IRS ruled that an illegal alien who lived in the United States for 19 years until his death with his wife, who entered illegally and remained in the United States illegally, were domiciled, subject to the estate tax.

3. NON-RESIDENT ALIENS (NRA)

(a) ESTATE TAX RULES

IRC § 2101 – Tax Imposed
IRC § 2102 – Credits Against the Tax
IRC § 2103 – Definition of gross estate
IRC § 2104 – Property within the United States
IRC § 2105 – Property outside the United States
IRC § 2106 – Taxable Estate
IRC § 2107 – Expatriation to avoid tax

(b) GIFT TAX RULES FOR NRAs

IRC § 2501(c)(1): Taxable Transfers

A gift tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual resident or non-resident.

IRC § 2050(a)(2):

Except as provided in Paragraph (3), Paragraph (1) shall not apply to the transfer of taxable property by a non-resident not a citizen of the United States.

IRC § 2501(a)(3): Exceptions

Paragraph (2) shall not apply in the case of a donor to whom § 877(b) applied for the taxable year which includes the date of the transfer.

IRC § 877 **–** Expatriation to Avoid Tax (Estate & Gift Tax)

Every non-resident alien individual to whom this section applies and who, within the 10-year period immediately preceding the closing of the taxable year, lost United States citizenship shall be taxable for such taxable year in the manner prescribed in subsection (b) if the tax imposed pursuant to such section exceeds the tax which, without regard to this section, is imposed pursuant to Section 871.

(c) NRA ESTATE TAX RULES

In IRC § 2101(a) provides:

"Except as provided in Section 2107, a tax is hereby imposed on the transfer of **the taxable estate determined as provided in Section 2106 of every decedent non-resident not a citizen of the United States**.

IRC § 2103: Definition of Gross Estate

The value of the Gross Estate of every NRA shall be that part of his gross estate (determined as provided in IRC § 2031) which, at the time of his death, is situated in the United States.

IRC § 2106(a) provides:

"*Definition of Taxable Estate*: For purposes of the tax imposed by Section 2101, the value of the taxable estate of every decedent non-resident not a citizen of the United States shall be determined by deducting from the value of that part of his gross estate which, at the time of his death, is situated in the United States… the following deductions…"

Reg. 20.0-1(b)(2) provides:

A non-resident decedent is a decedent who, at the time of his death, had his domicile outside the United States.

<u>PLANNING NOTE</u>:
The NRA's gross estate is limited to "that part of his gross estate which, at the time of his death, is situated in the United States." For the NRA, only assets that are deemed to have their situs in the United States are subject to the U.S. gift, estate and GST taxes, although the general rules of IRC § 2031 apply to determine in the first instance whether the asset would be includible in the estate of the decedent (which necessarily implicates the usual includibility sections of IRC § 2036, § 2037, § 2038, and § 2041).

(d) SPECIAL RULES

(1) <u>Choice of Law, Foreign Jurisdictions</u>:

In determining whether the decedent has a property interest, the United States federal tax will look to local law to determine whether the decedent had a particular property interest. In *<u>Estate of Vandenhoeck v. Commissioner</u>*, 4 T.C. 125 (1944), acq. 1944 C.B. 29, and in *<u>Estate of Simon v. Commissioner</u>*, 40 B.T.A. 651 (1939), acq. 1942 C.B. 5, the Tax Court held that only one-half of the decedent's stock ownership would be included in the decedent's United States estate because the ownership interest was to be determined by the laws of France and Spain, respectively, where it was determined that the surviving spouse (wife) had a vested right to one-half of the property.

(2) <u>Jointly Owned Property</u>

The general rule applicable to United States citizens and residents is that one-half of property owned jointly with a spouse will be includible in the estate of the first spouse to die. If, however, the surviving spouse is not a United States citizen, then the entire value of the property is includible in the estate of the first spouse unless the surviving spouse can prove contribution. (IRC § 2056(d)(1)(B) provides that if the surviving spouse is not a United States citizen, then IRC § 2040(b) will not apply.)

(e) REAL ESTATE

Real property located in the United States is property subject to estate taxes for an NRA. Regs. 20.2104-1(a)(1).

<u>PLANNING NOTE</u>:
The NRA may consider purchasing property in the United States through a non-U.S. corporation as if they would not own "real" property located in the United States.

(f) TANGIBLE PERSONAL PROPERTY

Tangible personal property located in the United States, except certain works of art on loan for exhibition, are property of an NRA. Regs. 20.2104-1(a)(2).

(g) CORPORATE SECURITIES

IRC § 2104; provides "Stock in Corporation." For purposes of this subchapter, shares of stock owned and held by a non-resident not a citizen of the United States, shall be deemed property within the United States only if issued by a domestic corporation. Regs. 20.2104-1(A)(5).

PLANNING OPPORTUNITY:
In an unusual glitch, IRC § 2501(a)(2) provides that lifetime gifts of U.S. securities by NRAs are excluded from the U.S. gift tax (but would not be excluded from the estate tax).

