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Estate Planning for Non-resident Aliens

With increasing investment in the United States by foreign investors, wealth transfer taxes in the United States applicable to non-resident aliens ("NRAs") have increased in importance. Gift tax provisions of the Internal Revenue Code apply to certain gifts made by NRAs.¹ U.S. estate tax provisions apply to U.S. property held by an NRA at the time of his/her death.² This article examines the tax consequences of gratuitous transfers by NRAs of U.S. property prior to death and at death, and evaluates the advisability of an NRA changing his/her domicile to the United States.

I. Estate and Gift Tax Provisions Applicable to NRAs

For U.S. estate tax purposes, Section 2101 defines a NRA as a "decendent nonresident not a citizen of the United States."³ This definition involves two requirements. First, the individual must have been an alien (i.e., not a U.S. citizen) at the time of death and, second, the individual must not have been a resident of the United States at the time of death.⁴ Treasury Regulation Section 20.0-1(b)(1) states that "a 'resident' decedent is a decedent who, at the time of his death, has his domicile in the United States." The definition

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¹I.R.C. §§ 2501-2524 (1983).

²I.R.C. §§ 2101-2108 (1983).

³I.R.C. § 2101(a). (1983). An exception is provided in § 2107 with respect to individuals who expatriated from the United States within a 10-year period ending at death in order to avoid taxation. Their estates are taxed under the statutes which apply to U.S. citizens and residents.

⁴See 8 U.S.C. (1982)(Aliens and Nationality).

of a nonresident alien is identical for gift tax purposes, except for the fact that the date of gift is the significant date.⁵

The estate of a deceased NRA is subject to the U.S. estate tax only to the extent of property deemed situated in the United States at the time of death.⁶ Property deemed situated in the United States includes real property located in the United States,⁷ U.S. corporate stock wherever situated,⁸ U.S. bonds,⁹ cash (excluding most U.S. bank deposits),¹⁰ and other personal property of a nontransitory nature located in the United States at the time of death.¹¹ Stock of a foreign corporation, even though held in a U.S. safe deposit box on the date of death, is not included in the U.S. gross estate.¹²

The U.S. gift tax applies to NRAs who make gifts of tangible property located in the United States at the time the gift is made.¹³ The tangible property stipulation excludes items such as U.S. corporate stock and includes items such as U.S. real property held directly or through an ownership vehicle other than a corporation (e.g., a partnership), interests in U.S. businesses operated in a noncorporate form, and other nontransitory, tangible personal property located in the United States.

The annual exclusion will provide gift tax relief to NRAs making gifts of U.S. property. The annual gift tax exclusion is a provision which is applicable to U.S. gifts made by NRAs as well as to gifts made by U.S. citizens and/or residents.¹⁴ Qualified gifts are simply gifts of a present interest as opposed to a future interest. For example, a remainder interest is not a present interest as it is not available to the donee currently. However, the Code does provide for transfers to a trust for the benefit of minors to qualify for the exclusion if certain conditions are met.¹⁵

The potential for a married couple to give up to \$20,000 per donee per year tax-free under the annual exclusion is not available to NRAs. NRAs do not qualify for the gift-splitting provisions of Section 2513. Both spouses must be U.S. citizens and/or residents in order to treat a gift of property as given one half by each spouse when, in reality, the property is owned by one of the spouses. Therefore, NRA married couples will be able to exclude \$20,000 per donee per year from the U.S. gift tax only where each actually

⁵26 C.F.R. § 25.2501-1(b) (1983).

⁶I.R.C. §§ 2101(a) and 2103 (1983).

⁷26 C.F.R. § 20.2104-1(a)(1) (1983).

⁸I.R.C. § 2104(a) and Reg. § 20.2104(a)(5) (1983).

⁹I.R.C. § 2104(c) and Reg. § 20.2104(a)(7) (1983). *See* exception, 26 C.F.R. Reg. § 20.2105-1(1) and (m) (1983).

¹⁰I.R.C. § 2105(b)(1983).

