The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 13, No. 12 December 2005

TAX INSIGHTS from ROBERTS & HOLLAND LLP

Are Your Non-U.S. Executives Prepared For U. S. Estate Tax?

By Sanford H. Goldberg and Quincy Cotton

Many multinational companies have non-U.S. citizen executives working in the United States. Although usually limited to three or four years, these assignments may continue for an extended period, such that the executive and his family establish strong ties to, and acquire substantial assets in, the United States. Most such executives (and the companies that employ them and field their questions) quickly become familiar with the U.S. income tax rules that apply to them. However, they often do not understand the U.S. estate tax consequences of their status.

Resident Or Nonresident?

Like income taxation, U.S. estate taxation turns on status as either a resident or nonresident. Residence for income tax purposes, however, is quite different from residence for estate tax purposes. Indeed, an executive here on a short-term assignment for a few years is most likely a U. S. resident for income, but not for estate tax purposes.

Sanford H. Goldberg, a Partner in Roberts & Holland LLP, concentrates on international taxation, providing tax and estate planning to U.S. and non-U.S. individuals and families with multiple-country heirs and beneficiaries. Quincy Cotton, also a Partner in Roberts & Holland, works with high net worth U.S. and non-U.S. individuals to structure estate plans using sophisticated techniques including family entities, freeze transactions and defective grantor trusts. Roberts and Holland confines its practice to tax matters, with 40 tax lawyers in its New York City and Washington, DC offices.

A person becomes a resident for estate tax purposes by being present in the United States with the intention to remain indefinitely, or without the intention to return to his *home* country. There is no bright-line test, as there is for income tax residence, which is based on the number of days of physical presence here. Rather, this is a "domicile" test and is based on all the facts and circumstances. Among the most relevant factors are:

- Size, cost and use of residences here and in the home country. Does the taxpayer rent or own?
- Location of cherished possessions (heirlooms, fine art, etc.)
- Location of family and close friends. The longer a foreign national spends here, the more close friends he will develop in the United States. Where do his children attend school? How often does the family travel to the home country? Where do they spend their vacations?
- Location of business interests. Does the company require (or desire) that the executive stay in the country to run the U.S. operation on a permanent basis, or is the assignment finite? Does the executive have other business interests and, if so, where are they located?
- Participation in community activities. Religious affiliations? Club affiliations?
- Statements of domicile in legal documents (*e.g.*, a Will), visa applications, etc., are relevant, as are oral statements indicating intention to remain in the United States or to return to the home country.

Estate Taxation Of Residents

If an executive becomes a U.S. domiciliary, he will be subject to Federal estate tax on his worldwide assets. Tax is imposed on the taxable estate (gross estate minus debts and other deductions) in excess of the "exclusion amount" in effect in the year of death. The exclusion amount is $1,500,000 for decedents dying in 2005; it is scheduled to increase to $2,000,000 in 2006.[1] Thus, an executive with less than $1,500,000 of worldwide assets ($2,000,000 in 2006) would owe no Federal estate tax.[2] The top rate is 47% in 2005, 46% in 2006.

What if an executive's worldwide assets exceed the exclusion amount? For most married couples, estate tax is not usually imposed until the second spouse dies. This is because upon the death of the first spouse, a well-crafted Will takes advantage of the maximum exclusion amount then available and passes the amount in excess of the exclusion amount to the surviving spouse in a manner that qualifies for the marital deduction.

The marital deduction generally shelters the full amount of assets passing outright or in a qualifying marital trust (sometimes referred to as a "QTIP" trust) to a spouse who is a U.S. citizen. Whatever the surviving spouse does not spend during the remainder of her life is subject to estate tax at her death, based on the estate tax law then in effect.

A Non-Citizen Spouse

If a surviving spouse is not a U.S. citizen (even if she is a U.S. resident), estate tax will be imposed on assets passing to her outright. In this case, the marital deduction is available only if the assets pass to a "Qualified Domestic Trust" (or QDOT). While the QDOT does avoid immediate estate tax, it yields a significantly less beneficial result than the QTIP, because it merely *defers* the *decedent's* tax.

The most onerous of the QDOT requirements is that the estate tax that would have been imposed at the decedent's death, but for the marital deduction, (1) must be withheld and paid over to the IRS from any distribution of principal by the QDOT to the surviving spouse and (2) must be paid with respect to assets remaining in the QDOT upon the death of the surviving spouse. Since the tax imposed on the QDOT is the tax that was deferred when the first spouse died, any reduction (or even repeal) of the estate tax at the time the second spouse dies will not benefit the QDOT.

Can The QDOT Rules Be Mitigated?

If the surviving spouse becomes a U.S. citizen within 9 months (with a potential extension to 15 months) after her husband's death, she will be entitled to the marital deduction for U.S. citizen spouses. (She must have remained a U.S. resident between the date of the husband's death and the date she acquires U.S. citizenship.)

