Advising The Estate Planning Client With International Interests

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Where in the world is your client's tax bill?

THIS ARTICLE WILL FOCUS on how international issues operate within the context of the federal estate and gift tax system. It will also outline solutions for practitioners in the areas of both estate planning and estate administration in regard to those international issues.

At first, the topic of international estate planning may conjure up notions of shifting assets to tropical locations via offshore trusts. However, international considerations arise in the seemingly average client, as in the following examples:

- A U.S. legal resident lives in Philadelphia, Pennsylvania, and is a citizen of France. He owns no property in France and does not generate any income from outside the United

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States. The beneficiaries of his estate are his four siblings, two of whom live in France.

- A woman dies a resident and a citizen of the United States. She owned an interest in the family home in Scotland.
- A married couple sets up an estate plan. They learn that it is best that they equalize their estates. The spouse with most of the assets is a citizen and must make large transfers to the other spouse, who is a noncitizen.
- A woman is a resident of Barcelona and a citizen of Spain. She travels every winter to her home in California in the United States. In her later years she becomes ill and is unable to travel back to her home in Spain. She remains in her California residence for two years before passing away.
- A U.S. citizen moves to Canada and remains there for 30 years until her death. She has very few ties left to the United States at the time of her death, except for the occasional visit with relatives. She dies at her home in Canada with an estate worth about $16 million.
- A citizen of India has been living in the United States for 35 years. His wife has an untimely death at the age of 58 after a short illness and the couple has no estate plan. The man will inherit about $1.5 million from his wife.

The examples above illustrate the need for practitioners to know about the basis for taxing authority of other countries and how that taxation overlaps with the U.S. system of taxation. How does property located outside the U.S. affect a taxpayer's estate? Is the unlimited marital deduction for both federal gift and federal estate tax the same for noncitizens? How does the determination of residence affect one's tax liability? Should a client seek to change citizenship or residency status to reduce tax consequences? The adviser in each of the above examples should know how to identify the international issue in each situation and to advise accordingly.

TAXING AUTHORITY • The United States bases its taxing authority on four possible grounds. The first is U.S. citizenship. Any U.S. citizen, wherever located, making transfers during life is subject to the federal gift tax and at death, the estate of a U.S. citizen decedent is subject to the federal estate tax. The gross estate of a citizen includes "all property wherever situated" to the extent of the decedent's interest. Internal Revenue Code (Code) §2031. This includes all property located outside the United States. (All section references are to the Code unless otherwise indicated.)

Every citizen decedent must file Form 706 if the estate exceeds the federal estate tax exemption amount and the decedent made no taxable gifts during life. For those citizen decedents who had taxable gifts during life, the amount of taxable gifts subtracted from the federal estate tax exemption amount is the new exemption amount. If a citizen's estate is valued over the new exemption amount, he or she must file Form 706.

Assume a decedent had a gross estate of $1.4 million, made gifts during life of $200,000, and died in 2004. At first glance, a gross estate of $1.4 million with an exemption amount of $1.5 million would appear to mean that the decedent need not file Form 706. However, the amount of taxable gifts ($200,000) subtracted from the federal estate tax exemption amount ($1.5 million) is the new exemption amount ($1.3 million). Since the gross estate of $1.4 million is greater than this amount, the decedent must file Form 706.

The philosophy behind the U.S. citizenship basis for taxation is that citizenship offers a kind of insurance policy. United States citizens have the protection of the U.S. government wherever they travel and they can return to the United States at any time. Richard L. Doernberg, *International Taxation in a Nutshell* §1.05 (West Group, 5th ed. 2001). Taxation is the "payment" for the benefits that are accessible to U.S. citizens wherever located.

Legal Residency

The second ground for federal estate and gift taxation is U.S. residency. Any resident of the United States, regardless of citizenship, is subject to the federal gift tax when making transfers during life. At death, any U.S. legal resident is subject to the federal estate tax in the same way a citizen is. A resident's entire estate, "all property wherever situated," is taxable. Taxable gifts made during life are used to calculate the federal estate tax exemption amount, as calculated for citizens, above.

U.S. Situs Property Of Nonresident Aliens

Those decedents who neither live in the United States nor are citizens thereof are known as nonresident aliens. Because the U.S. cannot base taxing jurisdiction on citizenship or residency in their case, it claims taxing jurisdiction on any property of nonresident aliens deemed to be situated in the United States. §2103. Generally speaking, such property will include real estate and the tangible personal property physically located inside U.S. borders. Nonresident aliens are subject to the federal gift tax involving lifetime transfers of U.S. situs property and are subject to the federal estate tax for the transfer at death of U.S. situs property.

