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Estate and Gift Tax Overview

Non-Citizen Spouse Issues

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Introduction

- Welcome to fun and profit with the Internal Revenue Code. This part of the materials explains how estate, gift, and generation-skipping transfer (GST) taxes are calculated and imposed on taxpayers (or their estates).
- Concurrent discussion with the treatment and planning for non-citizen spouses as well.

Background and History

- Why does an attorney need a professional doctorate?
- The field of wealth transfer taxation is extremely complex and this discussion is only a brief overview of the important tax fundamentals associated with estate planning.
- As we will discuss, tax policies are highly dynamic and constantly change due to the influence of economic and political forces.
- IMPORTANT: Effective planning requires that practitioners understand both current and future tax regimes to gain a better understanding of what the law was, is, and could recently become.

Before 1977

- The estate and gift taxes were originally completely independent of each other.
- Estate and gift taxes had separate graduated tax rate schedules.
- $30,000 lifetime gift tax exclusion.
- $3,000 annual gift tax exclusion.
- $60,000 estate tax exclusion.
- Martial deduction set at fifty percent (50%).
  - We take this one for granted.
- Intervivos and testamentary gifts to charity were fully excluded.
- Gift tax rates lower than estate tax rates to encourage lifetime transfers.

Unified System

- Current system of taxation.
- Single rate schedule applies to both the estate and gift tax.
- Unified transfer tax covers all gratuitous transfers.
- Eliminated prior exemptions allowed under the formerly separate taxes and replaced them with a unified tax credit.
- Generation skipping transfer tax imposed on transfers to younger generations.
  - Goal is for the government to collect taxes at the transfer of wealth at each generation.
- Qualifying marital deduction set at 100%.
- Take Away: Notwithstanding certain changes to the unified system contained in the recent American Taxpayer Relief Act of 2012, without competent planning the current regime has the ability to decimate even relatively modestly wealthy estates.
  - For example, in recent years the highest marginal rate for the estate and gift taxes has been higher than the highest marginal tax rate for individual income tax.

The Economic Growth and Tax Reconciliation Act

- In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"). EGTRRA enacted a protracted repeal of the estate and generation-skipping transfer taxes. It also provided for a protracted modification of the Federal gift tax through 2010.
- Also known as the "Bush Tax Cuts."
- Sunset: EGTRRA contained a "sunset provision" — meaning that, absent Congressional intervention, the estate, gift, and generation-skipping transfer tax regime that existed immediately prior to EGTRRA's enactment would, once again, become the law on January 1, 2011.
  - And this is what happened.

American Taxpayer Relief Act of 2012

- Background:
  - Weeks of public and private discourse.
    - Most notably between President and Speaker of the House.
  - Introduced by Senators Reid and McConnell.
  - Senate debated on New Year's Eve and Passed it in the early hours of New Year's Day
    - Bipartisan vote of 89-8.
    - House concurred 257-167.
  - Signed into law January 2, 2013

American Taxpayer Relief Act of 2012

- Effect on Estate Tax:
  - Compromise in the federal estate tax was to make the 2011 and 2012 law "permanent," but with a compromise rate of 40 percent.
  - Makes a technical correction to the portability provisions, proposed by the staff of the Joint Committee on Taxation, changing "basic exclusion amount" to " applicable exclusion amount" in section 2010(c)(4)(B)(i).
  - Everything else about the 2012 law is made permanent. All "sunsets are removed.
    - There are no longer any "as if…had never been enacted" provisions.
  - In particular, the "exemption" – technically the applicable exclusion amount for estate and gift tax purposes and the GST exemption for GST tax purposes is:
    - $5 million permanently indexed from 2011– (i.e., presently $5.34 million)
    - Permanently unified (i.e., is the same for gift tax purposes and lifetime transfers)
    - Permanently portable for gift and estate (not GST) tax purposes
  - There is no "clawback." This is addressed for gift tax purposes in the flush language to Section 2505(a)(2) and, to some extent, for estate tax purposes in Section 2001(g) (both of which are no longer sunsetted). But the real answer to the feared estate tax clawback is that the applicable exclusion amount will not go down – at least not without further congressional action which presumably would include specific provisions to prevent clawback.

Permanent?

- Residual Discomfort
  - In the House, 207 Members of the 113th Congress are among the 272 who voted for the "Death Tax Repeal Permanency Act of 2005" (H.R. 8) in 2005 or the 222 cosponsors of the "Death Tax Repeal Permanency Act of 2011" (H.R. 1259). Adding 47 other new Republicans (since 2005) results in 254 Members which possible no-tax or low-tax leanings.
  - Sixty Senators in the 113th Congress are among the 84 who voted for a 35 percent rate and $5 million exemption during consideration of the Fiscal 2009 budget resolution in 2008 or the 38 cosponsors of the "Death Tax Repeal Permanency Act of 2012" (S. 2242). Adding five other new Republicans (since 2008) results in 65 Senators with possible no-tax or low-tax leanings.
  - TAKE AWAY: Is this really over? Is this really permanent?

