Estate Taxation of a Non-Resident Alien

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Mr. Merric presents nationwide more than 30 times a year. He is honored to have spoken at:

- Regis Campfield's Notre Dame Tax and Estate Planning Institute (2007);
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- Chicago Bar Association (2004), (2007), and (2008).

Mark Merric has been fortunate to be one of the few authors that have had three, four, and five part series published in Estate Planning Magazine, Journal of Practical Estate Planning, and Leimberg LISI. He is also a co-author of the following three treatises:

- The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, Commerce Clearing House (CCH) treatise, first edition;
- Asset Protection Strategies, American Bar Association (two chapters); and
- Asset Protection Strategies Volume II, American Bar Association to be published Apr. 2005 (MM responsible for 1/5 of the text).

Table of Contents

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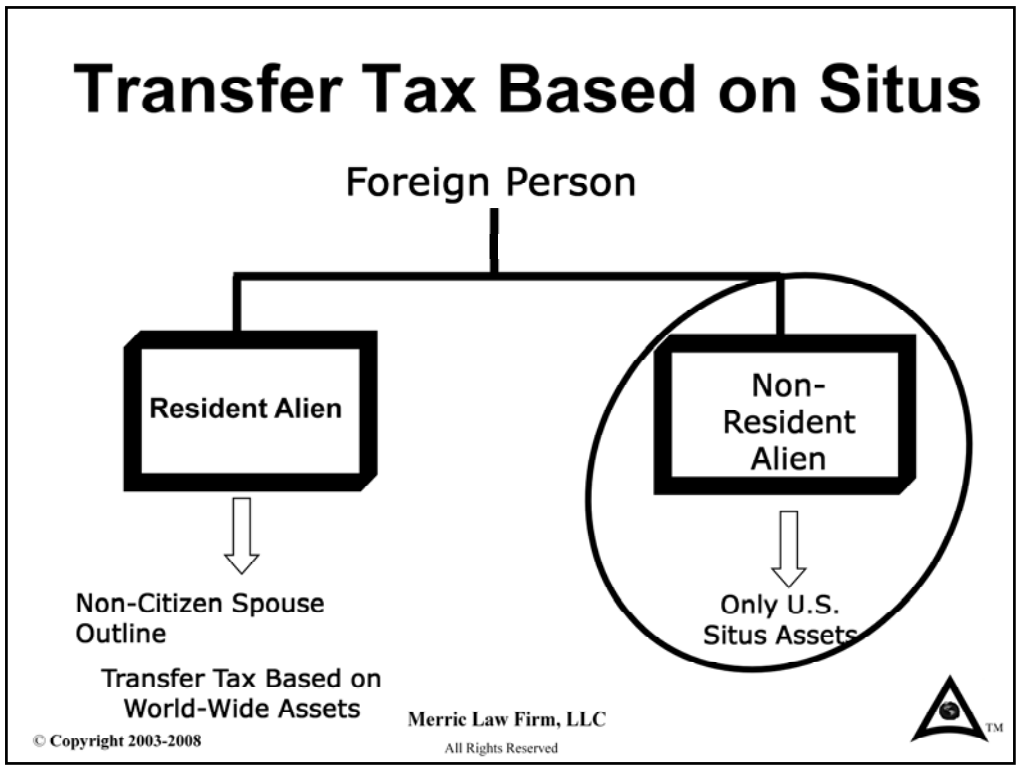
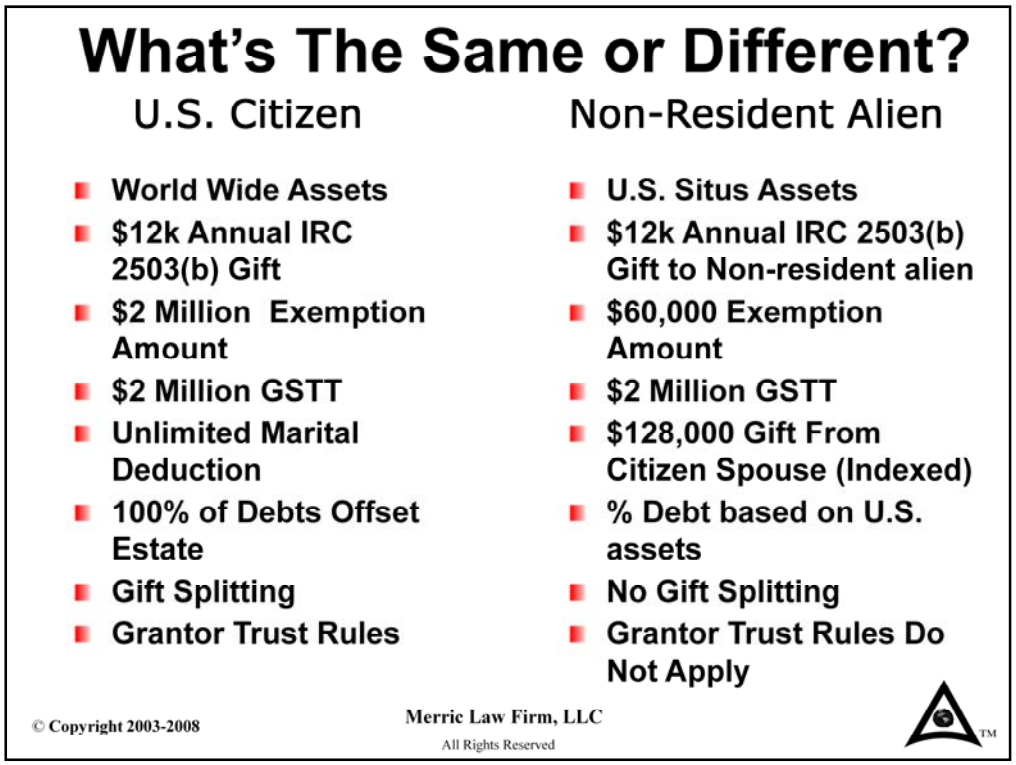


A. Transfer Based on Situs

While a resident alien pays transfer tax based on his or her world-wide assets, a non-resident alien is subject to transfer tax only on U.S. situs assets. As noted in the Non-Citizen Spouse outline, a foreign person's classification for U.S. transfer tax purposes is based on the foreign person's domicile. Domicile is an intent test, based on all the facts and circumstances. A nonresident alien includes persons living outside of the United States as well as individuals that are living in the United States who are not domiciled in the US.