Unlike the exemption amount for U.S. citizens and residents, the federal estate tax exemption amount is only $60,000 for nonresident aliens in 2003. §2102(c)(1). Any nonresident must file Form 706-NA if the value of property located in the United States and includable in the estate of the decedent exceeds this amount. Taxable gifts made during life are used to calculate the federal estate tax exemption amount, as calculated for citizens, above.

Practitioners should note that the federal estate tax reaches all nonresident aliens, not just those with the top one or two percent of wealth, as is the case for U.S. citizens and residents. For instance, if a nonresident alien has a gross worldwide estate of only $300,000, with $100,000 located in the United States, Form 706-NA must be filed and federal estate tax paid. Though the tax in such a case would be minimal (about $5,200) the practitioner must be careful not to overlook the tax needs of a nonresident alien simply because he or she is not wealthy.

Expatriates

The United States exerts its taxing authority over certain former U.S. citizens who have renounced citizenship and left the United States in the past 10 years. It also claims taxing authority over certain long-term residents of the United States who have renounced their residency.

Citizenship, residency, U.S. situs assets, and expatriation are the four bases on which the United States justifies the taxing authority for the federal estate and gift tax. Many foreign countries, however, use only residency as a basis for taxation. This difference will often result in the taxation by two different countries on the same transfer during life or at death. Doernberg, *supra*, at §2.04. Double taxation is not an uncommon occurrence and the tax adviser must know the options for minimizing this risk.

UNITED STATES DEFINITION OF RESIDENCY • The increase in international travel has made the possibility of dual residences more common. It is possible that individuals with more than one residence fit the definition of residency for more than one country and unknowingly subject themselves to each country's taxing jurisdiction as a result. There may be a tax benefit to establishing residency in one country over another in order to avoid paying more tax than is needed.

For those clients who keep a house in more than one country, determining residency is key. (Practitioners should note that the determination of residency for income tax purposes does not necessarily translate to residency for estate tax purposes. The definition of residency is different for both tax systems. Joint Committee on Taxation, *Review of the Present-Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency* (JCS-2-03, February 2003).) The definition of residency for U.S. federal estate tax purposes is "a decedent, who at the time of death, had domicile in the United States." A person acquires domicile, according to the law, by living in a particular location "for even a brief period of time, with no definite present intention of later removing therefrom." Treas. Reg. §20.0-1(b)(1).

How does one prove "lack of intent to remove therefrom"? To determine the intent of an individual, many factors are considered. Such factors include the individual's residential location, whether or not he or she owns or rents a home, the size and value of any owned home, personal ties to the location (such as club membership), personal possessions, and even a chosen burial site. Other factors used to determine residence include the residence listed on legal documents, passports, visa applications, voter registration, and income tax returns. *Estate of Paquette v. Commissioner,* 146 T.C.M. (CCH) 1400 (1983).

To illustrate how the definition of residency is determined by a number of factors, consider the *Paquette* case. The decedent was a citizen of Canada and he lived in Montreal. In his retirement each year he would spend seven summer months in Canada and five winter months at his vacation home in Florida. The decedent died at his home in Florida. The IRS argued that the decedent was a resident of the United States, and therefore subject to estate tax on his estate, "wherever situated." The decedent's Executor argued that the decedent was both a citizen and a resident of Canada. Canada has no estate tax and so the decedent's estate would be subject to taxation by the United States on the basis of his being a nonresident alien. Therefore, the U.S. federal estate tax would extend to only that property situated in the United States, such as his home and tangibles in Orlando, Florida. If the court ruled in the IRS's favor, however, the U.S. federal estate tax would be levied on all of the decedent's property wherever situated. The result of the case would have made a large difference in the amount of estate tax due.

The U.S. Tax Court determined that a "resident" decedent is a decedent who at the time of death had domicile in the United States. A domicile, once acquired, is presumed to continue until it is shown to have been changed. To establish a new domicile, a decedent must do two things: reside in the United States and have the intention to remain here indefinitely.

The decedent in this case was domiciled in Canada and had not demonstrated an intention to remain in the United States indefinitely. Even though the decedent sold his home in Montreal, Canada and transferred his tangible personal property to furnish his home in Orlando, this did not rise to the level of intention to change domicile, because he did so due to illness. The decedent had repeatedly reiterated his intent to purchase a new apartment in Montreal when his health improved. He flew to Montreal regularly after the sale of his home there to meet with business and financial advisers, doctors, and his accountant. The decedent referred to himself as a resident of Montreal in his last Will. He filed income tax returns, voted, and maintained a driver's license in Canada and maintained his valid Canadian passport. His automobile was purchased, registered, and insured in Canada and most of his assets were in

Canada. The U.S. Tax Court found the decedent to be a resident of Canada for U.S. federal estate tax purposes and subject only to taxation on his U.S. situs property, as a nonresident alien.

