



# ESTATE OF PLAY

Leigh-Alexandra Basha and Shelly Meerovitch  
discuss how to identify and solve problems in  
the taxation of non-resident aliens in the US

## ➤ KEY POINTS

### WHAT IS THE ISSUE?

Advising non-US clients with US connections is a complex task made more challenging by frequently opaque and obscure US tax rules.

### WHAT DOES IT MEAN FOR ME?

Proper advance planning can successfully avoid unintended onerous tax exposure.

### WHAT CAN I TAKE AWAY?

An overview of the US federal income-tax and transfer-tax rules as they apply to non-US citizens, and certain transfer-tax pitfalls and planning suggestions.

US CITIZENS and residents<sup>1</sup> are subject to US federal income tax on their worldwide income.<sup>2</sup> Non-resident, non-citizens (NRNCs) are generally subject to US federal income tax only on 'fixed, determinable, annual or periodical' (FDAP) US-source income and on income 'effectively connected' (ECI) with the conduct of a US trade or business.<sup>3</sup> An NRNC's ECI is taxed at regular, graduated income-tax rates (up to 39.6 per cent for 2016).<sup>4</sup> NRNCs' US-sourced FDAP income – e.g. certain interest, dividends, rents, salaries, annuities – is taxed at a flat rate of 30 per cent (or a lower treaty rate) under a gross-basis withholding regime.<sup>5</sup> US federal estate, gift and generation-skipping transfer (GST) taxes (collectively, 'transfer taxes') apply to US citizens and US residents on a worldwide basis, regardless of the location of the transfer or transferred assets,<sup>6</sup> at rates as high as 40 per cent of the gift or bequest.

An additional GST tax applies to transfers to beneficiaries more than one generation below the transferor unless transfer tax is imposed on an individual in the intervening generation.<sup>7</sup> The GST tax is a flat 40 per cent of the taxable amount.<sup>8</sup>

Transfer taxes apply to transfers of property situated in the US<sup>9</sup> made by an NRNC, with the *situs* test being narrower for gift-tax purposes than estate tax. Transfer taxes are generally paid by the donor.<sup>10</sup> An annual exclusion permits annual gifts, to an unlimited number of donees, of up to USD14,000<sup>11</sup> per donee. NRNCs are ineligible for any lifetime applicable exclusion amount for gifts exceeding the annual exclusion gift, and their estate is granted a USD60,000 exemption equivalent.<sup>12</sup> NRNCs are subject to tax on their accumulated gifts over their lifetime at a maximum rate of 40 per cent in 2016. GST tax may also apply. ➤