Underlying Concepts

- The taxable estate: When a taxpayer dies (the "decedent"), the decedent's estate is subject to federal estate tax.
  - Snapshot at death.
  - Gross Estate: The gross estate is all that property subject to the Federal Estate tax. This is different than the probate estate which is determined by state law, rather than Federal law.
    - The concept of the Gross Estate is highly comprehensive.
  - The taxable estate subject to this tax consists not only of the property interests the decedent owned individually (§§ 2031 & 2033), but also of other interests owned by the decedent with others or property over which the decedent exercised dominion or control up until the time of death. (Gross estate – deductions allowed = taxable estate).

The Gross Estate

- Property Owned by the Decedent: This includes personal effects, clothing, jewelry, stock, bonds, other debt securities, furniture, works of art, bank accounts, vehicles, interests in businesses and the like are all included in the Gross estate (IRC § 2033).
- Joint Tenancy Property: One-half of the value of an interest in property owned by the decedent and the decedent's spouse in joint tenancy; and all interest in property owned by the decedent and a third party in joint tenancy except to the extent that the surviving joint tenant can show original contribution to its cost (IRC § 2040).
- Life Insurance Proceeds. Proceeds from an insurance policy on the decedent's life, unless the proceeds are not payable to the decedent's estate and the decedent retained no "incidents of ownership" in the policy (IRC § 2042).
  - Irrevocable Life Insurance Trust
- Annuities. Annuities received by a beneficiary because they survived the decedent, at least to the extent of the decedent's contribution to the annuity (IRC § 2039).
  - Straight-life annuities are not included in the calculation of the taxable estate.
- Gifts Within Three (3) Years of Death. Certain gifts within three (3) years of death (IRC § 2035(d)(2)).
- General Powers of Appointment. Property over which the decedent held a general power of appointment (IRC § 2041)

The Gross Estate

- Other — Power Over Property Held in Trust. In addition, a decedent's taxable estate also includes property over which the decedent held certain retained powers – incidences of ownership. Although the Internal Revenue Code does not require that these powers be held by the decedent in connection with a trust, often they are held that way by the decedent as the trust's settlor. For example, property held in trust can be included in the taxable estate if the decedent/grantor retains:
  - A power to amend or revoke the trust (IRC § 2038);
  - A right to enjoy or possess the trust property or to designate who shall enjoy or possess the trust property (IRC § 2036);
  - A reversionary interest in the trust assets (IRC § 2037); or
  - An unlimited power to remove or replace the trustee(s).
  - Also, in some circumstances, a decedent who is not a settlor of a trust could possess a power that causes all or part of the trust assets to be included in the decedent's estate.
    - For example, if the decedent was both a beneficiary and a trustee of a trust, the trust property could be included in the decedent's estate if the decedent possessed a power, not limited by an ascertainable standard, to make trust distributions to himself or herself. (See IRC §§ 2036, 2038).

The Estate Tax

- Not an Inheritance Tax — The estate tax is not an inheritance tax like those imposed by many state jurisdictions.
  - I.e., Often imposed on the right to "inherit."
- Rather, the estate tax is imposed on the decedent's estate, taxing the decedent's right to transfer property at death
  - Another difference between estate and inheritance taxes is that inheritance taxes generally include larger exemptions the closer the relationship the heir has to the decedent. Other than the marital deduction, the estate tax generally does not take into consideration the relationship the decedent had to the heirs.

Persons Subject to the Estate Tax

- Decedent is either a U.S. citizen or is a resident (i.e., has domicile) in the U.S. at the time of his or her death. (Subchapter A).
- Estates of decedents who are neither citizens nor residents of the U.S., but have property situated in the U.S. are governed by an entirely different subchapter, Subchapter B.

Valuation of Property Transferred

- Value of property transferred is usually the fair market value on the date the gift is made — i.e., the date of the decedent's death.
  - Alternative valuation: This is a relief provision that was initially drafted to ease the economic hardship if the assets in the gross estate decline in value during the six months after death.
    - If election is made for alternative valuation, then all assets in the gross estate are valued at that time — no cherry picking.
    - If alternative valuation is used, then the valuation must have the net effect of decreasing the overall taxable estate.
    - Post-death income is not included in the taxable estate – the taxable estate is a "snapshot" at the time of death of the decedent.

Current Rates

- The estate tax is imposed on a decedent's estate. The top tax rate is currently 40% of the net taxable estate.
- In 2014, a decedent's estate is entitled to a maximum $5.34 million exemption from Federal estate tax -- (depending on the extent of lifetime gift tax exemption used by the decedent).

Form 706

- Form 706. A United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) should be filed whenever a decedent's estate exceeds the decedent's remaining estate tax exemption.
  - It may also be advisable to file a 706 when certain elections with respect to GST tax need to be made.

Marital Deduction Planning

- Requirements for the Estate Tax Marital Deduction. Three (3) essential requirements must be met for an interest to qualify for the §2056 estate tax marital deduction:
  - The decedent must be survived by a U.S. citizen spouse;
  - The interest must be includible in the decedent's U.S. gross estate and pass to the surviving spouse; AND
  - The interest must be deductible, i.e., the interest must not be nondeductible or terminable.

The Gift Tax

- Introduction. This tax is imposed on the donor of a gift.
  - Quick Note: Please note that both gifts and inheritances are excluded from the recipient's gross income under IRC §102.
    - The standard for determining a gift or inheritance was established in the *Duberstein* case which requires that the property be transferred according to "detached and disinterested generosity."
  - The tax thus imposed is on the right of the donor to transfer his or her property.

