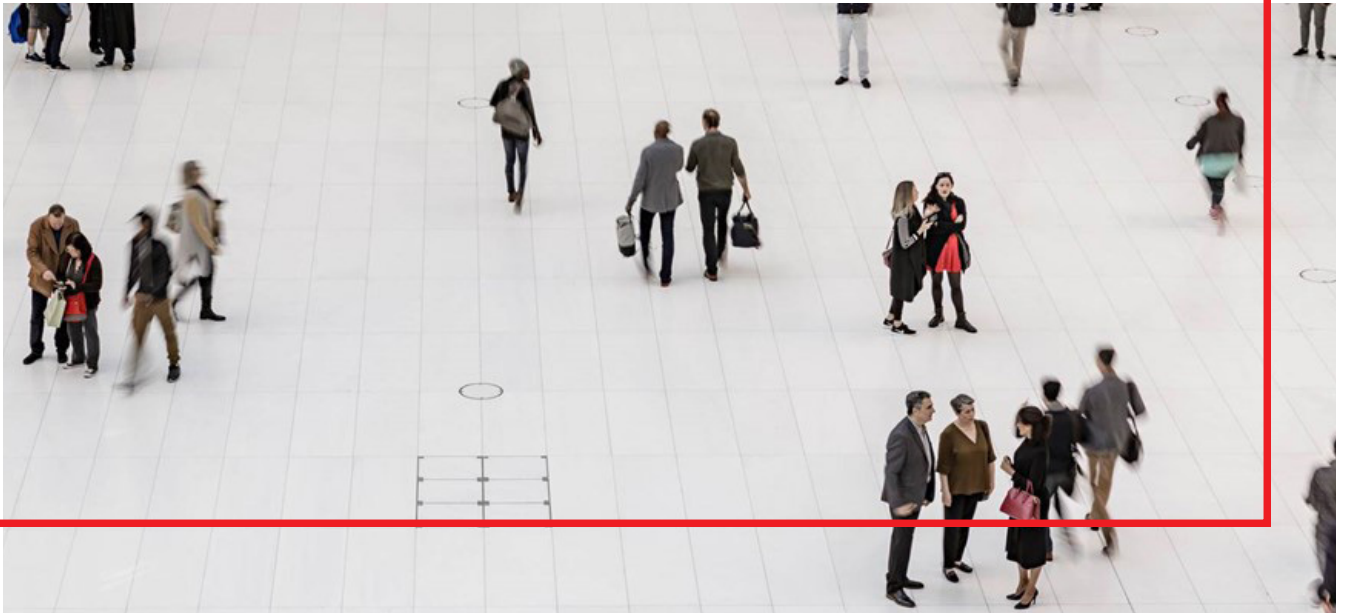


# Planning for non-US citizens



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It is not uncommon for a client or a client's spouse to be a permanent resident of the US but not a US citizen (i.e., a green card holder). A green card holder domiciled in the US is subject to US estate and gift taxes to the same extent as a US citizen.<sup>1</sup> That is, in most instances a green card holder is subject to US estate and gift tax on the gift or bequest of property located anywhere in the world. Unfortunately, most transfers to a non-US citizen spouse fail to qualify for what is known as the "marital deduction" for estate or gift tax purposes (see Sections 2056(d)(1) and 2523(i) of the Internal Revenue Code). This is not always understood by couples to whom it may apply and can result in tax consequences that are both surprising and unfortunate.

## Transfers at death and the qualified domestic trust

The federal estate tax marital deduction allows an individual at the time of their passing to leave, outright or in certain types of trusts, an unlimited amount of wealth to a spouse who is a US citizen without immediate estate tax.<sup>2</sup> Most estate plans for married couples are designed to defer estate tax at the death of the first spouse, thereby preserving the maximum amount of property for the benefit of the surviving spouse during their lifetime.

For example, a typical estate plan might provide that, at the death of the first spouse, the maximum amount that can pass estate tax free by reason of the deceased spouse's remaining federal lifetime estate and gift tax exemption amount (\$12.06 million for 2022) passes to a credit shelter trust for the benefit of the surviving spouse and descendants, and that any excess over the deceased spouse's remaining exemption amount passes outright to the surviving spouse. An outright bequest to a US citizen spouse qualifies for the unlimited federal marital deduction, so this plan (a) takes maximum advantage of the first to die's estate tax exemption (by leaving the exemption amount to a trust that will not be subject to estate tax at the surviving spouse's subsequent death) and

(b) postpones all federal estate tax until the death of the surviving spouse.