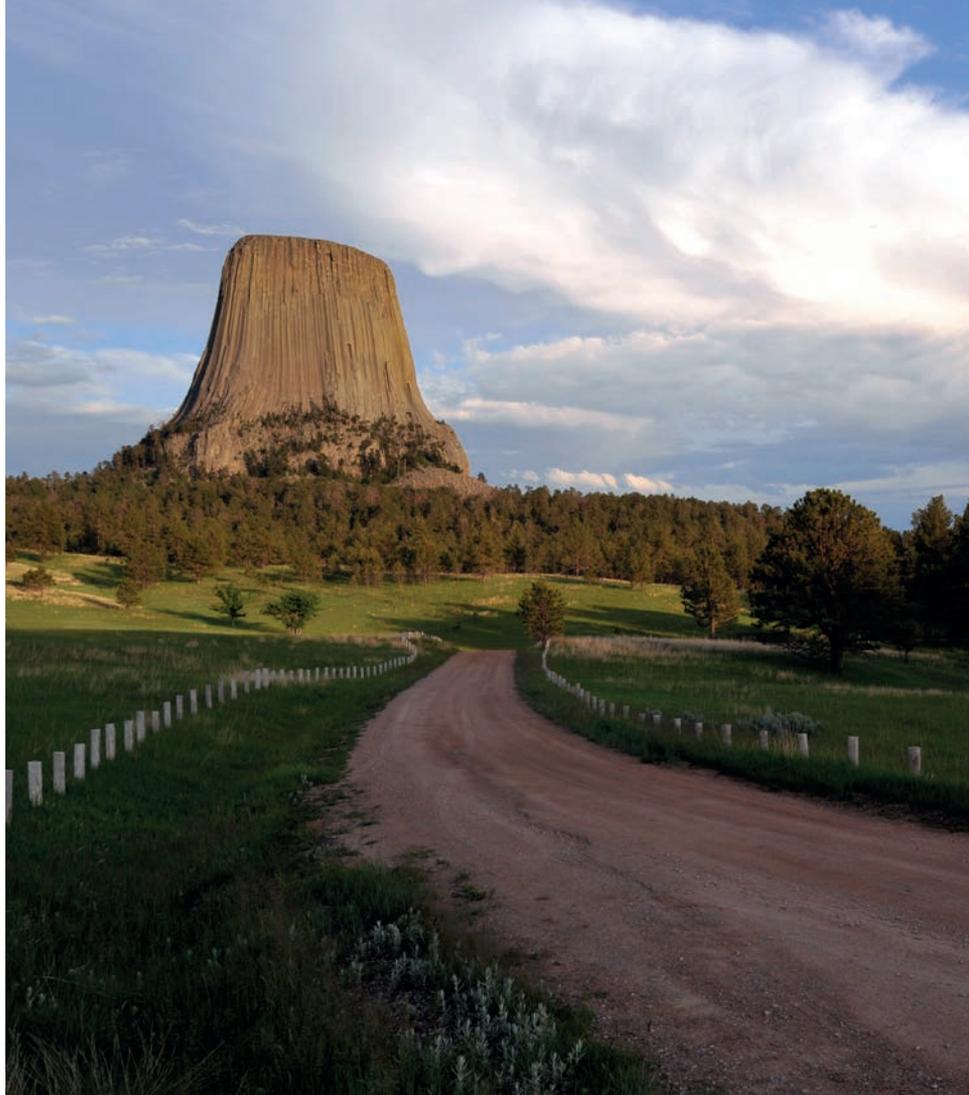
## WORLDWIDE US TAXATION – RESIDENCE v DOMICILE

### FOR INCOME TAX – RESIDENCE

A non-US citizen meeting either the residency test or the Substantial Presence Test will, unless a treaty applies, be subject to US federal income tax<sup>13</sup> on a worldwide basis. The residency test is met if the individual is a ‘lawful permanent resident’ of the US at any time during the calendar year (i.e. holds a Permanent Resident Card, known as a green card)<sup>14</sup> or elects to be treated as a US tax resident.<sup>15</sup>

For the Substantial Presence Test, individuals who are neither US citizens nor green-card holders will be treated as US tax resident during a particular year if they were physically in the US for at least 31 days during a calendar year, and the sum of (i) the number of days present in the US in the current calendar year, (ii) one-third of the number of days physically in the US in the first preceding calendar year, and (iii) one-sixth of the number of days physically in the US in the second preceding calendar year equals or exceeds 183 days.<sup>16</sup>

There are exceptions to the Substantial Presence Test, based on closer connections, unexpected medical conditions and special visa classifications.



## *‘No marital deduction is available for gifts of US situs property made to a non-US citizen spouse’*

### FOR TRANSFER TAXES – DOMICILE

Residency, for transfer-tax purposes, is based on domicile. Foreigners become US domiciliaries and residents for transfer-tax purposes only if they (i) are present in the US, however briefly, and (ii) intend to remain indefinitely. If there is no intent to remain indefinitely, the individual will be treated as a non-resident. A person’s current domicile continues until a subsequent domicile is established.<sup>17</sup>

Since intent is subjective, domicile is established by surrounding facts and circumstances, including one’s primary residence, place of employment, familial ties, centre of vital interests, etc.

### NRNC STRATEGIES AND PITFALLS

NRNCs living in the US can inadvertently become subject to worldwide US income or transfer tax. The number of days spent in the US and abroad should be tracked, since the Substantial Presence Test can result in exposure to worldwide US

income taxation. For transfer-tax purposes, NRNCs must be mindful of establishing a US domicile or acquiring US *situs* assets. Tax treaties may alter the residency rules via tie-breaking provisions where residence rules of multiple jurisdictions apply.