¹¹Reg. § 20.2104-1(a)(2) (1983). *See also* *Delanie v. Murchie*, 177 F.2d 444 (CA-1, 1949), 49-1 USTC ¶ 10,707.

¹²26 C.F.R. § 20.2105-1(f) (1983).

¹³I.R.C. § 2501(a)(1) and (2) (1983).

¹⁴I.R.C. § 2503(b) (1983).

¹⁵I.R.C. § 2503(c) (1983).

owns one half of the property given to a particular donee, such as in community property situations.

NRAs are able to reduce their U.S. estate by taking advantage of the exclusion from gift tax for certain educational and medical expenses paid for an individual. Section 2503 provides that a taxpayer can pay an individual's tuition at a qualified educational institution and/or medical expenses without incurring gift tax liability.¹⁶ Furthermore, no statutory limit is applied to such payments. However, medical expenses reimbursed by insurance do not qualify. The key to qualifying the expenses as excludable is that they be actually paid by the taxpayer.¹⁷ A gift of cash (or other property) to the individual by the taxpayer, followed by a payment of the individual's medical expenses or tuition by such individual himself, would not qualify. The educational institution must be one which would qualify under Section 170 for the charitable contribution deduction.¹⁸ The medical expenses must be for medical care defined under Section 213(e) as qualifying for the medical expenses deduction.

The individual for whom such medical and/or educational expenses are paid need not be a dependent of the taxpayer and can be either a part-time or full-time student.¹⁹ Additionally, such payments do not reduce the taxpayer's annual exclusion for gift tax purposes.²⁰ Thus, a NRA could provide the tuition for a U.S. education for children, grandchildren, or any other individual, and still give each such individual up to \$10,000 in gifts tax-free per year. Eye care, dental work, and other medical needs could be paid for an individual such as an adult child, grandchild, or other relative for whom the NRA is not obliged to provide such care, without the incurrence of the U.S. gift tax. Moreover, the NRA could give each such individual up to \$10,000 in gifts tax-free per year in addition to paying for such expenses.

The advisability of NRAs transferring significant amounts of property during life, subject to the gift tax, rather than transferring the property at death, subject to the estate tax, may be determined by the difference in marginal rates for the two taxes. NRAs are subject to the same gift tax rates as U.S. citizens and/or residents despite the fact that the U.S. estate tax rates applicable to NRAs are different from those applicable to U.S. citizens and/or residents.

The maximum gift tax rate applicable to the U.S. gifts made by NRAs in 1988 and thereafter will be 50 percent on a taxable gift in excess of \$2,500,000.²¹ The rate applicable to taxable gifts in excess of \$2,000,000, but

¹⁶I.R.C. § 2503(e) (1983).

¹⁷H.R. 201, 97th Cong., 1st Session, 1981-2 C.B. 393.

¹⁸I.R.C. § 170(b)(1)(A)(ii) (1983).

¹⁹H.R. 201, 97th Cong., 1st Session, 1981-2 C.B. 393.

²⁰H.R. 201, 97th Cong., 1st Session, 1981-2 C.B. 393.

²¹I.R.C. §§ 2502(a)(1) and 2001(c)(1) (1984).

not more than \$2,500,000 will be 49 percent. The maximum estate tax rate applicable to the estates of NRAs is 30 percent on a taxable estate in excess of \$2,000,000.²²

For transfers in excess of \$2,500,000, NRAs would pay additional tax of 20 percent (50 percent rate-30 percent rate) of the fair market value of the transfer for the privilege of making the transfer during life as opposed to delaying the transfer until death. While the amount of the additional tax on life-time transfers totaling less than \$2,500,000 would be less as a percentage, the cost could still be significant.

II. Transfer Tax Advantage of U.S. Residency

There are several factors which must be considered simultaneously in comparing the U.S. estate tax as applied to the estate of a domiciliary (i.e., a U.S. resident for estate tax purposes) with its application to the estate of a NRA. These include particularly the difference in the applicable estate tax rates, the difference in the unified credit available to estates of U.S. citizens and/or residents and the "unified credit"²³ available to the U.S. estates of NRAs, the possible difference in the property which must be included in the U.S. gross estate, and the availability of the marital deduction.

