

Tax Planning for Non – U.S. Citizens CE Eligible



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U.S. Estate Taxation (In general)

- Applies to U.S. Citizens
 - Birth in U.S.
 - Born outside U.S. to citizen parent – depends upon purpose for being outside U.S. and state of law at time of birth
 - Naturalization
 - U.S. Citizen by U.S. Possession/Territory
 - Not considered a U.S. “Tax” Citizen if citizenship is based on residing in Territory (example: Puerto Rico)

U.S. Estate Tax for U.S. Citizens

- Taxed based on citizenship
- Worldwide assets subject to estate tax
- Availability of exclusion amount at death
 - \$5,250,000 (2013), indexed for cost of living
 - Unlimited marital deduction
 - Spouse must be a U.S. Citizen

U.S. Income Tax For U.S. Residents

- Permanent resident alien – green card holder
- Definition in Internal Revenue Code (IRC) § 7701(b)
- Lawfully allowed to reside permanently in United States
- Income tax determination

U.S. Income Tax for Resident Aliens

- Residence status by physical presence
 - U.S. resident if –
 - for at least 31 days current calendar year; and
 - for a total of 183 days during the current year and two (2) preceding calendar years
 - Each day in current year counts 1
 - Each day in 1st preceding year counts as 1/3 day
 - Each day in 2nd preceding year counts as 1/6 day
 - Exception for other country with “closer connection” if less than 180 days in current year

Residency Status by Physical Presence (Cont'd)

- Days excluded:
 - Student, athlete temporarily in U.S.
 - Unable to leave due to medical conditions
 - Transit in United States between countries.

If U.S. Resident For Income Tax Purposes

- Individual is exposed to income tax on worldwide income
- Taxation not limited to income with U.S. source

U.S. Residency for Estate Tax Purposes

- Different test for Estate Tax purposes
- A “resident” decedent is a decedent who, at time of death, had domicile in “United States”-Treasury Regulation (Treas. Reg.) § 20-1(b) (1)

U.S. Residency for Estate Tax Purposes (Cont'd)

- Domicile analysis is driven by intention
- Domicile can be established in a brief period of time if intention to remain is present
- Holder of “Green Card” may not be “resident for estate tax purposes” but probably is!!
- Physical presence in U.S. important part of analysis

U.S. Residency for Estate Tax Purposes (Cont'd)

- Treaties: When a treaty is applicable, treaty provides an alternate test for determining residency. Treaties often consider:
 1. Location of Permanent Home
 2. Location of closer personal and economic interests
 3. Individual's habitual abode
 4. Citizenship

U.S. Estate Tax Applies Fully to Resident Aliens

- U.S. estate tax applies to resident aliens and U.S. citizens in a similar manner
- Both are subject to tax on worldwide assets!!
- Both have the full applicable exclusion amount available
 - \$5,250,000, indexed (2013)
- Deductions generally available in manner similar to U.S. Citizens with notable exception of marital deduction.

What About The Marital Deduction??

- Marital deduction is available for transfers from a resident alien decedent (or non-resident alien decedent subject to estate tax) for transfer to U.S. Citizen spouse.
- Focus is on citizenship of surviving spouse not decedent.

Rationale For Denial of Marital Deduction to Non-U.S. Citizen Spouses

- With enactment of unlimited marital deduction Congress perceived a risk that the non-U.S. citizen surviving spouse could simply relocate and change tax jurisdictions.
- Congress would “miss” the chance to tax at spouse’s death which was the quid-pro-quo for the unlimited marital deduction.

Estate Planning for a Non Citizen Spouse

- Marital deduction available with use of Qualified Domestic trust (QDOT)
- The QDOT is designed to protect United States Treasury from missing opportunity to tax at surviving spouse's death.