(h) BANK DEPOSITS

- In general, bank deposits are not subject to estate taxes by the NRA, unless the interest paid thereon would be subject to U.S. income taxes as effectively connected with the conduct of a trade or business within the united states. IRC § 2105(b)(1); 871(i)(3).

- IRC § 2105(b)(1) excludes from the estate tax "amounts described in IRC § 571(i)(e) if any resident therein could not be subject to tax by reason of IRC § 871(i)(1) were such interest received by the decedent at the time of his death.

- All other amounts on deposit in the U.S. are includible. In *Estate of Ogarrio v. Commissioner*, 40 T.C. 242 (1963), cash in the decedent's brokerage account was not a bank deposit because the brokerage house was not a bank.

- Bonds issued by U.S. entities are not included in the estate of an NRA. This includes treasury bonds, municipal bonds, and corporate bonds, unless the NRA owns more than 10% or more of the total combined voting power of all classes of stock. IRC § 2105(b)(3).

(i) TRANSFERS, REVOCABLE TRANSFERS & TRANSFERS WITHIN THREE YEARS OF DATE OF DEATH

(1) IRC § 2104(b) "Revocable Transfers and Transfers Within Three Years of Death" For purposes of this sub-chapter, any property of which a decedent has made a transfer, by trust or otherwise in the meaning of IRC § 2035 to IRC § 2038, inclusive, shall be deemed to be situated in the United States, if so situated either at the time of the transfer or at the time of the decedent's death.

4. PROPERTY WITHOUT THE UNITED STATES

(a) LIFE INSURANCE PROCEEDS

IRC § 2105 provides:

"*Proceeds of Life Insurance*: For purposes of this sub-chapter, the amount receivable as insurance on the life of a non-resident not a citizen of the United States shall not be deemed property within the United States.

(b) PARTNERSHIP INTERESTS

Partnership interests are not listed as property within the United States under IRC § 2104, nor do they appear in the "without" section under IRC § 2105. The argument is that the partnership is more like a corporation and therefore would be exempt from the U.S. gift tax with respect to non-resident aliens.

5. RATES OF TAX & UNIFIED CREDIT FOR NRAs

The estate tax rate for NRAs are the same rates as are applicable to a resident or a citizen, but the unified credit is limited to $13,000 with an exclusion amount of only $60,000 (with no increase for inflation). IRC § 2102.

6. MARITAL DEDUCTION

The NRA is entitled to a marital deduction assuming the bequest to the spouse otherwise would be eligible for the marital deduction. (If the surviving spouse is not a United States citizen, the QDOT rules must apply.)

In order to be eligible for the marital deduction, any bequest to a surviving spouse who is a non-citizen spouse must comply with IRC § 2056(a), which defines a qualified domestic trust (QDOT). In general, the trust must require that at least one trustee of the trust be an individual citizen of the United States or a domestic corporation and such trust must provide that no distribution, other than a distribution of income, may be made from the trust unless a trustee, who is an individual citizen of the United States or a domestic corporation, has the right to withhold from such distribution the tax imposed by this section on such distribution.

PLANNING NOTE:
Even though the estate tax is repealed during 2010, principal distribution from a QDOT will continue to be taxed until January 1, 2021. In the event the amount of assets passing, treated, or deemed to have passed to the QDOT exceeds $2,000,000 as of the date of the decedent's death, a bank trustee must be used.

7. EXPENSES

IRC § 2053 allows deductions for funeral expenses, administration expenses, and claims against the estate, provided they are allowable by whatever jurisdiction in which the estate is being administered and further limited to the ratio that the U.S. assets bear to the total of worldwide assets. Code § 2106(a)(1).

8. MORTGAGE DEDUCTIONS & INDEBTEDNESS

Section 20.2053-7 provides that:

"A deduction is allowed from a decedent's gross estate on the full unpaid amount of a mortgage upon, or any other indebtedness in respect of, any property of the gross estate… provided the value of the property undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate."

9. REPORTING MECHANISM: USE FORM 706-NA

10. RECEIPT OF FOREIGN GIFTS

(a) SMALL BUSINESS TAX ACT OF 1996; HISTORICAL REFERENCE

A foreign grantor would create a trust for a U.S. relative that qualified as a grantor trust under U.S. income tax rules. Since the grantor was not a U.S. citizen, there would not be any actual U.S. income tax paid by the grantor and distributions to the U.S. beneficiary would be free of income taxes.

In 1996, these rules were changed by the Small Business Tax Act of 1996 by defining a "foreign trust" and a "U.S. Trust." In simple terms, in order to be a U.S. trust, "(1) a court within the United States is able to exercise primary supervision over the administration of the trust, and (2) one or more U.S. persons had the authority to control all substantial decisions of the trust." IRC § 7701(a)(30)(E). A "foreign trust" is defined as "any trust other than a trust described in sub-paragraph (e) of paragraph 30.

