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U.S. Estate and Gift Taxation of Nonresident Aliens

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I. Introduction

The U.S. transfer tax regime requires special planning for nonresident aliens who invest in the United States. The U.S. estate and gift tax rules for individuals look first to whether an individual is a U.S. citizen. If the individual is not a U.S. citizen, then the next inquiry is whether the individual is a resident of the United States, with residence in the transfer tax context being synonymous with being a U.S. domiciliary. While U.S. citizens and residents are subject to worldwide estate and gift taxation on their gratuitous transfers, nonresidents (meaning here persons who are neither U.S. citizens nor U.S. domiciliaries) are only subject to the U.S. transfer tax system on property that is situated, or deemed situated in the United States. In addition, nonresident aliens are generally not subject to U.S. gift tax on the transfer of intangible property (such as U.S. securities) regardless of where the property is situated or deemed situated. Further, nonresidents are only subject to the Federal generation-skipping transfer tax with respect to transfers to a person or persons that effectively "skip" a generation where such transfers have been subject to the Federal estate or gift tax.

This article surveys the basic rules governing the estate and gift taxation of nonresident aliens. The starting point for this analysis is to determine whether the transferor who is not a U.S. citizen is a *resident* of the United States for U.S. estate and gift tax purposes.

II. Residence for Federal Estate and Gift Tax Purposes

For an individual who is not a citizen of the United States, the determination of residence for Federal estate and gift tax purposes is predicated upon *domicile*. For Federal estate and gift tax purposes, "[a] person acquires domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom."[1] Although the intent of an individual is subjective, it is established by objective criteria such as his statements and conduct and by external facts and circumstances. Because they are prone to being self-serving, an individual's statements concerning his or her domicile are generally accorded only a relatively small amount of weight. Therefore, courts generally will consider additional factors such as the location of an individual's: (i) residential real property; (ii) social and religious affiliations; (iii) business activities; (iv) bank accounts; (v) personal property; (vi) jurisdiction for voting purposes; (vii) driver's license; and (viii) registration of personal property, such as automobiles, boats and airplanes, as well as other factors that demonstrate that a particular jurisdiction has the most significant relationship to the individual.

Unlike the mechanical tests that are used to determine residence for income tax purposes,[2] there is no clear, objective standard to ascertain whether an individual is domiciled in the United States.[3]

III. Federal Estate Taxation of Nonresident Aliens

For Federal estate tax purposes, the value of the U.S. gross estate of a nonresident alien consists only of property (including property that is beneficially owned) that is situated, or deemed situated, in the United States at the time of his or her death.[4] Importantly, property situated outside the United States need not be disclosed to the Internal Revenue Service unless certain deductions or credits are claimed, or the decedent is an expatriate of the United States who has renounced his U.S. citizenship or long-term residency within ten years of his death.

The following general rules apply to determine the situs of property for U.S. estate tax purposes:

Tangible Personal Property

The tangible personal property of a nonresident alien that is actually located in the United States has a U.S. situs and is subject to the Federal estate tax (as well as to the Federal gift tax).[5] For this purpose, cash is considered to be tangible personal property.[6] Therefore, any cash in the United States, including cash in a safe deposit box in the nonresident's name, is includible in the nonresident's gross estate.[7]

Real Property

Real property is deemed situated where it is located.[8] The law of the jurisdiction where the property is located governs whether it is characterized as real property. Generally, real property includes improvements, fixtures, crops, timber and mineral interests.

Importantly, where a nonresident mortgages his U.S. real property on a non-recourse basis and, thereby, has no personal liability for the indebtedness, only the equity value of the real property is includible in his U.S. gross estate. On the other hand, if the mortgage is a recourse mortgage (*i.e.*, it is the personal obligation of the nonresident and is enforceable against him or his estate), the total fair market value of the U.S. real property is includible in the nonresident's estate. In the latter case, only a portion of a mortgage is deductible, and then only if the personal representative of the nonresident discloses the value of the nonresident's worldwide assets on the Federal estate tax return.[9] Frequently, such full disclosure will not be desirable, and, accordingly, where possible, it is preferable if the mortgage on the nonresident's U.S. real property is non-recourse.

A condominium will generally be considered real property. In contrast, a cooperative apartment will generally be considered intangible personal property because it consists of an interest in the shares of a U.S. corporation, plus a proprietary lease.

Because U.S. real property is deemed situated in the United States, nonresident investors frequently use non-U.S. corporations to acquire title to real property located in the United States.

If a nonresident investor already owns real property in the United States, it may be possible for him to transform it into non-U.S. intangible personal property by transferring it to a foreign (non-U.S.) corporation in consideration for the shares of the corporation. In this manner, the nonresident investor may be able to avoid having the property deemed situated in the United States for Federal estate tax purposes. Although such a transformation may be possible from a Federal estate tax standpoint, it may trigger certain adverse income tax consequences under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), and such consequences require careful analysis.

