

Foreign Individuals and the U.S. Estate Tax (Similar to an Inheritance Tax)©

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The U.S. federal government has a very strong and potentially costly estate tax which is similar to an inheritance tax since it arises at death. This tax is unlike any tax that exists in, for example, Mexico, or in many other countries outside of the U.S. For this reason, many foreign individuals do not understand the costs, risks, and tax implications of owning property or doing business within the U.S. The specific focus of this article is to discuss some of the costs, risks, and tax implications to foreign individuals of the estate taxes that exist in the U.S.

The estate tax becomes effective upon the death of an individual.

Currently, the U.S. federal estate tax rates range from 18 percent upon the first USD\$ 10,000 of taxable transfers and continues to increase to a rate of *50 percent. These highest rates were modestly reduced from 55 percent beginning in 2002.

The cost of this tax can be enormous and, if not properly planned for, the family members and heirs of an individual will not be able to receive the primary value of these properties and instead the administrator of the estate will be required to pay over a large portion of the estate to the U.S. federal government in the form of the estate tax. In addition to the federal estate tax, many States within the U.S., such as California and Texas, have a separate estate tax that applies to properties located within these States.

*In 2001, a new federal tax law (the "Act") modified estate and gift tax rates as follows:

Death In Year	Estate Tax Life Time Exemption Equivalent for Non-U.S. Citizens with Foreign Domicile	Estate Tax Exemption Equivalent For U.S. Citizens or U.S. Domicile	Highest Estate and Gift Tax Rate
2002	US\$ 60,000	US\$ 1 million	50%
2003	US\$ 60,000	US\$ 1 million	49%
2004	US\$ 60,000	US\$ 1.5 million	48%
2005	US\$ 60,000	US\$ 1.5 million	47%
2006	US\$ 60,000	US\$ 2 million	46%
2007	US\$ 60,000	US\$ 2 million	45%
2008	US\$ 60,000	US\$ 2 million	45%
2009	US\$ 60,000	US\$ 3.5 million	45%
2010	Estate Tax - Repealed	Estate Tax - Repealed	N/A
	Gift Tax Rate	Gift Tax Rate - Maximum Rate	35%
2011	US\$ 60,000	US\$ 1 million	55% + 5% (surtax in higher estates)

On whom does the high costs of the U.S. estate tax fall?

The U.S. estate tax applies to all U.S. citizens, all non-U.S. citizens who permanently reside in the U.S., and to all non-U.S. citizens who do not permanently reside in the U.S. but have "U.S. situs property" located in the U.S. upon their death.

The amount of the estate tax that must be paid by an individual's estate depends upon a number of variables, especially including the value of the property owned and the location of the property

at the date of death. Careful estate tax planning can help preserve wealth and property that has been accumulated, through many years of hard work, within a family or business.

Citizens and Other Persons Permanently Residing in the U.S.

U.S. citizens and persons who are permanently residing in the U.S. are subject to the estate tax on their worldwide estate. In other words, if a person in this category has property throughout the world (whether it is located in the U.S., Mexico, Central America, South America, the Caribbean, Europe, Asia, Africa, or any other place) almost all of this worldwide property is used to calculate the estate tax owed.

This draconian tax result, means that a non-U.S. citizen, such as a Mexican citizen, can be subject to the U.S. estate tax on all of their property (whether it is located in Mexico, the U.S., or other parts of the world) if they permanently reside in the U.S.

Non-U.S. Citizens Who do Not Permanently Reside in the U.S.

Persons who are not U.S. citizens and do not permanently reside in the U.S. are still subject to the estate tax on their "U.S. situs property."

What is deemed to be U.S. situs property of a foreign individual?

All of the following property that is owned directly by the foreign individual will be subject to the U.S. estate tax:

- Most all personal property physically located in the U.S. (e.g., automobiles, art, boats, animals, jewelry, etc.);
- Stock of a U.S. corporation (e.g., stock in a closely held California corporation, Microsoft stock, IBM stock, stock of a family-owned Texas corporation, GM stock, etc.);
- Debt obligations of U.S. persons (including certain governmental entities) owned by the foreign individual. This includes accounts receivable from a U.S. person or company, certain government bonds, and promissory notes owed by U.S. companies or U.S. individuals, etc.;
- Other intangible properties such as contractual rights, goodwill, judgment debts, partnership interests, trust interests, patents, trademarks, and copyrights may be U.S. situs property (" . . . if . . . issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit."); and
- All real estate located in the U.S. such as apartment buildings, office buildings, houses, ranches, factories, etc.