LEGAL RESIDENT ALIENS • A legal resident alien must be aware of the differences his or her immigration status presents in the tax context, even though he or she may have lived in the United States for many years. Legal residents should consider the planning issues that citizenship in the country of origin may raise.

The number of immigrants coming to the United States has increased significantly in recent years. The number of immigrants admitted to the United States in 1998 was 654,451, and by 2001 that number had increased to 1,064,318. U.S. Department of Justice, Office of Policy and Planning, Statistics Division, Annual Report, *Legal Immigration, Fiscal Year 2001*(August 2002). This number represents those immigrants who were admitted to legal resident status. In 2001, 63 percent of new legal residents were admitted based on their sponsorship from family members already living in the United States. Sixteen percent were admitted based on employment preferences. *Ibid.* Professionals with advanced degrees or "of exceptional ability" were the second largest category of employment-based admission. This subcategory increased 45 percent between 1998 to 2001.

The following is a review of the law regarding the situs of assets, deductions, and credits allowed against the federal estate tax, and the federal gift tax laws for inter vivos transfers as it pertains to legal resident aliens.

U.S. Situs Property

When a taxpayer has assets in more than one country, the situs of those assets is a factor in determining the tax system to which they are subject. The U.S. defines the situs of assets for both citizens and legal residents in the same way.

Real estate located in the United States has a U.S. situs and real estate located outside the United States has a foreign situs. Tangibles physically located in the United States generally have a U.S. situs and tangibles located outside the United States generally have a foreign situs.

All intangible property is deemed to have a U.S. situs for federal estate taxation purposes. Federal estate tax is levied on all assets in which the decedent had an interest, wherever situated. §2031.

Deductions

Both citizens and legal residents may take deductions against the federal estate tax. Deductions can include administration expenses of the estate, attorney's and accountant's fees, funeral expenses, and probate fees.

Charitable contributions of an estate are deductible even if they are paid to a foreign organization. Unlike the federal income tax, there is no requirement that the recipient charitable organization be organized in the United States to enable a charitable deduction. Also, unlike the income tax charitable deduction that is limited to a percentage of adjusted gross income, the estate tax charitable deduction is unlimited. If an entire estate is left to charity, there will be no federal estate tax due. Treas. Reg. §20.2055-1(a)(4).

Marital Deduction Planning

Citizens are afforded an unlimited marital deduction for both the federal estate tax and the federal gift tax. In other words, a spouse can gift an unlimited amount of property without incurring any gift tax, as long as the recipient spouse is a citizen. At death, an estate of any size can pass to a surviving spouse without incurring federal estate tax, as long as the recipient spouse is a citizen.

A significant difference in the law between citizens and legal residents is the lack of the unlimited marital deduction for transfers during life or at death to a noncitizen spouse. Note that this difference only applies if the *surviving* spouse is a noncitizen. The status of the donor spouse is irrelevant. If a citizen spouse dies leaving a noncitizen spouse, the marital deduction is not available. §2056(d). If a noncitizen spouse dies leaving a citizen spouse, the marital deduction is available.

To illustrate the difference in the marital deduction law in transfers at death, assume a married couple, both of whom are citizens with a combined estate of $3.5 million. Their respective wills leave all property to the other spouse. At the death of the first spouse, his or her share of the $3.5 million (let's assume $1.75 million) passes to the surviving spouse. Because of the unlimited marital deduction, there is no federal estate tax due. §2056(a). The surviving spouse has an estate worth $3.5 million and at his or her death, when all assets pass to the children, federal estate tax will be due.

Now assume the recipient spouse is a legal resident. The first spouse dies and leaves $1.75 million to the surviving spouse. Because the marital deduction is not afforded to noncitizen surviving spouses, the transfer (minus the estate tax exemption amount of $1.5 million) is taxable for estate tax purposes, at rates beginning at 43 percent in 2004. §2001(c). Thus the estate tax bill is about $100,000—a considerable difference from the previous tax bill of $0.

