Estate and gift tax situs of assets – specific examples

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The first part of this series summarised basic US gift and estate tax situs rules and how the gift and estate taxes are applied to individuals who are not US citizens and are not domiciled in the United States for transfer tax purposes (non-resident aliens) (for further details please see "Estate and gift tax situs of assets – basic rules"). This article provides examples of certain specific assets that are often part of a non-resident alien's investment portfolio.

Stock of US corporations

Stock of any corporation incorporated in any state in the United States(1) is considered to have a US situs for estate tax purposes. Thus, if a mutual fund is organised as a US corporation, it is situated in the United States even if it holds non-US stocks.

American depository receipts

Stock of any corporation incorporated outside the United States is not deemed situated in the United States. In Private Letter Ruling 200243031, the Internal Revenue Service (IRS) clarified that American depository receipts (ADRs), which represent ownership rights in underlying shares of a foreign corporation, are not US situs for estate tax purposes. ADRs are certificates evidencing ownership in American depository shares of a specified foreign corporation that are on deposit with a bank in the foreign corporation's home country. ADRs do not constitute shares of stock issued by a domestic corporation and, therefore, are not property within the United States.

Tax code definition of US domestic corporation

Stock owned by a non-resident alien is deemed to be property within the United States for estate tax purposes only if issued by a US domestic corporation. The Internal Revenue Code specifically provides that the term 'domestic' when applied to a corporation means created or organised in the United States or under the laws of the United States or of any state. The term 'United States' when used in a geographical sense includes only the states and the District of Columbia. This means that corporations incorporated in the US Virgin Islands or Puerto Rico (two US territories) are not domestic corporations for estate tax purposes. Nevertheless, that same US Virgin Islands or Puerto Rican corporation will be considered a US investor under Security and Exchange Commission rules, which define the term 'state' to mean any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands or any other possession of the United States.

Estate tax blocker corporation

Since shares of a non-US corporation do not have a situs in the United States for estate tax purposes, a properly structured non-US corporation can hold US situs assets and serve as a blocker from US estate tax (for further details please see "Tax planning for US equities owned in a non-US trust structure") .

Debt obligations

Debt obligations of a US person (including a corporation organised in a state in the United States), the federal

government or a US state are deemed situated in the United States for estate tax purposes. However, there are broad exceptions to this rule resulting in most debt obligations held by non-US residents being deemed situated outside the United States.

Most corporate debt held by non-resident aliens qualifies for the 'portfolio interest exemption', meaning that interest on the debt is not subject to US withholding tax or income tax when received by the non-resident alien. The Internal Revenue Code specifically provides that any debt obligation qualifying for the portfolio interest exemption is deemed to be situated outside the United States for estate tax purposes. Thus, if a non-resident alien owns debt issued in the United States and does not pay tax on the interest (because it is not subject to US withholding tax), the debt instrument is not subject to US estate tax on the investor's death. Certain debt is outside the scope of the portfolio interest exemption, including debt with a maturity of 183 days or less which does not pay interest.

The Internal Revenue Code also provides that short-term notes are deemed foreign situs as long as they are not effectively connected with the conduct of a US trade or business. As a result of this provision, Treasury bills, which mature in one year or less, are exempt from US estate tax even if they do not qualify for the portfolio interest exemption.

While tax-exempt state and local bonds that do not pay interest are also outside the scope of the portfolio interest exemption, they are not specifically excluded from US estate tax. Thus, state and local short-term obligations would be subject to US estate tax.

Bank deposits

Bank deposits with 'persons carrying on a banking business' are not considered situated in the United States for US estate tax purposes unless the deposit is considered to be effectively connected with a US trade or business operated by a non-resident alien. 'Persons carrying on a banking business' include commercial banks, as well as federal and state-chartered savings and loan organisations and credit unions, as long as the funds can be withdrawn on demand.

Bank deposits in an offshore branch of a commercial US bank are not considered situated in the United States even if the deposit is effectively connected with a US trade or business.

