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Uncle Sam Wants You (To Pay Tax): The Only Two Certainties

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This article is the third in a bimonthly series, which addresses U.S. tax considerations for U.S. expatriates. The following explores U.S. transfer taxes and how U.S. citizens living abroad can benefit from a cross-border estate plan that is tax efficient.

I. Introduction

In March, we wrote the first article in a series regarding tax considerations for U.S. taxpayers living abroad.[1] We discussed a handful of common problems that we, as practitioners, see frequently arising for U.S. expats. In May, we wrote a second article to highlight ways expats can plan ahead so that the aforementioned pitfalls are avoided.[2] As Benjamin Franklin famously observed in 1789, "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes."[3] Here we will touch on both of those certainties.

In this third part of the series we will address the U.S. transfer tax regime. Perhaps it is best to start with the nomenclature. Like life insurance (which may provide little benefit while the policy holder is alive) or family law (which is often concerned with the cessation of family ties), the "transfer tax" regime is a euphemism. "Transfer tax," which is how we will refer to the three taxes in this article, means the estate, gift, and generation-skipping transfer taxes that make up Subtitle B of the Internal Revenue Code. These taxes are relevant for every U.S. person at least once (upon death). Yet for Americans living abroad they tend to arise more often, such as when purchasing property with a non-American spouse.

This article is intended to address some of the particular transfer tax problems that may face expatriates, with emphasis on the estate and gift taxes. We provide a brief overview of the basic transfer tax rules before applying the rules in a non-U.S. context.

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II. The ABCs of the U.S. Federal Taxes on Estates, Gifts, and GSTs

A. Who Pays the Tax? No Good Deed Goes Unpunished

The U.S. federal transfer tax system is comprised of three distinct but related taxes:

(1) The U.S. federal gift tax (a tax on gratuitous transfers during lifetime).[4]

(2) The U.S. federal estate tax (a tax on gratuitous transfers at death).[5]

(3) The U.S. federal generation-skipping transfer ("GST") tax (broadly, a tax on gratuitous transfers during lifetime or at death that "skip" a generation, e.g. a gift or bequest from a grandparent to a grandchild).[6]

Unlike income tax, the transfer taxes are generally imposed on the transfer and paid by the transferor. That is, the person giving the gift,[7] the representative of person that died,[8] or the person making a GST must pay the relevant tax.[9] Although the recipient of the transfer receives something of value and, therefore, has an increase in wealth, the recipient is generally not taxed.[10]

B. Which Gifts Are Subject to the Transfer Tax Regime?

As we discussed in the first article of this series, U.S. federal income tax broadly applies to U.S. citizens, residents, and green card holders. Meanwhile, nonresident aliens ("NRAs") may be subject to U.S. federal income tax on certain U.S. source income. For transfer tax purposes, the rules are slightly different.

As a practical matter, the transfer taxes apply to U.S. citizens and domiciliaries on their worldwide assets, and may apply to any individual with property situate in the U.S. at the time of death. Both of these principles apply irrespective of where the donor lives but, unsurprisingly, are subject to certain exemptions, deductions and credits, and treaty overrides.

For readers that shun the practical and insist on gritty detail, we have good news: technically, the rules are more circuitous. For example, the gift tax statute states that the gift tax applies to "the transfer of property by gift during such calendar year by any individual, resident or nonresident."[11] However, Treasury Regulations state that the gift tax only applies to "transfers by gift of property, wherever situated, by an individual who is a citizen or resident of the United States,"[12] and go on to state that by "resident" they mean "an individual who has his domicile in the United States at the time of the gift."[13] Domicile is acquired "in a place by living there, for even a brief period of time, with no definite present intention of moving therefrom."[14] For these purposes, an individual's domicile, once obtained, remains until a new domicile is acquired elsewhere (in the same manner of physical presence and intention to remain).[15] Consequently, a person can be resident in the U.S. for income tax purposes but not domiciled in the U.S. for gift tax purposes.

Similarly, the estate tax gets to a relatively straightforward result by a complicated means. Code Section 2001 imposes the estate tax on the "taxable estate of every decedent who is a citizen or resident of the United States."[16] Yet, the Treasury Regulations state that a resident is someone that "had his domicile in the United States."[17] Meanwhile, Code Section 2101 imposes a (different) tax "on the transfer of the taxable estate (determined as provided in section 2106) of every decedent nonresident not a citizen of the United States."[18] The parenthetically referenced Section 2106 defines the taxable estate of a nonresident, non-citizen by reference to "that part of his gross estate which at the time of his death is situated in the United States."[19]

Generation-skipping transfers are defined in the Code,[20] however, the Code does not put any territorial limits on the definition. Accompanying Treasury Regulations, however, state that the determination "as to whether an event is a GST is made by reference to the most recent transfer subject to the estate or gift tax."[21] Thus, the U.S. citizen and domiciliary rule applies in the GST context as well.

