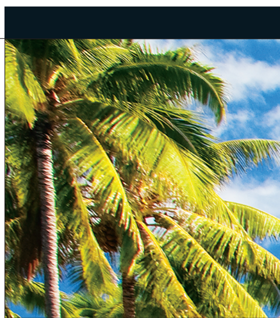

Estate Planning Gets More Complex for Non-U.S. Citizens

Tax treaties, as well as the Internal Revenue Code, need to be reviewed when advising non-U.S. citizens about strategies to minimize transfer taxes.

JONATHAN A. MINTZ

The confluence of several events have a created a perfect storm for planning for non-U.S. citizens. As is discussed below, these events include the implementation of the Foreign Account Tax Compliance Act (FATCA), global economics, and the general attractiveness of the U.S. for investment.

Background

International estate planning takes two forms: inbound and outbound. With inbound planning, a non-U.S. person either invests in U.S. assets (typically businesses or real estate) or contemplates a move to the U.S. With outbound planning, a U.S. person invests abroad. Inbound and outbound planning are quite different. The focus of this article is inbound planning, and it is intended to provide an overview of the important and often-misunderstood topic of U.S. estate planning for non-U.S. citizens.

It is critical to note upfront that a gift or estate tax treaty, and more likely an income tax treaty, between the U.S. and the client's native country or countries may modify the general rules set forth below. This article discusses these treaties in general terms but when working with international clients, it is important to know whether a treaty applies and, if so, the impact of that treaty.

Implementation of FATCA

Beginning in July 2014, the U.S. implemented what amounts to a unilateral imposition of disclosure requirements, directed at foreign financial institutions and non-financial foreign entities, designed to uncover U.S. persons who are hiding foreign assets to avoid U.S. taxation.[1] In response, that same month and year, the Organisation for Economic Co-operation and Development (OECD) adopted an automatic exchange of financial information, now known as the Common Reporting Standard (CRS). As of the writing of this article, 57 jurisdictions have signed an agreement to enable automatic *bilateral* sharing of country-by-country information, and several of these jurisdictions have begun to report accounts held by or for the benefit of other countries' citizens.[2]

In an ironic twist (one not lost on these foreign financial institutions), the U.S. refuses to participate in CRS and has publicly said that it will not disclose assets held by foreigners to their native governments. Therefore, as a direct result of the imposition of these U.S. disclosure requirements, the U.S. has now become the world's greatest secrecy haven, and foreigners are moving assets to the U.S. in unprecedented numbers.[3] Some of these investments are the result

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of the investor's *desire* for anonymity, while others are the result of the investor's *need* for secrecy (e.g., in countries where kidnapping and other horrible crimes are a real risk for families of wealth).

Strength of U.S. economy

The second major factor in this perfect storm is the relatively strong U.S. economy. While parts of Asia in particular have stronger economies today (although even these economies are slowing), much of the world has a more stagnant GNP than the U.S., making the U.S. an attractive place to invest wealth. As of the writing of this article, Germany's long-term interest rates are negative, and other countries in Europe and elsewhere have little or no economic growth.

Attractive for investment

The third major factor contributing to this perfect storm is a more long-term factor: in comparison to many parts of the world, the U.S. is a relatively safe and attractive place to invest. Investors do not even consider as a possibility government confiscation, let alone the effect of true government instability. The strength of the U.S. democracy is very attractive to many people throughout the world. Absent pre-planning, however, the taxes we will discuss below can become an unwelcome surprise for these individuals.

Many of these individuals also want to experience the "American dream" and move to the U.S. But as is also explored below, this can have significant U.S. tax consequences that should be addressed before they move to the U.S.

