Transfer Taxation Of Non-Resident Aliens

Charlotte K. Ito,
a partner with Fox Rothschild in San Francisco, designs and implements strategies for the accumulation, management, and transfer of wealth for high net worth individuals and their families. Her practice includes domestic and international estate and personal planning for closely held business owners, company founders, venture capitalists, private and public company executives, and entertainment, sports, and media figures. She handles asset structuring for privacy, multigenerational estate planning, business succession planning, and complex probate and estate administration. She is a Fellow of the American College of Trust and Estate Counsel and an Academician with The International Academy of Estate and Trust Law and is Vice-Chair of the California State Bar Trusts & Estate Section Executive Committee. She has spoken for the State Bar of California, California Continuing Education of the Bar, Society of Trusts & Estate Practitioners (STEP), the International Bar Association, American Bar Association, California Probate and Mental Health Institute, Bar Association of San Francisco, the Alameda County Bar Association and the Northern California Trust Companies Association.

Charlotte K. Ito

A. Domicile: The estate and gift taxation of nonresident non-citizen individuals (non-resident aliens, or "NRAs") depends on the individual's domicile. An NRA is an individual who is not domiciled in the US. Thus, domicile is the threshold question that determines the rights and obligations of the parties and the character of the property. *See* Treas. Reg. §§20.0-1(b); 25.2501-1(b).

1. Residence refers to a place of abode. Residence without the requisite intention to remain indefinitely will not be sufficient to constitute domicile.

2. Domicile is not the same as residence. Domicile refers to a permanent home where an individual intends to remain or to which he intends to return. Domicile includes both the act of residence and an intent to remain. An intention to change domicile does not effect a change unless actual removal takes place.

    a. Contrast To Income Tax Approach. Domicile does not involve the day-counting method used for income tax residency. *See* IRC §7701(b). A green card is not determinative of the issue. For estate and gift tax purposes, if an individual is physically present in the U.S. and intends

to remain in the U.S. indefinitely, then the individual is domiciled in the U.S. and is a U.S. resident for estate and gift tax purposes regardless of the individual's pending status for income tax purposes.

b. Facts And Circumstances To Demonstrate Intent:

i. Duration of stay in the U.S. and other countries, frequency of travel between countries;

ii. Location of business and social contacts;

iii. Size, cost, and nature of home (vacation home, owned or rented);

iv. Location of expensive and cherished personal possessions;

v. Membership in church or other organization;

vi. Registration to vote;

vii. Place of driver's license and auto registration;

viii. Location of assets (bank accounts, personal property, etc.);

ix. Reasons for residence in a particular location;

x. Declarations of residence or intent made in visa applications for reentry permits, wills, deeds of gift, trust instruments, letters and oral statements.

c. Double Domicile: Because the test is subjective and different countries may assert domicile over an individual, an individual may be found to have more than one domicile. In that case, tax treaties may relieve double tax burdens through tax credits for tax on property located in another country or through deemed situs rules. The taxpayer may elect the treaty provisions or the code (section 2014 death tax credit), whichever is more favorable. Treas. Reg. §20.2014-4.

3. Situs Of Assets. The U.S. subjects NRAs to transfer taxes only on U.S. situs assets. The definition of U.S. situs assets is different for gift tax versus estate tax.

B. Gift Tax

1. Overview

a. NRAs are taxed on only gifts of real property or tangible personal property located in the U.S. IRC §§2501(a)(1); 2511(a); Treas. Reg. §25.2511-1(b). Gifts of intangible personal property by NRAs will not be subject to U.S. gift tax. IRC §2501(a)(2).

b. The U.S. planner should work with counsel in the foreign jurisdiction to determine whether a gift tax or other transfer tax will occur on gifts. Double taxation may be avoided in the foreign jurisdiction if the foreign jurisdiction permits a tax credit for U.S. gift tax paid for the transfer of U.S. situs property. The U.S. does not provide a tax credit against US gift tax for any foreign gift taxes paid, so it is critical that the planner verify that any credit in the foreign jurisdiction is not limited due to lack of U.S. reciprocity for the foreign gift tax credit. See IRC §2505(a).