B. Comparison of U.S. Citizen to a Non-Resident Alien

1. U.S. Situs Property and Exempt Amounts

Under IRC § 2103 only property situated in the US is taxed in the non-resident alien's estate, not worldwide assets. Unfortunately, only $60,000 in value can pass estate tax free. After the $60,000 amount is reached, the estate tax rate starts at 26 percent and goes up to 45 percent. As an example, a US citizen or resident domiciled in the US with an estate of $500,000 will be allowed to pass the entire estate tax free; but a nonresident alien not domiciled in the US with an estate of similar value will pay $142,800 in estate taxes. Conversely, a non-resident alien receives the same $2 million GSTT exemption. Treas. Reg §. 26.2263-2(d).

2. Unlimited Marital Deduction

A U.S. Citizen receives an unlimited marital deduction for gifts to a spouse. However, a U.S. person gifting to a non-resident alien is limited to $128,000 (indexed 2008) per year.

3. Debt Reduces Estate Only By a Percentage

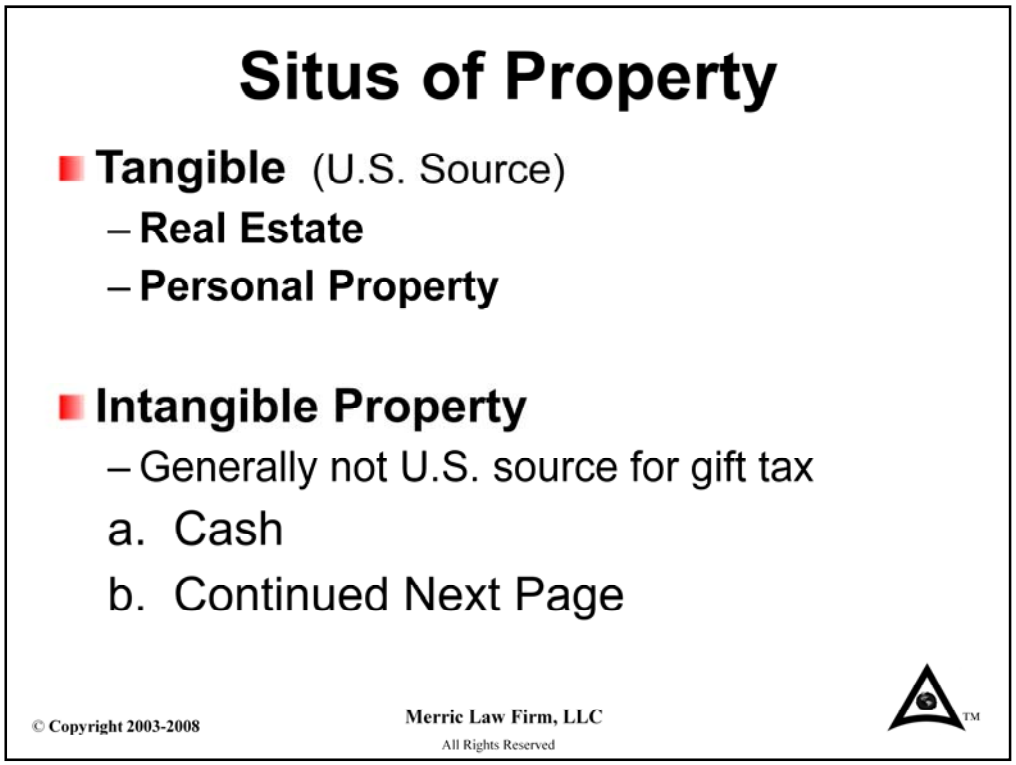
Regarding U.S. situs assets that are included in a non-resident alien's estate, only a percentage of any debt (including funeral expenses and expenses of administration) is deductible against the U.S. estate. The percentage is computed by taking U.S. situs property and dividing by world-wide property.

4. No Gift Splitting

Only a citizen and resident alien may elect gift splitting. IRC § 2513(a)(1). Therefore, this election is not available to a non-resident alien.

5 Grantor Trust Rules

Many estate planners prefer the IDIT as one of his or her sophisticated estate planning techniques. Unfortunately, as discussed in detail later, this estate planning technique is generally not available for non-resident aliens because of the difficulty in creating a grantor trust for the benefit of a foreign person.



C. Situs of Property

Since only property that is deemed to have a US situs is included in the non-resident alien's taxable estate, it is important to determine how property is classified for US situs purposes. The classification system is similar to the source of income tests used for income tax purposes. For gift tax purposes, there are two major classification categories: tangible and intangible property. For gift tax purposes, tangible property has a U.S. situs, but intangible property does not. Likewise, for estate tax purposes, tangible property and several types of intangible property have a U.S. situs.