However, an outright bequest to a non-US citizen spouse does not qualify for the unlimited federal estate and gift tax marital deduction, so the above plan would require the payment of estate taxes at the first spouse's death. There is, however, one way for assets passing to a non-US citizen spouse to qualify for the unlimited estate tax marital deduction: those assets may pass to a qualified domestic trust (QDOT).<sup>3</sup> A QDOT is a trust created for the benefit of a non-US citizen spouse that meets certain requirements to defer estate taxes that may otherwise be due at the first death. To qualify as a QDOT, a trust must

- Pay all income to the surviving spouse for life on at least an annual basis.<sup>4</sup>
- Not permit principal distributions to anyone other than the surviving spouse during the surviving spouse's life.<sup>5</sup> Importantly, all principal distributions to the surviving spouse (except in cases of hardship<sup>6</sup>) will be subject to estate tax at the time of distribution at a 40% rate.<sup>7</sup> In addition, any principal in the trust on the death of the surviving spouse will be subject to a 40% estate tax.<sup>8</sup>
- Have at least one US trustee who has the power to withhold the estate tax due on a principal distribution.<sup>9</sup> A US trustee is a trustee who is a citizen of the US or a domestic corporation.<sup>10</sup> In addition, if the trust has an initial value of more than \$2 million (taking into account exclusions, including a certain amount of value attributable to a personal residence), the US trustee must be a bank,<sup>11</sup> or the trustee must post a bond<sup>12</sup> or letter of credit in an amount equal to 65% of the initial value of the trust assets.<sup>13</sup>

## Transfers during life and the annual exclusion

A QDOT cannot be used to shelter lifetime gifts to a non-US citizen spouse from the federal gift tax. As a result, most lifetime gifts to such a spouse will use up a portion

<sup>1</sup> IRC § 7701(b)(1)(A).

<sup>2</sup> IRC § 2056(a).

<sup>3</sup> IRC § 2056A.

<sup>4</sup> IRC § 2056(b)(7)(B)(ii)(I).

<sup>5</sup> IRC § 2056(b)(7)(B)(ii)(II).

<sup>6</sup> Treas. Reg. § 20.2056A-5(c)(1).

<sup>7</sup> Treas. Reg. § 20.2056A-5(b)(1) and IRC § 2001.

<sup>8</sup> Treas. Reg. § 20.2056A-5(b)(2).

<sup>9</sup> IRC § 2056A(a)(1).

<sup>10</sup> Id.

<sup>11</sup> Treas. Reg. § 20.2056A-2(d)(1)(i)(A).

<sup>12</sup> Treas. Reg. § 20.2056A-2(d)(1)(i)(B).

<sup>13</sup> Treas. Reg. § 20.2056A-2(d)(1)(i)(C).

of the donor spouse's federal lifetime estate and gift tax exemption amount (\$12.06 million for 2022) or, if the donor has already exhausted their lifetime exemption amount, result in a gift tax liability of 40%. There are, however, a couple of exceptions:

- There is a special gift tax annual exclusion for gifts made to a non-US citizen spouse. For 2022, an individual can make an outright gift of up to \$164,000 per year to a non-US citizen spouse without using any of the donor's federal lifetime gift tax exemption amount.<sup>14</sup> (This annual exclusion is indexed for inflation and is therefore expected to increase over time.)
- Certain transfers by one spouse into the joint names of the donor spouse and the non-US citizen spouse may not cause negative gift tax consequences. The gift tax consequences of the creation or termination of such a joint tenancy ownership depend in part on the type of property transferred:
  - If the property is real estate, the purchase thereof is not considered a gift for gift tax purposes if the property is acquired by the spouses as joint tenants with right of survivorship (JTWROS) or as tenants by the entirety, regardless of which spouse furnished the funds to acquire the property. If the joint tenancy is terminated during the non-US citizen spouse's lifetime (e.g., if the couple sells the real estate), it may be considered a gift to the non-US citizen spouse to the extent that the non-US citizen spouse receives a share of the proceeds greater than the share attributable to the amount the non-US citizen spouse contributed in order to acquire the property.<sup>15</sup>
  - If the property is tangible personal property (e.g., a boat), each spouse is deemed to own one-half of the property. As a result, if a spouse buys an item of tangible personal property and titles the property in their joint names, the spouse who bought the property is deemed to have made a taxable gift to the non-US citizen spouse equal to one-half of the value of the property.
  - If the property is a joint bank or brokerage account, the gift tax consequences depend on the nature of the account and state law of where the couple resides. If the spouse who creates the account has the legal right unilaterally to take back all of the property without the consent of the other spouse, there is no gift when the account is created. To the

extent that the other spouse withdraws any property from the account, there is a gift to the spouse who makes the withdrawal at the time of the withdrawal. If, by contrast, the spouse who creates the account does not have the right unilaterally to withdraw funds from the account, the account is deemed to be owned one-half by each spouse. Accordingly, if a spouse establishes such a bank or brokerage account in the spouses' joint names, the spouse establishing the account makes a gift to the non-US citizen spouse of one-half of the value of the account.