2. Situs Rules

a. Corporate shares are considered to be intangible property and therefore not taxable for U.S. gift tax purposes.

b. Debt obligations issued by a U.S. corporation, U.S. government, or a state are treated as intangible property.

c. Gifts of checks constitutes a gift of money that is tangible property. The gift occurs when the donor has parted with dominion and control, i.e., when the check is paid, certified or accepted by the drawee bank. Gen Couns. Mem. (Sept. 24, 1976).

d. Cash itself may not be treated as an intangible. Treas. Reg. §25.2511-3(b)(4)(iv). Cash in a safe deposit box of an NRA not engaged in business in the U.S. was includible in the decedent's gross estate situated in the U.S.. Rev. Rul. 55-143, 1955-1 C.B. 465.

e. By gifting intangibles, the NRA can remove the intangible asset from his or her estate with no gift tax cost. A key to planning is to transform taxable property (e.g., U.S. real estate) into intangible form (an entity such as a corporation or partnership) and the gift intangible assets (which should be exempt from U.S. gift tax under IRC §2501(a)). However, bear in mind that the IRS could assert the "step transaction" doctrine if the transfer of the U.S. real estate to the entity occurs shortly before the gift. The transaction "needs seasoning" to avoid the argument that the steps are part of a prearranged plan to convert a tangible asset to an intangible one for the purposes of making a gift. *See De Goldschmidt-Rothschild v. Commissioner,* 168 F.2d 975 (2d Cir. 1948); *Davies v. Commissioner,* 40 T.C. 525 (1963).

f. Partnership/LLCs. The Code and Regulations do not provide rules about the situs of an NRA's interest in a partnership or LLC. The debate about the situs of partnerships focuses on the "aggregate theory" or the "entity theory".

i. Under the aggregate theory, the partnership is ignored and viewed as a collection of the underlying assets whose individual situs must be determined to, in turn, determine the application of the U.S. transfer tax. If the asset is U.S. real estate, its situs is the U.S. and therefore subject to U.S. transfer tax. Each asset, its situs, and the transfer tax applicability must be separately determined.

ii. Under the entity theory, the existence of the partnership holds and the situs of the partnership would control. If the entity theory is used, the partnership interest is considered intangible personal property. Ownership of a partnership interest by an NRA would not necessarily result in estate tax inclusion (unless another partner was an individual domiciled in the U.S. or a domestic corporation). The situs would depend on the location of the trade or business, place of organization, domicile of the partner, the place where the partnership's legal records are maintained, and where title transfer of partnership interests occurs. Richard A. Cassell, Michael J. A. Karlin, Carlyn S. McCaffrey & William P. Streng, *US Estate Planning for Nonresident Aliens Who Own Partnership Interests*, 99 Tax Notes 1683 (June 16, 2003).

iii. If the aggregate theory were to apply to single member LLCs, the LLC's underlying assets would be examined to determine situs. The entity's existence would be ignored under this analysis.

iv. Check the box regulations allow business entities to choose their classification. Treas. Reg. §§301.7701-2, 301.7701-3.

3. Gift Tax Marital Deduction

a. An NRA who transfers property to a U.S. citizen spouse is allowed an unlimited marital deduction. IRC §2523.

b. An NRA who transfers property to an NRA spouse receives no marital deduction. IRC §2523(i).

c. Section 2523(i)(3) provides that the principles of Sections 2515 and 2515A (repealed by the Economic Recovery Tax Act of 1981) apply.

i. Section 2515 provides that the creation of a tenancy by the entirety or joint tenancy between husband and wife with right of survivorship (hereafter "joint interests") in real estate either by one spouse alone or by both spouses, additions to such value in the form of improvements or reduction in indebtedness on such property shall not be deemed transfers of property regardless of the proportion of the consideration furnished by each spouse. When such joint interest terminates other than by reason of death of a spouse, the spouse is deemed to have made a gift to the extent that the proportion of the total consideration furnished by such spouse multiplied by the proceeds of such termination (whether in form of cash, property or interests in property) exceeds the value of such proceeds of termination received by such spouse.

