

## Wealth Planning

### Summary of U.S. Income, Estate and Gift Taxation for Non-Resident Aliens



The Wealth Planning Group consists of experts from across the Private Banking North America Business<sup>1</sup> to provide you with the advice and strategies needed to develop a comprehensive wealth plan. Together with your Relationship Manager, the Wealth Planning Group can help you go beyond your investments to create a plan designed to support and protect the people and causes you care most about for years to come.

#### Overview

The United States (“U.S.”) continues to offer attractive investment options to foreign individuals. While investment yields and returns are key factors to consider in any investment decision, the taxation of such investments is also critical. As a result, it is important to understand the basic rules of U.S. taxation as they apply to a foreign individual (also known as a Non-Resident Alien or “NRA”). This paper sets forth a brief summary of the U.S. income, estate and gift tax rules applicable to these individuals.

U.S. taxation of a NRA hinges on whether the individual is defined as a U.S. person and whether the asset is considered U.S. “source” or “situs” property. Although the same terms are used for income, estate and gift tax purposes, the definition of a U.S. person, or a NRA, and what is considered U.S. source or situs property varies among the different tax regimes. For example, it is possible that an individual may be subject to U.S. income tax but not the U.S. estate and gift tax. Therefore, an individual must be very careful in reviewing the rules for the specific situation involved and seek the advice of qualified tax and legal professionals.

The following are the general rules only.<sup>2</sup> The U.S. has tax treaties with many countries, which may modify the general rules below.

#### Income Tax

##### Who is a NRA for Income Tax Purposes?

For U.S. income tax purposes, “residency” is key when it comes to categorizing an individual as a U.S. person or NRA. If an individual is a U.S. person, then he would be subject to U.S. income tax on his worldwide income. If an individual is a NRA, then he would be subject to U.S. income tax only on his U.S. source income. A U.S. resident for U.S. income tax purposes is defined as one of the following:

1. *Citizenship* – A person is a U.S. person if he is a U.S. citizen. It does not matter that the individual does not spend any time in the U.S. As long as he

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<sup>2</sup> Unless otherwise noted, the general rules herein are derived from the Internal Revenue Code and applicable Treasury Regulations.

remains a U.S. citizen, he would be deemed a U.S. person for income tax purposes.

2. *Green Card* – A person is a U.S. person if he has a green card.
3. *Election* – A person is a U.S. person if he affirmatively elects to be treated as a U.S. person.
4. *Substantial Presence* – A person is a U.S. person if he is physically present in the U.S. for (i) 31 days or more in the current calendar year; and (ii) 183 days or more under the 3-year look back test based on a weighted formula. The formula includes all the days of the current year, 1/3 of the days of the preceding year and 1/6 of the days in the second preceding year. For example, if an individual spends 135 days in the U.S. in each of the current and preceding 2 years, then he is a U.S. resident for income tax purposes under the substantial presence test. This is because under the formula, his total number of days is 202.5 days, which exceeds 183 days: 135 days in 2013 (all the days in the current year), 45 days in 2012 (1/3 of the days in 2012) and 22.5 days in 2011 (1/6 of the days in 2011).

There are a few exceptions to the above substantial presence test, including: (1) certain Visa holders (e.g., a student in the U.S. on a “F” Visa); (2) if an individual were unable to leave the U.S. for medical reasons (does not include those who come to the U.S. to seek medical treatment); and (3) if an individual were in the U.S. for 182 days or less in the current year and can prove that he has a “closer connection” to another taxing jurisdiction. What is considered a “closer connection” is largely based on the individual’s facts and circumstances.

Of the four tests discussed above, the substantial presence test is the one that may most likely be overlooked by foreign individuals. Therefore, it is very important for foreign individuals to be mindful of the number of days spent in the U.S. and to keep a well-documented calendar.

#### What is U.S. Source Income for Income Tax Purposes?

If an individual is deemed to be a NRA, then he would be subject to U.S. income tax only on his U.S. source income. Generally, U.S. source income is divided into two categories:

1. Income effectively connected with a trade or business in the U.S. (e.g., income generated from a U.S. based business owned by a NRA).

2. Income *not* effectively connected with a trade or business in the U.S. (e.g., income generated from investments).

Income connected with a trade or business in the U.S. is taxed at the graduated income tax rates (currently a top Federal rate of 39.6%). Income that is *not* effectively connected with a trade or business is generally taxed at a 30% flat rate (or a lower rate if a treaty applies).

There are several important exceptions to the above rules. First, certain interest from “portfolio debt” would not be considered U.S. source income. This generally includes interest received from U.S. government and corporate bonds. Second, interest received from U.S. bank deposits are exempt. Third, capital gain from sales of U.S. stock is also exempt (note that capital gain from the sale of real property located in the U.S. is generally taxable but will depend on the nature of the real estate holdings). There is no exception for dividends from U.S. stocks and they are taxed at a 30% flat rate (or a lower rate if a treaty applies).

#### Estate and Gift Tax

##### Who is a NRA for Estate and Gift Tax Purposes?

For U.S. estate and gift tax purposes, “domicile” is key when it comes to categorizing a person as a U.S. person or NRA. If an individual is a U.S. person, then he would be subject to U.S. estate tax on his worldwide assets upon death and U.S. gift tax on his worldwide transfers during life. If an individual is a NRA, then he would be subject to U.S. estate and gift tax only on his U.S. situs property.