The maximum tax rate applicable to estates of U.S. citizens and/or residents is 55 percent in 1984-1987 and 50 percent in 1988 and thereafter.²⁴ Section 2101(d) provides for a maximum rate applicable to the estates of NRAs of 30 percent. Therefore, even with the reduced maximum rate, the estates of NRAs fare better with respect to U.S. estate tax rates than do the estates of U.S. citizens and/or residents.

Look at a situation in which a NRA acquires U.S. domicile prior to death:

Mr. Garcia, a U.S. domiciliary, died in 1984 with a taxable estate of \$4,000,000. The U.S. estate tax would be \$1,744,500. If Mr. Garcia had remained a NRA, the U.S. estate tax on his taxable estate of \$4,000,000 would be \$980,400. If Mr. Garcia died a U.S. domiciliary in 1988 or later, the U.S. estate tax on his taxable estate of \$4,000,000 would be \$1,583,000. The estate tax applicable to the death of a NRA in 1988 would be the same as in a 1984 death, i.e., \$980,400. The 30 percent maximum rate applicable to the estates of NRAs keeps the tax liability lower for a

²²I.R.C. § 2101(d) (1983). An exception is the application of the higher rates (which normally are imposed only on the estates of U.S. citizens and residents) where citizenship is forfeited for tax avoidance purposes, or where foreign countries impose more burdensome taxes on U.S. citizens and residents than the United States imposes on NRAs. See I.R.C. §§ 2107(a) and 2108(a) (1983).

²³The unified credit is not available for gifts made by NRAs. Inadvertently or otherwise, Congress did not "unify" the estate and gift tax as applicable to NRAs. See I.R.C. § 2505(a) (1983).

²⁴I.R.C. § 2001 (1984).

NRA despite the rate decreases being phased in by The Economic Recovery Tax Act of 1981.²⁵

A. UNIFIED CREDIT

In the above example, the major difference in the estate tax on the estate of a U.S. domiciliary dying in 1984 and one dying in 1988 resulted because the unified estate and gift tax credit available to U.S. citizens and/or residents is being increased over a seven-year period.²⁶ The reduction in the U.S. estate and gift tax rate will not affect a taxable estate unless it is in excess of \$2,500,000. The increase in the unified credit applies to all estates, irrespective of size. It is being phased in over a seven-year period until it reaches a maximum of \$192,800 for decedents dying in (or cumulative gifts made in) 1987 and later years. This increased credit raises the overall tax-free gift and/or estate amount to \$600,000 for 1987 and thereafter. However, the unified credit applicable to NRAs was not increased. Under Section 2102(c) it remains at \$3,600, which results in the overall tax-free estate amount of \$60,000.

A NRA with an expected taxable estate of less than \$940,000 would benefit with respect to the unified credit from a change to U.S. domicile because \$940,000 is the breakeven point with respect to the rates and unified credit applicable to the taxable estates of U.S. citizens and/or residents, and NRAs. As the taxable estate figure decreases below \$940,000, the availability of the larger unified credit offsets the difference in the estate tax rates. This is indicated by following two examples which assume that the unified credit has not been utilized by pre-death gifts. Additionally, they assume that the NRA did not have non-U.S. situs assets which would be reachable by the U.S. estate tax in the event of U.S. domicile.

Example: If a NRA's U.S. taxable estate equalled \$600,000, the U.S. estate tax resulting from a 1987 death would be \$68,400 (i.e., \$72,000-3,600 credit). If the NRA established U.S. domicile prior to death, the U.S. estate tax liability would be zero, i.e., the unified credit would eliminate any estate tax liability (i.e., \$192,800-192,800 credit).