ii. Section 2515A provides that in the case of the creation (either by one spouse alone or by both spouses) of a joint interest of a husband and wife in personal property with right or survivorship, or additions to the value thereof in the form of improvements, reductions in the indebtedness, or otherwise, the retained interest of each spouse is to be treated as one-half of the value of their joint interest. This rule does not apply with respect to any joint interest in property if the fair market value of the interest or of the property cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses.

d. Transfers To NRA Spouses: Under IRC Section 1041(a)(1), no gain or loss is recognized on a transfer of property from an individual to a spouse. This rule does not apply if the transferee spouse is an NRA. Gain or loss is recognized (assuming no other nonrecognition rule applies) at the time of a transfer of property if the property is being transferred to an NRA spouse. IRC §1041(d); Temp. Treas. Reg. §1.1041-1T, Q&A-3.

4. Gift Tax Charitable Deduction: An unlimited deduction applies for gifts to eligible charities. IRC §2522.

5. Annual Exclusion

a. NRAs are entitled to the annual exclusion ($13,000 in 2011) for gifts from NRAs to each donee. IRC §2503(b). Gift splitting is not allowed unless each spouse is a U.S. citizen or resident and therefore is not available to NRAs. IRC §2513(a)(1).

b. No gift tax applies to payments for tuition and medical care that are made directly to the service provider. IRC §2503(e).

c. An annual exclusion of $136,000 (2011 amount) is allowed for transfers to an NRA spouse. IRC §2523(i)(2).

d. There is no lifetime gift tax exemption available to NRAs. IRC §§2501(a), 2505.

e. No gift splitting. IRC §2513.

6. Treaties may determine which jurisdiction has authority to impose tax on the basis of the status of the donor or decedent and what is considered to have a U.S. situs. The bilateral gift tax treaties are:

a. Australia;

b. Austria;

c. Denmark;

d. France;

e. Germany;

f. Japan;

g. Sweden;

h. UK.

7. Make Gifts Of Non-U.S. Situs Assets — Make irrevocable gifts of non-U.S. situs assets before becoming U.S. domiciliary:

a. Outright;

b. Gifts to a U.S. grantor trust;

c. Gifts to spouse.

C. Estate Tax

1. For NRAs, the U.S. estate tax applies to property with a U.S. situs. IRC §§2101(a), 2103, 2106(a); *see also* §2031. The situs is determined at the time of transfer or at the time of death. IRC §2104(b). A tax treaty may also specify the situs rules for a particular country.

2. Some situs rules contained in the Internal Revenue Code are listed below. In each case, the planner must determine whether the property may be deemed to have a different situs under the treaty. The planner will then be able to advise whether it is preferable to choose the Code or treaty method for all property (the executor or trustee cannot pick and choose between the Code and treaty).

a. Stock in a U.S. corporation has a U.S. situs. IRC §2104(a); Treas. Reg. §20.2104-1(a)(5). Stock in a foreign corporation has a foreign situs regardless of the location of the certificates. Treas. Reg. §20.2105-1(f); *Estate of Charania v. Shulman,* , 608 F.3d 67, 73 (1st Cir. 2010), *aff'g in part,* 133 T.C. 122 (2009). In *Charania*, decedent and his wife were born in Uganda and were U.K. citizens. They did not sign a marriage contract. In 1972, Idi Amin, President of Uganda, expelled Ugandans of Asian descent. Decedent and his family left Uganda and moved to Belgium. All of their assets in Uganda were seized by the government. Decedent and his wife lived in Belgium from the time they were forced to leave Uganda to the time of decedent's death. Decedent held shares of Citigroup stock at his death. Decedent's estate filed a return that included the value of half the shares of stock, taking the position that the stock was community property under Belgian law. The opinion reviewed English and Belgian conflicts of laws principles and concluded that the stock was separate property

