Key Estate Planning Concepts for International Clients

Estate and gift tax techniques that are the foundation of common planning strategies do not necessarily apply to noncitizens or nonresidents.

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In recent years, both the IRS and practitioners have vastly increased their focus on international compliance issues. Service-authorized programs for retroactive offshore disclosures have generated more than $10 billion of revenue for the federal government. Practitioners have been inundated with requests by clients to participate in retroactive disclosure programs (and, very possibly, could soon be inundated with requests from clients to fight FBAR assessments made by the Service against individuals who did not voluntarily come forward).

What sometimes does not receive proper focus is the additional needs associated with these clients; one primary area is in the realm of estate and gift planning. Clients making offshore disclosures often have significant worldwide assets in their names, and thus can benefit from estate planning advice incorporating the same.

For clients who currently or previously resided overseas, maintain significant assets overseas, or propose to leave assets to beneficiaries who live outside the U.S., estate and gift planning advice is often not basic. Instead, it can involve a multi-jurisdictional approach, factoring in foreign ramifications of a typical U.S.-based plan. Failure to recognize foreign-specific issues in this type of plan can have disastrous consequences. This article provides an outline of items to consider from an international estate and gift planning perspective, illustrating circumstances where issues may arise and potential approaches to implement.

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Who faces taxation on gifts and bequests?

As a threshold matter, a practitioner must ascertain whether a client is subject to U.S. estate and gift taxes and, if so, the degree of exposure.

Citizens and residents. U.S. citizens and residents are taxable on the transfer of their worldwide estate, generally determined by including the value of all property wherever situated (i.e., either inside or outside the U.S.) at the time of death.[1] A credit against the estate tax is available; for 2017, the estate tax exclusion is $5.49 million (with this amount adjusted annually for inflation).[2] This amount can be used for bequests to anyone, regardless of whether the recipients are U.S. citizens. After application of the exclusion amount, the excess portion of the estate is taxed at the federal level at a rate of 40%.

An unlimited marital deduction usually is applicable on death, whereby a decedent can pass assets to his or her surviving spouse free of any tax.[3] Such exclusion is available, however, only when the surviving spouse is a U.S. citizen; it is inapplicable where the surviving spouse is not a citizen (even if the spouse is a U.S. resident).[4] Where bequests are made to a noncitizen spouse (regardless of where the spouse resides), the aforementioned $5.49 million exclusion is instead used (subject to estate tax treaty provisions, as discussed below). For transfers to noncitizen spouses to qualify for the marital deduction outside of estate tax treaty provisions, the marital bequests must either be held in a QDOT or the surviving spouse must become a U.S. citizen (also discussed below).

A tax is also imposed for each calendar year on the transfer by citizens and residents of gifts of their worldwide assets (with the estate tax exclusion amount usable for lifetime gifts).[5] Generally, the gift tax exclusion is unlimited for gifts between spouses; however, as with the estate tax, this exclusion is inapplicable where the donee spouse is not a U.S. citizen.[6] Where the donee spouse is a noncitizen, an annual exclusion amount (not cutting into the aforementioned $5.49 million exclusion amount) is instead available, with such amount set at $149,000 for 2017.[7] Gift splitting is typically available for when spouses give gifts to other persons, doubling the exclusion amount available (i.e., from $14,000 to $28,000 in 2017); however, gift splitting is not permitted where one spouse is a nonresident alien.[8]

Determinations as to U.S. citizenship are typically straightforward; a person almost always knows whether he or she is a U.S. citizen. More ambiguity exists in regards to whether a noncitizen is treated as a U.S. resident; importantly, "residency" for estate and gift tax purposes is not necessarily the same as "residency" for income tax determinations.

Under estate and gift tax rules, an individual is treated as a U.S. resident decedent (for estate tax purposes) or resident donor (under gift tax rules) when he or she establishes a U.S. domicile—i.e., the person is a U.S. resident and has no present intention of leaving.[9] Whether an individual has established a U.S. domicile is determined based on his or her specific facts and circumstances; factors taken into account include:

- Whether the individual held a green card (which evidences a stronger desire to stay permanently in the U.S. than residence without the green card).
- The length of stay in the U.S.
- The significance of remaining links to any prior country of residence.

Taking a "facts and circumstances" approach to residency in the estate and gift tax context makes determinations more ambiguous than in the income tax context. Given the differences in exemption amounts between residents and nonresidents, the effects of classification as a resident can be significant.

