

## Estate taxation of a nonresident alien

Most estate planners at one time or another have occasion to represent individuals or couples at least one of whom is either a noncitizen or a nonresident alien. This may be an infrequent enough occurrence that keeping track of the rules applicable to these clients is difficult. The U.S. has unique estate and gift tax rules applicable to resident and nonresident aliens. These rules are relatively complicated, and in certain respects counterintuitive. An estate planner who represents nonresident alien clients, who plan any contact with the U.S., either by spending time in the U.S. or by investing in assets situated in the U.S., should be aware that significant taxes may be saved if planning is accomplished at an early stage. This *Practice Alert*, which is excerpted from a more extensive article in the January 2007 issue of *Journal of Taxation*, examines some of the rules applicable to the estate taxation of a nonresident alien.

**Gross estate.** In general, US. estate tax applies to that portion of a nonresident alien decedent's gross estate which at the time of his or her death is situated in the U.S., including but not limited to intangible property' (Code Sec. 2103). Some of the sites rules governing U.S. estate taxation of assets in a nonresident alien's estate are as follows.

**Real property.** Real property located in the U.S. is subject to U.S. estate tax (Reg §20.2104-1(a)(1)). If the property is encumbered, and the debt is 'recourse' (meaning it is the personal obligation of the decedent), the full FMV of the real estate unreduced by the mortgage is subject to estate tax.

It frequently happens that a nonresident alien will purchase a second home in the U.S. without realizing that the home will be subject to estate tax. If the home were instead purchased by a foreign corporation owned by the nonresident alien, the home might not be subject to U.S. estate tax assuming all the formalities of the corporation were respected (see the discussion of corporate stock, below). It may be prudent to interpose a disregarded U.S. entity, such as an LLC, between the foreign corporation and the real estate to facilitate a potential future sale of the property. If the nonresident alien already owns the home in his or her individual name, it might be transferred to a foreign corporation but the transfer could be subject to U.S. income tax.

**Tangible personal property.** Art, jewelry, furniture, and other tangible personal property located in the U.S. are subject to U.S. estate taxation. (Reg § 20.2104- 1 (a)(2)) This would include cash and collectibles that are stored in a safety deposit box in the U.S.

There is an exception for works of art imported solely for purposes of exhibition that were on loan (or en route) •for those purposes to a public gallery or museum with no part of the earnings inuring to the benefit of a private shareholder or individual at the time of the decedent's death. (Code Sec. 2105(c); Reg § 20.2105-1(b)) In addition, tangible personal property of a personal nature that a nonresident alien brings into the U.S. while visiting is not subject to U.S. estate tax.

**Stock of a corporation.** Shares of stock issued by a domestic corporation, irrespective of the location of the certificates, are subject to U.S. estate tax. (Code Sec. 2104 (a); Reg § 20.2104-1(a)(5)) In IRS Letter Ruling 9748004, IRS applied this rule to impose estate tax on a U.S. mutual fund organized as a corporation,

even though the mutual fund invested solely in foreign securities.

Because stock of a foreign corporation is not subject to U.S. estate tax, holding U.S. situs assets through a foreign corporation constitutes a planning opportunity. To the extent the foreign corporation does not engage in legitimate business activities or operate in an arm's-length fashion, however, there is a risk that it will not be respected as an effective shield from U.S. estate tax. Other foreign entities may not be considered the equivalent of a corporation but may instead be treated as a trust that is looked through for purposes of determining whether the decedent died owning U.S. situs assets.

**Debt obligations.** Debt obligations of a U.S. person, or of the U.S., a state, any political subdivision thereof, or the District Of Columbia, are subject to U.S. estate tax (Code Sec. 2104(c); Reg § 20.2104-1(a)(3) and (4)), subject to some significant exceptions.

In general, if interest from a debt obligation payable to a nonresident alien is exempt from U.S. income tax, the underlying debt obligation is likely to be exempt from U.S. estate tax. And Code Sec. 2104 (e) provides that the rule of estate tax inclusion does not apply to a debt obligation where the interest would be treated as income from sources outside the U.S. for income tax purposes.

**Certain bank deposits.** The situs rules in Code Sec. 2104 and Code Sec. 2105 are complex with respect to bank deposits, which are treated as debt obligations under Reg § 20.2104-1(a)(7) and Reg § 20.2105-1(k). A deposit with a U.S. bank described in Code Sec. 871(i)(3) generally is not subject to U.S. estate tax under Code Sec. 2105(b)(1).

A deposit not subject to tax would

include an interest-bearing account with a U.S. bank that is not effectively connected with the conduct of a trade or business in the U.S. Likewise, under Code Sec. 2105(b)(2), a deposit with a foreign branch of a domestic corporation or domestic partnership is not subject to estate tax if such branch is engaged in the commercial banking business. A deposit with the domestic branch of a foreign corporation, however, can be subject to U.S. estate tax. Non-bank deposits, such as cash accounts in U.S. brokerage firms, are likely to be subject to U.S. estate tax.

**Transfers with retained interests.** Code Sec. 2035 through Code Sec. 2038 generally include in a decedent's gross estate property with respect to which the decedent retained a beneficial interest or control over its disposition. Under Code Sec. 2104(b), any transfer described in Code Sec. 2035 through Code Sec. 2038 by a nonresident alien decedent in trust or otherwise will be subject to U.S. estate tax if the property had a U.S. situs either when transferred or at the time of the nonresident alien's death.

**Beneficial interests in trusts.** A beneficial interest in a trust holding U.S. situs assets is subject to U.S. estate tax to the extent the interest is of a type that would cause the trust corpus to be included in the estate of a U.S. citizen or resident.