C. Exemptions: Some Good Deeds Go Unpunished

Not every gift, bequest, and GST is taxed; some are excluded. Yet the rules governing how much of a gift or bequest is excluded have been a moving target since (at least) 2001.[22] Over the last two decades, the estate and gift exclusions have been coupled (or "unified"), uncoupled, repealed, increased, and recoupled.

Presently, all individuals subject to gift tax are allowed an annual gift tax exclusion amount of $10,000, per donee.[23] This amount is adjusted annually for inflation.[24] For 2015, the annual gift tax exclusion amount is $14,000.[25] An individual can make $14,000 gifts to an unlimited number of recipients each year before needing to use a portion of her lifetime exemption.

Each U.S. citizen or domiciliary is also granted a cumulative lifetime gift and estate tax exemption amount that exempts $5 million worth of property from the U.S. federal estate and gift tax, adjusted annually for inflation.[26] For 2015, the unified estate and gift tax exemption amount is $5.43 million.[27] Generally, this means that a U.S. citizen or domiciliary can give away during lifetime and/or at death a combined total of $5.43 million without triggering a U.S. federal estate and gift tax charge. Gratuitous transfers in excess of the applicable exemption amount are subject to estate and gift tax at a tax rate of up to 40%.[28] The exemption amount available on death is reduced to the extent taxable gifts (gifts in excess of the annual exclusion amounts described in below) are made during lifetime.[29] The unified estate and gift tax exemption amount does not renew once it has been used. However, if a taxpayer is married, any unused portion of a lifetime exemption is portable to a surviving spouse (but different rules apply in the GST context).

III. Additional Considerations in the International Context

For U.S. citizens living abroad, certain parts of the transfer tax regime become particularly cumbersome. For example, if a U.S. citizen is married to a non-U.S. citizen, the U.S. citizen must consider whether any of their spouse's estate will be taxed by the U.S. at death. Closely related is whether joint ownership of property causes any issues for the couple.

A. Inclusion in the Estate

In multinational families, special care must be given to determine what assets are included in a decedent's taxable estate. It will include not only the assets that the decedent owned outright in his or her name, but also certain assets that were transferred during lifetime in which the decedent retained certain rights.[30] For example, a retained interest to possess or enjoy a piece of property. Or, if property is held in an entity that is a controlled foreign corporation ("CFC"), retaining the right to vote shares in the CFC may bring the shares entire value in to the estate.[31]

For non-citizen non-domiciliaries ("NCNDs"), the estate tax applies to transfers of U.S. situate property whether tangible, such as personal chattels located in the U.S., and intangible, such as stock in companies incorporated in a U.S. state (e.g. New York). However, a treaty may override this general rule and deem certain U.S. bank accounts and other assets not subject to estate tax in the hands of an NCND. (Treaties are discussed below.)

As discussed above, the estate tax applies to a U.S. citizen's property wherever situated but provides a healthy exemption for the first $5.43 million of assets. NCNDs do not benefit from this large exemption. An NCND is only allowed a credit against the estate tax on the first $60,000 of assets subject to tax, a sum that is not indexed for inflation and has not been increased since 1988.[32] It bears noting that the rate brackets for

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estate tax levied on NCND owners of property at death are condensed. The top marginal rate of estate tax, 40%, is imposed on an estate exceeding the threshold of $1 million. Suppose Nancy, an NCND, marries an American and together they buy (as tenants in common) a vacation home in Albuquerque. Nancy dies in 2015 and leaves her interest in the property (valued at $250,001) to her spouse. Unless a treaty or some planning mitigates the situation, Nancy's estate will pay estate tax in the U.S. of $70,800.

B. Inter Vivos Transfers to a Spouse

Gifts to a U.S. citizen spouse during life are entitled to an unlimited marital deduction when computing the donor's gift tax.[33] According to the legislative history, Congress intended that a "decedent with a small or medium-sized estate should be able to leave sufficient property directly to the surviving spouse for support during the lifetime of the spouse without the imposition of an estate tax."[34] This intent assumes that such gifts will be taxable when they become part of the estate of the recipient spouse (a U.S. citizen). Thus, the U.S. is not providing a true exemption from tax, but rather delaying the required payment until the second spouse's death.