1. Tangible Property (Real Estate and Personal)

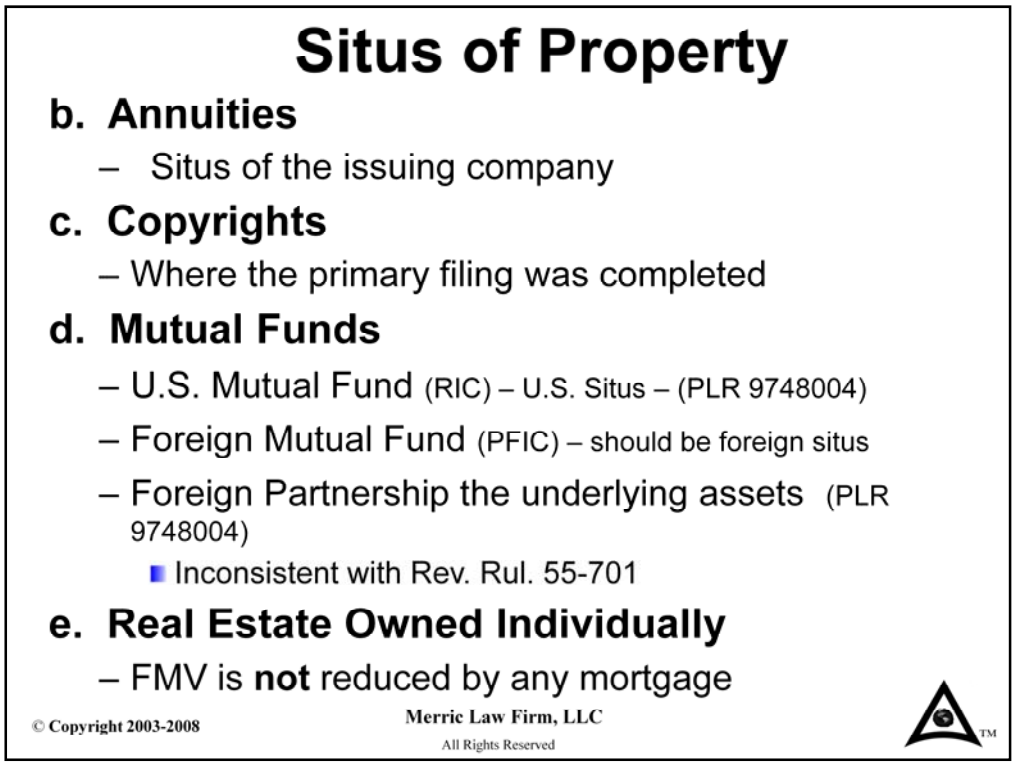
Real estate and tangible personal property located in the US is taxable for estate and gift tax purposes. Real estate and tangible personal property outside of the US is not US situs property. Tangible personal property includes: furniture, art, collectibles, and cash.

2. Intangible Property

Intangible property located in the US is generally taxable for estate tax purposes only. The situs of intangible property depends upon the exact nature of the property.

a.. Cash

Cash held in bank accounts of US banks is intangible, and it will be deemed to be US situs, only if it is connected with a US trade or business. Rev. Rul. 82-193; Rev. Rul. 54-623 and IRC § 2105(b)(1) bank deposit interest exception.



b. Annuities

Annuities regardless of the underlying investments are US situs property if issued by a US company.

c. Copyrights, Patents, and Trademarks

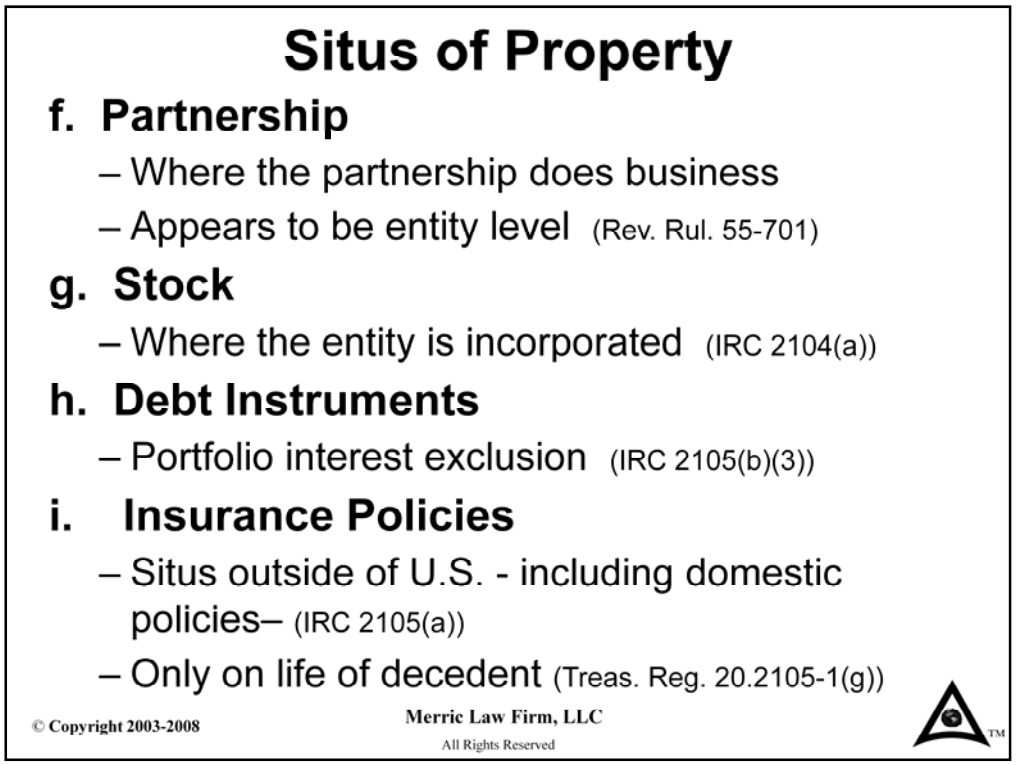
The Treasury Regulations hold that a copyright is foreign source if it is not enforceable against a U.S. person. This old definition in the Treasury Regulations is of little help because of all the international treaties on copyrights, patents, and trademarks. Some help is provided if the U.S. has an estate tax treaty with another country. Absent such treaty, some authors use the primary place of filing as a general rule to determine situs.