Transfer taxation for non-U.S. citizens

Under current law, a U.S. citizen or "resident" has a federal estate tax exemption equivalent amount of $5 million indexed for inflation ($5.49 million in 2017); taxable wealth above this threshold is subject to a 40% tax.[4] For transfer tax purposes, residency is determined by a person's *domicile*, or presence with the intent to remain indefinitely, at the time of the gift or death.[5] In other words, for transfer tax purposes only, a noncitizen is a U.S. resident if he or she currently lives in the U.S. and intends to remain there indefinitely, or if he or she previously lived in the U.S. with an intent to remain in the U.S. indefinitely without changing that intent, regardless of where he or she lives currently. Conversely, living in the U.S. with the intent to return home to one's native country means that individual is not a resident of the U.S. for transfer tax purposes (a non-U.S. resident is commonly referred to as a non-resident alien, or NRA).[6]

Domicile is a subjective test—what is the individual's intent—that is determined by objective factors.[7] Some of the factors the IRS considers include the following, although no single factor is determinative:

- Duration of stay in the U.S. and other countries and frequency of travel between countries.
- Size, cost, and nature of homes (vacation home, owned, rented, etc.).
- Location of the individual's immediate family.
- Location of business and social contacts.
- Membership in religious and other organizations.
- Location of expensive/cherished personal possessions.
- Registration to vote.
- Place of driver's license and vehicle registration.
- Location of bank and investment accounts.
- Reasons for residency (temporary employment, etc.).
- Declarations of residency or intent made in visa applications, estate planning documents, letters, and oral statements.[8]

Residency matters because, unlike U.S. citizens, a non-U.S. person (i.e., someone who is neither a U.S. citizen nor a U.S. resident)[9] is only subject to transfer tax on U.S.-*situs* property.[10] Situs is a technical term meaning the legal location of property. Unfortunately, the rules are different for gift and estate tax purposes.

Gift tax. For gift tax purposes, non-U.S. persons are subject to tax only on gifts of real property or tangible personal property located in the U.S.[11] Tangible personal property includes jewelry, art, antiques, cars, and other tangible possessions. Significantly, cash and checks cashed in the U.S. are tangible personal

1 Enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, FATCA also imposes additional reporting requirements for U.S. persons.

2 For updated information in signatories, see the OECD's Automatic Exchange Portal, online at www.oecd.org/tax/automatic-exchange/news/.

3 This may be an oversimplification of events, but the result was clearly set into motion by the actions of the U.S. Treasury.

4 Sections 2001 and 2010.

5 Reg. 20.0-1(b). This regulation also provides that "[r]esidence without the requisite intention to remain indefinitely," on the other hand, "will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal."

6 See Reg. 20.0-1(b)(1).

7 See Reg. 25.2501-(1)(b).

8 See IRS Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions*, for a discussion of the similar "closer connection" factors.

9 The Code frequently refers to U.S. citizens and "residents." As is discussed below, the "residency" test for transfer tax purposes differs from the residency test for income tax purposes. Because many foreign clients do not like the moniker "nonresident alien," this article uses "non-U.S. person" throughout to signify someone who is not a U.S. citizen and not a resident for transfer and/or income tax purposes, as dictated by the context.

10 Sections 2103, 2501(a)(1), and 2511(a).

11 *Id.*

property located in the U.S., and thus subject to gift tax.[12]

Intangibles—such as shares in a U.S. corporation or debt obligations from U.S. corporations or the U.S. or state governments—are not subject to gift tax.[13] It is unclear whether partnership and LLC interests are intangible personal property; if they are, gifts of these interests are also not subject to gift tax.

As discussed above, a U.S. person has a $5 million (indexed for inflation) "unified credit" against the federal gift and estate tax.[14] This means that if a U.S. resident or citizen makes a gift of more than the gift tax annual exclusion amount ($14,000 in 2017)[15] to one individual other than a spouse in any tax year, he or she (i.e., the donor) must file a gift tax return (Form 709) that uses up some of his or her $5 million exemption. Alternatively, absent a tax treaty that modifies these amounts, a non-U.S. person is allowed only the $14,000 gift tax annual exclusion for transfers to a non-spouse.[16] In other words, a non-U.S. person who transfers more than $14,000 of U.S. situs property to any one individual other than a spouse must pay gift tax at graduated rates up to 40% of the amount over $14,000.