Persons Subject to the Gift Tax

- Persons Subject to Gift Tax:
  - Donor is citizen or resident (i.e., has domicile) here in the U.S.; or
  - Property that is the subject of the transfer is situated in the U.S.
    - Gifts of intangible personal property by non-U.S. citizens (stocks or bonds) are usually not subject to the U.S. gift tax regime.
      - » BUT MAY BE APPLICABLE TO THE U.S. ESTATE TAX REGIME
  - Gifts from a corporation are generally treated as gifts from the shareholders of the corporation.

Valuation of Property Transferred

- <u>Valuation of Property Transferred:</u>
  - Value of property transferred is usually the fair market value on the date the gift is made.
- <u>Gifts to Charity Must Be Valued:</u>
  - Otherwise, donors may lose their deduction.

Two Concepts: Lifetime Exemption and Annual Exclusion

- Lifetime Exemption: Under current law for 2014, during the donor's lifetime, the donor may make gifts totaling up to $5.34 million without paying any gift tax. (IRC § 2505).
  - The donor must, however, file a gift tax return for such gifts.
  - STRATEGY: A tax saving strategy based on the lifetime exemption is to make a gift of appreciating assets that uses all or part of the donor's lifetime exemption, which will cause all future appreciation to be outside of the donor's estate.
- Annual Gift Exclusion. Each year, a donor may make gifts of up to a certain, specified amount. For 2014, the exclusion is $14,000 per person, provided the recipients have a "present interest" in the gift. (IRC § 2503(b).)
  - No gift tax return is required for these gifts. (However, in some situations the donor may want to file a gift tax return to fix the value of the gift and keep it well-documented.)
  - STRATEGY: A tax saving strategy based on the annual exclusion is to make annual exclusion gifts, either outright or in trust, to the donor's beneficiaries. Overtime, these gifts can substantially reduce the donor's taxable estate — especially in the case where completed gifts of appreciating assets are made.

Complete vs. Incomplete Gifts

- The Internal Revenue Code imposes a gift tax on all gratuitous transfers exceeding the annual exclusion, "in trust or otherwise" (IRC § 2511(a)), but only if the gift is "complete" (as opposed to "incomplete"). A settlor / donor may reserve a power in a trust, either intentionally or unintentionally, that makes the gift wholly or partially incomplete.
  - See Treas. Reg. § 25.2511-2. Examples of powers that make a gift in trust incomplete include:
  - Reserving a power to re-vest beneficial title to trust property in the settlor. Treas. Reg. § 25.2511-2(c).
  - Reserving a power over disposition of the gift. Treas. Reg. § 25.2511-2(b).
  - Reserving a power to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard. Treas. Reg. § 25.2511-2(c).
    - *GENERAL RULE: Notice the trade-off between the gift tax and the estate tax. If a gift is incomplete, then it generally will not be subject to the gift tax but will be included in the taxable estate for estate tax purposes. On the other hand, if the gift is complete, then the property is now outside of the taxable estate for estate tax purposes, but will be subject to the gift tax for amounts exceeding the annual exclusion and amounts for lifetime transfers.*

Annual Exclusion: A Present Interest in Property?

- Using a Settlor's Annual Gift Exclusion. If a settlor makes a completed gift to a trust, then the settlor may want to minimize the gift tax consequences by using the settlor's annual $12,000 gift tax exclusion. This exclusion, however, is only available for a gift of a "present interest in property," which is defined to be "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property."
  - Treas. Reg. § 25.2503-3(b).
  - Conversely, if a settlor makes a gift of a "future interest," the settlor cannot use his or her annual exclusion. IRC § 2503(b). A
  - future interest is one that is "limited to commence in use, possession, or enjoyment at some future date or time." Treas. Reg. § 25.2503-3(a).
  - Problems arise in this situation since most irrevocable trusts are intended to hold property for the future benefit of the beneficiaries and gifts of property to these trusts by themselves are not gifts of present interests.
  - If this were not so, there would be little reason for establishing the trust since, the whole point of the trust is often to avoid outright distributions of property without the approval of a responsible trustee. Therefore, unless additional planning is done, gifts to irrevocable trusts are almost always gifts of 'future interests' and will not qualify for the annual exclusion from the gift tax.

Crummey Demand Rights

- For the most part, a gift to an irrevocable trust is still a gift to the trust beneficiaries. *Helvering v. Hutchings*, 312 U.S. 393 (1941).
- However, by itself, the gift does not create a present interest in the beneficiary.
- Accordingly, one way for a gift to an irrevocable trust to be a gift of a present interest is when the trust beneficiaries have at least a temporary right, sometimes called a "demand right," to withdraw the contributed property from the trust at the time the property is contributed.
- This right is sometimes called a "Crummey" demand right, named after the case of *Crummey v. Commissioner*, 397 F2d 82 (9th Cir. 1968).
  - Court held that where a settlor created a trust and gave his children the right to withdraw any contributions he made up until the end of the year in which the contributions were made, those contributions qualified as gifts of a present interest.
  - With respect to Crummey demand rights, subsequent rulings by the IRS have held that:
    - A right to demand and receive at least a pro rata portion of trust principal is a gift of a present interest to the extent of each beneficiary's pro rata portion of the gift. Rev. Rul. 80-261.
    - A demand right qualifies for the gift tax annual exclusion as long as the beneficiary has a real and immediate benefit.