d. Mutual Funds

U.S. mutual funds are generally organized as a regulated investment company. A regulated investment company must be a domestic corporation. IRC § 2105(d) applies a look through rule. To the extent of bank deposits, debt obligations, or foreign stock, the mutual fund is treated as sited outside the U.S. On the other hand, an offshore mutual fund is also many times classified as a corporation (i.e. a PFIC). In this case, situs should be outside the U.S. On the other hand, if the offshore mutual fund is classified as a partnership, the Service may look to the underlying assets of the partnership. PLR 9748004. Looking to the underlying assets of the partnership seems inconsistent with Rev. Rul. 55-163 discussed on the following page.

e. Real Estate Owned Individually

U.S. real estate owned individually is U.S. Source property. Treas. Reg. § 20.2104-1(a)(1). Be careful to note however, the value of the real estate is not reduced by any mortgage it is subject to.



f.. *Partnership or LLC Interests*

Partnership and LLC interests are US situs if the entity is conducting a trade or business in the United States. In other words, the Service does not look through to the underlying assets of the partnership. Rather, the decision is at the entity level – where the partnership does business. Rev. Rul. 55-701.

g. Stock

Stock (equity) in a corporation organized in the United States is U.S. situs property. IRC § 2104(a); Treas. Reg. § 20.2104-1(a)(5).

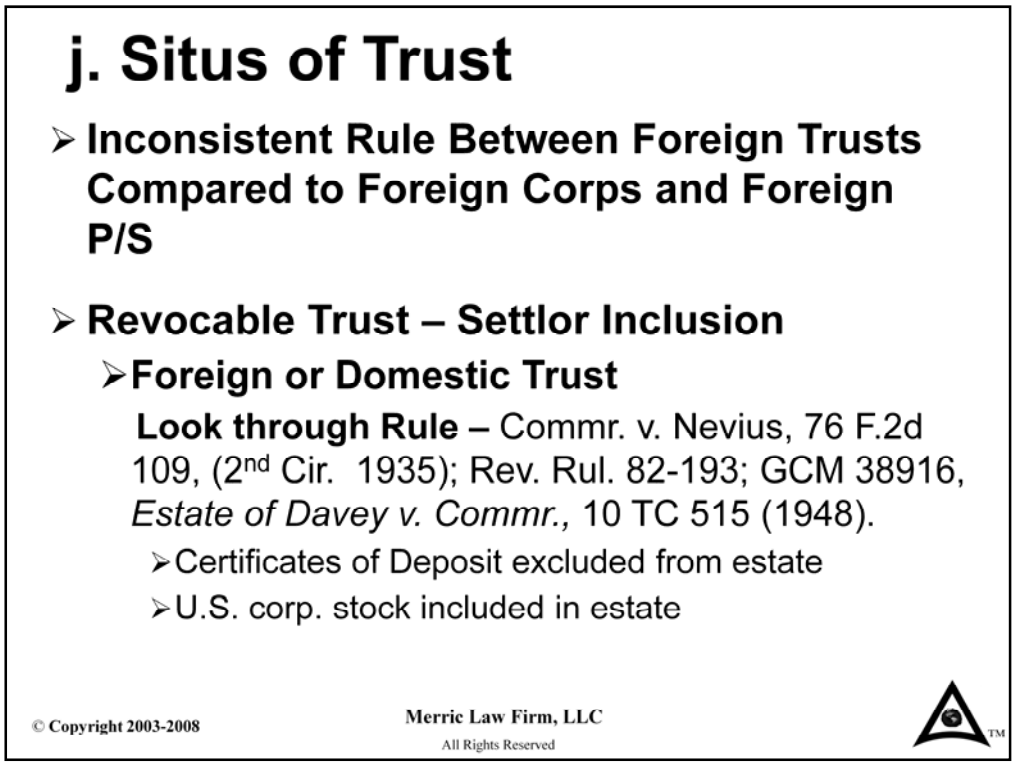
h. Debt Instruments

Debt issued by U.S. persons or entities have a U.S. situs. Conversely, similar to the income taxation for a non-resident alien, debt instruments that are classified as portfolio interest are exempt for estate tax purposes. IRC § 2105(b)(3).

i. Insurance Policies

Insurance policies on the decedent non-resident alien's life are not US situs property. IRC § 2105(a); Treas. Reg. § 20.2015-1(g). This is true regardless of whether the insurance policy is a whole life policy, a universal life policy, or a variable life policy.

In the 1990's, during the period that the US stock market was experiencing record gains year after year, the insurance companies began to offer opportunities to participate in those equity markets. Insurance companies modified the investment opportunities by creating Variable Universal contracts that allow policy holders to assume more of the investment risk and at the same time invest in insurance company managed mutual funds that invested in stocks and bonds.



j. Situs of Trust

The situs rules for a trust appears to be inconsistent with the corporation and partnership rules. For a corporation, it is the place of incorporation. Most likely for a foreign partnership, it is the place where the partnership has its principal place of business. Therefore, a foreign corporation or a foreign partnership with its primary place of business outside the U.S. should be foreign situs assets. However, in *Commr. v. Nevius*, 76 F.2d 109 (2d. Cir. 1935); *Estate of Swan v. Commr.*, 247 F.2d 144 (2nd Cir. 1957) – where decedent's interest in civil foundations (i.e. stiftungs were held to be equivalent to a revocable trust), held a look through rule applied to foreign revocable and simple trusts.