## Planning implications

A couple where one or both spouses are non-citizens should strongly consider an estate plan that establishes a QDOT for the surviving spouse. The QDOT would hold any assets in excess of the deceased spouse's federal estate tax exemption amount (\$12.06 million for 2022) and ensure that federal estate tax need not be paid at the death of the first spouse.

A married couple that includes a non-US citizen should also bear in mind that gifts to the non-US citizen spouse do not qualify for the federal unlimited marital deduction. Most outright gifts in excess of the gift tax spousal annual exclusion amount (\$164,000 for 2022) will use up a portion of the donor spouse's lifetime gift tax exemption and, to the extent they exceed that exemption, result in a gift tax liability. In particular, the couple should be aware that placing assets in joint names may result in an unintended taxable gift.

To ensure that a couple is in a position to take maximum advantage of their lifetime estate, gift and generation-skipping transfer tax exemption amounts (regardless of which spouse dies first), it is often desirable for each spouse to have an amount as close as possible to (or in excess of) their remaining estate tax exemption amount in the spouse's separate name. If, as is common, one spouse owns less assets than the other, it may be necessary for the spouse with more assets to transfer assets to the spouse with less assets to build up the latter's estate. If the spouse with less property is not a US citizen, this process can be difficult. In such a situation, an optimal strategy may be to transfer an amount each year up to the spousal gift tax annual exclusion to the non-US citizen spouse (\$164,000 in 2022).

<sup>14</sup> IRC § 2523(i)(2).

<sup>15</sup> IRC § 2523(d).

## From the non-US person's perspective—Planning for a US citizen spouse and descendants

In the global economy in which we live, often with residences and family members located throughout the world, it is not uncommon for a non-US person<sup>16</sup> to be married to a US citizen or to have children and grandchildren who are US citizens. Tax and estate planning for US citizens presumes the payment of US income and transfer taxes and therefore seeks to minimize those taxes. Common techniques include investment selection, use of charitable and marital deductions, and estate planning structures designed to minimize the fair market value of gifted assets. On the other hand, planning for a non-US person starts with the premise that the non-US person need not be subject to US income or transfer taxes.

If a non-US person is the owner of the family's wealth and has US citizen family members, US family members can benefit from US income tax savings during the non-US family member's lifetime. They can further protect this wealth from erosion by US gift, estate, and generation-skipping transfer taxes following the non-US person's death through the use of a multigenerational trust.

## US income taxes and transfer taxes<sup>17</sup> that may apply to a non-US person

### Income tax

A non-US person is subject to US income tax on US-source income.<sup>18</sup> This tax is generally withheld at a 30% rate unless a different rate applies under an income tax treaty between the United States and the non-US person's country of residence. Examples of US-source income subject to taxation include dividends paid by US corporations, rent received with respect to US real property, and US royalty payments. A non-US person is subject to US capital gains tax on the sale of appreciated US real property. This tax is imposed at US capital gains

rates if owned in individual name or at the US corporate income tax rates (the top marginal corporate tax rate is 21%<sup>19</sup>) if the property is held through an offshore company.<sup>20</sup> However, interest paid on nearly all publicly traded bonds of US issuers (government and corporate), interest paid on bank account deposits, and capital gains arising from the sale of US securities are generally not considered US-source income, and therefore a non-US person is not subject to US income tax on this income or gain.<sup>21</sup> A non-US person is subject to US income tax on income or capital gains received in connection with a US trade or business at the same graduated rates as US citizens and resident aliens.<sup>22</sup> A non-US person is not subject to the 3.8% surtax on net investment income.<sup>23</sup>

### Gift tax

A non-US person is subject to US gift tax if the person makes a gift of a US-situs asset.<sup>24</sup> For US gift tax purposes, US situs assets include real property (e.g., houses and condominiums but not shares of a US co-operative corporation through which the person has an apartment), tangible personal property located in the United States, and, importantly, a gift of cash that takes place in the United States (for example, cash transferred from the non-US person's US bank account to a US donee's US bank account). However, stocks and bonds of a US company are not US-situs assets for US gift tax purposes and a non-US person may make gifts of unlimited amounts of these assets without incurring any US gift tax.<sup>25</sup> Note that the annual gift tax exclusion (\$16,000 a year to any individual for gifts made in 2022) may be applied to a gift of a present interest in a US-situs asset.

