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

Tips on Protecting Your Loved Ones and Your U.S. Assets

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Introduction

If you or your spouse or family members hold U.S. assets such as real estate in the United States, you may have made an excellent investment. Interest rates are relatively low, real estate prices are relatively low, and sellers seem to be competing for buyers.

With thoughtful estate tax planning, you can protect these valuable assets and transfer them to loved ones. Smart planning is essential because federal estate and gift tax laws impose onerous restrictions on non-citizens (even if the non-citizen has a “green card”). Read this guide and contact us for more information.

Why putting off international estate tax planning is costly – especially for loved ones

It is tempting to put off estate tax planning, especially if you and your family members are healthy and happy. Don’t.

No one likes to think about dying someday. Some people consider it bad luck to discuss death. But family members who have come to the United States from elsewhere may find U.S. tax law quite different than what they were used to.

It’s important to set aside our emotions and consider a key fact: Federal estate and gift tax laws impose onerous restrictions on non-citizens (even if the non-citizen has a “green card”).

For example:

- Outright gifts during your lifetime to a non-U.S. citizen spouse – including making them joint owners of your real estate, stock, and bank accounts – can trigger gift tax problems immediately.

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- Or consider a non-resident non-citizen with no green card who bought a $1.5 million house with cash, intending to leave it to one of his children through a will or trust. That could trigger an estate tax of $495,000. With advice from an expert in estate planning, the family can avoid that tax bill.

- Likewise, gifts at death to a non-citizen spouse may not qualify for the "unlimited marital deduction." Your unsuspecting widow or widower may be forced to pay hundreds of thousands of dollars in estate taxes shortly after your death.

- If an investor buys a $1.5 million property in U.S. and dies owning it without ever having put it in a trust, the probate cost alone could be as much as $28,000. If that investor also happens to be a non-resident alien, the estate taxes could be $495,000.

The situation is even more challenging if either you or your spouse is a non-resident alien (or if s/he decides to move back "home" after your death, whether the green card is surrendered or not). Even if your estate is relatively modest, the tax effects can be devastating.

Accountants and attorneys each have an important role to play

Accountants may know a lot about keeping track of your money, but estate planning isn't their primary job. A real estate agent won't be an expert on tax law. A title company can't tell you the best way to pass your real estate assets to loved ones.

By working with an attorney experienced in international estate planning law, you can get all your questions answered and gain peace of mind that your loved ones will not face a snarl of tax issues down the road.

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If you own property outside of the United States, it's even more important to have a network of experts to call upon when you have an issue. Not all countries recognize trusts and other tools that work within the United States.

Smart estate tax planning doesn't take as much time as you might think, and typically pays for itself by lowering your exposure to tax liability. Read on to find out how.

Key tax issue: where is "home"?

Why planning your estate is more complicated if you are a not a U.S. citizen or not a U.S. resident or if your spouse is not a U.S. citizen

If you are a not a U.S. citizen or if your spouse is not a U.S. citizen, planning your estate is more complicated because the estate tax and gift tax laws for non-citizens can be very different than they are for citizens. If you are a not a citizen for estate and gift tax purposes, you must take care in planning your estate in order to minimize gift and estate taxes.

Definitions of residency and domicile

The first huge difference in the treatment of non-citizens comes in area of estate and gift tax law.

The IRS has two definitions for residency: one for income tax purposes and another for estate and gift tax purposes.

For income tax purposes, residency is defined as having a "presence" in the U.S.

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For gift and estate tax purposes, residency is defined as, "an intent to remain in a place indefinitely with no intention to move away from it." You can have many countries of residence, but for estate and gift tax purposes, you can have only one country of "domicile". And your country of domicile will determine how the U.S. will tax your estate.

Non-citizen exemption limits

Currently, U.S. citizens enjoy a $5.4 million exemption from both estate and gift taxes (at least in 2015).

Many non-citizens are limited to an estate and gift tax exemption of only $60,000.

The key question is where the non-citizen considers home or "domicile" to be. If a non-citizen does not consider the U.S. to be his home country, he can only claim a $60,000 estate and gift tax exemption.

To determine where a non-citizen's home is located for estate and gift tax purposes, the IRS uses a "facts and circumstances" test, which includes a review of the non-citizen's Visa status; the locations and values of other residences (real property); where his or her family members and close friends live; where his or her personal property is located - especially valuable items like fine art, currency, cash, stocks, and bank accounts; the location of the non-citizen's business interests; where the non-citizen is registered to vote and licensed to drive; where the non-citizen has his or her primary residence; and where he or she intends to be buried.