Mechanics in Crummey Waiver

- Mechanics of Crummey Demand Rights. The most common way of creating Crummey demand rights is to send a notice, sometimes called a "Crummey waiver," to the trust beneficiaries.
- The Crummey waiver notifies the beneficiaries that a gift has been made to the trust and also that the beneficiaries have the right for a limited period of time (such as 30 – 90 days) to withdraw their pro rata share of the gift.
- In addition, the notice asks the trust beneficiaries to sign a written acknowledgment that they received the notice.
- Assuming that the demand right is a bona fide right to withdraw trust property and that there are no secret agreements among the settlor and the beneficiaries that they will not exercise their demand right, the effect of a Crummey waiver is to give the trust beneficiaries a present interest in the gift and, thereby, permit the donor to use his or her $14,000 per person annual exclusion from gift tax.
  - Accordingly, by using Crummey waivers a settlor can transfer to a trust, without incurring any gift tax, the annual exclusion amount times the number of trust beneficiaries who possess a Crummey demand right. For example, a settlor with three children who are trust beneficiaries possessing a Crummey demand right could transfer $36,000 per year (3 x $42,000), gift-tax free, to the trust.

Form 709

- Form 709. A donor should file a United States Gift Tax Return (Form 709) whenever (a) the donor makes a gift in excess of the donor's annual exclusion or (b) the donor makes a gift of property whose claimed value is no greater than the annual exclusion, and the donor wants to put the IRS on notice of the claimed value.
- Form 709 is an annual return.
- Generally, you must file the Form 709 no earlier than January 1, but not later than April 15, of the year after the gift was made.
  - However, in instances when April 15 falls on a Saturday, Sunday, or legal holiday, Form 709 will be due on the next business day.

Generation-Skipping Transfer (GST) Taxes

- The tax is imposed for direct or indirect "skips," i.e., transfers to a person in a generation two or more from the transferor. The top tax rate is 40% of the amount of the transfer.
    - Designed to prevent partial avoidance on Federal gift and estate taxes on large transfers.
    - Preclude avoidance of estate tax or gift tax through transfers to lower generations.

GST TRIGGERING EVENTS

- Three situations where imposed.
  - Termination – Example: Termination of a Life Estate
  - Distribution – Distribution from a trust to a grandson.
  - Direct Skip – Giving assets directly to grandchildren.
    - Note that the imposition of Gift Tax or the GSTT is not mutually exclusive of each other. For example, in some situations, direct gifts to grandchildren will be treated as being a taxable event under the Gift Tax and also under the terms of the GSTT.
      - Thus, the tax imposed on the donor in such situations may exceed the value of the property transferred!
  - Current GST exemption is also set at $5.34 million.
    - Strategy: a Settlor may allocate his or her GST exemption to a trust so that the inclusion ratio is zero and future distributions from the trust to successive generations from the trust are not taxed.

Planning for Non-Citizen Spouse

- The purpose of our discussion today is to point out and discuss many of the basic issues involving the planning for non-citizen spouses we all will likely experience as trust and estate practitioners need to be aware of so that we can spot them and resolve them.
- International planning area is an area where many people do not have a particular area of expertise:
  - Many people are apprehensive.
  - However, pretty much a certainty that we will have some kind of international issue come up in our practices.
    - I.e., Even if we don't specialize in or deal with international clients

- The purpose is to help you identify the issues that come up and not necessarily give you all of the answers but give you enough so that you know that you have questions.
- One of the issues that is that there are many counter intuitive results.

Common Occurrences

- Examples:
  - Client is a U.S. Citizen but married to a non-U.S. citizen.
  - Client is not a U.S. Citizen.
  - Client has close relatives outside the U.S. who make transfers to them.
  - Clients who property outside the U.S.
  - Clients outside the U.S. have property in the U.S.
    - I.e., Numerous permutations.
  - Adding to the Complexity: Some of the rules are fairly counterintuitive.
    - Can lead to unfortunate surprises.
    - PURPOSE: TRY TO HIGHLIGHT SOME OF THE MORE FREQUENTLY ENCOUNTERED ISSUES.