(1) Revocable Trust – Settlor Inclusion Issues

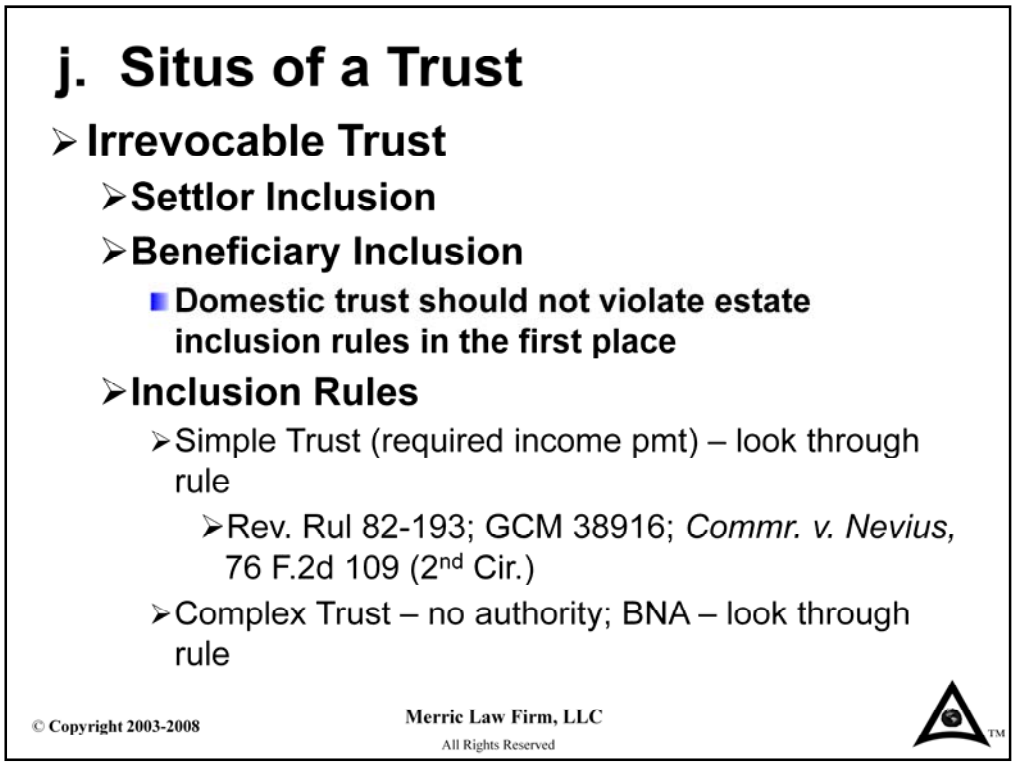
Under the look-through rule, the Settlor includes any U.S. source asset as if the settlor individually owned such asset. *Commr. v. Nevius*, 76 F.2d 109 (2nd Cir. 1935); GCM 38916; *Estate of Swan*, 247 F.2d 144 (2nd 1957); *Estate of Davey*, 10 TC 515 (1948); Rev. Rul. 55-163.

(a) Bank Deposit Exclusion

If the revocable trust deposits funds in the general fund of a bank that qualifies for the bank deposit interest exclusion under IRC § 861(a)(1)(A), then the settlor's estate shall not include the underlying bank deposit under IRC § 2105(b).

(b) U.S. Corporate Stock

Conversely, U.S. stock owned by a revocable trust is included in the settlor's estate. *Commr. v. Nevius*, 76 F.2d 109 (2nd Cir. 1935). Also see analogous authority under the simple trust analysis on the next page.



(2) Irrevocable Trusts

(a) Settlor Inclusion

Settlor inclusion usually is concerned with a foreign trust. This is because the foreign trust may have a reversionary interest or a general power of appointment, and it was not drafted in accordance with U.S. tax principles. It should also be noted that there appears to be only one case directly on point. *Commr. v. Nevius*, 76 F.2d 109 (2nd Cir. 1935). Further, most likely due to a non-compliance issue by foreign trusts, few cases will arise in the future. In the event a settlor has an inclusion issue, see the estate inclusion rules discussed below.

(b) Beneficiary Inclusion Issues.

A domestic irrevocable trust settled by a foreign person should be drafted to avoid U.S. estate tax inclusion issues. However, if the domestic irrevocable trust is not drafted in this fashion, then see the estate inclusion rules discussed below.