Furthermore, U.S.-citizen spouses have an unlimited marital deduction—meaning they can receive an unlimited amount of property from their spouse free of gift or estate tax.[17] Alternatively, when the donee spouse is a non-U.S. citizen, he or she can receive only $149,000 per year from his or her spouse free of gift tax.[18] Transfers above this amount to a noncitizen spouse are either: (1) subject to a 40% tax if there is no tax treaty authorizing a greater exemption amount; or (2) if a tax treaty exists granting a greater exemption amount, the transfer will use up some of this amount.[19]

Domicile is a subjective test—what is the individual's intent—that is determined by objective factors.

Tax-saving exception. The unlimited exclusion for transfers made directly to a medical or educational provider also applies to non-U.S. persons.[20] Therefore, non-U.S. persons can transfer an unlimited amount for educational or medical expenses, free of gift tax, as long as the payment is made directly to the medical or educational provider. If instead, however, the payments are made to a non-spouse family member who then pays for medical or educational expenses, the amount in excess of $14,000 will be subject to gift tax. Furthermore, payments made to non-U.S. citizen spouses will be subject to gift tax over $149,000, regardless of whether the non-U.S. citizen spouse is a U.S. resident. Thus, while some transfers are exempt from transfer tax (e.g., direct payments to educational and medical providers), transfers from non-U.S. persons are generally subject to up to a 40% tax beginning at very low thresholds.

Foreign gifts to a U.S. person are not subject to gift tax, but they must be reported to the IRS if they exceed certain thresholds, which vary depending on the source of the gift. A U.S. person who receives cumulative gifts exceeding $100,000 in any calendar year, if from an individual non-U.S. person or foreign estate, must report the amounts and sources of the gifts on Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." Alternatively, gifts greater than $15,671 from foreign corporations or foreign partnerships (including foreign persons related to such foreign corporations or foreign partnerships) must also be reported by the recipient on Form 3520.[21]

Estate tax. A non-U.S. person is subject to estate tax only on his or her U.S. situs property;[22] debts on the property (such as a mortgage on real property) may help reduce the value of the property subject to tax. For estate tax purposes, U.S. situs property subject to U.S. estate tax includes:

- All types of real property located in the U.S.
- U.S.-located tangible personal property, such as jewelry, antiques, cars, and other tangible possessions unless in transit to or from a museum.
- Shares of stock in U.S. corporations, regardless of where the shares are physically located.
- Mutual funds, if incorporated in the U.S.
- Cash deposits with U.S. brokers and cash in U.S. safety deposit boxes.
- Partnership interests in U.S. general and limited partnerships, as well as member interests in U.S. LLCs,[23] but not interests in foreign entities.

[12] It is unclear whether a wire transfer originating outside the U.S. takes place in the foreign country or the U.S. This author believes, however, that a strong argument can be made that the "transfer" takes place offshore because the sender loses control of the funds at the point of origination (i.e., in the foreign country). Under these circumstances, the wire transfer is not subject to gift tax.

[13] See Reg. 25.2511-3(b)(2).

[14] Reg. 25.2505-1.

[15] Section 2503(b).

[16] Sections 2102(b) and 2503(b)(1).

[17] Sections 2056 and 2523.

[18] Section 2523(i); Reg. 25.2503-2(f).

[19] See Reg. 20.2056A-1.

[20] Section 2503(e).

[21] See IRS Form 3520, and instructions thereto.

[22] Section 2103.

[23] Section 2104; Regs. 20.2104-1(a)(2) and 20.2105-1(a)(2).

Life insurance on the life of a non-U.S. person is not U.S. situs property.[24] If a non-U.S. person owns life insurance on the life of another, however, a policy issued by a U.S. insurer is U.S. situs property, whereas a policy issued by a foreign insurance company is non-U.S.-situs property. Moreover, property on loan to (or traveling to/from) a U.S. exhibition or museum is also excluded,[25] as are bank deposits and debt obligations that are not subject to tax.[26]

Again subject to an estate tax treaty, at death a non-U.S. person can transfer only $60,000 worth of U.S. situs property without having to pay U.S. estate tax; anything above $60,000 is subject to up to a 40% tax at the graduated rates.[27] Perhaps more surprisingly, a non-U.S. person can transfer to a spouse only $60,000 worth of U.S. situs property at death without having to pay estate tax; anything above this nominal amount will also be subject to up to a 40% tax unless it is left in a qualified domestic trust (QDOT).[28] A QDOT for a noncitizen spouse essentially replaces the unlimited marital deduction for transfers to that noncitizen spouse, regardless of his or her residency.