Intangible Personal Property

The estate taxation of a nonresident alien's intangible personal property depends on the type of property involved. Generally, intangible personal property, the written evidence of which is not treated as property itself (such as cash bills), is deemed situated within the United States if it is issued by, or enforceable against, a U.S. person.[10] However, as described more fully below, there are several exceptions to this general rule.

Stock in a U.S. Corporation and a Foreign Corporation

Shares of stock issued by a U.S. corporation and owned (or deemed beneficially owned by a nonresident alien at his death) are deemed situated in the United States.[11] In contrast, shares of stock issued by a foreign corporation and owned (or deemed beneficially owned) by a nonresident alien at his death are not deemed situated in the United States.[12] The location of the share certificate evidencing ownership of stock is irrelevant to the taxability of such shares for Federal estate tax purposes. Furthermore, the use of agency arrangements or nominees will not alter the tax consequences.

It is essential that the corporation be recognized as a corporation under the tax laws of the United States. For example, some foreign entities organized for business purposes, such as *stiftungs* (foundations), are not necessarily considered corporations for Federal estate tax purposes.

United States Treasury Regulations under section 7701 of the Internal Revenue Code now permit the owners of certain "business entities" that are not automatically classified as corporations to elect to be treated as an association taxable as a corporation or a partnership (if it has two or more members), or to be disregarded[13] (if it has a single member) for Federal tax purposes.[14] A "business entity" is defined as an organization or other contractual arrangement that qualifies as an "entity" for Federal tax purposes, but is not treated as a trust (or subject to other special treatment). Trusts are not eligible to elect to be treated as corporations or partnerships (or to be disregarded) for Federal tax purposes.

If a foreign corporation is used to hold property situated or deemed situated in the United States, it is preferable for the foreign corporation to acquire the property directly, if possible.[15]

Debt Obligations

The situs rule for debt obligations is similar to the situs rule for stock in a corporation. Thus, debt obligations of a U.S. person[16] or of a U.S. governmental entity which are owned (or deemed owned) by a nonresident alien decedent are deemed property situated in the United States "whether the written evidence of the debt obligation is treated as being the property itself or whether the decedent was engaged in a business in the United States at the time of his death."[17]

Several exceptions apply to the general rule regarding the U.S. situs of debt obligations of a U.S. person or a U.S. government agency. The exceptions for bank deposits and portfolio interest debt instruments are discussed below.

i. Bank Deposits.

U.S. bank deposits generating interest income that is exempt from Federal income tax to a nonresident alien are not subject to Federal estate tax.[18] Interest earned on a nonresident's deposits with banks and savings and loan associations (or similar institutions) is exempt from Federal income tax, provided it is not effectively connected with a U.S. trade or business.[19]

Although the rule that U.S bank deposits are not subject to Federal estate tax is generally clear with regard to U.S. bank deposits held by a nonresident,[20] the Internal Revenue Service takes the position that if funds are held in special deposits by a U.S. bank in a custodial capacity or in deposits held at U.S brokerage firms or other financial institutions which are not considered banks, they are not exempt from the Federal estate tax.[21] In addition, cash stored in a bank's safety deposit box is not within the bank deposits exception.[22]

ii. Portfolio Interest Debt Instruments.

Debt obligations, the interest on which qualifies as "portfolio interest," are excludable from the gross estate of a nonresident decedent.[23] To qualify as a debt instrument which generates portfolio interest and consequently will be treated as non-U.S. situs property, an obligation must have been issued after July 18, 1984, and either (1) the obligation must be in registered form,[24] or (2) if the obligation is not in registered form, (i) there must be arrangements reasonably designed to ensure that such obligation will be sold or resold in connection with its original issuance only to non-U.S. persons, (ii) interest on such obligation must be payable only outside the United States and its possessions, and (iii) on the face of such obligation there must be a statement that any U.S. person who holds such obligation will be subject to limitations under the U.S. federal income tax laws.[25] To be in registered form, (1) an instrument must be registered as to both principal and any stated interest and transfer of the obligation may be effected only surrender of the old instrument and either a reissuance of the old instrument or an issuance of a new instrument by the issuer to the new holder, (2) the right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent), or (3) the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both the methods described in (1) and (2).[26]

Life Insurance

Insurance proceeds payable by a U.S. insurance company on the life of a nonresident insured owner of the policy are deemed property situated outside the United States.[27] In contrast, if a nonresident alien owns a life insurance policy issued by a U.S. insurance company on the life of another person, the value of that policy is includible in the nonresident owner's estate.

Partnership Interests

The law regarding the situs of a partnership interest for Federal estate tax purposes varies depending upon whether, under the applicable local law, a partnership qualifies as a separate and distinct legal entity and whether the partnership survives the death of one of its partners.[28]

If the partnership is not recognized as a legal entity or terminates upon the death of the partner, the situs of the decedent's partnership interest is the location of the underlying partnership assets.