What if the spouse is unwilling or unable to take this step? Depending on the circumstances, it simply may not be possible for the spouse to do so within this time period. Pre-death planning can at least maximize the estate tax deferral by ensuring that each spouse has assets in their separate names. If a QDOT is unavoidable, the surviving spouse will want to be able to draw on other funds, so as not to accelerate the deceased spouse's estate tax by taking distributions of principal from the QDOT.

Estate Tax Applicable To A Non-U.S. Domiciliary

What if the foreign national executive with a clear intention to return to his home country happens to die while on U.S. assignment? A non-U.S. domiciliary, whether he dies in the United States or not, is subject to U.S. estate tax only on property situated here.

Real property and tangible personal property located in the United States are obviously "situated" here. The situs of intangible property is less straightforward. There are a few clear rules:

- Stock issued by a U.S. corporation is U.S.-situs property.
- Debt issued by a U.S. obligor is U.S.-situs property, subject to a number of exceptions, most notably: "deposits" with a U.S. bank or insurance company, or with the foreign branch of a U.S. corporation or partnership, if the branch is engaged in commercial banking business; debt obligations the interest on which is "portfolio interest" in the hands of the decedent; and certain other short-term debt obligations.
- Mutual fund shares: under legislation effective in 2005, a portion of a decedent's mutual fund shares may be non-U.S.-situs property, based on the portion of the fund's assets that would not have been U.S.-situs property if held directly by the decedent.
- Cash is tangible personal property. Note that cash in a U.S. brokerage account is not eligible for the "deposit" exception above.
- Life insurance on the life of the decedent is not U.S.-situs property.

There are quite a few other types of property for which the rules are not so clear. Partnership interests, for example, have been the subject of various rulings and other pronouncements that do not provide a clear rule regarding situs.

A non-U.S. resident is entitled to estate tax deductions for debts, expenses, and charitable contributions, but in a manner substantially more limited than for U.S. residents. Generally, the deductible portion of these items is based on the ratio of the decedent's U.S. assets to his worldwide assets. Furthermore, the decedent must generally disclose his worldwide assets in order to obtain the benefit of these deductions. Many taxpayers forego the deductions rather than make this disclosure.

Although a non-U.S. resident's estate includes only assets situated here, the tax bite on those assets can be significant. This is because the exclusion amount allowed to a non-U.S. resident is only $60,000 (a small fraction of the $1,500,000 exclusion amount available to U.S. citizens and residents). Indeed, a decedent with total assets of less than $1,500,000, but a large portion of which are U.S.-situs assets, might be better off taxable on his worldwide assets (*i.e.*, as a resident).

Treaties

The United States is a party to a small number of estate tax treaties. Treaties can provide rules for determining domicile, can change the situs rules for various types of property, and can provide more favorable tax rules than described above. For example, under certain treaties, an eligible taxpayer may be entitled to a portion of the exclusion amount otherwise not available or may receive a marital credit that improves the results for property passing to a non-U.S. citizen spouse.

Should A Foreign National Have A U.S. Will?

A U.S. Will may be desirable for administrative ease and efficiency, without regard to tax implications. When a person dies, the survivors need to do what's required to continue and/or wind up his affairs. Someone must be authorized to make decisions with respect to the decedent's assets. In the United States, this is achieved by "probating" the decedent's Will in the appropriate court. The process in the foreign country may be quite different from the U.S. process. In some countries the equivalent to probate does not occur, or occurs only after the tax return has been filed. After the foreign process has been completed, the foreign papers must be explained to the U.S. court. This could result in a lengthy "limbo" period before any action may be taken in the United States. Although a U.S. Will may not be required, it may be desirable for these practical reasons.

A U.S. Will may also be important for estate tax purposes. The current state of the estate tax law, with its phasing-up exemption amount, one year repeal, and then return with higher rates and a lower exclusion amount, makes post-death flexibility crucial for all wealthy taxpayers (U.S. or not). For the foreign national, these same considerations are in play. The foreign national may also have additional complicating factors that a well-crafted Will can address. Most importantly, if there is a non-U.S. spouse, there needs to be a QDOT and as much flexibility for dealing with the QDOT as is available under the law.

---

[1] *Under current law, the exclusion amount increases to $3,500,000 in 2009, the estate tax is repealed for the year 2010, and the estate tax returns in 2011 with a $1,000,000 exclusion amount. It is generally believed that legislative changes to the estate tax law are likely to be enacted before 2010.*

[2] *Many states also impose an estate tax, frequently with an exclusion amount that is smaller than the federal exclusion amount. (For example, New York State imposes estate tax on estates in excess of $1,000,000; the New Jersey threshold is $675,000.) Accordingly, there may be state death taxes even though the estate is under the federal exclusion amount threshold.*