Example: If a NRA's U.S. taxable estate equalled \$800,000, the U.S. estate tax resulting from a 1987 death would be \$104,400 (i.e., \$108,000-3,600 credit). If the NRA established U.S. domicile prior to death, the U.S. estate tax liability would be \$75,000 (i.e., \$267,800-192,800 credit).

²⁵Pub. L. No. 97-34, § 402(a) and (b)(1), amending I.R.C. § 2001(c) effective for deaths after December 31, 1981. Pub. L. No. 98-369, § 21(a)(1), postponed the final rate decrease to 50% until 1988.

²⁶Pub. L. No. 97-34, § 401(a), amending I.R.C. § 2010 effective for same deaths after December 31, 1981.

B. MARITAL DEDUCTION

An unlimited marital deduction is available with respect to the gifts and estates of U.S. citizens and/or residents.²⁷ Generally, this means that a U.S. citizen and/or resident can transfer an unlimited amount of property to a spouse (or a surviving spouse in the case of an estate) tax free. With the exception of certain estate and gift tax treaty provisions,²⁸ the marital deduction is not available to the NRA transferring gifts of U.S. property, nor is it available to the U.S. estate of a deceased NRA.

Example: Mr. Garcia owns U.S. real property valued at \$2,000,000 at the date of his death in 1984. One half of this property will pass to his wife under the terms of his will. The other half will pass to his four children. Temporarily assume that this is Mr. Garcia's only asset. If Mr. Garcia is a NRA at death, the marital deduction is not available and his U.S. taxable estate will be approximately \$2,000,000 (other considerations, such as mortgages, etc. aside). Therefore, his estate must pay a U.S. estate tax of approximately \$380,000.

If Mr. Garcia is a U.S. domiciliary, a 100 percent marital deduction is available for the half of the U.S. property passing to his surviving spouse. Therefore, the U.S. taxable estate is reduced to approximately \$1,000,000. The U.S. estate tax is approximately \$250,000, a \$130,000 tax saving for the estate.

It is not necessary for the NRA's spouse also to establish U.S. domicile. In fact, in many cases this would be undesirable from a tax standpoint. The marital deduction is available to the U.S. citizen and/or resident for gift and estate tax purposes regardless of the residence or domicile of the spouse.²⁹

The property passing to a surviving spouse qualifies for the marital deduction if it is not a terminable interest. Basically, a terminable interest is one which will not be included in the surviving spouse's estate at death. Examples of terminable interests are certain life estates.³⁰

Using the unlimited marital deduction to pass property tax free at death does not necessarily mean that an individual must neglect his/her children in favor of the surviving spouse. Recall that, by 1987, the unified credit will allow the passage of \$600,000 worth of property tax-free in addition to the tax-free transfer of assets qualifying for the marital deduction.

Even though the surviving spouse remains a NRA, the U.S. situs property inherited from the decedent and qualifying for the marital deduction, will be included in the surviving spouse's U.S. gross estate at death and, thus, become subject to the U.S. estate tax. However, the tax deferral is of some benefit to the estate. On the other hand, it may be possible for the surviving spouse to get the property out of the U.S. gross estate prior to death. For

²⁷I.R.C. § 2056 (1983).

²⁸E.g., Article 8(2) of the estate and gift tax convention between the United States and the United Kingdom and Article 11(1) of the estate and gift tax convention between the United States and France provide for a limited marital deduction.

²⁹See 26 C.F.R. § 20.2056(a)-1 (1983).

³⁰I.R.C. § 2056(b) (1983).

example, the property can be sold by the surviving spouse and any gain will be subject to the U.S. income tax.³¹ But such gain will be small if the property is sold before any significant post-death appreciation has taken place. Subsequently the surviving spouse could purchase intangibles. These could then be given to the eventual heirs of the surviving spouse without incurring the U.S. gift tax.³² Discretion must be exercised, particularly with respect to the timing of such events, when this type of tax planning takes place.³³

C. GIFT TAX EXCLUSION

Another possibility is for the surviving spouse to give the cash proceeds from the sale of the U.S. property to the eventual heirs in a manner so as to take advantage of the gift tax annual exclusion. However, this method would take several years (or many heirs) to accomplish without incurring tax consequences.