Cash deposits held in a brokerage (ie, investment) account or in a money market account, which by their nature are not deposits in a US commercial bank, are considered to have a situs in the United States and will be subject to US estate tax.

Life insurance

Proceeds paid on life insurance issued in the United States upon the death of the insured is not US-situs property for estate tax purposes. However, if at death a non-resident alien owns a life insurance policy issued in the United States that insures the life of another person, such policy is a US-situs asset, although only its current cash surrender value is subject to US estate tax.

Partnerships

A business entity formed under the laws of a state in the United States with at least two members, which is not a corporation under state law, is classified as a partnership for tax purposes. Thus, general partnerships, limited partnerships and limited liability companies (with at least two members) organised in a state in the United States are classified as partnerships. These entities may file an entity classification election (commonly knowns as a 'check-the-box election') with the Internal Revenue Service and elect to instead be treated as a corporation for tax purposes. If such an election is made, the entity is classified as a US domestic corporation for US tax purposes, including estate and gift tax purposes.

A non-US entity is classified as a partnership for US tax purposes only if:

- there are at least two members; and
- at least one member has unlimited liability.

A non-US entity classified as a partnership may make a check-the-box election to be treated as a corporation for US tax purposes. Non-US entities where all members have limited liability are automatically classified as foreign corporations. These entities may make an election to be treated as a partnership, provided that such entity is not a *per se* corporation (which cannot elect to be treated as a partnership).**(2)**

The Internal Revenue Code and the Treasury Regulations do not specifically address the estate and gift tax treatment of entities classified as partnerships for US tax purposes. Partnerships could be treated as intangible

property. Partnerships could also be viewed as an aggregate of assets, in which case each partner would own a portion of the aggregated assets owned by the partnership.

Under the aggregate theory, if a non-resident alien owned an interest in a non-US partnership that held US-situs assets, then at death the decedent would be subject to US estate tax on their share of the US assets. There is limited authority on this issue.

One case found that when a partnership terminates on the death of the partner (eg, a two-member partnership), each partner is considered to own the underlying assets (see *Sanchez v Bowers*, 70 F2d 715 (2nd Cir 1934)). Based on this case, it is possible to take the position that if a partnership does not terminate at the death of the partner, the partnership is an intangible asset. If taking the position that the partnership is an intangible asset, it is important to determine where the partnership is located. The determination could include the following factors:

- where the partnership was formed;
- where the partnership's business is conducted;
- the location of the partnership's books and records; and
- the domicile of the partners.

Due to the uncertainty of the treatment of foreign partnerships, it is typically not recommended that a non-US partnership be used as a 'blocker' entity to hold US-situs assets (for further details on estate tax blockers please see "Estate and gift tax situs – basic rules"). If a non-US entity is classified as a partnership and holds US-situs assets, it is recommended that an election be made to treat the entity as a corporation so that, for US tax purposes, the entity is treated as a non-US corporation. Alternatively, it is generally advised that a non-US corporation be used to hold any interests in an entity organised in the United States and classified as a partnership.

In some cases, a non-resident alien prefers to hold US-situs assets in a non-US partnership despite the risk that the non-US partnership is not an effective blocker (eg, if the blocker holds US real estate, an entity classified as a partnership is subject to tax at preferential long-term capital gains on the sale of the property while a corporation is subject to tax at corporate tax rates. Today the rates are almost identical (21% for corporate tax and 20% for long-term capital gains), but historically the corporate tax rate has been 35%). To minimise the risk of the non-US partnership entity being treated as an 'aggregate' of its assets, it is instead recommended that the non-resident alien set up a non-US corporation (with at least two members) and file a check-the-box election for the entity to be taxed as a partnership. This way, the owners have the rights and liabilities of a shareholder under local law rather than the rights and liabilities of a partner. While there is still a risk of estate tax inclusion, the owners would benefit from any lower tax rate for partnerships in the example above.