Three Parts

- First: Is the Client a U.S. Citizen? If not, where is the client domiciled?
  - One of the more important intake questions.
  - These questions are not as easy and straight forward as they appear to be at first blush.
  - Different tax consequences that follow from whether the client is a U.S. Citizen, whether the client is domiciled or whether the client is neither a citizen nor domicled as well as planning opportunities for each of those statuses.
- Second: Gift Tax Issues
  - Discuss issues such as property ownership.
  - How inadvertent taxable gifts can be made.
  - Decisions on how to hold property.
  - Gift taxes consequences that can occur from changing form of ownership.
- Third: Estate Tax Issues

Fact Pattern

- Jeff and Natalie are Norwegian Citizens living in the U.S. They both have legal visas. They are originally from Oslo, moved to San Diego where they spent 10 years and now live in Park City, Utah.
- They own a house Park City as joint tenants. They also own a summer condo in St. George jointly. Jeff also owns real property, a vacant lot ("Lot 1"), in Kaysville in his individual name. Next to that vacant lot is another vacant lot ("Lot 2") held in Jeff and Natalie's joint names.
- Natalie is presently employed and manages a successful global private equity group. She receives a substantial compensation of approximately $10 million per year. The majority of her salary is deposited into a bank account at Zion's Bank that is held jointly with Jeff.
- Jeff and Natalie's account with Zion's presently holds $20 million. Natalie has equity in the company worth approximately $100 million.
- Jeff is the homemaker. Nonetheless, he worked for several years as an attorney and then shareholder at Kirton McConkie specializing in international trusts and estates. He presently has a bank account worth $150K in his own name as well as stock in U.S. companies worth $500K. He owns a small home he inherited from his parent back in Oslo worth about $250K USD.
- Jeff and Natalie have four kids. Sydney was born in Oslo before the couple left Norway. Bennett was born during a visit to Salt Lake while the couple was still living in Oslo. Sydney is 10 and Bennett is 6. Jack and Lia, the two youngest kids, were both born by the couple while living in the U.S.
- Both have considered filing for a green card in the past or obtaining a U.S. citizenship.

Core Question

- If these clients came into for a first consultation, what is the first question to ask?

Are you a U.S. Citizen?

- Not as easy of a question as it might seem.
  - Well, they don't think they are U.S. citzens.
    - From Norway.
    - Here only on visas.
    - No current citizenship or green card.
      - » Probably they are not U.S. citizens

Surprises and Pitfalls

- Inverse: Many U.S. citizens believe incorrectly that they are no longer U.S. citizens.
    - They think they have lost or have given up their U.S. citizenship.
        - Started out as U.S. citizens but may have become citizen's elsewhere and think that automatically they cease to be U.S. citizens.
    - Another reason they don't think are U.S. citizens but they are is that they only lived in the U.S. briefly.
    - Some people who have never lived in the U.S. are surprised to learn that they are in fact U.S. citizens and, therefore, are surprised to learn they are subject to U.S. income tax and transfer taxes on their worldwide income.
    - Critical point to take away from this discussion:
        - General Rule: A U.S. Citizen is taxed on globally on their income and wealth transfer taxes apply on all their assets, wherever located, worldwide.

U.S. Citizenship

- Four ways in which someone becomes a U.S. Citizen:
  - Most common:
    - Born in the U.S.
      - We often think of someone who is born here and has also lived here.
      - BUT, the living in the U.S. part is not necessary.
      - Merely being born in the U.S. is sufficient even if the client left the U.S. shortly after birth and never comes back here.
      - Many people can be (unfortunately) unpleasantly surprised to find out that they are, in fact, U.S. citizens and that they, therefore, are responsible for filing U.S. income tax returns even though they are living elsewhere and filing returns in other countries.
        - » Bennett is a U.S. citizen even though parents are not and were not living in the U.S. at the time of his birth.
        - » Jackson and Lia are also U.S. citizens.

U.S. Citizenship

- Naturalized:
  - Come to the U.S. as an immigrant.
  - Get a green card.
  - Take the test to become naturalized.
  - Second most straightforward.
- Less Straightforward Ways:
  - Derivative Citizenship:
    - Occurs when a parent of a child less than 18 years old.
      - If Jeff OR Natalie get a green card, take the test and become naturalized before Sydney is 18, Sydney will automatically become a U.S. citizen.
  - Complex:
    - Someone is born outside the U.S. and either of that person's parent is a U.S. citizen, then that child MAY be a U.S. citizen depending on which year he or she was born – (law changes).
      - Look at the years relevant to your client's case.
      - Where both or just one parent a citizen?

Why Are You Telling Me This?

- You need to check the facts.
  - Client or a client spouse first comes into your office and says, "Well, I am not a U.S. citizen, but my mother was…"
    - Red Flag!
  - No point in engaging in non-citizen spouse estate planning and related issues IF, in fact, the spouse of your client is a U.S. citizen – which situation can be more common than you realize.
  - Depending on citizenship and domicile, will change overall consequences for tax purposes and, potentially, overall strategy.

Domicile

- Once you have reached the conclusion the client is not a U.S. citizen and is living in the U.S.
  - Next important inquiry?
    - ARE YOU DOMICILED IN THE U.S.?
  - Unlike being subject to U.S. income taxes which is a bright-line test.
    - Income Tax Liability Test:
      - Either client has physical presence in the U.S. for 180 days; or
      - U.S Citizen; or
      - Greencard.

Domicile

- Domicile is not a bright-line test, but is a much grayer analysis.
  - IMPORTANT: Planning in this area turns on domicile.
    - Often not carefully analyzed.
    - If not citizen and not domiciled, client will generally only be subject to U.S. transfer taxes on U.S.-sitused property.
      - Very few properties are "sitused" for U.S. gift and estate tax purposes -- Narrow class of Assets.
    - Non-resident aliens cannot use the $5.34 million current exemption amount.
      - Instead, can only transfer at death $60K of property.
      - Additionally, if client and spouse are neither domiciled here, then each of them may use the $14K annual gifting amount, but they may not split the gift.