Domicile is defined as one of the following for U.S. estate and gift tax purposes:

1. *Citizenship* – Similar to the income tax rules, if an individual is a U.S. citizen, then he is a U.S. person. The actual length of time spent in the U.S. is irrelevant.
2. *Domicile* – An individual acquires domicile in a place by living there, for even a brief period of time, with the intention to remain in that place. Once domicile is established, it is presumed to continue until the individual establishes domicile in another jurisdiction. For example, if a foreign individual were to domicile in the U.S. and then later travel to another country and pass away there, that person’s domicile is still in the U.S. unless it can be proven that he established domicile in another country before his death.

Unlike the income tax rules, where the determination for a U.S. person has a bright-line *objective* test such as the number of days the individual is present in the U.S., the estate and gift tax determination depends on domicile, which is a *subjective* test based on the specific facts and circumstances. Below is a list of factors often considered for this purpose. This list is by no means exhaustive and it is important to note that no single factor is dispositive.

Factors when considering domicile:

- Relative time spent in the U.S. and other jurisdictions
- Location, size and cost of residences
- Location of membership to social clubs, religious organizations or other membership-type establishments
- Location of business, bank accounts, personal property, etc.
- Location of family members and close friends
- Individual statements where the individual declares to be the domicile (e.g., declaration in the will or trust instrument, application for bank accounts or visa)

**What is U.S. Situs Property for Estate and Gift Tax Purposes?**

If an individual is deemed to be a NRA, then he would be subject to U.S. estate and gift tax only on his U.S. situs property. What is considered U.S. situs property varies depending on the estate or gift tax regime. Below is a chart summarizing certain assets that are commonly held by a NRA.

| Property Type   | Estate Tax           |    | Gift Tax |    |
|---|----------------------|----|----------|----|
|   | Yes                  | No | Yes      | No |
| Tangible Personal Property in U.S. (e.g., artwork, jewelry) | X                    |    | X        |    |
| Currency in U.S. Safe Deposit Box                           | X                    |    | X        |    |
| Cash Deposits in a U.S. Bank                                |                      | X  | X        |    |
| U.S. Real Estate  | X                    |    | X        |    |
| Non-U.S. Real Estate  |                      | X  |          | X  |
| U.S. Stocks   | X                    |    |          | X  |
| Non-U.S. Stocks   |                      | X  |          | X  |
| U.S. Government and Corporate Bonds                         |                      | X  |          | X  |
| U.S. States/Muni Bonds                                      | X                    |    |          | X  |
| U.S. Partnership/LLC Interest                               | Depends <sup>3</sup> |    |          | X  |
| Retirement Plans  |                      | X  | N/A      |    |
| Life Insurance Cash Value                                   | X                    |    |          | X  |
| Life Insurance Death Benefits                               |                      | X  |          | X  |

**What may be some Planning Strategies to Mitigate the U.S. Estate and Gift Tax?**

For individuals with U.S. situs assets that are subject to the U.S. estate or gift tax, proper planning is critical in order to mitigate any potential tax liability. For example, a NRA may use a foreign corporation to hold his U.S. situs assets. Because shares in a foreign corporation are not considered U.S. situs property, they are also not subject to the U.S. estate tax. It is important to note, however, that the foreign corporation must be formed and operated such that the corporate entity is respected. In addition, there may be other tax and non-tax issues relating to such a structure in the NRA's home country. Tax and legal advisors should be consulted to ensure that the proposed structure is appropriate for the specific situation.

<sup>3</sup> It is uncertain whether U.S. partnership/LLC interest is includable for estate tax purposes. There is little authority on the issue and legal commentaries vary. A possible treatment would be based on the entity approach which provides that the partnership/LLC is analyzed at the entity level for situs purposes. Another possible treatment would be based on the look-through approach where each underlying asset of the partnership/LLC is evaluated for situs purposes.

### What are the Rules Relating to Exemptions and Exclusions for a NRA?

In addition to the above mentioned rules, there are other important distinctions between the tax treatment of a U.S. person and a NRA. Below is a chart summarizing the key differences for 2015.

|   | U.S. Person                                     | NRA  |
|---|---|--|
| Estate Tax Exemption Amount   | \$5,430,000 per person <sup>4</sup>             | \$60,000 per person  |
| Top Estate and Gift Tax Rate  | 40%   | 40%  |
| Lifetime Gift Tax Exemption Amount                                      | \$5,430,000 per person <sup>4</sup>             | \$0  |
| Annual Gift Tax Exclusion Amount  | \$14,000 per donee <sup>4</sup>                 | \$14,000 per donee <sup>4</sup>  |
| Gift Splitting Between Spouses  | Yes, if both spouses are U.S. people            | No   |
| Marital Deduction for Lifetime Gifts                                    | Unlimited if recipient spouse is a U.S. citizen | \$147,000 per year if recipient spouse is a non-U.S. citizen <sup>4</sup>                            |
| Marital Deduction for Testamentary Bequests                             | Unlimited if recipient spouse is a U.S. citizen | \$0, if recipient spouse is a non-U.S. citizen, unless assets are held in a Qualified Domestic Trust |
| Gift Tax Exclusion for Direct Payment of Medical and Education Expenses | Yes   | Yes  |
| Portability <sup>5</sup>  | Yes   | No   |

### Summary

Taxation plays a significant role for foreign individuals making U.S. investments. The U.S. tax rules are complex and vary among the income, estate and gift tax regimes. Furthermore, the general rules may change if there is an applicable treaty. However, opportunities exist and with the proper planning, U.S. investments will continue to be an attractive option for foreign individuals.

<sup>4</sup> Indexed for inflation.

<sup>5</sup> Portability provides a surviving spouse with the opportunity to use the last deceased spouse's unused estate tax exemption amount.

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