Nonresident aliens. Unlike with citizens and residents, nonresident aliens of the U.S. are not subject to estate tax on worldwide assets, but rather are subject to tax on only certain assets located within the U.S.[10] The estate of a nonresident alien, however, receives a credit that is equivalent to an exemption from taxation of only $60,000;[11] a maximum 40% rate of tax is applicable.[12] Estate tax is assessable on assets located within the U.S., including U.S. real estate, tangible personal property, securities of U.S. companies, and accounts with brokerage firms.[13] Generally, deposits with U.S. banks are not subject to U.S. estate tax when the account is not effectively connected with a U.S. trade or business.[14]

For gift tax purposes, nonresident aliens normally are subject to tax on lifetime gifts of tangible property within the U.S.[15] Tangible property within the U.S. includes real property situated within the country, tangible personal property within the U.S. at the time of the gift, and U.S. currency or cash situated within the U.S. at the time of the gift.[16] Intangible property owned by a nonresident is not subject to gift tax.[17] A nonresident alien (the same as a U.S. resident or citizen) maintains the ability to make gifts of up to $14,000 per donee per year without gift tax imposition.[18]

While reduced exemption amounts for bequests and gifts can markedly increase transfer taxes due by a nonresident, the scope of taxes is also narrowed for these individuals—only certain assets within the U.S. are subject to tax. The rules applicable to nonresident aliens provide the ability to select particular classes of assets for gifts/bequests in order to eliminate U.S. transfer taxes owed.

Appropriate planning regarding the types of assets held (especially if done before acquisition) can thus

1 Section 2001; Reg. 20.0-1(b).
2 Section 2010; Rev. Proc. 2016-55, 2016-45 IRB 707.
3 Section 2056(a).
4 *Id.*
5 Section 2501.
6 Section 2523(a).
7 Section 2523(i); Rev. Proc. 2016-55, *supra* note 2.
8 Section 2513(a)(1).
9 See Regs. 20.0-1(b) and 25.2501-1(b).
10 Section 2103.
11 Section 2102(b)(1).
12 See 2001(c).
13 Reg. 20.2104-1(a)(1).
14 Section 2105(b)(1).
15 Section 2501(a)(1).
16 Reg. 25.2511-3.
17 Section 2501(a)(2).
18 Section 2503(b).

minimize U.S. transfer tax implications. Under these rules, it is also tremendously advantageous for a nonresident who anticipates becoming a citizen or resident in the future to make gifts of non-U.S. tangible property (or even to accelerate anticipated bequests) before establishing U.S. citizenship or domicile.

Formulating the estate plan

Once the client's U.S. status has been ascertained, the client's goals for planning should be discussed (as with any other estate plan). Complications can arise based on citizenship/residency status of proposed beneficiaries, particularly in regard to a noncitizen spouse. The location of assets held by the client can also raise distinct issues. A (noncomprehensive) discussion of these items is below.

As a threshold matter, obtaining information on a client's worldwide assets is of vital importance. As with income tax reporting, clients may not recognize that worldwide assets are subject to U.S. estate and gift tax; as a result, there is risk these assets would not be proactively disclosed by the client. Additionally (and as illustrated below), the location of assets can have significant effects on their ultimate disposition—whether a particular planning approach will be optimal (both from a tax and functional perspective) must take into account the laws of the country in which assets are sitused.

Noncitizen spouse. As noted above, normal U.S. transfer tax rules regarding transfers to a spouse are inapplicable when the surviving spouse is not a U.S. citizen. The U.S., seeking to preserve its ability to assess transfer taxes on assets held by a resident or citizen, designs its rules in this area to ensure that taxes ultimately will be paid on these assets (and that a noncitizen cannot evade taxes simply by extinguishing his or her U.S. connections prior to death). Where bequests are made to noncitizen spouses, the approach often advised is the use of a qualified domestic trust (QDOT). While the QDOT is beneficial in many instances, it is vital to note that estate and gift tax treaty provisions can sometimes provide treatment to noncitizen spouses that give better results from a U.S. perspective than QDOT usage.

QDOT. Outside of treaties, for marital property to be passed to a surviving noncitizen spouse free of tax (once the applicable exclusion amount is exhausted) a QDOT usually must be used (unless the surviving spouse was a resident of the U.S. at all times after the decedent's death and becomes a U.S. citizen prior to the filing of the estate tax return).[19] Requirements for QDOTs include the following:

1. A QDOT trustee must be a U.S. citizen (or a U.S. corporation).
2. The trust instrument must provide that principal distribution cannot be made unless the trustee withholds the estate tax amount imposable on the distribution.
3. The trust must meet any regulatory requirements for collection of tax.
4. The executor of the estate must elect to treat the trust as a QDOT.[20]

Income distributions from a QDOT are exempt from taxation.[21] Distributions of principal from the QDOT, however, are subject to QDOT taxation unless an exception applies; when a taxable principal distribution occurs, the decedent's estate tax is increased.[22] The QDOT thus normally functions as a method to defer—rather than eliminate—estate taxes.

Subsequent citizenship. If a surviving spouse becomes a U.S. citizen, no QDOT estate tax is imposed on any distribution from a QDOT after the spouse becomes a citizen and before the spouse's death, and no tax is imposed on the property remaining in the trust at the spouse's death if certain conditions are met.[23] The trustee of a QDOT is required to notify the Service that the surviving spouse has become a U.S. citizen.[24]

The QDOT normally functions to ensure ultimate payment of U.S. estate tax, giving a jurisdictional basis to tax assets held within the trust. Outside of the context of a surviving spouse who becomes a U.S. citizen, the QDOT functions as a tax-deferral mechanism; rather than removing taxes owed, taxes are only deferred until the death of the surviving spouse. From a planning perspective, it is advantageous to use the $149,000 annual exclusion for gifts to noncitizen spouses in planning during a client's lifetime, as it allows for tax-advantaged transfers between spouses.