### Estate tax

A non-US person's estate is subject to US estate tax if the person dies owning US-situs assets with a value in excess of \$60,000, either in personal name or in a revocable trust.<sup>26</sup> For purposes of the US estate tax, real estate and

<sup>16</sup> As used in this whitepaper a non-US person is an individual who is not a US citizen or a US resident alien (a "green card holder"), who does not reside in the United States a sufficient number of days in any calendar year to be a US resident for US income tax purposes under the so-called substantial presence test under Section 7701(b)(3) of the Internal Revenue Code, and who is not a domiciliary of the United States for US estate and gift tax purposes.

<sup>17</sup> An estate tax treaty or gift tax treaty between the United States and the non-US person's country of residence may alter the tax consequences of the rules discussed in this whitepaper.

<sup>18</sup> IRC §§ 861(a) and 871(a).

<sup>19</sup> IRC § 11(b).

<sup>20</sup> IRC § 897(a)(1).

<sup>21</sup> Treas. Reg. § 1.871-7(a)(1).

<sup>22</sup> IRC § 871(b).

<sup>23</sup> IRC § 1411(e).

<sup>24</sup> IRC § 2511.

<sup>25</sup> Treas. Reg. § 25.2511-3.

<sup>26</sup> IRC § 2102(b).

tangible personal property located in the United States, as well as shares of stock of a US corporation and shares of a US co-operative corporation, are considered to be US-situs assets. US mutual funds organized in corporate form are also considered to be US-situs assets.

However, cash in a US bank account, publicly traded US corporate and government bonds, and ADRs (American Depositary Receipts) are not considered to be US-situs assets for estate tax purposes.<sup>27</sup> If a non-US person wishes to invest in US equities, the person (or the person's revocable trust) generally holds the equities through a non-US corporation, often referred to as a blocker corporation with the consequence that for US estate tax purposes the person does not own the US equities in the person's personal name at the person's death.

### **Generation-skipping transfer tax**

A gift or bequest by a non-US person to a skip person is not subject to the US generation-skipping transfer tax if the gift or bequest was not subject to US gift or estate tax.<sup>28</sup>

### **Lifetime gifts made by non-US persons to US citizens**

A non-US person may make an unlimited amount of lifetime gifts to US family members, or a US trust for their benefit, without payment of any US gift tax provided that the gifted property is not a US-situs asset. The US donee will pay no US tax on the principal amount of the asset received, but the US donee must report each gift to the IRS on Form 3520 to the extent that the gift from a single non-US person or related non-US persons exceeds \$100,000 in any calendar year. Failing to file Form 3520 can result in significant penalties.<sup>29</sup> Qualified medical or educational payments under Section 2503(e) of the Internal Revenue Code are not gifts for purposes of the gift tax and therefore are not required to be reported. Form 3520 is due when the US donee's federal income tax return is due.

### **Use of a foreign grantor trust during the non-US person's lifetime**

A foreign grantor trust<sup>30</sup> is a tax-efficient trust structure used in situations where the owner of the wealth is a non-US person wishing to leave assets for the benefit of his or her heirs who are US persons (that is, residents for US income tax purposes, US green card holders, or US citizens, including dual citizens, collectively "US beneficiaries"). Grantor trust status for US tax purposes is available for trusts created by a non-US person as grantor only if (i) the trust is revocable or (ii) the only amounts distributable from the trust during the lifetime of the grantor are amounts distributable to the grantor or to the grantor's spouse.<sup>31</sup>

A properly structured foreign grantor trust, where the non-US person, as grantor, is the owner of the trust's assets for US income tax purposes, exempts most income and capital gains earned by the trust (and any distributions thereof) from US federal income tax during the lifetime of the grantor, in addition to providing the non-tax benefits of an inter vivos trust structure.

Individual US beneficiaries of a foreign grantor trust are generally not taxed on income distributed to them from the trust since the trust assets are considered to be owned by the non-US person. The trustee of the trust must provide a Form 3520-A (Foreign Grantor Trust Beneficiary Statement) to the US beneficiary, who then must report such distribution (regardless of amount) on Form 3520.<sup>32</sup> The information disclosed to the IRS may be minimized if the trust distribution is made to the grantor instead of directly to the US beneficiary and then given by the grantor to the US beneficiary. In this instance, the gift is only required to be reported on Form 3520 if the aggregate value of gifts to the US beneficiary from the grantor (and related parties) during any calendar year exceeds \$100,000.

<sup>27</sup> IRC §§ 2104 and 2105.

<sup>28</sup> Treas. Reg. § 26.2663-2.