There is also a risk that a gift of a partnership interest owning US real estate or tangible property located in the United States would be subject to gift tax since the partnership might not be an intangible asset for gift tax purposes. In fact, the question of whether a partnership is an intangible asset for gift tax purposes for a non-resident is on the list of areas on which the Internal Revenue Service will not rule (see *Internal Revenue Bulletin* 2020-01).

Single-member LLCs

A single-member limited liability company (LLC) organised in a state in the United States is automatically disregarded for tax purposes unless a check-the-box election is made to treat the LLC as a corporation. As long as no election was made, only US-situs assets owned by the disregarded LLC would be subject to US estate tax. Non-US-situs assets owned by the disregarded LLC would not be subject to US estate tax.

A single-member LLC organised outside the United States is automatically treated as a corporation for US tax purposes, unless an election is made to treat the company as a disregarded entity. As long as no check-the-box election was made, the single-member LLC, which is treated as a non-US corporation, can serve as a blocker corporation and own US-situs assets without estate tax exposure.

Transfers with retained interests

If a non-resident alien transfers assets which have a situs in the United States for estate tax purposes to a trust or company over which the individual retains control, the company or trust is considered to have a situs in the United States under Section 2104(b) of the Internal Revenue Code. The company or trust continues to have a US situs even if the contributed US assets have been exchanged for non-US-situs assets prior to the individual's death. As such, care needs to be taken in making transfers of US corporation stock to a company or trust even though the gift of the intangible property is not itself subject to gift tax.

For example, to avoid application of this provision, the assets can be sold to the trust or company or the individual should take care not to retain 'control' over the trust or company.

Interests in trusts

If a trust owns US-situs assets, in certain cases, the grantor of the trust (ie, the person who funds the trust) or the beneficiaries could be subject to estate tax on their death to the extent of their interest in the trust over the US-situs assets.

If the grantor has certain powers over the trust, including the following, any US-situs assets held directly by the trust are included in the grantor's estate for US estate tax purposes:

- the power to revoke the trust;
- the power to amend or otherwise change the trust;
- the power to remove the trustee and replace the trustee with a successor who is not independent; or
- the power to make distributions from the trust (it is generally advised that the grantor not serve as the trustee).

If a beneficiary has certain powers over the trust, including the following, any US-situs assets held directly by the trust will be included in the beneficiary's estate at death:

- a general power of appointment over the trust, which is the power to appoint property to the beneficiary or the beneficiary's estate, or to the creditors of the beneficiary or their estate; or
- the power to make discretionary distributions to themselves or their minor children (as to whom the beneficiary has a legal obligation to support).

A properly structured trust, where the grantor and beneficiaries do not have the powers listed above over the trust, is an effective US estate tax blocker. The trust may be located in or outside the United States and serve as an estate tax blocker. The income taxation of the trust and any US beneficiaries will be different depending on whether the trust is classified as a domestic trust or a foreign trust for US income tax purposes (for further details on US taxation of trusts please see "Overview (January 2020)".

Comment

Advisers to families with international investments must remember that determining situs for US estate and gift tax purposes can be tricky. A closer look at specific holdings can further clarify US tax situs and avoid uncertainty at death. For non-resident aliens, a significantly broader list of property is subject to US estate tax, as compared with gift tax (for further details please see "Estate and gift tax situs of assets – basic rules"). In addition to the general US tax situs rules discussed in this two-part series, advisers must also remember that some treaties modify the situs rules. With careful planning, non-US families can take advantage of US investment opportunities and avoid US gift or estate tax.

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Endnotes

(1) In this article, any discussion of a rule applicable to entities formed or incorporated in "any state in the United States" or to the government of a state in the United States also applies to entities formed or incorporated in, or the government of, Washington DC (although it is not a state).

(2) A '*per se* corporation' is a non-US corporation that, under the US entity classification regulations, is automatically deemed to be a corporation and is ineligible to elect US federal income tax treatment as anything else through the check-the-box election.

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