If the assets transferring to the noncitizen spouse exceed the federal estate tax exemption (either $60,000 or up to $5.49 million in 2017 by treaty, as the case may be), absent a QDOT, those assets above the threshold will be subject to up to a 40% U.S. estate tax, which is due within nine months of the death of the first spouse to die. Thus, just like with gifts, transfers from non-U.S. persons at death are generally subject to tax at very low thresholds.

The U.S. estate tax calculation for a non-U.S. person is similar to the calculation for a U.S. person, although not identical.[29]

Generation-skipping transfer tax. If the original transfer is subject to U.S. gift or estate tax, and it is made to a person two generations or more below the transferor, the generation-skipping transfer (GST) tax will also apply, subjecting the transfer to an additional 40% tax. Alternatively, if the original transfer was not subject to U.S. gift or estate tax, it also will not be subject to U.S. GST tax.[30]

Life insurance on the life of a non-U.S. person is not U.S. situs property.

Gift and estate tax treaties

The U.S. currently has gift or estate tax treaties with 17 countries. These are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Switzerland, and the United Kingdom.[31]

The goal of these gift and estate tax treaties is to eliminate double taxation between the U.S. and the client's native country. A detailed discussion of the various treaties is beyond the scope of this article, but suffice it to say that the majority of these treaties are estate tax treaties whereby the nonresident alien receives an exemption equivalent of the *greater* of $60,000 or the proportional exemption equivalent of a U.S. person using the following calculation:

Exemption equivalent amount for U.S. persons × (Value of the NRA's U.S. situs property / Value of the NRA's worldwide property).

For example, suppose a non-U.S. person owns a U.S. residence worth $1 million. Also suppose that the total value of his or her worldwide assets is $5 million. Thus, if the client dies in 2017, his or her exemption equivalent amount is $5,490,000 × (1/5), or $1,098,000—enough to fully exempt the home from U.S. estate tax.

Alternatively, if the same client has $10 million of worldwide assets, his or her exemption equivalent amount is instead $549,000, and thus $451,000 would be subject to approximately 38% tax, or $171,380 of U.S. estate tax. While this is obviously better than paying tax on the full $940,000, the net effect of this calculation is that the larger the percentage of U.S. to worldwide assets, the larger the non-U.S. person's exemption equivalent amount. Thus, in the extreme example, if the non-U.S. person owns only U.S. situs assets, he or she will get the full U.S. persons' exemption equivalent amount.[32]

Estate planning for personal-use real property

It is very common for non-U.S. persons to purchase real property in the U.S.—often as a residence either for themselves or for family members who are studying or otherwise living in the U.S. As discussed above, if a non-U.S. person purchases U.S. real property in his or her name, that property will be subject to potentially both gift and estate tax.

The simplest scenario is real property purchased for personal use. If a non-U.S. person purchases real property located in the U.S.

[24] Section 2105(a).
[25] Section 2105(c).
[26] Section 2105(b).
[27] Section 2102(b).
[28] Reg. 20.2056A-1(a).
[29] See Reg. 20.0-2(c).
[30] Reg. 26.2663-2.
[31] See the IRS website at www.IRS.gov.
[32] See, e.g., U.S.-Germany estate tax treaty, online at www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Protocol-Estate-Gift-Germany-12-14-1998.pdf.

in his or her personal name, because U.S. real property owned by a non-U.S. person is subject to both gift and estate tax, absent a gift tax treaty, he or she cannot give it away without paying gift tax to the extent the value of the gift exceeds $14,000.

What can the non-U.S. person do? One option is to purchase the real property through a trust that is outside the purchaser's estate for estate tax purposes.[33] Unlike with U.S. citizens, the trust can be a grantor trust only if it is revocable or no one other than the settlor or the settlor's spouse is a beneficiary during lifetime.[34] The decision as to whether to establish this as a foreign or U.S. trust will depend on many factors, including whether the beneficiaries are or will become U.S. persons.