Even though most individuals do not plan their future by concentrating on the expectation of death and the resulting taxes, U.S. domicile may be desirable from other viewpoints in addition to the estate tax benefits that may be derived. For example, it may ease management of U.S. property, give the taxpayer access to modern U.S. medical facilities and treatment, and provide other general benefits available to individuals domiciled in the United States.

D. SPECIAL USE VALUATION

Finally, requirements for special-use valuation of certain property included in a gross estate for U.S. tax purposes are of no avail to NRAs because the special-use valuation provisions apply only to the estates of U.S. citizens and/or residents.³⁴ As a general rule, property is included in a decedent's gross estate at its best use value. For example, a farm could be located near a rapidly developing commercial or residential area. As a farm, its current use value is \$500,000. However, in view of the development in the area, its commercial or residential use value is \$1,000,000. This is defined as its "best use" value.³⁵

If certain requirements are met, the estate can elect to include a family farm or other real property used in a family trade or business in the gross estate at a reduced value reflecting the property's current use value rather

³¹I.R.C. § 897 (1983).

³²I.R.C. § 2501(a)(2) (1983).

³³Dollie H. Click, 78 T.C. 225 (CA-4 dismissed taxpayer's appeal, 1983).

³⁴I.R.C. § 2032A(a)(1) (1983).

³⁵I.R.C. § 2032A(b)(2) (1983).

than its best use value. These requirements include "qualified heir"³⁶ (who actively participates in the operation of the property after the transfer),³⁷ and that a certain percent of the value of the decedent's gross estate be attributable to such qualified use property.³⁸

Section 2032A(a)(2) limits the maximum reduction in the best use value to \$750,000. The reduction cannot result in a value less than current use value. The basis of the property will be increased only to the extent of the value included in the gross estate, i.e., one cannot have the benefits of the current use valuation and also an increased basis equal to best use value.

III. U.S. Residency: Estate and Income Tax

A. U.S. DOMICILE

A "resident," for U.S. estate tax purposes, is defined in the regulations as "a decedent who, at the time of his death has his domicile in the United States."³⁹ With respect to the acquisition of "domicile," the Regulations state:

A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

The gift tax regulations define a "resident" for gift tax purposes in an identical manner.⁴⁰ Thus, under the Regulation definition, the two conditions—intention ("residence without the requisite intention to remain indefinitely will not suffice"), and active affirmation ("a person acquires a domicile in a place by living there")—must be met in order to establish U.S. domicile (i.e., residence). Both conditions must coincide at some point in time in order to establish U.S. domicile. "Actual residence may not be required in order to retain domicile, but it is a requisite to establish domicile; intention alone does not suffice."⁴¹ Intent, however, is required. Residence alone also is not conclusive nor sufficient evidence of a change of domicile.⁴²

Intent is determined by looking at all the facts and circumstances in each

³⁶I.R.C. § 2032A(e)(1) (1983).

³⁷I.R.C. § 2032A(e)(b) (1983).

³⁸I.R.C. § 2032A(b)(1) (1983).

³⁹26 C.F.R. § 20.0-1(b)(1) (1983).

⁴⁰26 C.F.R. § 25.2501-1(b) (1983).

⁴¹See *George D. Hampton, Jr., v. Comm.*, 38 TC 131 (1962). This case dealt with the issue of domicile in a community property state for purposes of community income and the federal income tax.