What is the philosophy behind this law? The unlimited marital deduction is allowed because the United States knows that it will be able to tax the property upon the death of the surviving spouse. However, a noncitizen surviving spouse has the ability to avoid the taxing jurisdiction of the United States by moving back to his or her country of origin. To prevent any missed opportunities, the United States immediately taxes the property of anyone who leaves it to a noncitizen spouse. H.R. Rep. No. 100-795, at 592 (1988).

What options do noncitizens have to avoid this estate tax? The first option is to become a U.S. citizen. §2056(d)(4). As a citizen, the survivor will have the marital deduction and the decedent's estate will be handled in the same manner as the estates of those born in the United States.

However, legal residents have many personal, professional, and financial reasons for maintaining the citizenship of their country of origin. The alternative for these residents is to incorporate a "qualified domestic trust" (QDOT) in their estate plan. A QDOT is a special trust that names at least one U.S. citizen or U.S. corporation as a trustee. §2056A. (Hence, the trust is based in the United States and within its taxing jurisdiction). This trust also names the surviving spouse as the beneficiary.

A QDOT is set up under the will or the revocable trust of the client. At death, all probate property will be directed to the QDOT to benefit the surviving spouse. However, the QDOT can also be used to shelter property passing outside of the decedent's estate, such as joint property. The law allows the transfer of the noncitizen spouse's interest in joint property to a QDOT without using a disclaimer. Another possibility is to re-title joint property during the life of the decedent as tenants in common so that the citizen spouse's interest in the property will pass through his or her estate to a QDOT at death. This transfer may incur gift tax consequences, however, as discussed below.

Property that ordinarily cannot be transferred or assigned, such as certain annuity contracts, individual retirement annuities, and pension plan payments, can still qualify for the marital deduction. The surviving spouse simply transfers the principal portion of each payment received from an annuity or retirement plan to a QDOT.

Even though property directed to the QDOT is then afforded the unlimited marital deduction, this trust does not recreate a situation identical to an outright distribution. The noncitizen beneficiary of a QDOT does not have unlimited use of the QDOT assets. The terms of the QDOT trust require that all income be paid out currently, so this portion can be accessed without restriction. The income is not subject to federal estate tax but is subject to federal income tax, just as it would be if the surviving spouse owned the principal outright and it produced investment income. §2056A(b)(3)(A). However, the principal of the QDOT may not be withdrawn without paying federal estate tax on the portion withdrawn. The U.S. trustee is liable for payment of a U.S. estate tax on all distributions of principal except those on "account of hardship." §2056(b)(3)(B). Tax practitioners will file IRS Form 706-QDT each year that principal is withdrawn from the trust. At the death of the spousal beneficiary of a QDOT, the U.S. trustee is liable for paying estate tax on the remaining principal. The estate tax due is calculated to match the same amount of tax as if paid at the death of the first spouse.

Some clients may learn of this difference in the law after the death of a spouse. A noncitizen surviving spouse has the option to become a U.S. citizen after the death of a spouse and before the filing of the federal estate tax return, including extensions, provided that he or she remains a resident of the United States in the meantime. Naturalization may take a considerable amount of time depending on the immigration backlog. In addition, as mentioned above, some clients simply do not wish to become U.S. citizens.

Fortunately, a QDOT can be created by the surviving noncitizen spouse even after the death of the decedent. Should a surviving spouse be faced with federal estate tax liability he or she can create a QDOT, transfer property inherited from the spouse, and then claim the marital deduction by the filing deadline for the federal estate tax (including extensions).

Credits

As mentioned above, legal residents are afforded the federal estate tax exemption amount, which is $1.5 million in 2004. This exemption amount is actually calculated as a credit of $555,800 on Form 706. This exemption amount increases steadily through 2009, it is repealed in 2010, and then it returns to $1 million due to a sunset provision in the law in 2011.§2010(c). Both U.S. citizens and legal residents are afforded the full estate death tax credit.

Citizen decedents and resident decedents are allowed to take a credit for any foreign tax paid. The credit is allowed for any estate, inheritance, legacy, or succession taxes actually paid to any foreign country. §2014. To calculate the amount of the credit available for use, first determine the percentage the foreign property bears to the total gross estate. Take this same percentage of the federal estate tax paid after application of the marital and charitable deductions. The credit for foreign death taxes cannot exceed this amount.

For example, assume a decedent has a gross estate of $3.2 million and $200,000 of the estate was subject to a foreign tax of $12,000. The federal estate tax due on the gross estate is approximately $800,000 and there is no marital or charitable deduction in the estate. The value of foreign property in the estate is 1/16 of the gross estate. Therefore up to 1/16 of $800,000, or $50,000, can be taken as a credit against foreign death taxes paid. Since the amount paid was $12,000, the entire amount may be taken as a credit against the $800,000 tax bill.