In contrast, if the partnership is both recognized as a separate legal entity and survives the death of its partners, the situs may be determined either by reference to the domicile of the deceased partner or by reference to where the business of the partnership is conducted. Despite judicial authority for the former position (i.e., determining situs by reference to the domicile of the deceased partner), the Service primarily focuses on where the business of the partnership is conducted.[29]

If a limited liability company has at least two members, it may be treated for U.S. tax purposes as a partnership. If a domestic limited liability company has only one member and the check-the-box election for treatment as a corporation has not been made, it is disregarded as an entity.[30] For foreign limited liability companies, the U.S. federal tax treatment of the entity depends upon whether each member of the entity has limited liability.[31] If each member has limited liability, it is treated as an association and may be taxable as a corporation.[32] If any member does not have limited liability, it is treated as a partnership.[33]

Trust Interests

There are two threshold requirements for a trust interest to be includible in a nonresident decedent's gross estate for Federal estate tax purposes: (1) the trust must be a valid trust on the nonresident decedent's date of death and (2) his interest in the trust must be indefeasibly vested in such manner as would cause estate tax inclusion if he were a U.S. citizen or resident (domiciliary) pursuant to Sections 2033 through 2046 of the Internal Revenue Code.[34] If these two preliminary requirements are met, then an analysis of the rules of Sections 2104 and 2105 of the Code, which sections classify property as having a situs within and without the United States, is necessary to determine whether the nonresident alien decedent's interest in the trust is includible in his gross estate for Federal estate tax purposes.

i. Nonresident is the Beneficiary of the Trust.

Since an interest must be indefeasibly vested, a mere expectation that a person will receive property is insufficient to trigger Federal estate taxation. If a nonresident decedent is the beneficiary of a non-U.S. trust and has a general testamentary over of appointment over the trust property (pursuant to Section 2041 of the Code) which consists of U.S. situs property (such as shares of stock in a U.S. corporation), such U.S. situs property will be includible in the nonresident's U.S. gross estate. [35]

ii. Nonresident is the Settlor of the Trust.

A nonresident alien decedent will be subject to U.S. estate tax inclusion where the nonresident settles a trust consisting of U.S. situs property either at the time that the property is transferred to the trust, or at the time of the decedent's death, and retains strings so as to cause estate tax inclusion under Sections 2035-2038 or 2042 of the Internal Revenue Code.[36]

iii. General Considerations.

If a nonresident alien decedent holds certain proscribed powers over, or interests in, a trust (whether foreign or domestic) pursuant to any of sections 2035 through 2038, 2041 and 2042 of the Code, the trust's property will be included in his U.S. gross estate if it is U.S. situs property *on either the date of the transfer or the date of death*.[37] The situs of such property held by the trust is determined based upon the rules set forth in Sections 2104 and 2105 of the Code.

Patents, Trademarks, Copyrights and Contractual Rights

In general, contractual rights, such as licenses of patents and trademarks, are deemed to be situated in the jurisdiction for which the license is granted.[38] However, an argument can be made that they are situated where they are enforceable, namely, the jurisdiction of the licensor.[39]

Estate Tax Consequences When Property is Transferred with Strings

Under section 2104(b) of the Code, a transfer of property (in trust or otherwise) situated in the United States either at the time of transfer or at the time of the transferor's death causes the property to be includible in the transferor's gross estate for Federal estate tax purposes if the "string provisions," namely sections 2035 through 2038 and 2042 of the Code, apply.[40] The principles used to determine whether property is situated within the United States for Federal estate tax purposes also apply here. Therefore, shares of stock of a domestic (U.S.) corporation which were directly transferred to a revocable trust would be ensnared by this rule notwithstanding that for purposes of the Federal gift tax, such shares were deemed to be situated outside the United States.[41]

The string provisions also affect property situated in the United States that a nonresident gratuitously transfers to a foreign trust. If a nonresident alien retains the right to alter, amend or revoke such a trust, the value of the property remains includible in his U.S. gross estate. Therefore, if the property is tangible personal property (such as cash), it should be removed from the United States before being contributed to the trust and should not be located in the United States at the time of the nonresident grantor's death.

Jointly Held Property

Generally, under Code section 2040(a), if property is held by a decedent and other persons as joint tenants with the right of survivorship the value of the jointly held property included in the estate of the first joint tenant to die is based on the amount of consideration the deceased joint tenant originally provided to acquire such property and to pay for subsequent capital improvements thereon.[42] There is in effect a "tracing rule." Thus, upon the death of a joint tenant, an appropriate percentage of the value of the jointly held property as of the date of the decedent's death (or alternate valuation date) will be included in the decedent's gross estate. This amount of estate tax inclusion is determined by multiplying the date of death value (or value as of the alternative valuation date) of the property by a fraction, the numerator of which is the amount of consideration furnished by the decedent and the denominator of which is the total amount of consideration provided by all joint tenants.

Notwithstanding the general rule of Code section 2040(a), under Code section 2040(b), if a decedent and the surviving spouse are the only joint tenants of the property, one-half of the value of the property will be includible in the deceased spouse's gross estate.[43] Thus, for such "qualified joint interests," the decedent's interest in jointly held property can be determined without resort to a complicated tracing rule.