Any transfers by a U.S. person to or distribution to a U.S. person from a foreign trust must be reported on IRS Form 3520-A. Additionally, IRS Form 3520-A must be filed each year by any foreign trust that has at least one U.S. owner, as defined in IRC § 671 through IRC § 679.

(b) ASSET PROTECTION TRUSTS

These trusts form the basis for the development of the domestic asset protection trusts and are discussed elsewhere.

(c) RECEIPT OF FOREIGN GIFTS

In general, there is no gift tax imposed upon the recipient of a gift. In the case of a NRA giving assets that are not deemed situated in the United States, there is no U.S. gift tax, the recipient does not owe any U.S. tax attributable to the receipt, but there is a reporting requirement under Section 6039(F), which was added by the 1996 Code. Specifically, Code Section 6039(F) provides:

"*Notice of large gifts received from Foreign persons (a) In General*: If the value of the aggregate foreign gifts received by a U.S. person (other than an organization described in Section 501(c)(3)(charities) and exempt from tax under Section 501(A)), during any taxable year exceed $10,000, such U.S. person shall furnish (at such time and in such manner as the secretary shall prescribe) such information as the secretary may prescribe regarding each foreign gift received during such year.

<u>PLANNING NOTE</u>:
By Regulation, the amount was increased to $100,000. Use Form 3520. This form is required to be filed by April 15 of the year following the year in which the gift was received and the failure to file is a penalty equal to 35% of the gross value of the transfer to the U.S. person.

11. THE EXIT TAX

Buried in legislation entitled "Heroes Earning Assistance and Relief Tax Act of 2008," which was effective on June 17, 2008, a new section entitled "Revision of Tax Rules on Expatriation" became effective imposing for the first time an "exit tax." In general a tax is imposed on wealthy persons who (1) give up U.S. citizenship and, in some cases, green cards, as if they sold all of their assets on the previous day with an exemption of $600,000; (2) there are some exempt assets and a deferral; and (3) a new gift or estate tax was imposed on a U.S. person who receives a gift or a bequest from an expatriate (at the highest rate with only the annual exclusion available).

(a) *Definition of "wealthy"*: The term "wealthy" is defined to include anyone where (a) the average annual net income tax of such individual for the period of five taxable years ending before the date of loss of U.S. citizenship is greater than $124,000 (with cost of living adjustments); or (b) the net worth of the individual as of such date is $2,000,000 or more.

(b) *Definition of "expatriate":* Any long term resident of the United States who ceases to be a lawful permanent resident of the United States (within the meaning of Section 7701(b)(6)). This generally means any person who were lawful permanent residents in at least eight taxable years during the period of fifteen years ending with the taxable year in which the expatriation occurs. IRC § 877(e)(2)

(c) *Amount of Tax*: Any applicable expatriate is treated as having sold all of the persons assets on a worldwide basis on the day before expatriation at its full fair market value. There is a $627,000 (2010) exclusion and the exit tax is essentially an income tax.

PLANNING NOTE:
The 2008 Act adds a new Chapter 15, "Gifts and Bequests from Expatriation." The new tax applies to gifts or bequests made to a U.S. citizen or resident by a "covered expatriate." This tax is computed at the highest wealth transfer tax rates in effect on the date of such receipt. A "covered expatriate" has the meaning given to such term by IRC § 877A(g)(1).

IRC § 877(a) provides:

(a) Treatment of Expatriates

(1) In general

Every non-resident alien individual to whom this section applies and who, within the 10-year period immediately preceding the close of the taxable year, lost United States citizenship shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection (after any reduction in such tax under the last sentence of such subsection) exceeds the tax which, without regard to this section, is imposed pursuant to Section 871.

(2) Individuals subject to this section

This section shall apply to any individual if –

(A) the average annual net income tax (as defined in section 38(c)(1)) of such individual for the period of 5 taxable years ending before the date of the loss of United States Citizenship is greater than $124,000 ($136,000 for 2010),

(B) the net worth of the individual as of such date is $2,000,000 or more, or

(C) such individual fails to certify under penalty of perjury that he has met the requirements of this title for the 5 preceding taxable years or fails to submit such evidence of such compliance as the Secretary may require.

This section applies to any United States citizen who renews citizenship or a permanent resident alien who relinquishes such state after being a permanent resident alien of 8 of the last 15 years.

12. FOREIGN DEATH TAXES & U.S. CREDITS

Inasmuch as the decedent was subject to the United States estate tax system, they may also be subject to a wealth transfer tax in anther country attributable to property located in that country, the United States will afford to the decedent's estate a tax credit for any "estate taxes paid in the foreign jurisdiction" unless a treaty governs.

PLANNING NOTE:

I*t is important that the tax in the foreign country be the equivalent of an estate tax to be eligible for the credit. In Canada, for example, the tax is in the nature of an income tax so it would not, in the absence of a treaty, be eligible for a credit.*