of Husband because the matrimonial domicile was in the U.K. They had not taken the necessary steps to change the matrimonial regime during the marriage to community property as provided by Belgian law. The stock of a U.S. corporation is considered a U.S. situs asset subject to the estate tax in the estate of a nonresident alien and therefore subject to U.S. estate tax. The result in this case could have been avoided with proper planning, i.e., hold stock through a non-U.S. entity or offshore trust, or stock could be gifted to family members. The Tax Court decision was affirmed by the U.S. Court of Appeals for the Eighth Circuit under a different rationale. The Eighth Circuit found that an English Court would apply the "rule of immutability" stated by the House of Lords in *De Nicols v. Curlier* [1900] A.C. 21. *De Nicols* involved two French citizens who married in France. The husband became a British subject and the couple spent the next 34 years in England. Their estate reached a significant size and when the husband died, a question arose whether the marital property regime of France or England governed the ownership of the couple's personal property. "The rule of *De Nicols* is that a change in marital domicile does not, in itself, effect a change in the marital property regime governing the spouses' rights in personal property acquired throughout the course of the marriage."

b. Any property of which the decedent has made a transfer, by trust or otherwise, within the meaning of sections 2035 to 2038, inclusive (i.e., revocable transfers and transfers within 3 years of death), shall be deemed to be situated in the U.S., if so situated *either* at the time of the transfer or at the time of the decedent's death. IRC §2104(b).

i. Thus, although gifts by an NRA of intangible property with a U.S. situs are not subject to U.S. gift tax, the exemption does not apply for U.S. estate tax purposes. Those U.S. situs intangibles may be includible in the NRA's U.S. gross estate under the lifetime transfer rules, even though their transfer is exempt from U.S. gift tax.

ii. If the U.S. situs property is real or tangible personal property, the gift is subject to gift tax (without any applicable credit amount offset) and may again be subject to estate tax without any credit for the U.S. gift tax previously paid.

iii. To prevent this double tax, it is important that the property have a non-U.S. situs at the time of the gift and at the time of death to ensure that the gift property will not be subject to U.S. estate tax as part of the NRA's U.S. estate.

c. Debt obligations of U.S. persons or the U.S., a state, or the District of Columbia, have a U.S. situs. IRC §2104(c).

d. Life insurance on the life of an NRA does not have a U.S. situs IRC §2105(a); Treas. Reg. §20.2105-1(g). The situs of life insurance on the life of others, however, depends on the location of the issuer of the policy. If the insurer is a U.S. company, the policy has a U.S. situs and if foreign, a foreign situs.

e. Unless effectively connected with a U.S. trade or business, bank deposits and certificates of deposit issued by a U.S. bank are treated as non-U.S. situs property. IRC §2105(b). Portfolio interest received by an NRA from sources within the U.S. are not taxed under IRC §871(h).

f. Real property located in the U.S. has a U.S. situs. Treas. Reg. §20.2104-1(a)(1). If the real property is subject to a nonrecourse mortgage, then the value included in the gross estate is net of the nonrecourse mortgage, i.e., only the equity. See below.

g. Tangible personal property located in the U.S. has a U.S. situs. Treas. Reg. §20.2104-1(a)(2). Intangible personal property that is not issued by or enforceable against a U.S. resident, corporation or governmental unit is considered situated outside the U.S. if the written evidence of the intangible personal property is not treated as the property itself. Treas. Reg. §20.2104-1(a)(4); 20.2105-1(e).

h. If the NRA has a beneficial interest in or general power of appointment over an irrevocable U.S. or foreign trust, U.S. estate taxation depends on the nature of the trust and the situs of each of the assets in the trust. If the trust holds U.S. situs assets at the time of death or if the trust transferred such assets within three years of death, or if the decedent transferred U.S. situs assets to the trust when the trust was funded, the trust assets will be taxed. IRC §2104(b); Tech. Adv. Mem. 95-07-044 (May 31, 1994) (trust property considered U.S. situs where decedent made transfer of property under section 2038 and property was situated in the U.S. at the time of transfer).