However, since 1988 the unlimited gift tax marital deduction has not been available if the donee spouse is not a U.S. citizen.[35] Instead, the U.S. citizen donor is allowed an increased annual gift tax exclusion amount (adjusted annually for inflation).[36] For 2015, the first $147,000 of gifts to a spouse who is not a U.S. citizen are excluded from taxable gifts.[37]

The inability to transfer assets between spouses where one is a non-U.S. citizen not only breaks from the norm in terms of how spouses think about their finances, but can also be an administrative headache with a number of potential pitfalls. From opulent jewelry gifts to shared interests in real property where one person is the family's breadwinner, it is not difficult to imagine a scenario whereby a spouse transfers money or property in excess of $147,000 during a year.

C. Transfers on Death to a Spouse

There is also an unlimited estate tax marital deduction for assets that pass outright to a surviving spouse who is a U.S. citizen.[38] Generally, the benefit of the deduction is that it allows the deceased spouse's estate to defer the payment of U.S. federal estate tax on such assets until the death of the surviving spouse (or potentially forever to the extent the surviving spouse consumes such assets during lifetime or the value of the surviving spouse's estate is within his available estate tax exemption amount).[39] However, assets that pass outright to a non-U.S. citizen spouse (including assets that pass to a surviving non-U.S. citizen spouse by operation of law, such as jointly owned property) do not automatically qualify for the unlimited estate tax marital deduction.[40]

D. Problems with Jointly-Owned Property

Practically speaking, most married copies that take title to real property together will own it as joint tenants with right of survivorship. Although administratively convenient, joint tenancy can create a raft of complications for U.S. income tax and transfer tax purposes where one spouse is a non-U.S. citizen. Should the U.S. citizen predecease the non-U.S. citizen, the full value of the property will be included in the U.S. citizen's estate unless it can be shown that the non-citizen contributed to the property.[41] Joint tenancy with right of survivorship may also disrupt an estate plan because the surviving spouse will automatically take outright title to the property upon the death of their wife / husband. Because cross-border families may use wills and trusts to minimize adverse taxation, it is notable that this automatic transfer circumvents the decedent's will and any testamentary trust created in that will (e.g. a qualified domestic trust).

Given the potential estate tax consequences, a couple may wish to sever the joint tenancy in favor of holding title as tenants in common. However, care should be given to ensure that taking title as tenants in common (for instance, 50/50), does not create a taxable gift where the non-citizen spouse takes an interest in the property that is greater than his or her contribution to the property.

E. Same-Sex Marriage Abroad

After the U.S. Supreme Court decision in United States v. Windsor in 2013 which struck down certain provisions of the 1996 Defense of Marriage Act,[42] the IRS has recognized all same-sex marriages legal under the laws of a U.S. State for federal tax purposes.[43] Thus, as of 2013, same sex spouses benefit from the spousal exemptions set out above. Although the IRS recognizes marriages under foreign law, individuals who are in a "civil partnership" or other legally recognized relationship that is not called "marriage" cannot benefit for tax purposes.[44]

IV. Planning Opportunities in the International Context

A. Qualified Domestic Trusts

In order for the deceased U.S. citizen spouse's estate to defer the payment of U.S. federal estate tax on such assets until the death of the surviving spouse, the assets must pass into a special type of trust known as a Qualified Domestic Trust ("QDOT").[45] Otherwise, U.S. federal estate tax is due on the death of the first spouse if the value of the deceased spouse's estate exceeds his or her available gift and estate tax exemption amount (e.g. $5.43 million less any taxable gifts made during lifetime). It may, therefore, be appropriate for the will of a U.S. citizen married to a non-U.S. citizen to include a QDOT to receive and hold assets in excess of the U.S. citizen's remaining exemption amount, providing for deferral of U.S. federal estate tax until the death of the non-U.S. citizen (or upon each distribution of principal to the non-U.S. surviving spouse).[46]

General QDOT provisions

Generally, under the terms of a QDOT, the trustee must hold the QDOT assets solely for the benefit of the surviving spouse during such spouse's lifetime. The trustee must distribute any income generated from the QDOT assets to the surviving spouse at least annually and has discretion to distribute the principal of the QDOT to the surviving spouse.[47] However, the trustee is prohibited under the terms of the trust from distributing principal to any beneficiary other than the surviving spouse during the surviving spouse's lifetime. If principal is distributed to the surviving spouse during the surviving spouse's lifetime, the "U.S. Trustee"[48] of the QDOT must charge and withhold U.S. federal estate tax at the time of the distribution. On the death of the surviving spouse, any assets remaining in the QDOT are subject to U.S. federal estate tax. A QDOT, which is commonly structured as a separate sub-trust of a larger trust, must have at least one "U.S. Trustee" and must be maintained and administered under the laws of a state of the U.S.[49] Additional restrictions apply depending on the value of the assets.

