

Foreign Nationals May Be Exposed to U.S. Estate Tax

When foreign nationals reside in the United States, many are aware that they will be subject to U.S. income tax on their worldwide income. What many are not aware of is that they also may be subject to the U.S. estate upon their death (and gift tax upon gratuitous transfers of property made during their lifetime).

In general, U.S. citizens pay Federal estate tax on their worldwide assets, regardless of the physical location of these assets. Foreign nationals (i.e., non-U.S. citizens) who are considered "domiciled" in the United States, are also subject to the Federal estate tax on their worldwide assets.

For purposes of the estate tax, a foreign national is considered domiciled in the United States if he or she lives primarily in the United States and has no definite present intent to leave. The person may travel away from his or her domicile, but always has the intention to return to it. Here are some of the factors the IRS will use to determine if a foreign national is resident for purposes of the Federal estate tax:

1. How much time does the person spend in the United States versus the amount of time spent in each foreign location?
2. Does the person own or rent U.S. housing? Does he or she have a home in foreign locations? What is the relative size and value of each home?
3. **Location of principal business interests, social club affiliations, religious affiliations, etc.**
4. Location of the person's family members and friends.
5. Where does the person file tax returns, including local income tax returns, property tax returns, intangibles tax returns, and others?
6. What jurisdictions have issued the person a driver's license?
7. Where do the person's primary banking and financial activities take place?

So, let's say you are a foreign national residing in the United States at your date of death. Assuming your spouse is not a U.S. citizen, your estate will be subject to Federal estate tax at rates up to 45%. In other words, your spouse could lose 45% of the value of your estate if proactive planning does not take place.

Estate Tax Planning

There are estate tax planning techniques and strategies that can be implemented in order to reduce or avoid the Federal estate tax. However, such planning techniques should be considered as soon as possible in order to provide maximum benefits.

Some planning techniques are the following:

- *Abandoning U.S. residency*

For example, those diagnosed as terminally ill or having time for advance planning may wish to terminate qualification as a U.S. resident. This option may be unavailable to a long-term resident alien (i.e., a non-U.S. citizen who is a permanent legal resident of the U.S. (i.e., a "green card" holder) for at least eight of the 15 tax years before departure).

- *Surviving spouse becomes citizen*

If the surviving spouse becomes a U.S. citizen before the estate tax return is filed and was a U.S. resident or domicile since the decedent's death, the estate can claim the unlimited marital deduction for bequests to that spouse. This is a relatively simple solution, assuming that the surviving spouse is willing and able to become a U.S. citizen.

- *Transferring assets to a QDOT*

A qualified domestic trust (QDOT) is a trust established under U.S. law, having at least one U.S. trustee. A major benefit of a QDOT is the ability to defer (rather than avoid) estate tax. There are also some disadvantages of using the QDOT. Some of the disadvantages include:

1. They are complicated, and difficult and costly to establish and administer.
2. Although providing the estate tax benefits described above, under U.S. tax law, the transfer of certain assets into a QDOT (e.g., retirement plan benefits, S corporation stock, certain life insurance policies and personal residences) may have significant adverse income tax consequences.

- *Using treaty benefits*

An estate tax treaty between the U.S. and the foreign national's home country can provide substantial benefits. These treaties often clarify the uncertainty surrounding residency determination, particularly if the taxpayer may be considered domiciled in both countries.

- *Making inter vivos gifts*

A foreign national can also make annual gifts of \$12,000 per donee at no transfer tax cost. In addition, for a taxpayer with a noncitizen spouse, although no marital deduction is allowed, a \$128,000 annual exclusion on gifts to a spouse is permitted.

- *Using life insurance*

Assets used to pay the estate tax can be replenished by life insurance proceeds. Generally, the insurance policy is held either in trust or by the insured's spouse or other family member, such that the death benefit is not included in the gross estate and thus not subject to Federal estate tax.

Conclusion

Foreign nationals and their families anticipating extended residency in the U.S. should be aware that the Federal estate may apply and address these issues on a proactive basis. This would include examining residency and domicile; comparing U.S. tax considerations to those of the home country; revisiting the potential effect these factors may have on family financial planning; and taking necessary action.

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