In Rev Rule 55-163, 1955-1 CB 674, IRS ruled that the situs of a beneficial interest in a trust is determined by the situs of the underlying assets. In Rev Rule 82-193, 82-2 CB 219, IRS ruled that a nonresident alien's reversionary interest in a trust holding a bank certificate of deposit was not U.S. situs property because the bank deposit was not taxable in the U.S. and the reversionary interest itself was not U.S. situs property for estate tax purposes.

**Partnership interests.** Neither the Code nor the regulations specifically address the situs of Partnership interests for estate tax purposes, and case law and rulings are inconclusive. It seems reasonable to conclude that a nonresident alien's interest in a U.S. partnership, particularly if it owns U.S. situs property or is engaged in a U.S. trade or business, will be subject to U.S. estate tax in the nonresident alien's estate.

All other situations should be evaluated according to the available authorities, which turn on the fundamental question of whether the partnership should be respected as a separately identifiable entity. In that event, the nonresident alien partner would be deemed to own intangible property, similar to shares of stock. If instead the partnership is seen as a transparent aggregate of its underlying assets, the nonresident alien partner would be deemed to own a share of such underlying assets.

Because it is now possible under the check-the-box rules to form a company under foreign law that will survive the death of an owner, and elect to treat that company for U.S. tax purposes as a partnership, the entity theory of taxation of a partnership interest perhaps has gained some additional support. Nevertheless, the uncertain treatment of partnership interests makes them difficult estate planning vehicles to use with confidence. Because an interest in a foreign partnership does not attract certain of the more onerous income tax rules applicable to foreign corporations, however, their use should not be ruled out as an opportunity, assuming the client is willing to accept the risks.

**Insurance proceeds.** Amounts receivable as insurance on the life of a nonresident alien decedent are not subject to U.S. estate tax on the death of the nonresident alien. (Code Sec. 2105 (a); Reg § 20.2105-1(g)) This rule provides a nonresident alien with a

substantial opportunity to avoid U.S. estate tax not available to U.S. citizens or residents.

The proceeds of a life insurance policy owned by a U.S. citizen or resident are subject to U.S. estate tax. (Code Sec. 2042) Accordingly, planning to avoid tax on the proceeds of a life insurance policy on the life of a U.S. citizen or resident typically involves transferring ownership of the policy to an irrevocable trust. The proceeds of a life insurance policy on the life of a nonresident alien decedent are not included in the decedent's gross estate, however, regardless of who owns the policy.

If a nonresident alien decedent owns a policy on the life of another person, and that policy is a U.S. situs asset; its value (not the proceeds) will be includable in the nonresident alien's gross estate for U.S. estate tax purposes.

**Deductions from estate tax.** In general, the estate of a nonresident alien decedent is entitled to deductions under Code Sec. 2106 similar to those allowed to the estate of a U.S. citizen or resident decedent. Nevertheless (and with certain exceptions), deductions are permitted only in proportion to the value that the U.S. situs assets represent relative to the decedent's worldwide estate. The necessity of disclosing worldwide assets in order to take deductions may cause certain taxpayers to forgo the benefit in the interest of maintaining nondisclosure with respect to the worldwide estate.

**Expenses and debts.** Deductions for expenses and debts of a nonresident alien's estate are allowed in the proportion of value of the U.S. estate to the value of the total estate, and the date-of-death value of the worldwide estate must be reported in order for the estate to claim such deductions (Code Sec. 2106(a)(1)). There is, in effect, an exception for real property encumbered by non recourse indebtedness, because if the debt is non recourse, the property may be

included in the gross estate net of the indebtedness.

**Charitable deduction.** A nonresident alien estate is entitled to a charitable deduction, subject to certain limitations. (Code Sec. 2106(a)(2))

**Marital deduction.** The marital deduction is available for transfers by a nonresident alien to a U.S. citizen spouse or in a qualified domestic trust (QDOT) for a noncitizen spouse to the same extent allowed to a U.S. citizen or resident transferor. (Code Sec. 2106(a)(3)) Worldwide assets need not be disclosed to obtain a marital deduction.

**Jointly held property. Code Sec.** 2056(d)(1)(B) states that Code Sec. 2040(b) (which provides that property owned jointly with a right of survivorship between spouses will be included at one-half its value in the estate of the first spouse to die) does not apply if the surviving spouse of the decedent is not a U.S. citizen. Instead, 100% of such property is includable in the first decedent's estate except to the extent the executor can substantiate the contributions of the noncitizen surviving spouse to the acquisition of the property. Thus, jointly owned U.S. situs property will be fully included in the gross estate of a nonresident alien who provided the funds to acquire such property. Because jointly owned property with a right of survivorship passes outright to the surviving spouse, if the surviving spouse is not a U.S. citizen, the surviving spouse will need to transfer the portion included in the gross estate to a QDOT in order to qualify for a marital deduction.

**Unified Credit.** Under Code Sec. 2102(b)(1), a nonresident alien's estate is permitted only a \$13,000 credit against the payment of U.S. estate tax, which will shelter \$60,000 from U.S. estate tax.

**Treaty considerations.** The U.S. has entered into estate and gift tax treaties with

several countries that generally are designed to avoid double taxation and may modify the foregoing rules. These treaties generally are applicable to residents of the member jurisdictions. Pursuant to Code Sec. 2102(b)(3), to the extent required under any treaty obligation of the U.S., a nonresident alien's estate may be allowed an estate tax credit equal to that available to the estate of a U.S. citizen or resident, multiplied by the proportion of the worldwide estate situated in the U.S.