Tax Planning for NRA's Who Own U.S. Property

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Individuals who are not citizens or residents of the United States, known as nonresident aliens ("NRA"), need to be aware of the United States estate and gift taxes that will be applicable to their U.S. fixed assets, for example, U.S. real estate. If an NRA owns fixed assets located in the United States, either directly or in a revocable trust, the liability for estate and gift taxes can be surprising. NRAs do not have the protection of the estate/gift tax exclusion of $5.45 million per individual: instead the exclusion is $60,000. If a married couple owns property and one spouse dies, the full value of the marital property located in the U.S. is immediately subject to an estate tax of approximately 40%. There is no unlimited marital exclusion for NRAs.

Similarly, if one spouse is a U.S. citizen and the other spouse is not, the unlimited marital deduction only applies if the surviving spouse is the U.S. citizen. If the surviving spouse is a non-citizen, even if a U.S. resident, the unlimited marital exclusion does not apply.[1]

If there has been no tax planning, 100% of the jointly owned property or property passing to the surviving spouse located in the United States must be included in the recently deceased spouse's estate, with estate taxes due on the amount in excess of $60,000. <u>If faced with this unwelcome news, the property can be placed in a "Qualified Domestic Trust" (QDOT), which provides for a marital deduction so that the estate tax will not be due until the surviving spouse's death.</u> The QDOT must be finalized prior to the date the estate tax return is filed, including extensions. If the funds (corpus) are then taken out of the trust, other than limited exceptions explained below, the amounts will be subject to tax and a Form 706-QDT is required to be filed with tax owed unless covered by a treaty.

Due to the onerous nature of these tax provisions, eighteen countries have estate/gift tax treaties with the United States, including Australia, Canada, Germany, Japan, and South Africa. Also, due to the onerous nature of the estate tax and the lack of an unlimited marital exclusion, the annual gift tax exclusion between spouses is $148,000 for 2016 for gifts of property to an NRA spouse. The spouse making the gift must make it intentionally, and so the gift tax exclusion is unavailable upon the date of death.

One caveat is that income from the U.S. assets is not subject to estate/gift tax, although could be subject to income tax. The Internal Revenue Code specifies: "No [estate] tax shall be imposed on any distribution of income to the surviving spouse." The Treasury Regulations set

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[1] Internal Revenue Code §2040, §2056(d), and Treasury Regulation §20.2056A-8 provide special rules for joint property where the surviving spouse is an NRA. Either a Form 706 (if decedent is a U.S. citizen) or a Form 706-NA (if the decedent is an NRA) must be filed. The Form 706/706-NA, or a request for an automatic six month extension, is due to be filed within nine months of the date of death.

forth the requirements and definitions to determine the payments that satisfy the definition of "income" for these purposes.

The Internal Revenue Code and accompanying Treasury Regulations set forth different requirements for a QDOT that holds assets that are worth $2 million or less, and a QDOT holding assets worth greater than $2 million. Essentially, there must be a U.S. trustee with the authority and ability to pay any estate taxes that are due upon the death of the surviving spouse. Those principles are accomplished differently depending upon the value of the assets. The effect of the QDOT is to provide an unlimited marital deduction and to defer the estate taxes until the death of the surviving spouse. The property in the QDOT may be reduced in value through distributions to the surviving spouse on account of hardship due to health, maintenance, education or support. Said qualifying distributions do not subject the QDOT to estate/gift tax. Amounts paid for expenses of the trust are also not taxable distributions. Another option is for the surviving spouse to become a U.S. citizen and resident, and thus become eligible for the $5.45 million exclusion from estate taxes. Another important factor is whether there is an estate/gift tax treaty with the country of citizenship of either spouse since that may also provide tax relief.

The state laws applicable to such estates must also be reviewed for possible liability. For example, in the District of Columbia, the estate tax is based upon Federal tax schedules and liability. There is currently a $1 million exemption regardless of whether the decedent is a U.S. citizen or not. Amounts over $1 million are subject to a separate D.C. estate tax. If the property has been excluded from Federal tax in a QDOT due to the unlimited marital deduction, then the D.C. estate tax would also be delayed until the death of the surviving spouse. Federal and state estate tax forms still need to be filed within a short time period from the date of death.

The unwelcome news that a U.S. estate tax may be due, not to mention a state inheritance or estate tax, on the value of U.S. real estate upon the death of a nonresident alien should be dealt with as part of intentional U.S. gift and estate tax planning. A little bit of planning can avoid surprises and save money in the long run.