i. If an NRA directly holds a U.S. trade or business, the assets are treated as having a U.S. situs. IRC §2103.

j. An annuity contract, a contract to receive money, has a U.S. situs if the contract is with a U.S. entity (analogous to a debt).

k. The situs of pension plans and other retirement benefits probably depends on the location of the employer (e.g., IRAs, profit sharing or pension plan, deferred compensation plan of a U.S. company).

l. The situs of a partnership interest is not clear-cut and turns on the familiar entity versus aggregate theory of partnerships. The issue is whether the NRA should be treated as owning an interest in the partnership similar to owning a share of stock or as owning undivided interests in the various properties held by the partnership itself. Resolution of the issue may depend on the facts and analysis of case law and analogies to the situs of property subject to a lien, in which case the residence of the partnership will be the location of the principal executive office of the business. Interests in a foreign LP that holds U.S. situs assets would be subject to estate tax (the partner's pro rata share). *See* Rev. Rul. 55-701, 1955-2 C.B. 836 (non-U.S. situs partnership if partnership does not conduct business in the U.S.).

m. The situs of a limited liability company interest depends whether the LLC is treated as a corporation or partnership.

n. The NRA may have transferred property but retained certain powers or rights that such that those interests are includible in the NRA's gross estate. For example, if the NRA transfers intangible property outside the U.S. which is used by the transferee to purchase real property located in the U.S. for the NRA, the US real property would be includible in the NRA transferor's US gross estate.

o. Should a foreign corporation be used to hold U.S. assets? If the NRA remains the true owner and holder of the assets, then the IRS will treat the NRA as still owning the US asset directly. *See Fillman v. United States*, 355 F.2d 632 (Ct. Claims, 1966) (foreign corporation was a mere nominee of the NRA owner).

3. Marital Deduction: The availability of the marital deduction for the estate of an NRA depends on the surviving spouse's citizenship. If the surviving spouse is a U.S. citizen, the estate is entitled to an unlimited marital deduction for property passing to the surviving spouse. IRC §§2056(a); 2106(a)(3). If the surviving spouse is not a U.S. citizen, the unlimited marital deduction is not available unless a Qualified Domestic Trust is used. IRC §2056(d). Estate tax treaties may also provide for alternative options.

a. The marital deduction applies only to property with a U.S. situs at the time of the NRA's death. IRC §§2106(a)(3); 2056.

b. If foreign situs property is left to a surviving U.S. spouse, the marital deduction does not apply if the property was not included as part of the decedent's estate. Moreover, it will be subject to U.S. estate tax upon the surviving spouse's death.

i. It may not be desirable to place foreign situs assets into a credit shelter trust because those assets are not included in the NRA's U.S. estate anyway.

ii. However, if the surviving spouse is a U.S. citizen or resident, placing the foreign situs property in a nonmarital exemption type of trust may be useful to avoid U.S. estate tax in the surviving spouse's estate.

iii. On the other hand, if the foreign law does not permit or recognize this type of trust, it may be more beneficial to leave the foreign situs assets for children or other beneficiaries.

c. If the marital deduction is used in the U.S. along with the applicable credit amount, there is no U.S. estate tax. If there is a foreign death tax on decedent's death, the foreign tax credit will be lost because there is no U.S. liability to be credited against. The formula clause needs to take foreign tax credits into account.

d. If the NRA's surviving spouse is not a U.S. citizen, the amount of to be included in the NRA's estate is determined according to Section 2040(a) (the amount of consideration furnished by the NRA). The surviving spouse is treated as having furnished consideration to the extent the NRA made a gift to the surviving spouse. under the amount of consideration furnished by the decedent. IRC §2040(a). The qualified joint interest rule (where 50 percent of qualified joint interests are included in the decedent's estate) does not apply. IRC §§2031, 2040(a), 2040(b), 2056(d)(1)(B); Treas. Reg. §20.2056A-8.

