International Law Office

PRIVATE CLIENT & OFFSHORE SERVICES - USA

Estate and gift tax situs of assets – basic rules

03 December 2020 | Contributed by Kozusko Harris Duncan

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Introduction

Individuals who are not US citizens and are not domiciled in the United States for transfer tax purposes (non-resident aliens) are subject to US gift tax only on gifts of real property and tangible personal property located in the United States. On death, a significantly broader list of property is subject to US estate tax. Advisers to families with international investments should familiarise themselves with the basic US situs rules and options for owning US-situs assets that may shelter them from gift and estate tax. Then, a closer look at specific holdings can further clarify US tax situs and avoid uncertainty at death.

Gift tax credits, exclusions and deductions limited for non-resident aliens

US gift tax is levied at a top rate of 40% on taxable gifts in excess of an annual exclusion amount ($15,000 for tax years 2020 and 2021). All donors are entitled to the annual exclusion amount, but non-resident aliens are not eligible to double this amount using the election to split gifts with a spouse, even with a US citizen spouse. In addition, US citizens and residents are allowed a tax credit that currently shelters up to $11.58 million in 2020 and $11.7 million in 2021 (the 'exclusion amount') of lifetime gifts from tax. However, no such credit against gift tax is available to non-resident aliens.

Similarly, charitable and marital deductions are limited for non-resident alien donors. Charitable gifts of US property qualify for a gift tax deduction only if made to a domestic US charity. Gifts to a spouse qualify for a gift tax marital deduction only if the spouse is a US citizen. For both US and non-US donors, gifts to a spouse who is not a US citizen are limited to an annual exclusion amount of $157,000 in 2020 and 159,000 in 2021.

As a result of these limitations, US gift tax on taxable gifts made by non-resident aliens can be substantial (for further details on US gift tax please see "Overview (January 2020)").

Estate tax levied on US-situs assets in excess of $60,000

US estate tax is levied at the same rates as gift tax, topping out at 40% on taxable estates over $1 million. The estate of a decedent who was domiciled in the United States at death is entitled to a tax credit that will shelter amounts up to that decedent's remaining exclusion amount (as noted above, currently $11.58 million). However, this credit is not available to the estate of a non-resident alien decedent. Instead, the credit available to a non-resident alien's estate shelters only $60,000 from estate tax. That exclusion amount is not indexed for inflation and has not changed in many years. The charitable deduction and marital deduction are also limited for estates of non-resident aliens who died owning US-situs property.

For decedents who qualify as residents of certain countries that have an estate tax treaty with the United States,(1) the impact of US estate tax may be reduced. However, treaty protection does not mean that the assets of a non-resident alien will actually pass free of tax, since the estate is likely to be subject to estate or inheritance tax by the home country.

Potential US estate tax should always be considered when investing in US-situs assets. As discussed below, a non-resident alien may be able to avoid estate tax by investing in US property through an offshore holding company or mutual fund (for further details on US estate tax and the difference between income tax residency

and transfer tax domicile, please see "Overview (January 2020)").

US real property is always US situs

Gift tax
Real property located in the United States has a US situs for US gift tax purposes. Thus, a non-resident alien's lifetime gift of US real property is subject to US gift tax. In addition to land and houses, condominium apartments are also considered real property and subject to US gift tax. On the other hand, ownership in a cooperative apartment building (common in New York City) is not considered real property but, instead, is an interest in a corporation which owns real estate. As discussed below, intangible interests in a corporation may be gifted without being subject to US gift tax.

Estate tax
Real property located in the United States also has a US situs for estate tax purposes. Thus, any real estate – including personal residences, commercial buildings and land – held directly by a non-resident alien at death is subject to US estate tax. As with gift tax, an interest in a cooperative apartment building is not considered an interest in real property because it is an interest in the corporation which owns the building. However, as described below, for estate tax purposes, corporations organised in the United States are US-situs intangible property subject to US estate tax.

Tangible personal property physically in the United States is US situs with some exceptions

Gift tax
Tangible personal property physically located in the United States has a US situs for US gift tax purposes. As such, a lifetime gift by a non-resident alien of US-situated tangible property is subject to US gift tax.