Code section 2040(b), however, does not apply if the surviving spouse is not a citizen of the United States at the time of the decedent's death.[44] Accordingly, in such cases, the decedent's estate must employ the general "tracing rule" of Code section 2040(a) to determine the amount includible in the deceased spouse's estate.

Credits

The applicability of credits depends on the type of property that is included in the nonresident's gross estate and is frequently limited.

i. The Applicable Exclusion Amount.

A nonresident is allowed a "credit" against the Federal estate tax of $13,000.[45] This credit is the equivalent of an exclusion of $60,000, and therefore pales in comparison to the applicable exclusion amount of $5,000,000 ($5,120,000 in 2012) that is currently allowed to U.S. citizens and residents. Treaties, where applicable, may increase the amount of exclusion to which a nonresident decedent is entitled.

ii. Credit for Tax on Prior Transfers.

There is a credit for Federal estate taxes paid on property passing to the nonresident within ten years prior to and two years after the death of the nonresident.[46]

iii. Other Credits.

No credit is allowed to the estate of a nonresident for death taxes paid to foreign governments.[47]

Deductions

In addition, the availability of deductions from the gross estate of a nonresident alien is similarly limited. Deductions attributable to property situated outside the United States are not available, and certain deductions attributable to property situated within the United States are available on a proportionate basis.

i. Marital deduction.

Federal tax law provides an unlimited marital deduction to the estate of a nonresident (dying after November 10, 1988) who leaves his property situated, or deemed situated in the United States to a U.S. citizen surviving spouse, provided that the usual statutory requirements to ensure that the property will be taxable at the death of the surviving spouse are met.[48] In contrast, transfers of such U.S. property from a nonresident to his non-U.S. citizen spouse will qualify for the marital deduction only if the property is also transferred to a Qualified Domestic Trust ("QDOT") for the benefit of the surviving spouse.[49]

Similarly, a marital deduction with respect to the estate tax is allowed to the estate of a U.S. citizen or resident (domiciliary) for transfers to his non-U.S. citizen spouse only if the property transferred is held in a QDOT for the benefit of the spouse.[50] In order to qualify for the marital deduction, all property, whether probate or non-probate, passing to a non-U.S. citizen surviving spouse must be placed in or irrevocably assigned to a QDOT on or before the extended due date of the Federal estate tax return, with the outside limit for such transfers being one year after the time prescribed by law, including extensions, for filing the Federal estate tax return.[51] A QDOT may be created by a decedent, his or her executor or surviving spouse.

In order for a trust to be a QDOT, the following requirements must be met:

1. The trust must require that at least one trustee be an individual U.S. citizen or U.S. corporation;[52]
2. The trust instrument must provide the U.S. trustee with the right to withhold the estate tax imposed on any distribution of principal from the trust;[53]
3. The trust must comply with such regulations as are promulgated to ensure the collection of any estate tax imposed on the trust;[54]
4. The executor of the decedent must make an irrevocable election with respect to the trust on the decedent's Federal estate tax return, which must be filed within one year of the due date for the return, including extensions;[55] and
5. The trust must be organized as a trust or, in foreign jurisdictions which do not recognize trusts, must have substantially the same effect as a trust.[56]

Property passing to a QDOT must qualify as qualified terminable interest property under Section 2056(b)(7) or otherwise qualify for the marital deduction under section 2056.[57]

The purpose of the third requirement set forth above is generally to ensure that an estate tax (the "deferred estate tax") is paid at the earlier of the following occurrences: (a) upon distribution of trust principal before the surviving spouse's death (except in the case of hardship), in which case the deferred estate tax would apply to the value of the principal distributed, or (b) upon the death of the surviving spouse, in which case the deferred estate tax would apply to the value of the principal remaining in the trust as of the surviving spouse's death.[58] The imposition of the deferred estate tax would be accelerated, however, if there were no U.S. citizen or domestic corporation acting as a trustee of the trust or if the trust were to cease to meet the regulatory requirements to ensure the collection of tax.[59]

Significantly, all trust distributions of income to the non-U.S. citizen surviving spouse are exempt from the estate tax. In addition, estate tax-free distributions of principal are permitted in the case of hardship.[60]

Although the Code provides a marital deduction to the estate of a nonresident alien, estate planners should be careful in using it. For example, if a nonresident is married to a U.S. citizen, it is generally not advisable to leave property that otherwise is not subject to the Federal estate tax to his surviving spouse in a manner that will cause such property to be taxed in the estate of such spouse. In such case, it may be better to leave such property to the surviving U.S. citizen spouse in trust, rather than outright, and ensure that the provisions of the trust will not cause the assets thereof to be includible in the gross estate of the U.S. citizen spouse such as by conferring upon the surviving spouse a general power of appointment.[61]

ii. Charitable Deductions.