For NRNCs with assets in the US, the main concern is tax exposure created by direct ownership of US *situs* assets. In most cases, pre-acquisition planning can mitigate or eliminate tax exposure. After acquisition, life insurance can hedge against the potential estate-tax liability.

### GIFT-TAX STRATEGIES

No marital deduction is available for gifts of US *situs* property made to a non-US citizen spouse.<sup>18</sup> However, every donor spouse (US or foreign) is entitled to gift up to USD149,000 in 2017 to a non-US citizen spouse free of gift tax.<sup>19</sup> To qualify, such gifts must be of a ‘present interest’.<sup>20</sup>

When NRNCs make completed gifts of corporate stock, the transfer is generally not subject to US federal gift tax.<sup>21</sup> However, if US real property is gifted, the donor is subject to US gift tax unless the real property is owned through a corporation and the NRNC gifts the stock, in which case the transfer is exempt.

The tax treatment of gifts of partnership interests is unclear. Certain cases and authority hold that partnership interests are intangible and not subject to gift tax, and others hold that, if the partnership owns US real estate, it is a gift of the underlying asset.<sup>22</sup> Further, if the sole purpose of the partnership is avoiding gift tax, the Internal Revenue Service may argue it is a gift of a US *situs* asset.<sup>23</sup>

### ESTATE TAXES

NRNC DECEDENT’S US ESTATE  
For NRNC decedents, US estate tax applies only to US *situs* assets.<sup>24</sup> NRNCs’ gross estate includes the value of all real, tangible and intangible property situated in the US at the time of death.<sup>25</sup>

If the decedent transferred US *situs* property and retained a life estate, the full value of the property, as of the date of death,<sup>26</sup> is included in the US gross estate.<sup>27</sup> The gross estate also includes gifts of US *situs* property made within

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US TAX ON NON-RESIDENT ALIENS



intangible. Under the latter, one looks to the underlying assets to determine if any of them, given separately, would generate a transfer tax. Old case law holds partnership interests as intangible<sup>32</sup> and *situs* can be determined according to where partnership business is conducted rather than the *situs* of its assets. Thus, the safest planning route is to treat an interest in a partnership engaged in a US trade or business as US situated.

Arguably, US estate tax does not apply to a partnership that is not engaged in a US trade or business. Therefore, interests in partnerships owning unrented residential US real property or raw land held solely for investment may be considered non-US situated, in which case they will not be included in the decedent's US estate.

Many NRNCs prefer to own US real property through a foreign corporation or to purchase life insurance to cover the estimated estate-tax liability. However, ownership through a foreign corporation can give rise to branch profits tax, although several treaties substantially reduce this. If no treaty applies, a tandem structure of a US subsidiary owned by a foreign parent may minimise both US estate tax and branch profits tax. Structuring foreign investment through debt can also be attractive because both the interest and the note can be exempt from income and estate tax under the portfolio interest exception. Alternatively, acquiring US real property through a trust can provide favourable income-tax rates and shield from US estate taxes.

The value of US real property encumbered by debt is subject to special rules for NRNC decedents.

Generally, only one-half of jointly owned property held by US citizen spouses is included in the decedent's estate, regardless of contributions.<sup>33</sup> However, when one spouse is a non-US citizen, different rules apply, resulting in substantially different tax treatment depending on the citizenships of the decedent and surviving spouse.

#### CONCLUSION

Advising international clients with US connections requires an understanding of US federal tax rules. The US system of worldwide taxation creates potential pitfalls for non-US citizen clients. Proper advance planning can successfully avoid unintended onerous tax exposure.