Gift Tax

The annual gift tax exclusion of $11,000 is the same for all donors, regardless of citizenship or residency. In general, gifts made by an individual above the annual exclusion of $11,000, per person per year, incur federal gift tax.

However, spouses again are subject to a different law. For those clients gifting to a citizen spouse, the amount of the gift tax deduction is unlimited. Just as two citizen spouses can transfer an unlimited estate to each other at death without incurring federal estate tax, citizen spouses can also transfer as much to the other during life in the form of a gift without incurring the federal gift tax.

Should a transfer be made to a noncitizen spouse, however, the IRS limits the gift tax exclusion. As in the limited marital deduction for noncitizen spouses, the noncitizen spouse avoids the taxing jurisdiction of the United States should he or she decide to leave the country enriched by the gift from his or her spouse. Therefore, gifts made to a noncitizen spouse are limited to $100,000 (indexed) per year. As in the marital deduction exception, the citizenship or residency of the donor spouse is unimportant. §2523(i)(2).

When equalizing the estates of a married couple in which one of the spouses is a noncitizen, it is important to keep in mind the gift tax exclusion. Spouses may need years of time in order to shift assets appropriately due to the limitation on gifting. Again, the option of citizenship is available.

To Naturalize Or Not To Naturalize?

The effect of the federal estate and gift tax system on a client may be a key factor in the decision to become a citizen of the United States. To be naturalized a candidate must be a legal resident of the United States for at least the last five consecutive years, be 18 years of age or older, have the ability to speak, read, and write English, have a basic knowledge U.S. government and history, and have good moral character. Office of Immigration Statistics, Bureau of Citizenship and Immigration Services, *2002 Yearbook of Immigration Statistics*.

Part of the naturalization process is that the applicant pledge allegiance to the United States and renounce his or her country of origin. This may serve as a barrier to naturalization for many legal residents because of the pride and allegiance legal residents have to their country of origin. On the other hand, some legal residents have embraced the United States as their new home as a result of fleeing an oppressive government in their country of origin. Other factors, such as tax issues, benefits of citizenship in the country of origin, benefits of citizenship in the United States, and even voting rights are considerations in naturalization.

EMIGRATION AND NONRESIDENT ALIENS • It is not an uncommon occurrence for legal residents of the United States to return permanently to their country of origin. In fact, roughly 220,000 legal resident Americans decide to permanently leave the United States each year. U.S. Bureau of the Census 1995-1997. Perhaps surprisingly, 48,000 native-born Americans choose to permanently leave the United States each year as well. Yet it is still possible for the United States to tax these individuals even if they have no property located in the United States. How is this possible?

The U.S. estate tax is applied against the estate of an expatriate of the United States who is no longer a long-term resident or citizen. §2107. The estate tax is imposed on nonresident aliens if they relinquished citizenship or long-term residency within 10 years of the date of their death and if they had a principal purpose of avoiding taxation.

An individual is treated as having a principal purpose of avoiding taxation if the annual net income for the five taxable years before the loss of citizenship exceeded $100,000 (indexed after 1996) or the net worth as of the date of the loss of citizenship is greater than $500,000 (indexed after 1996). §877(a)(2). It appears as if the United States wants to make sure it gets a fair chance to maintain taxing authority over the wealthy—even after they permanently sever all ties to the United States.

To avoid the "principal purpose of avoiding taxes" requirement, an individual taxpayer may secure a ruling from the IRS confirming that the expatriation is not motivated by a desire to avoid taxes. Otherwise an expatriate must simply survive for more than 10 years after leaving the U.S. permanently to avoid taxation.

Emigration may actually be used as an estate planning tool for some clients. Consider the wealthy woman who is a citizen of the United States. Her total estate is about $16 million. She moves to Canada and lives there for close to 30 years. She has no intention of moving back to the United States. Canada has no estate tax. However, since she is a citizen of the United States, her estate will be taxed at rates of about 49 percent at her death. Emigration is a smart option for her to avoid an estate tax bill of approximately $7 million. Once she renounces her U.S. citizenship, she will still be presumed to be emigrating for tax avoidance purposes—which is precisely correct. If she survives another 10 years, however, this presumption is a moot point and she avoids federal estate tax on all assets except those physically located in the United States.

Nonresident Aliens

A nonresident alien cannot be taxed based on citizenship, residency, or expatriation after 10 years. However, the United States may still have taxing authority because of property physically located in the United States.