Bequests, legacies, devises or transfers from a nonresident to the United States or any political subdivision thereof, or to any charitable corporation organized in the United States and established and operated for religious, scientific or educational purposes, or to a trustee or fraternal organization for charitable purposes within the United States, are allowed as a charitable deduction. If charitable transfers qualify, the entire deduction is allowed and no apportionment is required,[62] but the personal representative must disclose the value of the decedent's worldwide gross estate in order to claim the charitable deduction.[63]

iii. Deductions for Funeral and Administration Expenses, Claims Against the Estate, Indebtedness, Taxes and Losses.

Section 2053 of the Code allows deductions for funeral and administration expenses, claims against the estate, indebtedness in respect of property which is includible in the U.S. gross estate, and taxes. In addition, Section 2054 allows deductions for losses. Further, under

Section 2058, a deduction is available for state death taxes.

Importantly, in order for a nonresident's estate to take any deduction under Section 2053 or 2054, the nonresident's entire estate must be disclosed to the Internal Revenue Service, and the decedent's personal representative may not wish to disclose this information. Consequently, the personal representative may decide to forego the deduction for Federal estate tax purposes.[64]

IV. Federal Gift Taxation of Nonresident Aliens

What is Subject to Gift Tax?

A nonresident is subject to the Federal gift tax only on gratuitous transfers (direct or indirect, by trust or otherwise) of real or tangible personal property situated in the United States.[65] In contrast to the rules that apply for estate tax purposes, transfers of intangible property by nonresidents, such as shares of stock of domestic corporations or debts of a U.S. person or entity, are specifically excluded from the gift tax unless the donor is a nonresident who expatriated from the United States and meets certain statutory requirements.[66] Accordingly, in determining the Federal gift tax for a nonresident (and assuming that an expatriation situation does not apply), the only issues that need to be addressed are:

(1) whether the gift consists of real or tangible personal property and, if so,

(2) whether it is situated in the United States.

As with the estate tax, real or tangible property is situated in the United States only if it is physically located in the United States.[67]

Because no gift tax applies to gifts of debt obligations of U.S. persons or stock of U.S. corporations, a nonresident may wish to make gifts of this type of property, especially since they would be subject to the Federal estate tax if held at death. In addition, if a nonresident wishes to make a gift of tangible personal property which is located in the United States, he should remove it from the United States before making the gift to avoid the Federal gift tax. In this way, he will avoid both the Federal gift tax and the "gross up" consequence if the Federal estate tax applies to his estate.

Importantly, even if the donor removes the property from the United States to transfer it gratuitously, he should not retain rights or powers that, under sections 2035 through 2038, 2041 and 2042 of the Code, make the property includible in his gross estate if situated in the United States at the time of his death.[68]

If a nonresident purchases tangible personal property while visiting the United States, it is clearly advisable from the nonresident's standpoint to hold off making any gifts of such property until after he has left the United States to avoid the federal gift tax.

Moreover, when a nonresident transfers funds to a donee who is located in the United States, as an extra layer of precaution (although technically not required), the nonresident should avoid using checks drawn on U.S. banks and wire transfers into the United States.

Computation of the Gift Tax

The federal gift tax is a cumulative tax that is determined by computing a tentative tax on taxable gifts made during the applicable period, plus taxable gifts made subsequent to June 6, 1932. The tentative tax applicable to the prior gifts is then subtracted to determine the actual tax.

i. Annual Exclusion.

The annual exclusion of $13,000 per donee is available to a nonresident.[69] In order to qualify, the gift must be of a present interest in property. Significantly, nonresident spouses are unable to split gifts to effectively double the annual exclusion. As more fully discussed below, the annual exclusion amount for gifts by a spouse to a non-U.S. citizen spouse is increased to $100,000, subject to indexing (with this amount at $136,000 for 2011 and $139,000 for 2012).

***ii. Gift Tax Exclusion for the Direct Payment of Tuition or Medical Care*.**

A donor (including a nonresident) is permitted to exclude from taxable gifts amounts paid on behalf of an individual as tuition to a qualifying educational organization for the education or training of such individual, or amounts paid on behalf of an individual to any person who provides medical care (as defined in IRC § 213(d)) with respect to such individual as payment for such medical care.[70] The payments of these expenses by a donor must be made *directly* to the educational institution or provider of medical services. If a donor intends to transfer assets to a donee and such a transfer would be subject to gift taxes, the donor may instead pay educational or medical expenses of the donee directly, and such payments will not be subject to gift taxes if the IRC § 2503(e) requirements are met.[71]

iii. Federal Gift Tax Rates.

The Federal gift tax schedule of rates for nonresidents is the same as the unified estate and gift tax rate schedule for U.S. citizens and residents. However, in contrast to the $13,000 credit available to nonresidents for estate tax purposes, no credit against gift tax is available to nonresidents.[72] Under current law, the rates begin at 18 percent on taxable gifts under $10,000 and go up to 35 percent.

iv. Unified Credit.