⁴²See *Estate of Bloch-Sulzberger v. Comm.*, 6 TCM 1201 (1947); *CCH Dec. 16, 129(M)*, and *F. Giacomo Fara Forni v. Comm.*, 22 TC 975 (1954).

particular case.⁴³ Consideration will be given to the ability of the individual to form intent (e.g., restricted non-immigrant status is a bar to intent),⁴⁴ statements of intent (made via visa applications, entry permits, tax returns, etc.),⁴⁵ length of actual residence in the United States,⁴⁶ style of living in the United States as compared with style of living in another country,⁴⁷ ties with the "former" domicile,⁴⁸ reason(s) for long absence from the "former" domicile,⁴⁹ country of citizenship,⁵⁰ and reason for an extended stay in a country other than the claimed domicile.⁵¹

Acquiring U.S. residence for income tax purposes would be undesirable in many instances. Furthermore, acquiring residence (domicile) for U.S. estate tax purposes may result in the acquisition of residence for U.S. income tax purposes as well.⁵²

⁴³Bank of New York and Trust Co., Ex'r., v. Comm., 21 BTA 197 (1930), acq. XI-1 C.B. 4, 67.

⁴⁴See Rev. Rul. 80-363, 1980-2 C.B. 249, revoking Rev. Rul. 74-364; Elkins, President, University of Maryland, v. Moreno, et al., 425 US 647 (1978).

⁴⁵See Lee Rosenberg v. Comm., 37 F.2d 808 (CA-DC, 1930); 2 U.S.T.C. ¶ 456; Texas v. Florida, et al., 306 US 398 (1939); Bloch-Sulzberger v. Comm., 6 TCM 1201 CCH Dec. 16, 129(M), (1947); F. Giacomo Fara Forni v. Comm., 22 TC 975 (1954); Frederick Rodiek, Ancillary Ex'r., 33 BTA 1020 (1936), nonacq. XV-2 C.B. 35, aff'd 87 F.2d 328 (CA-3, 1937).

⁴⁶See Rodiek, Ancillary Ex'r., 33 BTA 1020 (1936), nonacq. XV-2 C.B. 35, aff'd 87 F.2d 328 (CA-3, 1937); R.F. Cooper v. Reynolds, 24 F.2d 150 (D. Wyo., 1927).

⁴⁷See Nathaniel Shilkret, 46 BTA 1163 (1942), aff'd 138 F.2d 925 (CA-DC, 1943), 43-2 U.S.T.C. ¶ 9619; Farmers Loan and Trust Co., Ex'r., v. United States, 60 F.2d 618 (SDNY, 1932); Noah C. Rogers, Ex'r., v. Comm., 17 BTA 571 (1929).

⁴⁸See Lincoln T. Taira v. Comm., 51 TC 662 (1969).

⁴⁹See Robert W. Pashby v. Comm., 25 TCM 667 (1966), CCH Dec. 27, 994(M).

⁵⁰See Bank of New York and Trust, Union Trust Co. of Cleveland, Ex'r., v. Comm., 5 BTA 1272 (1927), acq. VII-1 C.B. 14, 32; Estate of Anthony H.G. Fokker v. Comm., 10 TC 1225 (1948), acq. 1948-2 C.B. 2.

⁵¹See Fifth Ave. Bank of New York, Ex'r., v. Comm., 36 BTA 524 (1937), acq. 1937-2 C.B. 9; United States v. Luria, 184 Fed. 643 (S.D.N.Y., 1911), aff'd 231 U.S. § 9 (1913).

⁵²Section 138 of *The Deficit Reduction Act of 1984*, Pub. L. No. 98-369 (July 18, 1984), amended Section 7701(b) to more clearly define "resident" for U.S. income tax purposes than has been the case in the regulations under Section 871. The legislation does not affect the definition of "resident" for federal estate and gift tax purposes.

For income tax purposes, an individual will be considered a resident of the United States if such individual:

- (1) has entered the United States as a permanent U.S. resident (the "green card test"); or
- (2) is present in the United States for at least 31 days during the current calendar year and has been present in the United States for a substantial period of time (the "substantial presence test").

The amendment to Section 7701(b) contains a substantial presence test which defines substantial presence as being in the United States for at least 183 days by taking into consideration the sum of (1) the days present during the current year, (2) one-third times the days present during the preceding year, and (3) one-sixth times the days present during the second preceding year.