Real estate located in the United States is deemed to be situated in the United States for purposes of the estate tax. Treas. Reg. §§20.2104-1(a)(1). Similarly, any tangible personal property physically located in the United States generally has a U.S. situs as well. Treas. Reg. §20.2104-1(a)(2). However, the situs of intangible personal property is determined by law and depends on the type of asset. For instance, stock in a U.S. corporation has U.S. situs, while insurance policies on the life of a nonresident alien have a foreign situs. §2104(a); 2105(a).

Interests in partnerships conducting a U.S. trade or business have a U.S. situs. Rev. Rul. 55-701, 1955-2 C.B. 836. One must look to the situs of the underlying assets to determine if business entities have a U.S. situs. *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934). Interests in trusts are determined by underlying assets as well. Rev. Rul. 55-163, 1955-1 C.B. 674. Any revocable or irrevocable transfer to a trust or transfer of property within three years of a decedent's death shall be deemed to be situated in the United States if the property transferred was situated in the United States at the time of the transfer or at the time of the decedent's death. §2104(b).

Deductions

Deductions against the federal estate tax do not depend on where expenses were incurred or where payment is made. Treas. Reg. §20.2106-2(a)(2). However, the deductible amount is limited to the extent of the estate situated in the United States. The amount of the deduction is calculated as a fraction, the numerator of which is the value of U.S. situs property and the denominator of which is the value of the worldwide gross estate. *Id*. For instance, if the worldwide estate for a decedent was $1.4 million and the portion of U.S. property is $200,000, only one-seventh of all deductions may be taken against the U.S. estate tax.

Ordinarily for citizens and resident decedents, any charitable contributions are deductible even if they are paid to a foreign organization. However, nonresident aliens may not deduct charitable contributions if they are paid to foreign organizations. §2106(a)(2). If the contribution is paid to U.S. organizations, however, the charitable deduction for estate tax purposes is unlimited to the extent of the U.S. situs estate. Treas. Reg. §20.2055-1(a)(4).

Credits

When permitted by treaty, the estate of a nonresident alien decedent is allowed the same unified credit as a U.S. citizen or resident, which is $1.5 million in 2004. In such a situation, the nonresident alien decedent is able to use only that portion of the unified credit equal to the ratio of the value of the gross estate situated in the United States over the total gross estate wherever situated. 2102(c)(3). Since this provision is fairly rare in tax treaties, the remainder of nonresident aliens are afforded a $60,000 exemption. This also calculates as a credit of $13,000. §2107(c)(1).

The estate of a nonresident alien can take a credit for any state death taxes paid. §§2102, 2011. As in the calculation of the unified credit, the maximum amount of the state death tax credit available is limited to that portion of the credit equaling the ratio of the value of property subject to state taxes over the total gross estate. §2102(b).

For instance, assume a nonresident alien has a U.S. taxable estate of $550,000 and dies in 2002. The taxable estate consists of real estate in two states. The real estate in Pennsylvania is worth $350,000. Inheritance tax is due only to the state of Pennsylvania in the amount of $15,750. The maximum state death tax credit allowed is equal to the ratio of $350,000 over the entire U.S. taxable estate of $550,000. The value of the property taxed at the state level is $350,000, which is 63 percent of the total U.S. estate. Therefore, 63 percent of $15,750, or $9,922.50, is the maximum state death tax credit allowable to offset the U.S. federal estate tax. Treas. Reg. §20.2102-1(b)(2) Example (1).

Gift Tax

Since neither residency nor citizenship tie the nonresident alien donor to the U.S. federal gift tax, the location of gifted property may serve as the basis to incur such tax. The annual gift tax exclusion of $11,000 is afforded to nonresident alien donors. §2503(b). They are also entitled to the gift-tax exclusion for tuition and medical care. §2503(e). Most forms of intangible property transferred by a nonresident alien are not subject to gift tax, since this kind of property is deemed to be situated outside of the United States. §2501(1)(2); Treas. Reg. §25.2501-1(a)(3).

The rules of gifting to a noncitizen spouse are the same as those for a legal resident spouse, discussed above. There is no unlimited gift tax exclusion but there is a limited $100,000 (indexed) annual exclusion. If a nonresident alien gifts to a citizen spouse, however, the amount of the gift tax deduction is unlimited, because the citizen spouse now has ownership of assets and because of his or her citizenship, those assets are subject to the taxing jurisdiction of the United States. Nonresident aliens are not entitled to the gift-splitting option with a spouse, however. §2513(a).