Although the credit applicable to Federal estate taxes is not available to a nonresident at the time the gift is made, gifts that are included in the calculation of the nonresident's Federal estate tax as adjusted taxable gifts are allowed a credit for the Federal gift tax if a Federal estate tax return for the nonresident is filed.[73]

v. Marital Deduction.

A nonresident is eligible for a marital deduction for a gift of U.S. situs property to his U.S. citizen spouse.[74]

However, whether the donor is a U.S. citizen, a U.S. domiciliary or a nonresident alien, no marital deduction is allowed at all for gifts to or for the benefit of a non-U.S. citizen spouse. As partial compensation for the complete loss of a marital deduction, the annual exclusion amount allowable for any gifts to a non-U.S. citizen spouse under Section 2503(b) of the Code is increased to $100,000, indexed for inflation.[75] For 2011 the indexed amount is $136,000, rising to $139,000 for gifts made to non-U.S. citizen spouses in 2012.

Special gift tax rules apply to joint interests created between a U.S. citizen or non-U.S. citizen spouse and his non-U.S. citizen donee spouse depending on whether the interest transferred is in real property or in personal property.[76]

vi. Charitable Deduction.

Charitable deductions by a nonresident are limited to gifts made to U.S. charitable corporations in the United States, any state, or any political subdivision of the United States, domestic veterans organizations and trusts, funds, foundations, fraternal orders or lodges for use within the United States.[77]

vii. Joint Gifts by Spouses.

As noted above, gift-splitting by spouses to third parties under section 2513 of the Code is permitted only if both spouses are U.S. citizens or residents (domiciliaries).[78]

viii. Treaties.

The United States has gift tax treaties with the following countries: Australia, Austria, Denmark, France, Germany, Japan, Sweden and the United Kingdom. These treaties may vary the application of the Federal gift tax provisions and should be reviewed when a nonresident from one of those jurisdictions makes a gift of U.S. property.[79]

V. Generation-Skipping Transfer Tax of Nonresident Aliens

Special generation-skipping transfer tax ("GST tax") rules apply to transfers by nonresident aliens that "skip" a generation (as further explained below).

The generation-skipping transfer, or "GST" tax, is currently a flat 35% tax imposed on transfers to "skip persons," a term which includes family members more than one generation, and unrelated persons more than 37½ years, younger than the donor.[80] The purpose of this tax is to ensure that property will be subject to full transfer taxation at each generational level. This tax is imposed *in addition to* the gift tax or estate tax.[81]

Under current law, the "GST exemption" permits a donor to transfer a total of $5,120,000 (in 2012) to skip persons free of GST tax.[82] The GST exemption is a one-time, cumulative exemption from taxation.

Significantly, with respect to nonresident aliens, transfers which are not subject to the Federal gift or estate tax (such as transfers of non-U.S. situs property by a nonresident alien) are not subject to the GST tax.[83]

VI. Conclusion

The U.S. transfer tax regime requires special planning for nonresident aliens who invest in the United States. Where the client is *not* a U.S. citizen, the initial question is whether the individual is a resident of the United States, with residence in the transfer tax context being synonymous with being a U.S. domiciliary. While U.S. citizens and residents are subject to worldwide estate and gift taxation on their gratuitous transfers, nonresidents (meaning here persons who are neither U.S. citizens nor U.S. domiciliaries) are only subject to the U.S. transfer tax system on property that is situated, or deemed situated in the United States. In addition, nonresident aliens are generally not subject to U.S. gift tax on the transfer of intangible property (such as U.S. securities) regardless of where the property is situated or deemed situated. Further, nonresidents are only subject to the Federal generation-skipping transfer tax with respect to transfers that are subject to the Federal estate or gift tax.

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1 Treas. Reg. § 20.0-1(b).

2 *See* I.R.C. § 7701(b).

3 Because there are different standards to determine the application of the Federal income tax laws and the Federal estate and gift tax laws, it is possible for an individual to be a resident of the United States for Federal income tax purposes but not a domiciliary of the United States for Federal estate and gift tax purposes, and vice versa.

4 *See* I.R.C. § 2103.

5 *See* Treas. Reg. §§ 20.2104-1(a)(2), 20.2105-1(a)(2), 25.2511-3(b)(1).

6 *See* Treas. Reg. § 20.2104-1(a)(2).

7 An important exception to the general rule that tangible personal property located in the United States is includible in a nonresident's gross estate applies in the case of works of art on loan for exhibition in a non-profit art gallery or museum. Such works of art are not deemed situated in the United States for Federal estate tax purposes. *See* I.R.C. § 2105(c); Treas. Reg. § 20.2105-1(b). Significantly, there is no corresponding exclusion for Federal gift tax purposes.

8 *See* Treas. Regs. §§ 20.2104-1(a)(1), 20.2105-1(a)(1).

9 *See* I.R.C. § 2106(b). The amount of this deduction is calculated by multiplying the amount of the outstanding mortgage by a fraction, the numerator of which is the value of the decedent's total U.S.-situs property and the denominator of which is the value of the decedent's total worldwide property.