Alternatively, as discussed above, life insurance owned by a non-U.S. person and issued by a U.S. life insurance company is *not* includable in the non-U.S. person's estate, unlike life insurance owned by a U.S. person. Thus, the non-U.S. person could simply purchase a life insurance policy to cover the potential gift or estate tax liability for owning the property.[35]

What if the goal is to benefit one or more of their children by letting them live in the property while they go to school and beyond? Under these circumstances, the purchase will ideally be by a trust for the benefit of their children, but otherwise similar to the trust above; if established or later moved to a state or foreign jurisdiction that permits self-settled trusts, the trust can include the power to add one or more parents as a discretionary trust beneficiary.

Alternatively, what if the plan is to sell the property immediately after the completion of the child's education? In this case, if a grantor trust is not possible, it might make sense to have the child buy the home in the child's name to take advantage of the Section 121 $250,000 exclusion. Again, life insurance issued by a U.S. insurance company and owned by the child might be the simplest way to insure against the risk of estate tax in the event of the child's premature death.

Estate planning for income-producing property

The ownership structure may be more complex when the U.S. property is income-producing property. In this scenario it may be difficult to minimize both transfer and income taxes for the property, so it is imperative to know the client's long-term objectives. First, consider the general income tax rules for non-U.S. persons.

Non-U.S. persons for U.S. income tax purposes

If an individual is a citizen or long-term permanent resident of the U.S., the U.S. subjects all of that person's property *worldwide* to transfer tax and income tax. In other words, all property of U.S. citizens and long-term permanent residents (defined as a green card holder for at least eight of the preceding 15 tax years), no matter where the property is located, is subject to U.S. income and transfer tax.

Alternatively, if that individual is not a U.S. citizen or long-term permanent resident, subject to a tax treaty with his or her native country, income taxation and transfer taxation depend upon legal *residency*. Of course, the income tax residency test is different from the transfer tax residency test, so one may be a resident for one or both tax systems, depending on the circumstances.

It is critically important to know the client's goals and objectives to minimize all tax to the extent possible.

Income tax "residency" test. For income tax purposes, a green card holder or other lawful permanent resident is a U.S. resident for income tax purposes,[36] until that status is rescinded or abandoned.[37] Alternatively, an individual can be a resident for U.S. income tax purposes if he or she: (1) is present in the U.S. 183 days or more in the current year (i.e., more than one-half of the year); or (2) is "substantially present" in the U.S., meaning present in the U.S. more than 31 but less than 183 days in the current year and the total number of days present in the U.S. in the current and two immediately preceding years equals or exceeds 183 days under the following formula:

- The number of days present in the U.S. in the current year.
- Plus: 1/3 of the number of days present in the U.S. in the immediately preceding year.
- Plus: 1/6 of the number of days present in the U.S. in the second immediately preceding year.[38]

If the sum of the above equals 183 days or more, he or she is a U.S. resident for U.S. income tax purposes unless it can be established that

33 If the trust owns an LLC or partnership that purchases the property from the beginning, it does not matter whether the LLC or partnership is an intangible.

34 Section 672(f)(2)(A).

35 Note, however, that in some states outright ownership by the nonresident alien may potentially subject the insurance proceeds to his or her creditors.

36 Reg. 301.7701(b)-1(b)(1).

37 Reg. 301.7701(b)-1(b)(2).

38 Section 7701(b)(1)(a); Regs. 301.7701(b)-1(c) and 301.7701(b)-2.

the individual has a closer connection to another jurisdiction.[39]

For example suppose an individual was present in the U.S. 115 days in 2016. If he or she was present 135 days in 2015, and 120 days in 2014, the substantial presence calculation is 180 days (115 + 45 (135/3) + 20 (120/6) days), and thus he or she is not a U.S. resident for U.S. income tax purposes.

Based on these very different tests, it is possible for an individual to be a resident for transfer tax purposes but not a resident for income tax purposes, and vice versa.