The substantial presence test does not apply to diplomats; teachers, trainees, or students for a certain period of time; hospital patients who enter the United States for reasons other than medical treatment and are prevented from exiting the United States due to their medical condition; and commuters from Canada and Mexico. The legislation is effective for taxable years beginning after December 31, 1984.

The Regulations define residence (for income tax purposes) as follows:

An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.⁵³

It is generally understood that an alien does not become a resident (for income tax purposes) merely because it is not known with certainty how long such individual must remain in the United States in order to achieve the given purpose for such stay.

For income tax purposes, an alien may be considered a resident even if such alien intends eventually to return to the home abroad; while, for estate tax purposes, an alien does not acquire a U.S. domicile (i.e., become a U.S. resident) if such alien has a definite present intention of later "removing" from the United States. Thus it seems that one can be a resident alien for income tax purposes and be a nonresident alien for estate and gift tax purposes *as long as* the present intention is to remain domiciled in another country. One may have a residence in one country and still remain domiciled in another country. Under the Regulations it is possible for an alien to be a resident of the United States for income tax purposes, while being nonresident for estate tax purposes. Following this reasoning, it seems possible that an individual could be domiciled in the United States for estate tax purposes, while being a resident of another country for income tax purposes as long as the intention was to retain, and eventually return to, the U.S. domicile. However, it would be difficult for an individual who recently attempted to attain U.S. domicile to retain it if the individual's actual residence in the United States, subsequent to attaining U.S. domicile, was brief, unless the brevity was due to factors beyond the individual's control.

B. DISADVANTAGES OF U.S. DOMICILE

From a tax standpoint, one must approach the acquisition of U.S. domicile with extreme caution for one major reason—the gross estate of a U.S.

⁵³26 C.F.R. § 1.871-2(b)(1983).

domiciliary will include the value of the decedent's worldwide estate, not merely U.S. situated property.⁵⁴ Therefore, NRAs with substantial foreign (i.e., non-U.S.) holdings are well advised to avoid U.S. domicile *unless* those assets located outside the United States are situated in a country which has a death tax comparable to the U.S. estate tax. In such a case, the foreign death taxes paid by the individual's estate will qualify for the U.S. credit for foreign death taxes paid, thereby cancelling out any U.S. tax liability on the same assets.⁵⁵ This cancelling-out effect only takes place where the foreign death tax rate, in effect, is at least as high as the U.S. estate tax rate and the assets are deemed foreign situs assets under U.S. tax law.

Example: Mr. Neron, a NRA, dies in 1984. His estate consists of property with a net value of \$1,000,000 situated in a South American country, and property with a net value of \$500,000 situated in the United States. His U.S. taxable estate is \$500,000 and the U.S. estate tax liability is \$50,400 (i.e., \$54,000-\$3,600 credit). The property situated in the South American country (his country of domicile) is excluded from the U.S. gross estate. If Neron established U.S. domicile prior to death, his U.S. gross estate would include the property situated in South America. Therefore, the taxable estate would be \$1,500,000 and the U.S. estate tax liability would be \$459,500 (i.e., \$555,800-\$96,300 credit). If the South American country did not have a death tax (or had a death tax lower than the U.S. estate tax), the taxes to Neron's estate are increased by U.S. domicile.

Example: Ms. Pierre, a NRA, dies in 1984. Her "net" estate consists of \$3,000,000 worth of property situated in a Western European country, and \$1,000,000 worth of property situated in the United States. Her U.S. taxable estate is \$1,000,000 and the U.S. tax liability \$140,400 (i.e., \$144,000-\$3,600 credit). Additionally, foreign death taxes are due in her country of domicile. If Ms. Pierre established U.S. domicile prior to death, the U.S. taxable estate would be \$4,000,000 (i.e., includes the worldwide estate) and the U.S. estate tax \$1,744,500 (i.e., \$1,840,800-\$96,300 credit) before credit for foreign death taxes paid. A credit would be allowed for any estate tax paid to the Western European country to the extent property was deemed situated there under U.S. tax law and, also, to the extent that such tax did not exceed the U.S. estate tax on the property situated in the foreign country.