If a person is neither a citizen of the U.S. nor considered to be domiciled in the U.S. (a non- resident alien or "NRA") for gift and estate tax purposes, then the only assets which would be subject to U.S. gift and estate taxes are those situated in the United States.

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Special rules for non-citizens

If citizenship is an option, now may be the time to take the plunge

If you or your spouse is not a U.S. citizen, it's essential that you inform your estate planning advisors and discuss the implications. The federal estate tax laws impose several onerous restrictions on non-citizens, so if citizenship is an option, now may be the time to take the plunge.

Marital deduction restricted

For most couples, the unlimited marital deduction is a key estate planning tool. It allows you to transfer any amount of property to your spouse, through lifetime gifts or bequests at death, free of gift and estate taxes. Eventually, of course, these assets may be taxed as part of the recipient spouse's estate.

Congress was concerned, however, that a non-citizen surviving spouse might leave the country with the assets and they would escape taxation altogether. To avoid this situation, Congress provided that when a surviving spouse is a non-citizen, the marital deduction is unavailable unless the assets are placed in a special trust called a Qualified Domestic Trust (QDOT). Assets the non-citizen spouse receives outright — including jointly owned property, life insurance proceeds and retirement benefits — are taxable immediately (depending on their value) unless the non-citizen spouse creates his or her own QDOT to hold the assets.

Ideally, the decedent spouse's will or trust will include a provision for the creation of the QDOT. However, if it doesn't, and it leaves everything to the non-citizen surviving spouse outright, he or she can establish the QDOT after the decedent spouse's death and add the assets he or she inherited from the decedent spouse to the QDOT after its creation.

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QDOT has many rules

The purpose of a QDOT is to ensure that, when a citizen's estate escapes taxation by virtue of the marital deduction, the United States ultimately collects taxes on the non-citizen spouse's estate. The law requires qualified domestic trusts to contain certain features. To qualify, therefore, a trust must:

- Have at least one trustee who is an individual U.S. citizen or a domestic corporation (for example, a bank or trust company), with the ability to withhold any estate taxes which would be due after each distribution from the trust
- Require the trustee to approve all distributions of "principal" from the trust
- Be designated as a QDOT by an election on the citizen spouse's federal estate tax return, and
- Retain enough property in the U.S. to cover any estate tax payable at the non-citizen spouse's death

In addition, if the QDOT assets are worth more than $2 million, the U.S. trustee must be a domestic bank or, alternatively, the individual U.S. trustee must furnish the IRS with a bond or letter of credit in an amount equal to 65% of the QDOT's value.

QDOT provides limited benefits

Even though you can preserve the marital deduction with a QDOT, non-citizen spouses are still at a big disadvantage. Most couples' estate plans include a marital trust, which provides for the surviving spouse and is sheltered from tax in the decedent's estate by the unlimited marital deduction. A surviving spouse who's a citizen can receive distributions of both income and principal from a marital trust without negative tax consequences. He or she can even deplete the marital trust and avoid estate taxes on the assets by spending them or giving them away using the annual gift tax exclusion.

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When the surviving spouse dies, assets remaining in the marital trust are taxed as part of his or her estate, but they can be sheltered from tax by the surviving spouse's estate tax exemption.

With a QDOT, it's a different story. Although a QDOT can distribute income free of estate taxes, distributions of principal to the non-citizen spouse are subject to estate tax (except in cases of hardship, which is not clearly defined in the Internal Revenue Code or regulations). The amount of tax is the additional federal estate tax that would have been imposed on the citizen spouse's estate if it had been increased by the amount of the distribution. Because of this, the non-citizen spouse can't avoid estate tax by spending the principal or giving it away.

In addition, when the non-citizen spouse dies, assets remaining in the QDOT will also be taxed as if they had been included in the citizen spouse's estate. That means the non-citizen spouse can't shelter the QDOT assets from estate tax by using his or her own estate tax exemption.

Example: sharing the wealth is more difficult

A basic estate planning principle is that each spouse should have assets in his or her own name roughly equal to the federal estate tax exemption. The reason for this is to avoid wasting either spouse's exemption. (There may be asset protection benefits as well.)

Here is an example:

Harry is married to Wilma, who is not a U.S. citizen.

Harry owns $6 million in assets, but Wilma has no assets in her name.

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Wilma predeceases Harry.