Estate tax treaties. The U.S. maintains 18 estate and gift tax treaties with other countries; treaties provide rules where two countries both maintain the ability to tax a gift or bequest under their laws. Treaty provisions vary based on the country at issue; consultation of the treaty where applicable, however, is of great importance because of the benefits that can come therefrom.

One dramatic example in the noncitizen spouse context is contained in the estate and gift tax treaty the U.S. maintains with Germany. Article 10(6) of the U.S.-Germany

19 Section 2056(d).
20 Section 2056A(a).
21 Section 2056A(b)(3)(A).
22 Reg. 20.2056A-5(b)(1).
23 See Section 2056A(b)(12).
24 Reg. 20.2056A-10(a)(2).
25 United States-Germany Estate Tax Treaty Art. 10(6).
26 Sections 2031 and 2501.

Treaty provides a marital deduction for qualifying spouses even where the surviving spouse is not a U.S. citizen. Under the Article's terms, the value of a decedent's taxable estate is determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes to the decedent's surviving spouse and that would qualify for the estate tax marital deduction if the surviving spouse were a U.S. citizen; such deduction is equal to the lesser of the value of the qualifying property or the applicable exclusion amount (i.e., $5.49 million for 2017).[25]

Qualification depends on four factors:

1. At the time of the decedent's death, the decedent must have been domiciled in Germany or the U.S.
2. The decedent's surviving spouse must have also been domiciled in Germany or the U.S. at the time of death.
3. If both were domiciled in the U.S., at least one must have been a German citizen.
4. The executor of the decedent's estate elects the benefits and irrevocably waives the benefits of any other estate tax marital deduction (i.e., a QDOT election).

The above illustrates an example of where treaty provisions provide vastly greater benefits than would be available outside of the treaty. Treaty benefits are not limited to nonresident spouses, but instead can provide relief under a multitude of circumstances. Where a client maintains interests in a country with which the U.S. maintains a treaty, consultation of treaty terms is thus vital.

Overseas assets/residence. As to the mechanics of planning, numerous issues require consideration; essentially, the entire plan must be evaluated in the context of all applicable laws. As stated above, U.S. citizens and residents are subject to estate and gift tax based on worldwide assets wherever held.[26] Where assets being transferred are held overseas, both the laws of the U.S. and of the country in which the assets are maintained must be considered. As one example, in many countries, the ability of a testator to transfer assets to persons of his or her choosing is severely limited by statutory provisions forcing them to allot a certain share to designated parties (i.e., a spouse or a child). These rules can minimize the options a client has in making dispositions, altering the normal flexibility a client would have in disposing of assets.

From both a tax and functional perspective, a significant issue can exist regarding using trusts in the manner often used in a U.S. plan. In many countries (particularly those operating under civil law systems), trusts as used in the U.S. are not recognized. When transfers are made to trusts, these transfers can sometimes (depending on the country) be taxed at the highest rates for transfers (i.e., a gift in trust to a spouse, which may normally be taxed at the most favorable rate, will instead be taxed at the highest one); the trust form itself may also not be respected. This can severely limit a trust's utility and, in some cases, make its usage entirely inappropriate.

Consideration of the other country's rules as to estate and gift taxes is also required. For example, in many countries inheritance taxes—rather than estate taxes—form the primary method of collecting tax on bequests. In some instances, the residence of the testator can determine whether inheritance taxes are due only on property owned within the country or on worldwide bequests (including from persons with no connection to the country). In addition, some countries have estate taxes but not gift taxes—obviously an important consideration when devising a client's planning strategy (and the financial ramifications of lifetime versus testamentary transfers).

The overarching issue with the above is the need to customize the client's plan to account for local laws where assets are held or where the client resides. Consultation with foreign counsel is of enormous benefit, as local attorneys are most familiar with the minutia of their country's laws. An issue connected to this is whether separate wills should be drafted in each country where a client holds assets. While this approach allows for provisions specifically tailored to the country in which assets are held, significant coordination is required between drafting attorneys. Given this, it is often beneficial to have one will covering worldwide assets (with counsel from each country reviewing the will for validity and effects under his or her country's laws).

Conclusion

Evaluating clients on a worldwide basis is absolutely critical in order to ensure the planned approach for the client optimizes results under the laws of the U.S. and all other relevant jurisdictions. Strategies that are appropriate under U.S. law may create harsh results under the laws of other countries; in a global plan, U.S. rules cannot be the sole focus. Assessing the client on a worldwide basis and involving outside counsel specializing in laws of relevant countries ensures the best results from a worldwide perspective are obtained. ■