A possibility, where property is situated in a country which has a lower death tax than the United States, or possibly no death tax at all, is to transfer title to such property to a spouse or other family member (or members) prior to establishing U.S. domicile. Such a move would depend on the particular circumstances in each case and, in many instances, may be undesirable. Furthermore, a transfer in form only, where the transferor continues to have the major voice in the management of the assets, is subject to collapse by U.S. tax authorities.⁵⁶

The inclusion of worldwide assets in the decedent's gross estate for U.S.

⁵⁴I.R.C. § 2031 (1983).

⁵⁵I.R.C. § 2014 (1983).

⁵⁶Estate of Swan, 247 F.2d 144 (CA-2, 1957), 57-2 U.S.T.C. ¶ 11,714.

tax purposes is not the only disadvantage of U.S. domicile which must be considered. There is the probability that U.S. domicile will be accompanied by classification as a U.S. resident for income tax purposes. This would mean subjecting the worldwide income to U.S. income taxation, and thus, the NRA with more than a negligible amount of foreign source income (i.e., income derived outside the United States) would be ill-advised to take a step which would result in U.S. taxation of such income.

C. AN ALTERNATIVE TO ESTABLISHING U.S. DOMICILE

One of the most popular means of avoiding the U.S. estate and gift tax is by investing in the United States through a foreign corporation. If the tax structure in the NRA's home country is favorable, or the NRA is able to use a tax haven country, investing in the United States through the use of a foreign corporation (i.e., incorporated outside the United States) can be very advantageous. The decedent's U.S. gross estate (for purposes of imposition of the U.S. estate tax) will not include stock in a foreign corporation, even though all the underlying assets of such corporation are located in the United States.⁵⁷

A foreign corporation is taxed only on U.S. source effectively connected income and U.S. source fixed or determinable, annual or periodic income.⁵⁸ However, the Internal Revenue Code authorizes taxation of capital gains incurred by foreign corporations on the disposition of U.S. real property interests, whether or not the foreign corporation is otherwise engaged in the conduct of a U.S. trade or business.⁵⁹ Such gains are deemed "effectively connected." Generally, an NRA individual receiving dividends from a foreign corporation will not have U.S. source income with respect to such dividends unless 50 percent or more of such foreign corporation's gross income (from all sources) for the three-year period ending with the close of its taxable year preceding the declaration of such dividend was effectively connected with the conduct of a trade or business in the United States.⁶⁰ A NRA's capital gain on the sale of stock in a foreign corporation usually will escape the U.S. income tax. Moreover, NRAs can sell their stock in a foreign corporation which holds U.S. real property interests without incurring the capital gain tax. The "effectively connected" taint does not reach to the NRA shareholders of a foreign corporation. However, if the foreign corporation distributes a U.S. real property interest (including a distribution in liquidation or redemption), the foreign corporation must recognize

⁵⁷I.R.C. § 2105(a) (1983).

⁵⁸I.R.C. §§ 881 and 882 (1983).

⁵⁹I.R.C. §§ 897(c)(1)(A) and (4)(A) (1983).

⁶⁰I.R.C. § 861(a)(2)(B) (1983).

any realized gain unless the distributee takes a carryover basis in the property.⁶¹

IV. Summary

The "best" estate planning for a NRA is a complex decision. The factors that argue for a change to U.S. domicile are the availability of the marital deduction, the substantially greater unified credit, the gift splitting possibilities of IRC section 2513, and the special use valuation. The factors that argue against a change to U.S. domicile are the greater marginal estate tax rates, the U.S. estate taxation of properties held worldwide, and possible U.S. income taxation of worldwide income. If on balance these factors would result in U.S. domicile being detrimental to the NRA's worldwide estate, the use of a foreign corporation to invest in the United States may be a viable alternative.

⁶¹I.R.C. § 897(d) (1983).