Requirements for a QDOT

- First, the trust must satisfy requirements to qualify for marital deduction
 - Properly passes from decedent spouse
 - Life estate/power of appointment trusts
 - Qualified Terminable Interest Property (QTIP)

Additional "Security" Requirements for Surviving Spouse

- Next, QDOT must comply with following:
 - At least one trustee must be a U.S. Citizen or domestic corporation
 - An individual of a "larger" QDOT needs to satisfy bonding requirements
 - "U.S." trustee's approval needed for all distributions
 - Specific requirements must be satisfied to assure collection of U.S. Estate Tax
 - An election must be made for QDOT treatment
 - QDOT can be created post-mortem

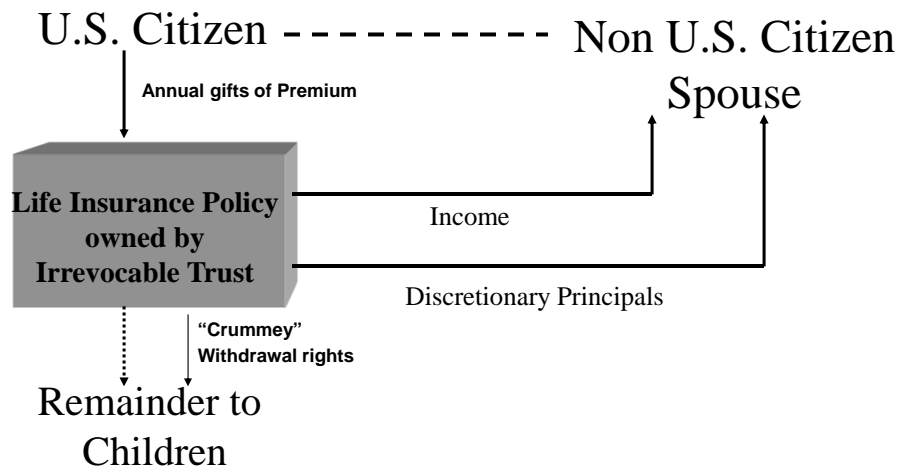
Operation of QDOT Trust

- At death of surviving spouse, assets "relate back" to estate of creator of QDOT and are taxed in that estate
 - Tax treatment is not same as QTIP trust and is much less attractive
- Income and "hardship" distributions are not subject to an Estate Tax
- All non-hardship principal distributions draw current Estate Tax
- QDOT can be quite unattractive and administratively complex

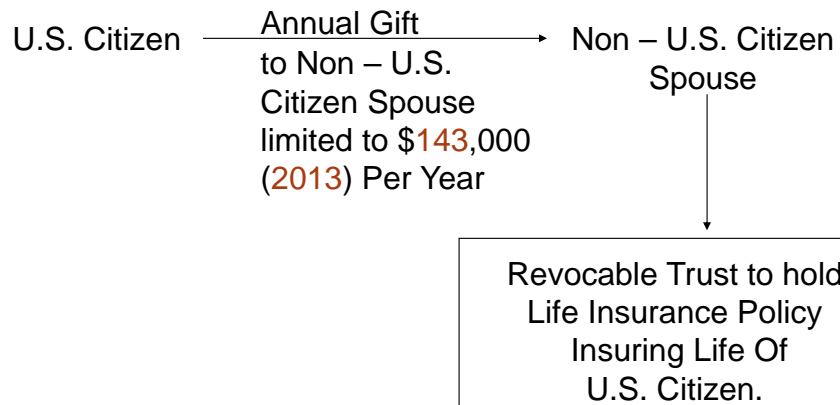
Life Insurance May Be Better Idea for Surviving Non-Citizen Spouse

- Instead of planning for use of QDOT; an alternative may be a life insurance policy for benefit of surviving non-U.S. Spouse
 - Can be owned by insurance trust to keep out of spouse's estate.
 - Allows spouse indirect access to trust principal without payment of estate tax
- Avoids potential estate tax caused by non-hardship distribution of principal from QDOT

Irrevocable Life Insurance Trust As A Substitute For A QDOT



Irrevocable Life Insurance Trust Created By Non-Citizen Spouse



U.S. Estate Taxation of Non-Resident Aliens (NRA)

- NRA's are not subject to U.S. estate tax on the same basis as are U.S. citizens or U.S. residents
- NRA's are subject to U.S. Estate tax only for assets having a U.S. Situs or presence

Property "Located" In The United States

- The determination of what property is located in the United States for U.S. estate tax purposes is governed generally by IRC § 2103-2105

Real Property Located In U.S.

- For U.S. estate tax purposes, U.S. real estate owned by a Non-Resident Alien is part of the U.S. taxable estate
 - Includes homes, farms, vacation property, condominiums, etc.

Tangible Personal Property

- U.S. situs property would include the following if located within U.S.:
 - Cash, jewelry or other valuables,
 - Contents of a house or apartment,
 - Art, cars, boats, etc.
 - Safe Deposit Box
- Exception for property “in transit” in the U.S.

