Wills and Trusts: Estates for Foreign U.S. Residents

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Foreign residents living in the United States are subject to a different estate tax regime (inheritance and gifts) than U.S. citizens. Surprisingly, the U.S. tax code can consider a foreigner as a non-resident for income tax purposes, but consider that same person as a resident for the purpose of estate tax. This article first explains the criteria used by the U.S. Internal Revenue Service (IRS) to determine residency. Then it examines the special status of U.S. residents both in terms of gifts in matters of inheritance.

1 / The criteria for qualification of U.S. resident on transfer taxes:

For the purpose of estate tax, the IRS considers a person to be a resident if that person has established residency in the US, while for income tax purposes, the IRS considers the individual's visa.

There are two criteria to be met to be considered a resident in the United States: (1) a physical criteria: currently living in the United States, and (2) an intentional factor: dmonstrating the intent to establish residency in the United States for an indefinite period of time.

The court will take into account the following factors:

a) The annual duration of stay in the United States,
b) The size, cost, and nature of the residency and other real estate property,
c) Location of real estate property,
d) Location of personal property,
e) Location of family and close friends,
f) Location of associations, clubs, and religious groups to which the individual adheres,
g) Location of his professional interests,
h) Declaration of residency visa applications, wills or other legal documents,
i) Individual's visa.

2 / The consequences of the status of U.S. resident

The IRS limits its taxation for a non-resident aliens to a limited number of properties located in the United States. However the non-resident alien receives only a tax deduction of $ 60,000 with a maximum tax rate of 45%.

Foreign residents enjoy the same estate tax exemption of $3,5M as American citizens (as of 2009). Like American citizens, residents must report to the IRS all of their assets whether they are located in the United States or abroad. The same rule applies for gifts. All gifts made abroad must be reported to the tax authorities. The bi-lateral tax treaties settle the problem of double taxation. Residents and U.S. citizens are entitled to an exemption of $1M for gifts during their lifetime. However, contrary to citizens, foreign residents do not enjoy the presumption of joint ownership between spouses. When an American couple has a joint account or has acquired a property in common, it is presumed that each owns half of the asset. An alien must demonstrate its contribution. For example, Marie and Pierre are French and reside in the United States. They acquired a house in common, either as tenants by the entirety or joint owners. Suppose that for any reason, Marie does not work and that Peter dies. If the house was acquired jointly with a right to survival as in tenancy by the entirety, Mary will automatically become the sole owner of the house. However, the U.S. tax authorities will request that the full value of the house is included in Peter's estate.

Also, non-resident aliens do not benefit from the unlimited deduction enjoyed by American surviving spouses. For example, John dies with an estate worth $5 million. If his spouse, Michele is American, she collects the entire estate and pays no inheritance tax. If Michele is not American, she pays an inheritance tax. After the $3.5 million deduction, the net inherited assets of $1.5 million [$5 million (property belonging to John) - $3.5 million (tax deduction)] are taxable at the maximum rate of 45%.

The IRS offers options to mitigate that disadvantageous tax law in the form of the special trust called "Qualified Domestic Transfer" Trust ("Qdot" or "QDT" trust). If the part above the deduction tax is collected by the surviving spouse through a Qdot trust, payment of

inheritance tax is deferred until later. The surviving spouse may receive trust income and pay taxes on income. For example, the spouse may receive dividends on the investments in the trust. If the surviving spouse requests a distribution of principal – by selling shares for example – he/she must pay the inheritance tax calculated on the principal amount distributed.

Some peculiar rules apply to QDOT trusts.

a) The surviving spouse can not be the trustee of the trust. The trustee should be a U.S. citizen. When the trust exceeds a certain amount, the U.S. tax authorities will require that a U.S. bank or the U.S. branch of a foreign bank be the trustee.
b) This trust can be terminated under certain conditions to the acquisition of U.S. citizenship of the surviving spouse.
c) However, if the surviving spouse dies without having acquired U.S. citizenship, the trust will pay inheritance tax on assets of the trust at the rate prevailing on the date of death of first spouse.

QDOT a trust is a solution to defer payment of inheritance by the surviving spouse upon the first death but requires heavy administration.

3 / Recommended Tax Strategies

When we talk about a couple who may have a taxable estate, the first piece of advice is to ensure that each spouse builds its own assets. As of 2009, assets aboce $3.5 million are taxable by the federal government. If federal law does not change in 2011, all assets of the estate over $1 million will be taxable at a maximum rate of 55%. For residents of the District of Columbia and Maryland, estates above $1 million are taxable. For Virginia residents, it appears that taxes for estates above $1 million will be reinstated.

It is therefore advisable to have separate accounts and to own property in tenancy in common with a declaration of the funds' origin.

Also, the tax administration offers an annual exemption for gifts to foreign spouses. Any spouse may give a foreign spouse $ 133,000 in 2009 without having to pay taxes or to begin their lifetime exemption of $1 million. By annual gifts, the spouse who has no income can build his/her assets. This annual exemption can also be used to establish a trust for life insurance. Upon death, the payment of life insurance is not included in the owner's estate.

4 / Other factors to consider to protect his family

Some families are dependent on the visa of the family member who works. The day the vis holder dies, the remaining family members lose their visas. It is therefore important to establish a will in which the spouse is appointed executor of that will. The spouse can then leave the country and obtain a visa in order to settle estate matters and become the sponsor of the remaining family members.

Establishing a will also allows you to appoint guardiens for your under-aged children. If those guardians are foreigners, the will will allow them to obtain a visa to enter the U.S. to take care of the children. It also allows you to appoint temporary local guardians who will care for your children until other family members arrive in the United States. The creation of a trust for minors must be analyzed in depth because the appointment of a trustee who is not an American citizen can have adverse tax consequences.

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