A gift of physical currency which takes place in the United States is likely considered a gift of US-situs tangible personal property. Based on this fact, there is some debate as to whether a wire transfer of cash into the donee's US bank account is equivalent to a gift of tangible cash or is a gift of an intangible bank deposit, which is not subject to gift tax as described below. Due to this uncertainty, when making a cash gift to a US taxpayer, the most conservative approach is to make the wire transfer from the donor's account located outside the United States to the donee's account also located outside the United States. Alternatively, the donor might consider gifting US treasury bonds, which do not have US situs for either gift or estate tax purposes. That said, a wire transfer of cash from a non-US account into a US account should be considered a gift of intangible property from the non-resident alien (although there is no Internal Revenue Service (IRS) guidance on this), which may require the US donee to file Form 3520 (for more details please see "Preparing US tax and information returns: Forms 3520 and 3520-A").

Estate tax
Tangible personal property physically located in the United States on the owner's death is also considered to have a situs in the United States for estate tax purposes. Tangible property includes art, jewellery and furniture. Physical currency located in the United States, whether US dollars or another currency, is generally considered to be tangible personal property. US-situs tangible personal property is subject to US estate tax to the extent that its value exceeds the $60,000 exemption amount.

There is an exception for certain loaned artwork located in the United States at the time of death. Artwork owned by a non-resident decedent is not considered to be property within the United States for estate tax purposes if it is:

- imported into the United States solely for exhibition purposes;
- loaned for those purposes to a public gallery or museum, no part of the net earnings of which inures to the benefit of any private shareholder or individual; and
- on exhibition, or en route to or from an exhibition, in such a public gallery or museum at the time of the owner's death.

Intangible property is US situs for estate tax but not gift tax

Gift tax
Intangible property such as copyrights, patents, contract rights, stock and debt obligations are not considered US situs for gift tax purposes. Thus, a non-resident alien may make a lifetime gift of US stock and not be subject to US gift tax.

Estate tax
On the other hand, for estate tax purposes, intangible property located in the United States is generally considered to be situated in the United States and subject to estate tax. Intangibles – including copyrights,

patents and contract rights – are generally considered to be situated in the United States if:

- the written evidence of this property is not treated as being the property itself; and
- the property is issued by or enforceable against a resident of the United States, a domestic corporation or a domestic government unit.

For example, an amount owed by a US person under a contract is clearly US-situs property. The IRS provides no further guidance on the application to assets such as intellectual property and licences which may be enforceable against a resident of the United States but issued outside the United States.

Estate tax 'blocker' corporation

Knowing the basic estate and gift tax rules allows non-resident aliens who want to invest in US-situs assets to avoid or prepare for any tax. For example, the non-resident alien might consider making lifetime gifts of US corporation stock to children since this will not trigger US gift tax. US children receiving such stock must comply with any US reporting requirements and know their transfer basis in the stock (for further details please see "Overview (January 2020)").

In addition, since US-situs property for estate tax purposes includes stock in a US company, but not stock in a non-US company, the non-resident alien may be able to avoid estate tax by investing in US property through an offshore holding company or mutual fund. The US estate tax rules generally do not look through these offshore companies, except in special circumstances and provided that the corporate form is respected by the shareholder. At death, no US estate tax is due because what the non-resident alien owned was the stock of the non-US corporation, which is not a US-situs asset. Thus, the non-US corporation is known as an 'estate tax blocker' (for further details and trust planning opportunities please see "Tax planning for US equities owned in a non-US trust structure").

Careful consideration should be given to investing in US real property. As discussed above, the estate of a non-resident alien is subject to US estate tax on the value of any interest in US real property owned at death. In addition, during life, non-resident aliens who own a US real property interest outright are subject to US gift tax if they give the property away. If the non-resident alien sells the US real property interest instead, they will be subject to withholding tax under the Foreign Investment in Real Property Tax Act 1980 (commonly known as 'FIRPTA') upon disposition of the property (for further details please see "Disposition of US Real Property Interests by Foreign Persons"). Rather than outright ownership, non-resident aliens may be able to utilise corporate blocker structures to invest in US real property.

Comment

For non-resident aliens, it is important to remember that a significantly broader list of property is subject to US estate tax, as compared with gift tax. The basic descriptions of real and intangible property above will not easily address all possible US investment options. Determining situs can be tricky. A closer look at specific holdings can further clarify US tax situs and avoid uncertainty at death. For example, cash in a US bank deposit account is excluded from being a US-situs asset for estate tax purposes, but non-bank deposits, such as cash accounts with US brokerage firms, are considered US-situs property. 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) The United States has estate tax treaties with Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, South Africa, Switzerland and the United Kingdom.