Bank Deposits

- Bank deposits including certificates of deposits with U.S. banks are not U.S. property, unless deposits are effectively connected with a US trade or business

U.S. Based Debt Obligations (Portfolio debt exception)

- General rule is that debt obligations of U.S. person or entities are U.S. situs assets
- Exception for “portfolio debt”- IRC § 2105 (b) & Sec. 871
 - Exception nearly swallows the general rule

Portfolio Debt Exception

- In general, all debts of a U.S. debtor which meet certain requirements to ensure that income is paid to a foreign taxpayer will be classified as “portfolio” debt.
 - Requirements are technical and must be complied with
- Most commonly held debt instruments issued by institutions fit portfolio debt exception
- Portfolio Debt is an income tax determination
- Portfolio exemption determines tax situs for estate tax purposes

Shares of Corporate Stock

- Situs of stock is determined by location of issuing company
- If company is a U.S. company, its shares will have U.S. situs
- If company is a foreign corporation its shares will have a foreign or non-U.S. situs

Shares of Corporate Stock (Cont'd)

- If individual owns U.S. company shares, they will be subject to estate tax
- Applies regardless of where shares are held
- This applies to corporation only - A different analysis applicable to partnerships
- Applies to all corporations: publicly traded, closely held or solely owned

Shares Of Corporate Stock (Cont'd)

- Rule can be a trap for foreign investors
- Most investors invest in U.S. through other entities
 - Closely held foreign investment companies
 - Large foreign mutual funds designed to keep its investors free of U.S. estate entanglements
- Situs rule applies to corporations as defined by Federal Tax Law
 - Check-the-box regulations

Joint Ownership of Property

- If a RA or a NRA owns property jointly with rights of survivorship, 100% of asset will be includible in decedent's estate
- This result can be overcome upon proof that survivor furnished consideration for joint property
- This presumption applies between spouses!!

Jointly Owned Property Between Spouses

- Usual assumption in marital context that 50% of property is in estate of decedent does not apply if survivor is a non-U.S. citizen.
 - This is a presumption capable of being overcome by evidence of contribution to joint property purchase

Life Insurance

- For U.S. estate tax purposes – life insurance contracts insuring life of a NRA are not includable in the gross estate of foreign Insured
 - Rule applies regardless of where issuer is located
 - Rule applies regardless of location of beneficiary
 - IRC Section 2105(a) mandates this result and specifically applies to life insurance
- For income tax purposes, contract generates U.S. source income if issued by domestic insurer

Estate Tax Computations for NRAs U.S. Taxable Estates

- IRC Sec. 2101 – Imposes tax similar to that of a U.S. resident or citizen
- IRC Sec. 2102(b) allows a “unified credit” of \$13,000, which shelters only \$60,000 of estate assets from tax!!
 - For Citizens/Residents of US Territories, actual credit allowed is greater of \$13,000 or \$46,800 multiplied by percentage of assets in US versus outside US
 - Potentially a little better than \$13,000, but not much
 - This exemption has not changed since 1988
- Above \$60,000, tax applies at graduated rates from 26% to top rate of 40% on values above \$1million (\$332,800 + 40% above \$1 million)

Example of Application

- NRA owns property in Greenwich, Connecticut with value of \$1,000,000 and dies in 2013*
 - Tentative tax is \$345,800
 - Credit available is \$13,000
 - Tax due is \$332,800

YIKES!!!!

Important Points for NRA

- How things are owned is very important!
 - No direct ownership of U.S. real estate
 - No direct ownership of stock in U.S. corporations
 - No ownership of U.S. debt unless “portfolio debt”
- U.S. situs rules are not intuitive and can be planned around
- Here “form” is as important as substance

Important Points for NRA

- How could assets be owned by NRAs?
 - US property could be owned by corporation , LLC, or partnership created in country of residency or other location outside of US
 - US property could be owned by trust created in country of residency or other location outside of US
 - Grantor should not have any power of trust that would cause US property to still be includable in estate
 - Effect of above options:
 - No US property is owned by decedent that would be subject to US estate tax

Applicability of U.S. Gift Tax to Non-Resident Aliens

- Like the estate tax, U.S. gift tax does not attach to non-resident aliens unless the gifted property is U.S. situs property
- Like U.S. estate tax, residency (based on domicile) will subject individuals to tax on worldwide transfers
- Critical time to determine location as “situs” is at time of gift

Gift Tax “Situs” Rules Similar to Estate Rules

- U.S. real property interests:
 - Residential property, commercial property or vacant land
 - Condominiums
- U.S. based tangible business assets

Gift Tax "Situs" Rules Similar to Estate Rules

- U.S. based tangible personal property
 - Art work
 - Jewelry
 - Collectables
 - Cash (currency)!!!