When Harry dies, the excess of the $6 million over his federal estate tax exemption ($1.5 million in 2005; $2 million in 2006, 2007, & 2008; $3.5 million in 2009; $5 million in 2011 and 2012 and back down to $1 million in 2013) is subject to estate tax.

If the assets had been divided equally between them, Wilma could have used her share to fund a bypass trust for Harry's benefit. The $3 million placed in the bypass trust would be sheltered from estate tax by Wilma's exemption and would not be included in Harry's estate when he dies. Harry's share of the assets would be sheltered from tax by his estate tax exemption.

But because Wilma isn't a citizen, equalizing the assets between the couple would have been problematic.

Ordinarily, when one spouse owns a disproportionate share of the wealth, the simple solution is for that spouse to transfer assets to the other spouse estate and gift tax-free under the unlimited marital deduction. The solution isn't so simple, however, when the transferee-spouse is a non-citizen. Because the unlimited marital deduction is unavailable, the transfer would be subject to gift tax.

In 2015, there is a $147,000 annual gift tax exclusion (indexed annually for inflation) for gifts to a non-citizen spouse, but it could take many years to build up that spouse's estate to an amount that equals the federal estate tax exemption (especially as the exemption rises). If the non- citizen spouse dies before that happens, then all or a portion of his or her federal estate tax exemption may be wasted.

Citizenship has its advantages

A non-citizen surviving spouse can avoid the QDOT requirements by becoming a U.S. citizen before the estate tax return is due (the non-citizen spouse must also maintain U.S.

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residency continuously until s/he becomes a U.S. citizen). However, any distributions from the QDOT will be taxed unless the non-citizen surviving spouse becomes a citizen before the estate tax return is filed. After the non-citizen surviving spouse becomes a citizen, the remainder of the assets in the QDOT can be transferred to him or her outright or transferred to a qualified terminable interest trust (QTIP) tax free.

Clearly, there are significant tax advantages to being a U.S. citizen. Attaining citizenship can be time-consuming, so if you or your spouse has been putting it off, consider consulting an immigration attorney and beginning the process as soon as possible.

Citizenship has its disadvantages

In some cases creating a foreign corporation to hold property and assets can avoid the estate taxation issue altogether. There are certain disadvantages to having a foreign corporation own property related to capital gains taxes, and each case will have to be considered individually to see what works best for each situation.

Consider annual gifts as an option

Another way to avoid the QDOT requirement is for the U.S. citizen spouse to make annual gifts to the non-citizen spouse. In 2011, a spouse can make an annual gift of $136,000 to a non-citizen spouse and it won't be subject to gift taxes. A non-citizen spouse can make unlimited gifts to his or her U.S. citizen spouse. Such gifts are not subject to gift taxes.

Choosing a guardian for minor children

The courts are concerned about losing jurisdiction over a child

Another matter that requires careful consideration is choosing a guardian for your minor children. For a non-resident or international client, this decision can be even more

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difficult because the primary candidates may all live abroad.

Under California law, a person can nominate a foreign guardian in his or her will. However, that nomination is not binding on the court. This means that California courts have the authority to disregard the election of a foreign guardian and appoint a U.S. citizen instead (Note: although this guide is meant primarily for Californians, it's important to note that not all states permit the appointment of a foreign guardian. So if you live outside of California, it's imperative that you find out whether your state will permit you to appoint a guardian who does not live in that state or who is not a U.S. citizen).

Giving the foreign guardian the authority to petition

In instances where the child's only relatives live abroad, it's possible that a child could be placed in foster care if a California court is unwilling to appoint a foreign guardian. It's important that your will should set forth in detail why appointment of a foreign guardian is in the best interests of the child.

Nominating a temporary guardian is especially important

As a non-resident, it's also imperative that you nominate a temporary guardian. This will ensure that your minor children don't end up in foster care while your foreign guardian's petition for guardianship is pending in the local court. The temporary guardian would also be able to care for the children while the foreign guardian petitions for guardianship in his or her country.

It's also important to include provisions in your will giving the foreign guardian visitation rights while his or her petition for guardianship is pending. If your will does not include such a provision, the temporary guardian will have complete discretion to allow the foreign guardian visitation or not.

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Other issues that come into play for non-residents who nominate foreign guardians involve changing the child's personal residence and transferring assets left to the minor child out of the country. California, like most states, has very strict guidelines which must be complied with when these issues arise. The reason for these strict guidelines is the concern the courts have about losing jurisdiction over the child or the property.

Getting started

Please contact us to discuss the particulars of your situation.

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