10 *See* Treas. Regs. § 20.2104-1(a)(4). There is an extremely significant distinction here between the Federal estate and gift tax rules for nonresident aliens. Intangible property, such as shares of stock of domestic corporations or debts of a U.S. person, irrespective of where the stock certificate or the written evidence of the debt is located, although deemed to be situated in the United States, generally is not subject to the Federal gift tax. *See* Treas. Regs. § 25.2511-3.

11 *See* I.R.C. § 2104(a); Treas. Regs. § 20.2104-1(a)(5).

12 *See* Treas. Regs. § 20.2105-1(f). The Internal Revenue Service has privately ruled that American Depositary Receipts ("ADRs") should not be includible in the gross estate of a nonresident alien. Despite being registered and issued generally by U.S. banks, ADRs represent shares of stock of foreign corporations and should be treated as such for Federal estate tax purposes. *See* Priv. Ltr. Rul. 200243031 (Oct. 25, 2002).

13 The owner of an entity that is disregarded reports all of the income

and expenses of the disregarded entity on his own return and treats the assets of the disregarded entity as his own.

[14] *See Pierre v. Comm'r*, 133 T.C. 2 (Tax Ct. 2009), holding that the "check-the-box regulations" under Section 7701 do not apply for Federal gift tax purposes so as to cause a single member limited liability company to be disregarded for Federal gift tax purposes.

[15] *See* I.R.C. § 2104(b).

[16] *See* I.R.C. § 7701(a)(30) for the definition of a "U.S. person."

[17] Treas. Regs. § 20.2104-1(a)(7); *see* I.R.C. § 2104(c).

[18] *See* I.R.C. § 2105(b).

[19] *See* I.R.C. §§ 871(i)(2)(A), (3) and 881(d).

[20] *See* I.R.C. § 2105(b).

[21] *See* Rev. Rul. 69-596, 1969-2 C.B. 179; G.C.M. 22,419, 1940-2 C.B. 288.

[22] *See* Rev. Rul. 55-143, 1955-1 C.B. 465.

[23] *See* I.R.C. §§ 871(h), 2105(b)(3).

[24] *See* I.R.C. § 871(h)(2)(B)(i). For portfolio interest to be exempt from Federal income tax for a nonresident alien, the recipient of interest payments must also provide the payor with a statement that the beneficial owner of the obligation is not a U.S. person. *See* I.R.C. § 871(h)(2)(B)(ii), (5). This is usually accomplished by furnishing Form W-8BEN. This requirement, however, does not apply when determining the situs of the debt obligation for U.S. Federal estate tax purposes. *See* I.R.C. § 2105(b)(3).

[25] *See* I.R.C. §§ 163(f)(2)(B), 871(h)(2)(A).

[26] *See* Treas. Regs. § 1.871-14(c). An obligation will be considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation.

[27] *See* Treas. Regs. § 20.2105-1(g).

[28] To lessen the impact of income taxation, partnerships and entities treated as partnerships for Federal tax purposes are sometimes used by nonresidents as investment vehicles for property situated in the United States. Caution is necessary, however, because to the extent that a nonresident makes an investment in a U.S. partnership through a foreign corporation, branch profits tax exposure may arise. Branch profits tax exposure may be avoided, however, by making the investment through a U.S. corporation which in turn is owned by a foreign corporation.

[29] *See* Robert C. Lawrence III, International Tax & Estate Planning – A Practical Guide for Multinational Investors § 3.2.6 at 3-17 – 3-20 (3rd ed. 2009).

[30] *See* Treas. Regs. § 301.7701-3(b)(1).

[31] *See* Treas. Regs. § 301.7701-3(b)(2).

[32] *See id*.

[33] *See id*.

[34] *See* I.R.C. § 2103; Treas. Regs. § 20.2103-1.

[35] *See Comm'r v. Nevius*, 76 F.2d 109 (2d Cir.) (U.S. estate tax inclusion of pro rata share of trust corpus attributable to U.S. securities over which nonresident alien decedent held a testamentary general power of appointment), *cert. denied*, 296 U.S. 591 (1935).

[36] *See* I.R.C. § 2104(b); Rev. Rul. 55-163.

[37] *See* I.R.C. §§ 2103, 2104(b).

[38] *See* Robert C. Lawrence III, *supra,* § 3.2.8 at 3-22.

[39] *See id*.

[40] *See* I.R.C. § 2104(b).

[41] The transfers to which Section 2104(b) apply are as follows:

- transfers of property interests that would otherwise be includible in the transferor's gross estate under section 2035, 2036, 2037, 2038 or 2042 of the Code, within three years of the decedent's death;
- transfers in which the decedent retained for his life, or a period not ascertainable without reference to his death, or for any period which does not in fact end before his death, the possession or enjoyment of the property, or the right to the income from the property, or the right to designate who would possess or enjoy the property or its income;
- transfers which require that in order to possess and enjoy the property the transferee must survive the transferor who retained a reversionary interest worth more than five percent of the value of the property immediately prior to his death; and
- transfers which at the date of the transferor's death are subject to a power in the transferor to alter, amend, revoke or terminate the same, or where the transferor relinquished any such power within three years of his death.