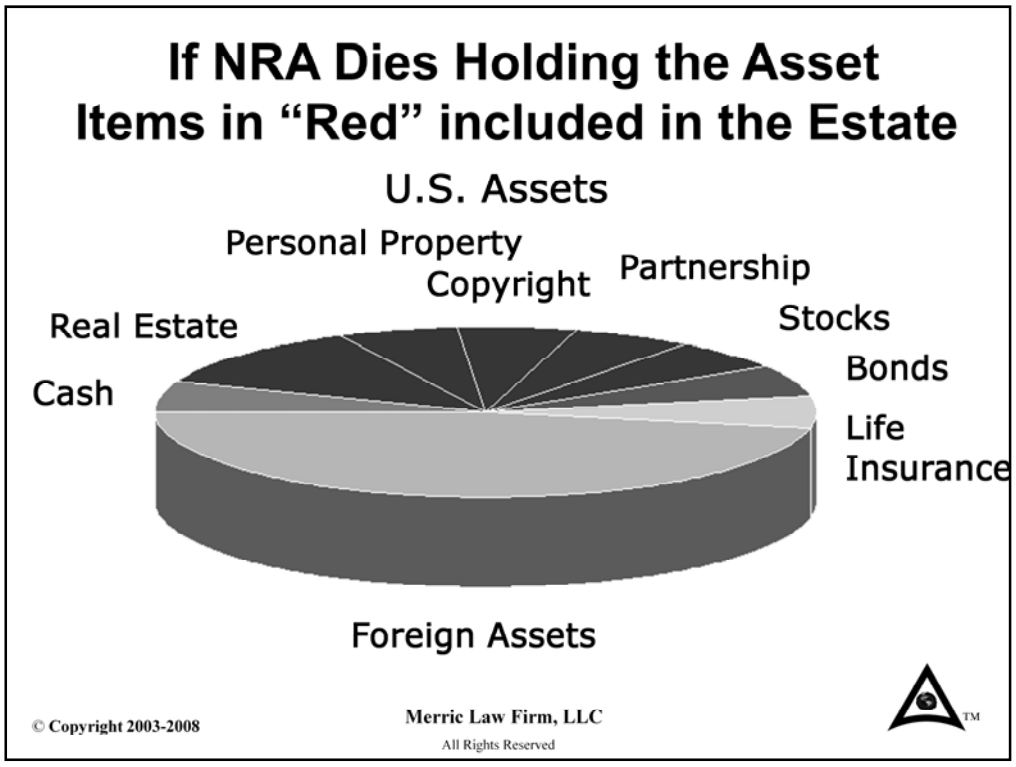
(c) Inclusion Rules

i. Simple Trust

Similar to a grantor trust, a simple trust uses a look-through rule to the underlying investment of the trust. Rev. Rul. 82-193; GCM 38916; *Commr. v. Nevius*, 76 F.2d 109 (2nd Cir). *Martin-Montis Trust, etc. et al. v. Commr.*, 75 T.C. No. 32 (1980); GCM 38650.

ii. Complex Trust

On the other hand, there is no direct authority regarding the treatment of a complex trust. BNA Federal Taxation of Income, Estates, Gifts, Part 21, Chapter 134: Specially Treated Taxpayers, p. 6 states "The situs of beneficial interests in trusts is determined by reference to the underlying assets."



D. U.S. Situs Assets For Estate Purposes

As noted in the previous explanation of situs, tangible personal property, copyrights, partnership interests, stocks, and annuities are all U.S. situs property. However, bonds generally are not U.S. situs and life insurance on the life of the decedent is not U.S. situs. Furthermore, generally foreign assets are not considered U.S. situs property.

1. Selling U.S. Assets

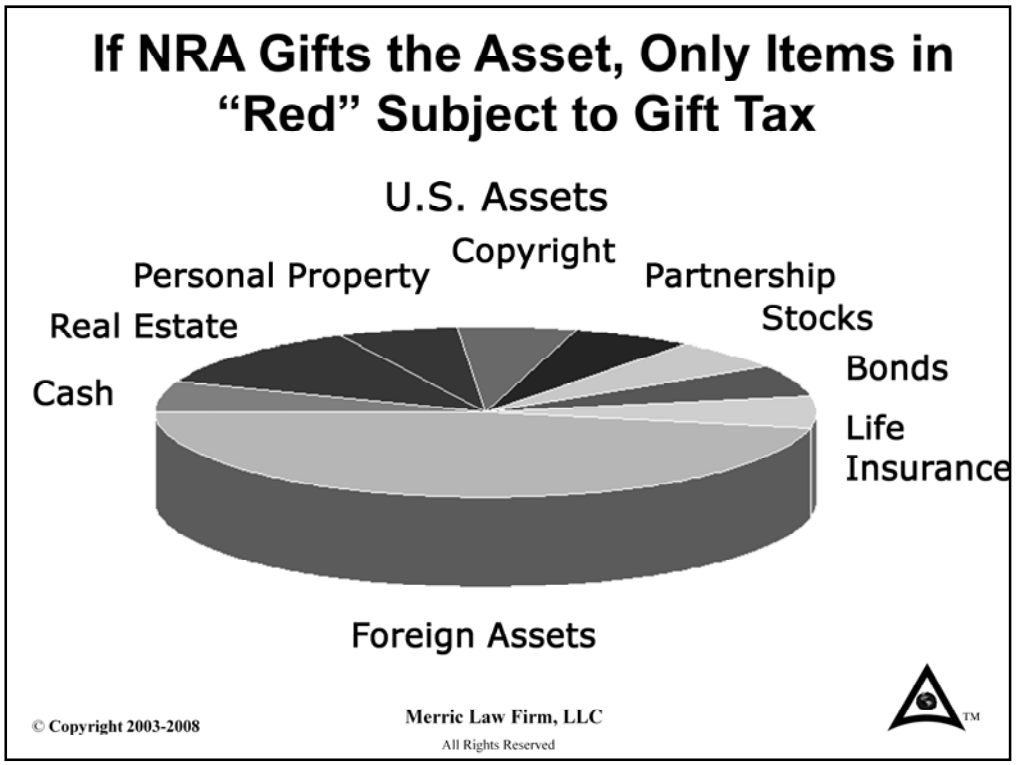
A simplistic approach to estate planning for a non-resident alien may be merely to sell U.S. situs assets and purchase non-U.S. situs assets. In some cases, this is all the planning that needs to be done. However, many times a foreign person holds U.S. investments that are generating a high rate of return, and such foreign person does not want to sell such U.S. investments.

2. Gifting U.S. Assets

Fortunately, the gift tax situs rules are more favorable than the estate tax situs rules. In this respect, there are plenty of opportunities for the non-resident alien who wishes to gift certain assets.

3. Wrappers

A third option for the non-resident alien is to change the situs of a U.S. asset by placing it in a foreign entity or insurance product. In other words, to place a "wrapper" around the U.S. asset that has the affect of changing the underlying U.S. asset's situs.