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- 1 As this term is defined in *Internal Revenue Code* (IRC) § 7701(b)
- 2 IRC § 61
- 3 IRC §§ 871, 872, 881, 882
- 4 Non-resident aliens are, however, exempt from the 3.8 per cent net investment income tax under IRC § 1411(e)
- 5 IRC §§ 1441-1446
- 6 IRC § 2001 (estate tax); §§ 2501, 2503 (gift tax); §§ 2601, 2603 (GST tax)
- 7 IRC § 261
- 8 IRC §§ 2602, 2641, 2001(c)
- 9 *Code of Federal Regulations* (CFR) § 26.2663-2(b)
- 10 IRC § 2502(c)
- 11 As of 2016. See IRC § 2503(b); *Revenue Procedure* 2015-53, s.3.35. Indexed for inflation
- 12 IRC § 2102(b)
- 13 Including the 3.8 per cent net investment income tax for tax years beginning after 31 December 2012. IRC § 1411
- 14 IRC § 7701(b)(1)(A)(i)
- 15 IRC § 7701(b)(1)(A)(iii). Of note, non-resident alien spouses of US tax residents can also elect to be considered a US tax resident on a joint tax return
- 16 IRC § 7701(b)(3)(A)(ii)
- 17 CFR §§ 20.0-1(b)(1), 25.2501-1(b)
- 18 IRC § 2523(i)
- 19 As of 2016. See IRC § 2010; *Revenue Procedure* 2015-53, s.3.35(2). Indexed for inflation
- 20 IRC § 2503(b)
- 21 IRC §§ 2501(a)(2), 2511(a). Note, however, that if the NRNC makes a completed gift of an interest in a foreign entity that is treated as a partnership for US tax purposes, the analysis is complicated by the risk that the foreign entity may be disregarded and the transaction viewed as though the NRNC made a transfer of a proportionate share of the underlying assets
- 22 *Blodgett v Silberman*, 277 US 1 (1928) held that the interest in a partnership owned by the decedent was an intangible for state inheritance-tax purposes. Private Letter Ruling 7737063 and Revenue Ruling 55-143, 1955-1 CB 465 found a partnership interest to be an intangible not subject to gift tax. General Counsel Memorandum 18718, 1937-2 CB 476, declared obsolete 1970-1 CB 280 concluded that the interest in a partnership is itself personal property
- 23 CFR § 1.701-2
- 24 IRC § 2101(a)
- 25 IRC § 2033
- 26 Or as of the alternative valuation date, which is six months after the decedent's death. IRC § 2032
- 27 IRC § 2036
- 28 See IRC §§ 2035-38, 2042
- 29 IRC § 2102(b)
- 30 CFR § 20.2105-1(g)
- 31 Rhoades and Langer, *US International Taxation and Tax Treaties* (Newark, NJ: Matthew Bender, 2005); Cassell, Karlin, McCaffrey, and Streng, *US Estate Planning for Non-resident Aliens Who Own Partnership Interest*, 99 *Tax Notes* 1,683 (Tax Analysts, 16 June 2003), reprinted in 31 *Tax Notes International* 563 (Tax Analysts, 11 Aug 2003)
- 32 *Blodgett v Silberman*
- 33 IRC § 2040(b)

the three-year period ending on the date of death and any gift tax paid thereon.<sup>28</sup>

NRNCs' estates receive a USD60,000 exemption equivalent (i.e. a credit of USD13,000).<sup>29</sup> Excess amounts are taxed at rates up to 40 per cent. A treaty may provide some relief via marital deduction, marital exemption and increased applicable exclusion.

#### SITUS RULES

US insurance proceeds payable on the life of a deceased NRNC policy owner do not have US *situs*.<sup>30</sup> However, if an NRNC owns US life insurance on another's life, the policy value on the NRNC's date of death will be subject to US estate tax.

While deposits with US banks are generally exempt from estate tax, funds held in special deposits by a US bank in a custodial capacity or at US brokerage firms are includible in NRNCs' US taxable estate. Stock in a domestic corporation is includible in the US estate of NRNCs; US real property owned by NRNCs through a foreign corporation is not.

The *situs* of a partnership interest (foreign or domestic) is not clearly defined for estate-tax purposes and may be determined under either the entity theory or the aggregate theory.<sup>31</sup> Under the former, partnership interests are