[42] *See* I.R.C. § 2040(a); Treas. Regs. § 20.2040-1(c)(3).

[43] *See* I.R.C. § 2040(b). An interest held by a decedent and the decedent's spouse as the only joint tenants (or as tenancy by the entirely) is a "qualified joint interest."

[44] *See* I.R.C. § 2056(d)(1)(B).

[45] *See* I.R.C. § 2102(b)(1). This credit is taken first, before the reduction of the Federal estate tax by the application of any other credits. *See* I.R.C. § 2101(b).

[46] I.R.C. § 2013. An example of a circumstance where property could be subject to the Federal estate tax in the transferor's estate after the death of the transferee (nonresident alien) would be where a transfer had occurred during the life of the transferor but was includible in the estate of the transferor because of the application of one of the Federal estate tax provisions, such as one of the string provisions.

[47] *See* I.R.C. § 2014. This section of the Code only provides a

credit for foreign death taxes imposed by I.R.C. § 2001, which provides for the imposition of estate taxes on U.S. citizens and residents.

48 *See* I.R.C. 2106(a)(3).

49 *See* I.R.C. § 2056(d)(2).

50 *See* I.R.C. §§ 2056(d), 2056A.

51 *See* I.R.C. § 2056A(d).

52 *See* I.R.C. § 2056A(a)(1)(A).

53 *See* I.R.C. § 2056A(a)(1)(B).

54 *See* I.R.C. § 2056A(a)(2).

55 *See* I.R.C. § 2056A.

56 *See* I.R.C. § 2056A.

57 *See* Treas. Regs. § 20.2056A-2(b). If a trust does not meet the requirements for a QDOT, as set forth above, but would have qualified for the marital deduction in all other respects, the time for determining whether a trust will qualify as a QDOT may be extended if a reformation proceeding is commenced prior to the due date for filing the estate tax return. In that event, the determination of whether the trust qualifies as a QDOT will be made at the conclusion of the reformation proceedings.

58 *See* I.R.C. § 2056A(b)(1)(A), (B).

59 *See* I.R.C. § 2056A(b)(4).

60 *See* I.R.C. § 2056A(3)(B).

61 Certain treaties, as well as the U.S. Treasury Department's Model Estate and Gift Tax Treaty, recognize some form of marital deduction which may elected in lieu of a QDOT.

62 *See* I.R.C. § 2106(a)(2).

63 *See* I.R.C. § 2106(b).

64 *See* I.R.C. § 2106(b); Treas. Regs. §§ 20.2106-1(b) and 20.2106-2(a).

65 *See* I.R.C. §§ 2501(a)(2), 2511(a).

66 *See* I.R.C. §§ 2501(a)(3), 2511(b), 2107.

67 *See* Treas. Regs. § 25.2511-3(b)(1).

68 *See* I.R.C. § 2104(b).

69 *See* I.R.C. § 2503(b).

70 *See* I.R.C. § 2503(e).

71 *See* I.R.C. § 2642(c)(3)(B). This exclusion also applies for generation-skipping transfer tax purposes. *See* I.R.C. § 2611(b)(1).

72 *See* I.R.C. § 2505(a).

73 *See* I.R.C. § 2101(b).

74 *See* I.R.C. § 2523(a).

75 *See* I.R.C. § 2523(i).

76 *See* Robert C. Lawrence III, *supra*, § 2.3.2 at 1-19.

77 *See* I.R.C. § 2522(b).

78 *See* I.R.C. § 2513(a)(1).

79 Treaties will often change the analysis under the Federal estate tax statutes as well, and should be reviewed as warranted.

80 There is a "predeceased child" exception such that the GST tax does not apply in certain situations where members of an intervening generation are deceased. For example, an outright gift from a grandparent to a grandchild born of the grandparent's deceased child is not subject to GST taxes.

81 GST tax is imposed on three types of transfers:
i. *Direct Skips:* These are transfers to a skip person that are subject to the estate tax or the gift tax.
ii. *Taxable Terminations:* These occur upon the termination (whether by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust unless (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from a trust to a skip person.
iii. *Taxable Distributions.* These are distributions from a trust to a skip person that are neither a direct skip nor a taxable termination.

82 *See* I.R.C. §§ 2631(c), 2010(c). *See also* Treas. Regs. § 26.2663-2 (1995) (final GST tax regulations providing for a GST exemption of $1,000,000 in accordance with the GST exemption at that time, but presumably intended to track subsequent increases in the GST exemption amount); Robert C. Lawrence III, *supra*, § 3.7 n.175, at 3-45 (advocating this construction).

83 *See* Treas. Regs. § 26.2663-2.

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