For income tax purposes, non-U.S. residents are generally taxed only on U.S.-source income.[40] Thus, if their only U.S. property is a second residence, and they do not collect rent, they have no U.S.-source income. If, however, they rent the property or have other U.S. property that produces income, the rate they pay depends on the type of income:

- Passive or portfolio-type income—including interest, dividends, rents, and royalties—is taxed at a flat 30% (typically withheld at source), although this rate may be reduced by tax treaty.[41]
- Wages, salaries, trade and business income, gains from the disposition of real property, and other "effectively connected to a trade or business income," or ECI, is subject to standard U.S. income tax rates up to 39.6%.[42]

Significantly, under the Code, capital gain from the sale of U.S. property (excluding real property) is not subject to tax or withholding,[43] and interest on U.S. bank accounts, including CDs, is not U.S.-source income.[44] Moreover, the Code treats a foreign trust as a "nonresident alien individual who is not present in the United States at any time."[45] Thus, gross income of the foreign trust includes only U.S.-source income,[46] and capital gain (excluding real property) and other tax-exempt income earned inside a foreign trust is also not subject to U.S. tax.

For these reasons, a foreign trust frequently is preferable to a domestic trust, but only where there are solely non-U.S. beneficiaries. With U.S. beneficiaries, distributions from a foreign trust carry a punitive lookback tax designed to discourage distributions greater than the current year's distributable net income, thereby preventing the trust from avoiding income tax simply by not making distributions.

As discussed above, if the non-U.S. person buys the real property in the name of a corporation (or potentially a partnership or LLC), he or she can transfer the corporate shares during lifetime without incurring gift tax. However, this will subject the property to double taxation if it is sold and the sale proceeds are distributed to the non-U.S. person.

Moreover, if the non-U.S. person dies owning the shares, the shares will be subject to U.S. estate tax. One frequently used solution is to have the U.S. entity be owned by a foreign entity, whose ownership is not subject to U.S. estate tax because it is a non-U.S. asset.[47] Unless the U.S. entity is a corporation, however, withholding will be required on any distributions to the foreign

[39] Reg. 301.7701(b)-2. This regulation sets forth the following nonexclusive list of closer connection factors, which are similar to the transfer tax "domicile" factors:

"(i) The location of the individual's permanent home;
(ii) The location of the individual's family;
(iii) The location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his or her family;
(iv) The location of social, political, cultural or religious organizations with which the individual has a current relationship;
(v) The location where the individual conducts his or her routine personal banking activities;
(vi) The location where the individual conducts business activities (other than those that constitute the individual's tax home);
(vii) The location of the jurisdiction in which the individual holds a driver's license;
(viii) The location of the jurisdiction in which the individual votes;
(ix) The country of residence designated by the individual on forms and documents; and
(x) The types of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States), Form W-8 (Certificate of Foreign Status) or Form W-9 (Payer's Request for Taxpayer Identification Number)." Reg. 301.7701(b)-2(d)(1).

[40] Section 871(a)(1).

[41] Section 871(a).

[42] Section 871(b).

[43] Section 871(a)(2).

[44] Section 862.

[45] Section 641(b).

[46] Section 872(a).

[47] *Id.*

[48] Section 884.

[49] Section 897.

[50] Section 871(a)(2).

[51] See Section 7701(a)(30); Reg. 301.7701-7(a).

[52] Under Reg. 301.7701-7(d), the following constitute substantial decisions:

"(A) Whether and when to distribute income or corpus;
(B) The amount of any distributions;
(C) The selection of a beneficiary;
(D) Whether a receipt is allocable to income or principal;
(E) Whether to terminate the trust;
(F) Whether to compromise, arbitrate, or abandon claims of the trust;
(G) Whether to sue on behalf of the trust or to defend suits against the trust;
(H) Whether to remove, add, or replace a trustee;
(I) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and
(J) Investment decisions; however, if a United States person under section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will."

[53] Section 641(b).

[54] Note that if the foreign trust is a partner or member in a partnership or LLC, respectively, engaged in business in the U.S., the foreign trust will be treated as engaged in the U.S. business of the entity. See Section 875(1). However, partnerships (and presumably LLCs) that trade securities for their own accounts are exempt under Reg. 1.864-2(c)(2)(ii).

entity. Moreover, if the foreign entity is a corporation, the U.S. entity may be subject to the branch profits tax, which, in short, taxes all of the "branch's" income as if it were distributed in the year earned.[48]

As this discussion demonstrates, it is critically important to know the client's goals and objectives to minimize all tax to the extent possible. For example, if the intent is to hold and not sell the property, it may be more important to eliminate gift and estate tax through a structure similar to the one discussed above. Alternatively, if the client intends to sell the property in the short term, income tax planning may be equally important, if not more so than transfer tax planning. For example, one could establish a structure similar to the one discussed above but draft the trust so that it is a grantor trust as to a U.S. beneficiary to minimize U.S. income tax and eliminate transfer tax.