Self-settling a QDOT

If a U.S. citizen or domiciliary (or NCND who owns U.S. situate property) leaves assets outright to a noncitizen spouse, the surviving spouse may still claim the marital deduction by transferring the property to a QDOT (on the same terms as above). Although this ability to self-settle a QDOT can be a useful tool to correct improper planning (or to act in the absence of planning), the transfer or irrevocable assignment of assets to the QDOT by the surviving spouse may have tax or legal implications in his or her country of residence or domicile.

B. Treaties

The U.S. estate tax treaties (like their income tax counterparts) often include a "savings clause" that allows the U.S. to tax its own citizens as if the treaty were never enacted.[50] Yet, as we have discussed above, the U.S. estate and gift taxes are often most challenging in the context of a couple with a non-U.S. spouse. It is often NCNDs that are the biggest losers.

For this reason, some of the estate and gift tax treaties provide piecemeal relief. For example, under the estate tax treaty with Germany, if a German national that is a NCND for U.S. purposes dies while owning movable property in the U.S. (such as shares in a U.S. corporation), that property is taxable only in Germany.[51]

Similarly, an argument could be made that the treaty with the U.K. provides an anti-savings clause to great benefit of U.K. nationals. Article 8, paragraph 5 of the U.S.-U.K. estate and gift tax treaty provides that if a U.K. national is a NCND for U.S. purposes, that "the tax imposed in the United States shall be limited to the amount of tax which would have been imposed had the decedent become domiciled in the United States immediately before his death, on the property which would in that event have been taxable."[52] It is possible to interpret the treaty as therefore allowing a U.K. national to claim the more generous estate tax exclusion to eliminate exposure for U.S. situate property, so long as the estate follows the proper procedure.

Yet these treaty positions are not entirely at home in this publication, which favors tax *planning*. They provide positions that may save the day if facts are particularly good; but are quite risky to rely on prospectively.

V. Conclusion: Couples Need Counsel

In stark contrast to other areas of taxation, in the transfer tax context it is often quite advantageous to be a U.S. citizen or domiciliary. The $5.43 million lifetime exemption allows individuals of moderate wealth to share during life or upon death without paying tax. The situation is complicated for expatriates who must also navigate tax laws in their local jurisdiction (and possibly in the jurisdiction where the property being transferred is located). Things get complicated when Americans marry a non-U.S. citizen and/or own assets together. In those cases, giving during life or at death gets a lot more complicated. Without proper planning, survivors of a decedent with property in the U.S. may conclude that taxes are the more painful of life's two certainties.

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Notes

1 Chris McLemore and Erin Fraser, *Uncle Sam Wants You (To Pay Tax): Income Tax Pitfalls for Americans Living Abroad*, Tax Planning International Review, Mar. 2015.

2 Chris McLemore and Erin Fraser, *Uncle Sam Wants You (To Pay Tax): It Pays to Plan Ahead*, Tax Planning International Review, May 2015.

3 Letter from Benjamin Franklin to Jean Baptiste le Roy (Nov. 13, 1789), *in* 10 The Writings of Benjamin Franklin 68, 69 (Albert Henry Smyth ed., MacMillan Co. 1907). *Accord* Christopher Bullock, The Cobler of Preston (1716) ("Tis impossible to be sure of any thing but Death and Taxes"); Edward Ward, the Dancing Devils (1724) ("Death and Taxes, they are certain").

4 *See* IRC § 2501(a)(1) (imposing tax on transfer of property by gift by any individual, resident or nonresident).

5 *See* IRC § 2001(a) (imposing the estate tax on all U.S. citizens and residents); *see also* IRC § 2101 (imposing the estate tax on all transfers of the taxable estate of decedent nonresident noncitizens).

6 *See* IRC § 2601 (imposing a tax on "every generation-skipping transfer").

7 IRC § 2502(c) (tax shall be paid by the donor).

8 *See* IRC § 2002 (payment made by the executor).

9 *See* IRC § 2602(a)(2)-(3) (stating the GST tax shall be paid by trustee or transferor). *But see* IRC § 2602(a)(1) (requiring the transferee to pay the GST tax in the case of a taxable distribution).

10 IRC § 102(a). *But see id.* at (b) (allowing for taxation of income from property received as a gift).

11 IRC § 2501(a).

12 Treas. Reg. 25.2501-1(a)(1).

13 Treas. Reg. 25.2501-1(b).

14 *Id.*

15 Although a green card will subject its holder to income U.S. federal income tax on a worldwide basis, it does not automatically give rise to transfer tax exposure.