Two Part Test for Domicile

- Presence Test: Person actually resides here in the U.S.
  - Easy to establish
- Intent Test: Does the individual have the intent to reside in the U.S. permanently – harder to establish.
    - No bright-line rule – based on facts and circumstances.
    - Example: Jeff always says he wants to move back to Norway, in fact, he has a house in Norway that he inherited from his recently deceased parents that is in his own name. He is not employed here.
    - Natalie is, however, employed here and only owns real property in the U.S. and says she wants to stay.

Self-Serving Client Statements

- Many statements clients make can be self-serving and it is important to look at the totality of the circumstances to determine intent for domicile.
  - Look at hardline facts:
    - Location of the residences owned by the individuals
      - Degree of use of assets
      - Largest and most expensive residence.
        - » Example: Jeff only owns a small house in Oslo. The home is really not worth much in comparison to Jeff's other U.S. real property holdings. He owns a much larger house in Park City. Natalie has no real property holdings outside the U.S.
        - » Fact that Jeff has home in Oslo and says he wants to go back there is just not determinative, he probably is still domiciled in the U.S.
    - Also look at the location of the individual's close family and friends.
    - Location of the individuals personal possessions.
    - Location of the individual's employment or business.
    - Licenses to drive
    - Where does the individual belong to church, communal or social organizations.
    - Where does the individual state his or her residence is?
      - Ex: Will or visa or tax declarations.
    - Where the individual owns a burial plot
- Just saying, "I am a Norwegian" can be self serving.
- Look at the totality of circumstances.

Importance

- Need to ask clients and determine if there is any doubt as to domicile.
- If domiciled but non-Citizens, will be treated as U.S. citizens with respect to U.S. estate and gift tax.
  - ONE DIFFERENCE
    - Although couple will be treated entirely as citizens for U.S. transfer taxes, there is ONE VERY IMPORTANT EXCEPTION.
    - NO MARITAL DEDUCITON TO A NON-CITIZEN SPOUSE!!!
    - THERE IS A LARGER ANNUAL EXCLUSION AMOUNT AS BETWEEN THOSE SPOUSES
      - Still limited – Presently $145,000 a year
        - » Sounds like a lot but can still significantly impede the overall planning for a client and/or the client spouse.
        - » Can cause SIGNIFICANT problems with one spouse putting additional assets into another spouse's name.
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Common Question

- I live here in the U.S. I love the U.S. I work and have employment here in the U.S. I never want to leave the U.S. and return to my domicile of origin. Is there any advantage for me to avoid U.S. citizenship?
  - Not really – Client is already taxed on their income based on their 180 day presence here in the U.S.
  - For estate, gift and wealth transfer tax purposes, they are already domiciled here as well.
  - Primary advantage that COULD be gained is to receive a 100% marital deduction if married.

Expatriation Rules (Generally)

- Client will be treated as though they sold all their assets at fair market value upon the date they relinquish their citizenship or greencard.

More on Importance

- So, you can see the importance of determining both citizenship and domicile before we engage in doing long term planning for the client.
  - What are the long-term client objectives with their estate.
    - What do we need to be aware in the estate tax, in the gift tax?
  - Can we capitalize on a situation where the client desires not to have domicile in the U.S. and to gift their non-sitused U.S. assets without being subject to U.S. gift tax?
  - Should be seek citizenship to obtain the marital deduction for client spouses that already have domicile?
  - Can we argue that client has domicile here in the U.S. temporarily in order to capitalize and transfer their U.S.-sitused assets (i.e., utilizing the $60K lifetime exclusion from the gift tax), and then change a critical and key factor in their facts and circumstances test to divest themselves of a U.S. domicile to transfer their remaining non-sitused U.S. assets?
    - Highlights importance of the initial inquiry.
  - RECOGNITION OF ISSUES: Domicile is up in the air generally when we have a spouse who is not a citizen working here in the U.S.
      - A greencard is not a per se indication of domicile.
      - Permanent resident may not be domiciled, though they usually are.

Gift Tax Transfers to Non-Citizen Spouse

- Basic Concepts
  - Citizenship and domicile is (again) an key threshold.
  - Let's assume Jeff is a non-citizen and non-domicile
  - Let's assume Natalie is a non-citizen but U.S. domicile.
  - If Jeff is a non-domicile, then only gifts of U.S.-sitused property from Jeff to Natalie will apply.
    - For gift tax, includes real property transfers and transfers of tangible assets located here in the U.S.
      - » Intangibles generally do not apply.
  - Jeff can still give away assets he owns in bank accounts, all Norwegian real estate without U.S. transfer tax implications.
    - Jeff could give away stock in U.S. companies – intangible assets.
    - VERY IMPORTANT TOOL!!!
      - While in this non-citizen and non-domicile status, you can capitalize on gifting without U.S. gift tax implication.

MAJOR CAUTION

- MAJOR CAUTION:
- If giving cash or cash equivalents to spouses, DO NOT GIVE IT IN THE FORM OF A CHECK!!!
    - IRS has held that checks to spouses are tangible assets and are U.S.-sitused property.
    - Recipient spouse open a bank account or wire the funds or, if at the same bank, have the bank transfer the assets from account to account in a non-tangible form.