USE OF TAX TREATIES • Regardless of the tax provision in question, practitioners should always check for a tax treaty between the United States and the foreign jurisdiction to address the provision. The objective of tax treaties is to reduce or eliminate double taxation for income, estate, inheritance, or gift taxes and to prevent tax evasion. There are currently 55 U.S. income tax treaties and 16 estate and gift tax treaties in force. Joint Committee on Taxation, *Review of the Present-Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency* (JCS-2-03, February 2003).

These objectives are satisfied when each party to the tax treaty agrees to limit its own right to tax based on citizenship, residency, or location of assets. Such treaties will generally define concepts such as domicile and residency, determine what property is subject to tax, specify where property is situated depending on the type of property, and calculate allowable exemptions, deductions, and credits.

Most U.S. tax treaties include a "savings clause." This provision preserves the U.S. right to tax U.S. citizens or residents who are also residents of other countries. This clause enables the U.S. to continue to tax its citizens or residents as if the treaty were not in force. Savings clauses can reach as far as to preserve the right to tax former citizens and even to former long-term residents who are now nonresident aliens.

When a decedent taxpayer takes a position on any tax return that a treaty of the United States modifies any provision of the Code and thereby effects a change in any tax incurred by the taxpayer, the taxpayer must disclose this position on Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b). Treas. Reg. §301.6114-1(d).

Model Tax Treaty

The U.S. Model Tax Treaty serves as a template for drafting tax treaties with other countries. The U.S. model takes the position that the country of the decedent's domicile may tax the lifetime transfers and transfers at death on a worldwide basis. A credit for taxes paid to another country on the basis of the situs of specific assets is allowed. For example, a U.S. citizen who is a resident of another country is taxed by the United States on all property wherever situated and the decedent's estate is given a credit for all taxes paid to any foreign country on that same property.

The Model Treaty determines the situs of certain assets. Model Treaty, art. 4. Real property and tangible personal property is subject to tax by the country in which it is physically located. Model Treaty, art. 5. Transfers of all intangible property are taxed only by the country in which the property is deemed to have situs. Each type of intangible property is defined and its situs determined by the treaty.

The Model Treaty determines the extent to which debts are deductible. Deductions are allowed to the extent of the ratio of the value of property with situs in one country over the gross estate wherever situated. Model Treaty, art. 8. A marital deduction for property transfers between spouses is allowed. *Id.*

Illustration: U.S.-French Estate And Gift Tax Treaty

France bases its taxing authority on citizenship and/or residency. France Law Digest, *Martindale-Hubbell International Law Digest* (2000). France has an inheritance tax that is based on the amount passing to a particular beneficiary as long as either the decedent or the beneficiary is domiciled in France. When both decedent and beneficiary are domiciled outside of France, tax is due on French situs assets only. Inheritance tax rates range from six to 50 percent and depend on the relationships of the decedent to the heirs as well as the size of the estate. As of 2000, there was a 400,000 franc exemption for transfers to surviving spouses.

There is a treaty between the United States and France that addresses the overlapping estate and gift tax laws of both countries. Since the United States bases its taxing authority on both citizenship and residency, as does France, double taxation will occur in the estate of any U.S. citizen living in France or any French citizen living in the United States. U.S.- France Estate and Gift Tax Treaty, Article 1.

First, the treaty resolves the issue of domicile to determine which country will have the primary taxing jurisdiction. For those decedents who are citizens of just one of the countries, there are two rules to determine domicile. The first rule is satisfied if either of the two following scenarios is true:

- In the first scenario, a decedent is considered domiciled in one country by default if he or she was only domiciled in the other country for fewer than five years out of the seven years before death because of employment purposes, or if the spouse of the decedent fits that same criterion.
- In the second scenario, a decedent is considered domiciled in one country by default if he or she was domiciled in the other country for a period of time ending with his or her death and he or she was in that country because of a renewal of employment or because of marriage to someone who fit that criterion. U.S - France Estate and Gift Tax Treaty, Article 4(3)(b)

The second rule only applies if the test for domicile cannot be resolved by using the first rule. Under this rule, a person is considered a domiciliary of the country in which he or she was a citizen and if he or she had a clear intention to retain domicile in that country. He or she cannot have been domiciled in the other country for more than five years during the seven years before death. *Id.* Article 4(3)(a).

Additional tests are given if domicile still cannot be established using these rules, and ultimately, if the question is still unable to be resolved, the two countries may resolve the question by mutual agreement. *Id.* Article 4(2).

The treaty dictates that regardless of the determination of the country with primary taxing jurisdiction, real estate and tangible personal property will be taxed by the country in which said property is physically situated. *Id.* Article 5. All other property (intangible personal property) is taxed by the country determined to have primary taxing jurisdiction.