16 IRC § 2001(a).

17 Treas. Reg. 20.0-1(b)(1).

18 IRC § 2101(a).

19 IRC § 2106(a).

20 *See* IRC § 2611, *et seq.*

21 Treas. Reg. 26.2611-1.

22 *See, e.g.* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 511, 115 Stat. 38, 70 (capping the maximum estate tax rate at 50 percent and repealing the phase-out of graduated rates); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 101, 301-304, 124 Stat. 3296, 3300 (reinstating the estate tax with a $5,000,000 lifetime exclusion amount and other changes); and American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101, 126 Stat. 2313, 2316 (eliminating the sunset provisions baked in to the 2001 legislation and amending the rate brackets).

23 IRC § 2503(b)(1).

24 IRC § 2503(b)(2).

25 Rev. Proc. 2014-61, 2014-47 I.R.B. 860, at § 3.35(1) (setting the 2015 exclusion amount to $14,000).

26 IRC § 2010(c)(3)(A) (providing the $5,000,000 exemption), (c)(3)(B) (increasing the exemption for inflation).

27 Rev. Proc. 2014-61, *supra* note 25, at § 3.33

[28] *See* IRC § 2001(c) (providing the rate schedule for estates subject to tax).
[29] *See* IRC § 2505(a). *See also* IRC § 2010.
[30] *See generally* IRC § 2036(a).
[31] *See* IRC § 2036(b).
[32] IRC § 2102(b). *See* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-647, § 5032(b)(1)(A), 102 Stat. 3343, 3669.
[33] IRC § 2523(a) (providing a deduction from gift tax equal to the value of any gift to a donor's current spouse).
[34] Tax Reform Act of 1976 Supplemental Report of the Committee On Finance United States Senate On Additional Committee Amendment to H.R. 10612, S. Rep't 94-938 Part 2 at 14 (July 20, 1976).
[35] *See* Technical And Miscellaneous Revenue Act Of 1988, Conference Report To Accompany H.R. 4333 at 113, H.R. 100-1104, part 2 (Oct. 21, 1988). *See also* IRC § 2523(i)(1) (denying the deduction set out in part (a)).
[36] *Id.* at § 2523(i)(2). Lifetime transfers of appreciated property to a non-US citizen spouse may be subject to U.S. federal income tax.
[37] Rev. Proc. 2014-61, 2014-47 I.R.B. 860, § 3.35(2).
[38] IRC § 2056. The unlimited estate tax marital deduction is also available for assets that pass in trust for the benefit of the surviving spouse during the surviving spouse's lifetime, provided the trust qualifies as a "qualified terminable interest property" ("QTIP") trust or a general power of appointment trust.
[39] The "deceased spousal unused exclusion amount" (i.e. portability) is beyond the scope of this article.
[40] *See* IRC § 2056(d)(1)(A).
[41] *See* IRC § 2040(a).
[42] United States v. Windsor, 570 U.S. _, 133 S. Ct. 2675 (2013).
[43] *See* Rev. Rul. 2013-17, 2013-38 IRB 201. *See also* IRS, Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law (Feb. 6, 2015), http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples.
[44] *See generally* IRS, Answers to Frequently Asked Questions for Registered Domestic Partners and Individuals in Civil Unions (Aug. 19, 2014), http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Registered-Domestic-Partners-and-Individuals-in-Civil-Unions.
[45] *See* IRC § 2056(d); IRC § 2056A.
[46] *See* § 2056A(b)(3); Treas. Reg. § 20.2056A5(c)(1).
[47] *See generally* Treas. Reg. § 20.2056A-2.
[48] A "U.S. Trustee" is defined as either (i) an individual citizen of the United States who has a tax home in the United States, or (ii) a U.S. domestic corporation. Treas. Reg. § 20.2056A-2(d)(1)(i)(A), (d)(2).
[49] *See* IRC § 2056A(a)(1); Treas. Reg. § 20.2056A-2(c).
[50] *See, e.g.* Convention For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect To Taxes On Estates, Inheritances, Gifts and Certain Other Transfers, U.S.-Denmark, art. I, ¶ 3, April 27, 1983.
[51] Convention For the Avoidance of Double Taxation With Respect to Taxes on Estates, Inheritances, and Gifts, U.S.-Ger., art. IX, December 3, 1980.
[52] Convention For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect To Taxes On Estates of Deceased Persons and On Gifts, U.S.-U.K., art. 8, ¶ 5, October 19, 1978.