Annual Exclusion Gifts

- Annual exclusion gifts do apply in the amount of \$14,000 (2013) per year
- Special annual exclusion gift of \$100,000 indexed (2013 - \$143,000) allowed for transfers to non-U.S. citizen spouse
- Transfers for education and medical expenses are exempt

U.S. Estate Tax Treaties

- There are two types:
 - Situs Treaties
 - Generally older, last one was Italy in 1956
 - Domicile Treaties

U.S. Estate Tax Treaties

- Situs Treaties
 - Designed to avoid double taxation
 - Primary taxing jurisdiction is given to treaty country where property is situated
 - Treaty includes rules for determining situs of variety of typically owned assets
 - Non-situs country may still tax property on some other basis (such as citizenship or domicile)
 - Treaty requires a tax credit that takes into account tax paid to situs country

U.S. Estate Tax Treaties

- **Domicile Treaties**
 - Avoid issue of actual situs of specific property
 - Allocates exclusive taxing authority to country of domicile
 - Treaties provide “tie-breaker” rules to settle domicile decision
 - Domicile type treaties do recognize ability to tax based on situs of following asset categories:
 - Immovables (including real property and livestock and equipment used in agriculture and forestry)
 - Business property of a permanent establishment
 - Assets pertaining to a “fixed base” used for performance of personal services (i.e. physician’s consulting room, or office of architect or lawyer)

U.S. Estate Tax Treaties – Domicile Treaty

- **Domicile Treaties generally apply to gifts as well as taxes at death**
 - Tangible movable property
 - Domicile treaties (except US-France) exempt from US gift tax gifts of tangible movable property having a US situs

U.S. Estate Tax Treaties – Domicile Treaty

- US provides a foreign tax credit (IRC 2014) in two instances:
 - Specified property is taxed by non-US situs country, or
 - US taxes based upon citizenship, while other treaty country is taxing based upon domicile

U.S. Estate Tax Treaties

Situs

Australia
Belgium
Finland
Greece
Ireland
Italy
Japan
Norway
South Africa
Switzerland

Domicile

Austria
Canada (estate tax only)
Denmark
France
Germany
Netherlands
Sweden (terminated 1/1/08)
United Kingdom

Planning for Future Inheritance from Non-Resident Parents

- Gifts and bequests transferred into the US are not subject to US transfer tax
 - If received directly by US Residents, property is now brought into US transfer tax system
 - Included in taxable estate of owner
 - Increases marital deduction issue if non-citizen spouse

Planning for Future Inheritance from Non-Resident Parents

- How could inheritance for US resident be structured?
 - Ask potential donors' to structure bequest through a generation skipping trust
 - Trust assets can be available to US residents
 - Keep assets out of transfer tax system
 - Entire family line can be eligible beneficiaries
 - Family member can be given a Limited Power of Appointment without adverse estate taxation

Why U.S. Citizens and Resident Aliens Don't Just "Leave"

- Recent changes to prevent expatriation to avoid tax
- Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) added new Section 877A and 2801 to Code
 - Section 877A imposes new mark to market exit tax
 - Section 2801 imposes a new succession tax
- Applies for those leaving after June 16, 2008

Section 877A "Exit" Tax

- One-time exit tax on citizen or resident
- All assets taxed as if they had been sold on day before expatriation
- Net gain is recognized to extent it exceeds \$600,000 indexed
- Income and net worth limitations apply to define "covered expatriate"
 - Average income tax liability that exceeds \$145,000
 - Net worth of \$2 million or more
- Exclusion for personal residence gain not applicable

Succession Tax Under New Section 2801

- Succession tax is imposed on individuals and trusts receiving gift
- Tax (similar in amount to estate tax top rate) imposed on gifts from individuals who were “covered expatriates”

Practical Points in Cross-Border Planning

- Estate planning documents must be drafted specifically to handle all assets
 - 1 Will or 2
 - Pitfalls of Ancillary Probate
 - Use of Revocable Trusts
 - Foreign Trusts with U.S. beneficiaries not usually recommended

Time for Questions

Questions?



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