Fortunately, most U.S. bank deposits, certain U.S. government bonds and proceeds from U.S. life insurance are not included as "U.S. situs" property and, therefore, not subject to the U.S. estate tax.

Calculating the U.S. Estate Tax for Foreign Individuals

There are certain deductions that are available to the estate before the estate tax is imposed. These deductions include certain expenses, losses, indebtedness, and taxes owed by the estate. However, foreign individuals who do not permanently reside in the U.S. usually can take certain deductions only if they first account for their worldwide assets. This means that the worldwide assets must be reported to the U.S. government and then a deduction is only available based upon an allocation of the expenses based upon the value of the U.S. situs property in relation to the worldwide assets.

There are also additional deductions for certain transfers for public, charitable, and religious purposes. Plus, there may be a so-called "marital deduction" if the surviving spouse is a U.S. citizen.

Estate Tax Rates

After the above deductions are taken, the estate tax rates are then imposed upon the total U.S. situs estate. As explained above, the estate tax rates are progressive and range from 18 percent upon the first USD\$ 10,000 for taxable transfers and continue to increase up through a *50 percent estate tax rate for amounts in excess of USD\$ 3,000,000.

The preliminary estate tax is then reduced by a mere USD\$ 13,000 estate tax credit (which corresponds to the USD\$ 60,000 exemption equivalent for foreign estates compared to the more generous exemption equivalents for U.S. estates of up to USD\$ 1,000,000). Other less common tax credits may also be available.

Collection and Enforcement of Estate Taxes

Under U.S. law, the executor of a nondomiciliary's estate is personally liable to the U.S. government for the U.S. estate taxes owed. The executor must file an estate tax return (IRS Form 706 NA) showing the amounts of estate taxes owed.

This return generally must be filed within nine months after death.

If the estate taxes are not paid, the U.S. government can usually seize property of the estate or the executor without obtaining a court order in order to pay for the outstanding estate taxes not paid.

Estate Tax Planning Opportunities

The above explanation of the U.S. estate tax shows just how dramatic and costly it can be to a foreign individual with U.S. situs property. Fortunately, there are many steps and planning opportunities that can be taken to minimize or eliminate any U.S. estate tax liability that otherwise might fall upon a foreign individual.

Depending upon the exact facts and circumstances of a particular case, some of the following tax planning steps may be available to reduce or eliminate the estate tax:

- Avoiding permanent residency (domicile) in the U.S.
- Restructuring and owning property in a fashion so that it is not U.S. situs property.
- Making certain qualified gifts of property prior to death.
- Transferring certain properties into certain legal entities.
- Operating U.S. businesses directly or indirectly through foreign corporations or other legal entities.
- Obtaining certain U.S. loans or other debt to reduce the taxable value of the estate.
- Utilizing life insurance and taking financial planning steps with U.S. financial accounts.

These types of estate tax planning opportunities need to be carefully considered on a case-by-case basis and coordinated with U.S. income tax planning techniques and opportunities.

Endnotes

1. Internal Revenue Code ("I.R.C.") § 2001, et. seq.
2. I.R.C. § 2001(c).
3. I.R.C. § 2104(a).
4. I.R.C. § 2104(c); Treas. Reg. § 20.21041(a)(7).
5. Treas. Reg. § 20.21041(a)(4).
6. I.R.C. § 2106(a).

7. I.R.C. §§ 2106(a)(1), 2053, and 2054.

8. I.R.C. § 2106(a)(2).

9. I.R.C. §§ 2106(a)(1) and 2056(d).

10. I.R.C. §§ 2102(c) and 2001(c)(1).

11. 31 U.S.C. § 3713(b).

12. Estate tax lien arises against the property included in the taxable estate of the decedent, and continues for a period of 10 years after the date of death. The IRS does not have to make any assessment, recording, or filing, for this "silent" lien to become effective which gives the IRS a right to an interest in the property. I.R.C. § 6324(a)(1). *Detroit Bank v. United States*, 317 U.S. 329 (1943).