<sup>29</sup> IRC § 6039F(c)(1)(B). A penalty equal to 5% of the amount of the gifts applies for each month for which the failure to report continues (not to exceed a total of 25%). However, no penalty will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect. IRC § 6039F.

<sup>30</sup> See IRC §§ 7701(a)(30)(E) and 7701(a)(31)(B), which set forth how a trust is determined to be foreign trust for US tax purposes.

<sup>31</sup> IRC § 672(f).

<sup>32</sup> A penalty equal to the greater of \$10,000 or 35% of the gross amount distributed from the foreign trust applies if the donee fails to file Form 3520. However, no penalty will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect. IRC § 6677.

### US income taxation of a foreign non-grantor trust following the non-US person's death

Once the grantor of a foreign grantor trust dies, the trust becomes a foreign nongrantor trust and is a separate taxpayer for US federal income tax purposes. As a foreign (non-US) taxpayer, the trust will not pay US income tax on most income and capital gains earned. The US beneficiaries of a foreign non-grantor trust are not subject to US income tax until the year in which the current or accumulated income of the trust is distributed to them.

For US federal income tax purposes, US beneficiaries receiving distributions from a foreign nongrantor trust will be deemed to be receiving distributions of income as long as the trust has any current or accumulated income, irrespective of how the trustee characterizes such distributions (for example, as trust principal). Once a foreign nongrantor trust has fully distributed all of its current and accumulated income, subsequent distributions to US beneficiaries are received by them as tax-free distributions of trust principal.

When a foreign nongrantor trust distributes an amount less than the current year's income, the income is taxed to the beneficiaries through inclusion on their individual income tax return in the year in which the distribution was received. Realized long-term capital gains, which are included in income for this purpose, are taxed at the lower capital gains rate (currently 15% or 20%, and possibly also the 3.8% surtax imposed on net investment income depending on the level of the US beneficiary's annual income).

#### Accumulation distribution rules<sup>33</sup>

Because US beneficiaries of a foreign nongrantor trust generally only become subject to US federal income tax in the year in which a distribution is made to them, there may be a temptation for US beneficiaries to defer receipt of distributions from the trust. However, US tax law largely eliminates this potential income tax deferral benefit. The so-called "throwback" tax on accumulation distributions provides that when income accumulated by a foreign nongrantor trust in one year is distributed to a US beneficiary in a subsequent year:

- All undistributed capital gains realized by the trust in prior years constitute part of the trust's distributable net income and are carried out to the beneficiary, but

are taxed to the beneficiary at ordinary income tax rates (currently up to 37%) and possibly the 3.8% surtax imposed on net investment income;

- The income may be taxed at the US beneficiary's applicable income tax bracket for the years in which income was accumulated; and
- An interest charge is imposed on the income tax due by the US beneficiary on the accumulated income per annum from the date the income was originally earned by the trust; the interest charge is imposed at the rate applicable to underpayment of tax<sup>34</sup> and is compounded daily.

### Restructuring considerations following the non-US person's death

In view of the punitive US income taxation that can apply to accumulation distributions made to a US beneficiary from a foreign nongrantor trust, careful planning should be undertaken in determining whether the trust should be restructured following the non-US grantor's death. For example, it may be desirable to restructure the trust to become a US trust<sup>35</sup> for US federal tax purposes (by changing the governing law of the trust to a US state and appointing a US trustee who has authority to control all substantial decisions of the trust<sup>36</sup>) or to distribute the US beneficiaries' share of the trust assets to a US trust for their benefit. Although this would subject the trust or the beneficiaries to US income tax on annual income attributable to the distributed assets, it would prevent the penalizing interest charges on accumulation distributions from the foreign trust. On the other hand, if a US beneficiary is not a US citizen or green card holder and expects to leave the US in the future, or is a US citizen or green card holder who expects to expatriate, the trust for the benefit of that beneficiary could remain as a foreign nongrantor trust and, after the beneficiary leaves the United States, the trust could pay out distributions to the beneficiary without imposition of US income tax.

There are significant tax and non-tax benefits in leaving the trust in place or restructuring the trust, rather than terminating the trust and distributing all of the assets outright to the beneficiaries. Most significantly, non-US situs assets that continue to be held in the trust will not be subject to US estate tax at the death of a US beneficiary, currently imposed at rates of up to 40%, and the assets may be protected from a beneficiary's creditors.

<sup>33</sup> IRC §§ 665-668.

<sup>34</sup> IRC § 6621(a)(2).

<sup>35</sup> IRC § 7701(a)(30)(E).

<sup>36</sup> Id.



# About the Advanced Planning Group



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