U.S. Estate Planning for Foreign Citizens

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Foreign citizens who own U.S. property or who reside or vacation in the U.S. are often unaware of the broad reach of the U.S. estate and gift tax regime (U.S. transfer tax) and of the strict transfer tax laws applicable to foreign citizens. Consequently, foreign citizens commonly fail to implement advance planning, which can avoid or minimize the U.S. transfer tax. In fact, this issue is frequently discussed in leading U.S. tax periodicals, with an emphasis on the need to educate foreign citizens about the high costs of not planning for the U.S. transfer tax.

One important issue every foreign citizen must determine is whether he or she is a U.S. resident for U.S. transfer tax purposes. Under the U.S. transfer tax, a person is a U.S. transfer tax resident if his or her domicile (primary residence) is in the U.S. Surprisingly, the U.S. transfer tax residency standard is different from the U.S. income tax residency standard. It is possible for illegal aliens and non-immigrant visa holders to be treated as U.S. transfer tax residents. Therefore, the issue of residency is often a matter of dispute between the IRS and wealthy foreign citizens and their estates.

If the IRS considers a person a U.S. transfer tax resident, then his or her entire worldwide property and assets are subject to the U.S. transfer tax system. For wealthy foreign citizens, this can result in a significant and unexpected tax liability. Non-residents also must pay very close attention to the U.S. transfer tax, because the tax applies to a non-resident's U.S. situs property. However, important loopholes exist in the non-resident U.S. transfer tax rules that offer non-residents significant opportunities to minimize U.S. transfer tax exposure, with appropriate planning.

Specifically, gifts of U.S. situs property made by a non-resident are subject to the U.S. gift tax. For U.S. gift tax purposes, U.S. situs property generally includes only tangible personal property (such as jewelry, artwork, automobiles and cash) and real estate located in the United States, but not intangible assets (such as stock in a U.S. company). However, for U.S. estate tax purposes, U.S. situs property is more broadly defined, and for example, does include stock in a U.S. company.

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Unfortunately, under the U.S. transfer tax system, a non-resident is afforded no gift tax exemption and only a $60,000 estate tax exemption. The lack of a significant transfer tax exemption often produces costly tax results to a non-resident who transfers during life or owns at death even a modest amount of U.S. property. Therefore, planning for the non-resident who owns U.S. property, such as a vacation house, often involves techniques to convert the U.S. situs property into non-taxable foreign property, or to have the foreign citizen become a U.S. resident to capture any U.S. estate tax exemption available to U.S. citizens and residents.

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An estate is generally entitled to an unlimited estate tax deduction for property passing to the surviving spouse if that spouse is a U.S. citizen. This critical deduction preserves the "marital estate" intact from the transfer tax until both spouses are deceased. However, if the surviving spouse is not a U.S. citizen this deduction is available only if special trust provisions are imposed upon the spouse's inheritance. Consequently, an important component of estate planning for foreign citizens may be the implementation of such trust measures to capture an unlimited marital deduction.

Finally, it is important to note that the U.S. has entered transfer tax treaties with a number of nations, which may alter the general tax rules and results discussed herein.

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