Non-Citizens and Non-Domiciles

- Still entitled to $14k annual exclusion.
- NO 100% marital deduction.
  - No marital deduction, period.
- Still entitled to the $145K annual exclusion for transfers to spouses.
    - True even though it is a U.S. citizen making a gift to a non-citizen spouse.
      - Considered a non-exempt transfer out of our system of taxation subject only to the annual exclusion.

Hypothetical 1

- Jeff's Real Property
  - Assume he owns it without any community property issues.
    - Assume it is all Jeff's
  - Assume he transfers to Natalie.
  - Major gift tax issue.
  - U.S.-sitused property.
  - NO GIFT TAX CREDIT FOR NON-CITIZEN, NON-DOMICILE.
    - First dollar to exceed the annual exclusion between spouses is taxed.
    - Strategy: Better to have Jeff transfer cash to Natalie and then have Jane purchase the property from Jeff.

Hypothetical 2

- Natalie's Property
  - Natalie is domiciled in the U.S., but is still a non-citizen.
  - She transfers her property to Jeff, her non-citizen husband.
  - Big difference is that Natalie is taxed on her worldwide assets as a U.S. citizen.
    - No distinction between tangible and real property on the one end and intangible assets on the other – transfers of all assets are subject to gift tax from Natalie.
    - Also gets the $145,000 exclusion, but no marital deduction.
    - However, Natalie has the full $5.34 million dollar unified exclusion – similar to a U.S. citizen.
    - So, if Natalie were to transfer $500,000 of property to Jeff, there would be no tax, but her remaining unified credit would be severely impacted.
      - A gift tax return would also be necessary to report the taxable gift and the use of her credit.
        - » Gifts from Natalie to Jeff are treated as any other gifts between U.S. spouses, with the exception there is no 100% marital deduction and, instead, Natalie only gets $145,000 in annual exclusion.
        - » In either case, the $145,000 is in place of the annual exclusion and not the marital deduction.
          - Again there is no marital deduction between non-citizens, period.

Note on Joint Assets

- Look at the St. George property in joint name.
- Assume Natalie purchased the property using separate assets and then transferred the property to her husband by creating a joint interest with a right of survivorship with her husband who contributed no assets to the purchase of the property.
- There is no gift on the creation of a joint survivor interest between spouses.
  - See Regs., Section 25.2515-1(a)(2)
- However, still have to track where the money to purchase the property came from.
  - Example: If the property is sold and the proceeds distributed equally between the spouses – could inadvertently create a gift tax scenario if, in fact, Jeff did not use any of his separate property to purchase the property.
  - Better Example: If Natalie just transfers the home and puts it into Jeff's name, we have a taxable gift subject to gift tax.
    - Will still be able to utilize $145,000 credit.

Joint Assets

- Bank accounts in joint name.
  - Generally, assets going into a joint account with a right of survivorship do not trigger a taxable gift either at the time the account is created or at the time contributions are made.
    - However, a taxable gift could be created at the time the non-contributing spouse removes money from the account.
  - CAUTION: If the account is in the nature of a tenant in common, it could.
    - Example: Some accounts require both parties to sign before assets may be removed from the account. If Natalie put the money into this type of account, she could be creating a taxable gift scenario since she cannot unilaterally remove the funds.

Basic Planning Tips for Gifting Where At Least One Spouse is a Non-Citizen

- Can gift up to $145,000K a year – use it each year or lose it.
  - Careful to not gift community property if spouse already owns it.
- Non-Citizen, Non-Domicile spouse can gift intangible assets.
- Non-Citizen, Non-Domicile spouse needs to avoid converting his or her assets to real or tangible property located in the U.S.

Estate Tax Issues

- Again, domicile controls – income tax rules and brightline tests are non-determinative to determine estate tax liability for non-citizen spouses
- Any determination for gift tax purposes during life will also be non-dispositive.
  - Domicile determination is made at the date of death.
  - Example: We know what the facts are today.
  - We don’t know:
    - When Jeff will die
    - When Natalie will die
    - The Order of Death
    - What the circumstances will be when one or the other dies

Backing Up

- Assume Jeff and Natalie are U.S. Citizens and die
  - Will be taxed on worldwide assets
  - Will have full applicable exclusion available – provided it was not exhausted during life in whole or in part due to lifetime transfers.
  - Unlimited marital deduction.
  - Presumption that 50% of joint property is owned by spouse.
    - Note: Presumption does not apply on the death of non-citizen spouses.
      - » Must track the money.

Hypothetical 1

- Let's say Natalie becomes a U.S. citizen prior to death.
- Jeff does not become a U.S. citizen, but becomes domiciled in the U.S.
- Order of death becomes important.
- Jeff dies first and transfers assets to Natalie.
  - Because domiciled in the U.S., Jeff's worldwide assets are subject to estate tax.
  - Full applicable exclusion qualifies.
  - Unlimited marital deduction will also be available with no special planning since Natalie is a U.S. citizen.