4. Funeral and administration expenses, claims against the estate, recourse debt, casualty losses and taxes are proportionately deductible, the proportion of which the value of the U.S. assets are the numerator and the value of the worldwide assets is the denominator. The amount attributable to the U.S. estate is this fraction multiplied against the deductible item. IRC §2106(a)(1). To get the deduction, the NRA's estate tax return needs to disclose the NRA's worldwide assets. Nonrecourse debt secured by US situs asset results in a dollar for dollar reduction. *See below*.

5. The foreign decedent's debt may also be apportioned to U.S. and foreign situs assets like administration expenses. Mortgages can be a trap for NRA's estates.

   a. Nonrecourse debt fully reduces the value of the U.S. situs property. Treas. Reg. §20.2053-7. This must be true nonrecourse debt where the lender can only look to the property in the event of default. In that case, the estate is allowed to deduct the mortgage in calculating the taxable estate. Recourse debt is allowed as a deduction which may in turn be apportioned.

   b. Example: Suppose an NRA owns a condominium in San Francisco worth $2,000,000 and subject to a mortgage of $1,500,000. Suppose further that the NRA owns $4 million of foreign situs property and no other debt.

      i. The net value of the U.S. situs assets is $500,000.

      ii. However, the debt allocable to the U.S. estate is as follows:

      $2,000,000 (U.S. gross estate) * $1,500,000

      $6,000,000 (worldwide gross estate)

      = $500,000

      iii. Thus, the U.S. gross estate ($2,000,000) less the allocable debt ($500,000) is $1,500,000, instead of the $500,000 net value of the U.S. situs assets.

   c. Nonrecourse debt in California is usually *not* really nonrecourse. California law gives the lender a choice of remedies: non-judicial foreclosure or slow and expensive foreclosure through the court.

If the lender chooses judicial foreclosure, then the lender will sell the property, and the borrower is personally liable for any shortfall. In practice, no one chooses judicial foreclosure.

d. To minimize U.S. estate taxes, the estate planner should consider having nonrecourse debt against U.S. situs properties (and therefore fully deductible) and using recourse debt for foreign liabilities (allocable).

6. The charitable deduction is available in full if the property is included in the NRA's gross estate, the contribution is made to a U.S. charity, and the NRA's worldwide estate is disclosed to the Service. IRC §2106(a)(2), (b).

7. Credits

a. NRAs are allowed a $13,000 credit against the estate tax. IRC §2102(b).

b. To the extent required under any treaty, the credit allowed is to be equal to the amount that bears the same ratio to the applicable credit amount as the value of the NRA's U.S. situs assets to the NRA's worldwide assets. IRC §2102(b)(3).

c. The U.S. will assert that it has primary jurisdiction to tax an NRA's U.S. situs assets so a credit for foreign death taxes is not available. The foreign jurisdictions will presumably tax only assets in their countries. If they tax U.S. situs assets on the basis of citizenship or residency, it is assumed that they will provide a tax credit for the U.S. taxes paid to avoid double taxation. IRC §2102(a).

8. Estate Tax Treaties: Treaties may determine which jurisdiction has authority to impose tax on the basis of the status of the donor and what is considered to have a US situs.

a. Bilateral Estate Tax Treaties are:

i. Australia;

ii. Austria;

iii. Denmark;

iv. Finland;

v. France;

vi. Germany;

vii. Greece;

viii. Ireland;

ix. Italy;

x. Japan;

xi. Netherlands;

xii. Norway;

xiii. South Africa;

xiv. Sweden;

xv. Switzerland;

xvi. United Kingdom

D. GST Tax: GST tax is imposed where an estate or gift tax is imposed on the property. Thus, it is possible for NRAs to make GST transfers without tax.

E. Foreign Marital Property Laws

1. Spousal rights may depend on what assets are considered part of the marital estate under the laws of the jurisdiction where the spouses were domiciled at the time of acquisition.
2. Spouses can resolve rights to marital property by agreement. Migrant couples need to know about prenuptial agreements
3. Factors:
   a. Where couple was married;
   b. The marital domicile at the time of the acquisition of the asset(s);
   c. Nature of the assets;
   d. Value of the assets;
   e. Source of the consideration for the property or source of the property itself.