E. U.S. Situs Assets For Gift Tax

1. Tangible Assets

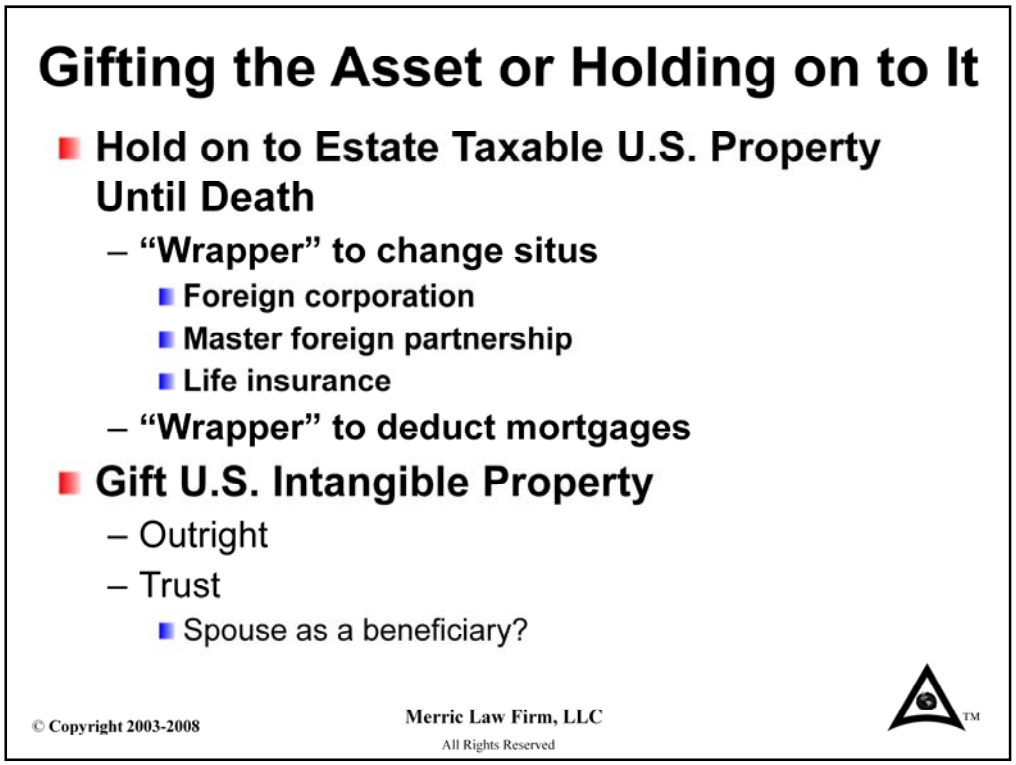
Only tangible assets are subject to U.S. gift tax. In essence, this means gift tax only applies to U.S. real estate and U.S. personal property. IRC § 2501(a). Treas. Reg. § 25.2511-1(b) and 25.2511-3.

2. Intangible Assets

Generally, intangible assets may be freely transferred to anyone without incurring a gift tax. IRC § 2501(a)(2)**.** So while most bonds and life insurance are exempt from gift and estate tax; U.S. annuities**,** U.S. copyrights, U.S. partnership interests, and U.S. stocks may be transferred to anyone (domestic or a foreign person) without incurring a gift tax.

For example, if Bill Gates were a non-resident alien for tax purposes, all of his ownership in Microsoft ($40 billion to $100 billion) could be gifted to his children without any gift tax whatsoever. Furthermore, none of the stock gifted would be included in Bill Gate's estate when he died.

The non-resident alien's ability to transfer U.S. intangible assets free of any U.S. gift tax creates an incredible estate planning advantage when compared to a U.S. citizen or resident alien. At first glance, it appears that U.S. intangibles could be gifted without limitation with transfers directly to children, spouses, and trusts. Conversely, there are some nuances when gifts are made to trusts and the settlor's spouse is also a beneficiary. These issues are discussed later in this outline.



F. Holding on to the Asset or Gifting It

1. Holding On To The Asset

a. Wrapper to Change Situs

If a client does wish to hold onto U.S. real estate, tangible personal property, U.S. annuities, U.S. partnerships, and U.S. stocks until death, he or she may still be able to escape some or all of the estate tax by using a "wrapper." A "wrapper" is an entity or a product that should change the situs of the underlying product. Typically, a wrapper will be (1) a foreign corporation, (2) a foreign partnership, or (3) an offshore life insurance policy.