Hypothetical 2

- If Natalie dies first:
  - Will also be subject to tax on worldwide income.
    - She is a U.S. citizen.
  - Will also have full applicable exclusion.
    - HOWEVER: Jeff is not a U.S. citizen.
    - Unlimited marital deduction not available for Natalie's estate when transferring assets to Jeff.
    - Annual gift tax exclusion not available.
    - Assets transferring to Jeff in excess of the applicable exclusion will be taxed at Natalie's death.
      - This is opposed to being transferred tax free to Jeff at Natalie's death via the martial deduction if Jeff were a U.S. citizen.

How to Remedy

- How to remedy:
  - Jeff can become a U.S. citizen after Natalie dies, but BEFORE the estate tax return become due.
    - Jeff must be also a U.S. resident.
    - Will be treated as U.S. citizen for estate tax purposes.
  - Qualified Domestic Trust – QDOT
    - Natalie may establish a QDOT for Jeff's benefit

QDOTs

- The term "QDOT" is an acronym for "Qualified Domestic Trust."
- Qualified Domestic Trusts were created under the Technical & Miscellaneous Revenue Act of 1988 (TAMRA), effective for decedents dying after November 10, 1988. Prior to TAMRA, the unlimited marital deduction was not allowed when property passed to a surviving spouse who was not a United States citizen. The creation of QDOTs was designed to provide a mechanism whereby property could pass to a non-U.S. citizen spouse and still qualify for the unlimited marital deduction.
- Remember, the gift and estate tax rates can be as high as 40% of the value of the property transferred.
  - Think of a married couple as one economic unit.
  - As long as property remains within that economic unit, the federal government keeps its hands off the property.
  - Married couples can transfer property from one spouse to the other as often as they'd like, either during lifetime or upon death.
  - It is only when property is transferred outside the economic unit (i.e., to someone other than the surviving spouse) that the federal government puts its hand out.
  - That's not to say that the federal government exempts inter-spousal transfers from the gift and estate tax. On the contrary, it subjects these transfers to the gift and estate tax, but then gives a corresponding deduction equal to the full value of the property transferred.
  - This deduction is called a marital deduction because it only applies to transfers from one spouse to another.
  - Furthermore, it is called an "unlimited marital deduction" because there is no limit on the amount of property that qualifies for the marital deduction.
  - The use of an unlimited marital deduction, rather than an outright exemption, effectively defers the tax until the death of the surviving spouse.

Requirements for QDOT

- How to qualify as a QDOT
  - Trust must name at least one individual U.S. citizen or domestic corporation as a trustee.
  - No distribution other than an income distribution may be made from the trust unless a U.S. trustee has the power to withhold tax on the distributions.
  - Must be maintained and administered under the laws of the U.S.
  - If the estate that will be passing into the QDOT exceeds $2 million, one of the trustees must be a domestic corporation or a bond must be taken out for 65% of the fair market value of the estate-to insure payment of taxes.
    - Natalie's QDOT for Jeff will be a large trust, so must meet these requirements.
  - If the estate is under the $2 million mark, then the law says that no more than 35% of the estate can be held in the form of real property located outside the U.S.

Additional Fallback

- The regulations are particularly flexible regarding the ability for someone other than the decedent to establish a QDOT, like the surviving spouse, a representative of a surviving spouse, or the executor for the estate.
  - Still, it is best to handle this type of matter as early as possible.

Other QDOT Issues

- The executor is required to make an election to qualify a trust as a QDOT
  - Election is made on a timely filed estate tax return.
  - Once made, the election is irrevocable.
  - Because the designated trustee will act as the withholding agent he or she may be personally liable for the taxes if they are not withheld or are withheld incorrectly.

Hypothetical 3

- Nonresident Aliens
  - Assume Jeff dies first and is not a U.S. Citizen and not a U.S. resident.
  - Property of a non-resident alien that is not U.S.-sitused property will NOT be subject to U.S. estate tax.
  - MAJOR NOTE: Differences in the categories of assets subject to gift tax and estate tax.
    - For estate tax, the term "U.S.-sitused property" includes intangibles derived from U.S.-sitused property will be included in the gross estate if it is derived from a U.S. person or entity.
      - Example: Stock issued by a U.S. corporation is NOT sitused for U.S. gift tax purposes but IS sitused for U.S. estate tax purposes.
    - Partnership Interests
      - If survive death, situs of partnership controls
      - If terminates, situes of partnership assets controls

Major Exceptions

- Deposits with U.S. Banks and Savings and Loan institutions.
  - Narrowly construed.
    - Does not include contents of safe deposit box –even if cash.
    - Does not include funds held by banks in a fiduciary capacity.
- Life insurance proceeds paid by a life insurance company if the insured is a non-resident alien.
- Exception for portfolio debt obligations issued after 1984.
- Works of art on loan for exhibition will also not be included.
- WORD OF CAUTION: Situs rules can and do change often with treaties. Depending on the treaty, many additional exceptions may apply so you have to check the treaty of the non-resident alien's applicable jurisdiction.

Non-Resident Alien Deductions and Credits

- Marital deduction only available if QDOT.
- Estate tax charitable deduction available only if transfers made to charities organized and operated in the U.S.
  - Many treaty exceptions may exist here.
- Only eligible for $60,000 exclusion.
  - May be changed with treaty.
    - But only 10 countries have these.

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