Illustration: U.K.–U.S. Estate And Gift Tax Treaty

A woman is a citizen and resident of the United States. She has a gross taxable estate of about $2 million in 2003, the year of her death. She owns a one-third interest as a joint tenant in common in a home in Scotland. The value of the home is approximately $2.3 million and the decedent's interest in the home is therefore $760,000. The tangible personal property in the home is worth about $25,000 and her interest is deemed to be one-third of that amount, or $8,300. Her remaining estate, valued at $1.2 million, is located in the United States.

The domicile of the decedent is unquestionably the United States. It is also apparent that both the real estate and the tangible personal property are physically located in Scotland and therefore, subject to the U.K. "capital transfer tax."

The U.S. maintains the right to tax a decedent's entire estate, wherever situated. The United Kingdom maintains the right to tax anyone domiciled in the United Kingdom at death. The United Kingdom can also tax the "immovable property," or property physically located there, of any decedent, regardless of domicile. Therefore, our decedent's Scotland home will be subject to both the U.S. federal estate tax and the U.K. capital transfer tax. The approximate U.S. federal estate tax due on the estate is $435,000. The approximate U.K. capital transfer tax due is $44,000. Our decedent has been subject to tax twice on the same property by two different countries.

Luckily, there is a treaty between the United States and the United Kingdom addressing any double taxation for federal estate and gift tax. The treaty states that the country in which the decedent was domiciled has the right to tax all property except for "immovable property," or property physically located in a country. U.S.-U.K. Federal Estate and Gift Tax Treaty, Article 4.

Therefore, since the decedent was domiciled in the United States, the United States has a right to tax all property except the real estate and tangibles located in Scotland. The United Kingdom has the right to tax the property physically located within its borders. The payment of capital transfer tax stands, therefore, and no refund will be granted.

The personal representative of the estate, however, should file Form 706 listing the Scottish assets but listing their includable value as $0. Each listing should reference that a treaty-based position is taken by the personal representative and the appropriate form, Form 8833, is attached. This will remove the U.S. federal estate tax assessed against the Scottish property from the return and reduce the tax due to about $94,997. It is imperative that the personal representative attach Form 8833 to Form 706. Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), is the filer's opportunity to invoke the U.S.-U.K. Federal Estate and Gift Tax Treaty and remove property physically located outside the U.S. from the taxing authority of the United States. The form is a simple one—it asks which article of the treaty the taxpayer is claiming and the calculations to spell out how a treaty changes the tax return filed.

CONCLUSION • It is important for practitioners to know the international interests of a client. Issues such as citizenship, residency, and location of assets are the most basic pieces of information each practitioner should know. International issues can trigger substantial tax consequences for a client depending on these issues and a change of citizenship or residency may even be considered as estate planning techniques. Adverse tax consequences of gifting and transfers at death can be remedied by planning carefully during life.

PRACTICE CHECKLIST FOR

Advising The Estate Planning Client With International Interests

Practitioners need to know about the basis for taxing authority of other countries and how that taxation overlaps with the U.S. system of taxation. How does property located outside the U.S. affect a taxpayer's estate? Is the unlimited marital deduction for both federal gift and federal estate tax the same for noncitizens? How does the determination of residence affect one's tax liability? Should a client seek to change citizenship or residency status to reduce tax consequences?

• The United States bases its taxing authority on four possible grounds:

__ Citizenship;

__ Legal residency;

__ U.S. situs of property;

__ Expatriate status of certain former U.S. citizens.

• Legal residency is sometime difficult to establish.

• Legal resident aliens are subject to tax on U.S. situs property. They can take deductions but there is no unlimited marital deduction for transfers to a noncitizen spouse. What options do they have?

__ The first option is to become a U.S. citizen. §2056(d)(4). As a citizen, the survivor will have the marital deduction and the decedent's estate will be handled in the same manner as the estates of those born in the United States.

__ The alternative for these residents is to incorporate a "qualified domestic trust" (QDOT) in their estate plan.

• The U.S. estate tax is applied against the estate of an expatriate of the United States who is no longer a long-term resident or citizen. §2107. The estate tax is imposed on nonresident aliens if they relinquished citizenship or long-term residency within 10 years of the date of their death and if they had a principal purpose of avoiding taxation.

• A nonresident alien cannot be taxed based on citizenship, residency, or expatriation after 10 years. However, the United States may still have taxing authority because of property physically located in the United States.

• Don't forget to check tax treaties that may cover your client's situation.