Ideally, the non-U.S. person seeks advice before purchasing the property, so he or she will have a full range of options.

FIRPTA. A detailed discussion of the Foreign Investment in Real Property Tax Act (FIRPTA) is beyond the scope of this article, but it is important to know that the sale of real property owned by foreign individuals or corporations may be subject to an additional withholding of up to 15% under FIRPTA. Significantly, this withholding is a percentage of the *total sales prices, not just the gain.* Personal residences with a sales price below $300,000 are exempt from FIRPTA withholding.[49]

Estate planning for interests in a U.S. business. An investment in a U.S. business is very similar to investment in U.S. real property. If the business is a U.S. corporation, the corporation's shares can be transferred free of gift tax, but ownership of the shares will result in estate tax at the investor's death. Moreover, if the corporation is a start up and is not producing income currently but is expected to produce gain upon sale in the future, the capital gain can be eliminated under limited circumstances.

As discussed above, other than gain from the sale of real estate, capital gain earned by a non-U.S. person for income tax purposes is not subject to U.S. income tax.[50] Thus, the non-U.S. person can either own the asset directly or, to eliminate the estate tax risk from premature death, a trust can be established as a foreign trust for U.S. tax purposes to own the asset. For the reasons discussed above, these trusts are frequently established in a U.S. jurisdiction as foreign trusts by intentionally failing the control test.[51] In other words, if there are no U.S. beneficiaries and no U.S. ordinary income, a trust with a foreign trustee (or a foreign trust protector with substantial decision-making authority)[52] will not be subject to U.S. income tax until after the asset is sold—at which point the non-U.S. person could remove the funds from the U.S. to avoid U.S. tax entirely.[53] This structure works particularly well for investment by a non-U.S. person in a U.S. start-up company (often a C corporation) that produces no dividends currently and will likely see a significant stock price increase in the future.[54]

Similar to investments in U.S. real property, the key is for the non-U.S. person to discuss these issues with a qualified professional *before* purchasing the business interest.

Pre-immigration planning. A non-U.S. person who intends to migrate to the U.S. should take steps now, *before* migrating, to reduce the overall taxation on property owned worldwide. By eliminating gain before migrating to the U.S. the non-U.S. person can minimize U.S. tax. For example, the non-U.S. person could make irrevocable gifts to long-term trusts for U.S. or non-U.S. beneficiaries. These can be either U.S. trusts or foreign trusts. However, if it is a foreign trust, it will become a grantor trust if the settlor becomes a U.S. person within five years of the trust's creation, which would subject all of the trust's assets to U.S. income tax.

In practice, these clients frequently do not engage counsel more than five years in advance. When that happens, the client should still establish the trust—which is in many respects similar to a domestic or foreign asset protection trust—to remove the assets from the U.S. transfer tax system, but invest the trust assets in such a way so as to not produce taxable income (e.g., through tax-efficient investments or a U.S. insurance policy that allows tax-free access to the policy's cash value—such as a non-modified endowment contract (MEC) policy, possibly private placement life insurance (PPLI). This will significantly reduce—if not eliminate—U.S. income tax going forward.

Conclusion

The gift and estate tax rules for non-U.S. citizens are vastly different from the rules for U.S. citizens. Therefore, when working with non-U.S. citizens, it is critically important that the estate planning professional have a working knowledge of the general tax rules applicable to non-U.S. citizens and, when appropriate, the impact of an income tax, gift tax, or estate tax treaty with one or more of the client's native countries. Through pre-planning, one can frequently save non-U.S. citizens significant U.S. taxes—sometimes millions of dollars or more—if planning is put in place before they become U.S. persons or buy U.S. property. ■