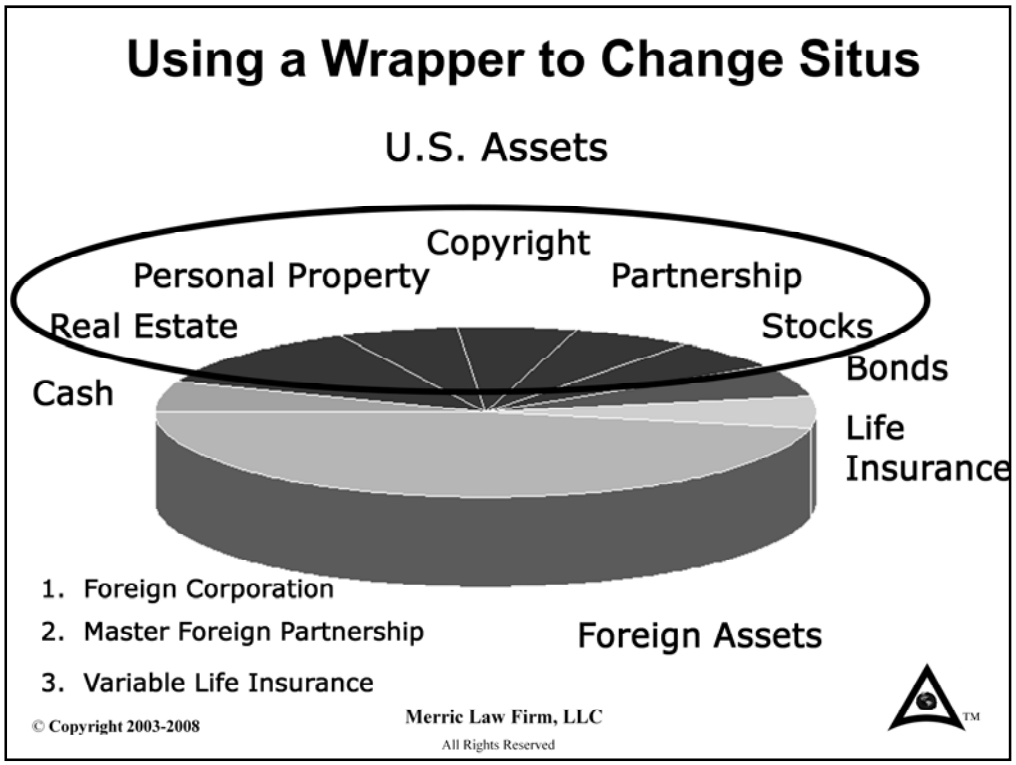
b. Wrapper to Deduct Mortgages

A non-resident alien may only deduct mortgages or other debt directly related to U.S. situs property only to a percentage. A domestic FLP or LLC wrapper may be able to make the debt fully deductible.

2. Gifting the Asset

As previously noted, a client may wish to give the property to his heirs to avoid U.S. or another nation's transfer tax. Most clients prefer to transfer property to their children in trust so that they may have some control until their death. (In the case of a non-resident alien, most likely a foreign trust would be used for gifting purposes). Further, many times the spouse of the settlor is added as a beneficiary of the trust. This provides a safety valve in case the settlor and his or her spouse need some of the gifted assets in the future.

Unfortunately, when the settlor's spouse is a beneficiary of the trust, there is a possible estate tax inclusion issue that is not present in the domestic planning arena (as discussed later in this outline).



G. Using a Wrapper to Change Situs

1. Foreign Corporation

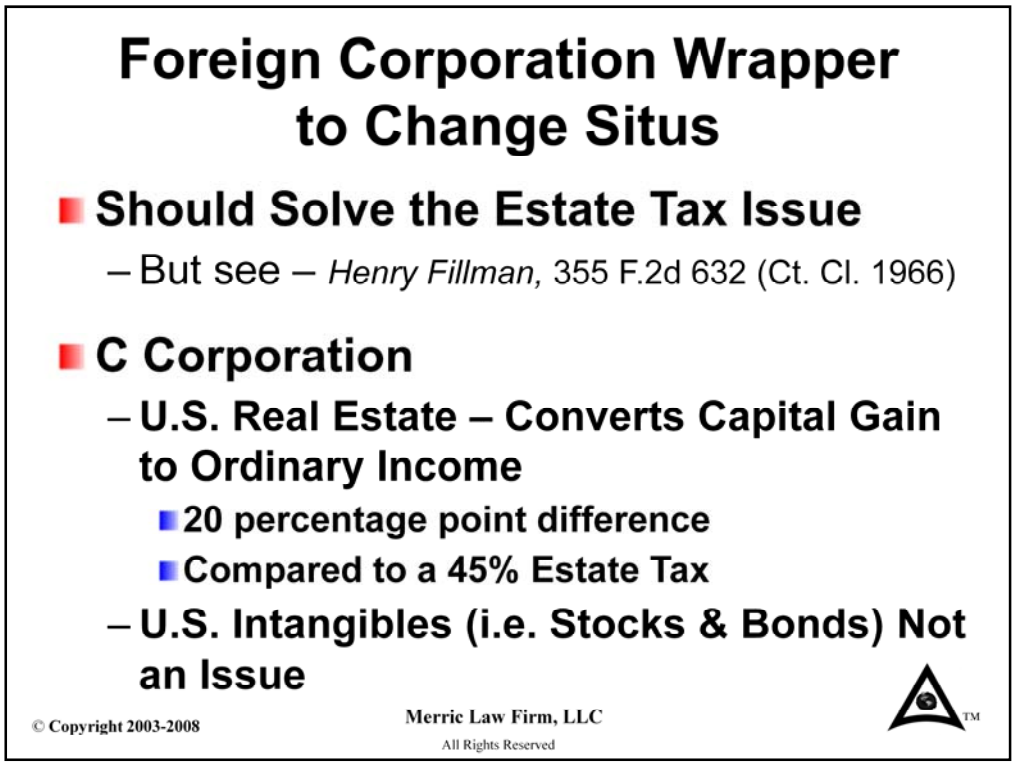
As previously noted, a corporation's situs is determined based on where the entity is incorporated. IRC § 2104(a). Therefore, a foreign corporation's situs would not be the U.S. For this reason, most international estate planners take the position that a foreign corporation may serve as a wrapper and hold U.S. real estate, U.S. copyrights, U.S. partnership interests, or U.S. stock. Upon the death of the non-resident alien, he or she would own the stock in a foreign situs corporation that would not be subject to U.S. estate tax. It should also be noted that the Treasury is currently studying the use of foreign corporations to avoid estate tax, particularly in the case when the decedent wholly owns the foreign corporation.

2. Foreign Partnership or LLC

A partnership or LLC situs is where a wrapper does business. Rev. Rul. 55-701. So what is the estate tax result if a decedent non-resident alien owned an interest in a Nevis LLC and the underlying assets of the Nevis LLC are exclusively U.S. stocks? Furthermore, assume that all transactions are executed through a Swiss private bank and the Manager conducts all business offshore. It seems authorities are split on this issue. A literal reading of Rev. Rul. 55-701 indicates the situs is where the business takes place – offshore. However, since all the underlying assets are U.S. based, many planners are concerned that situs may be the business activity of the underlying stocks.

3. Private Placement Insurance

A private placement insurance policy may hold individual securities (as long as the client does not direct the specific investments held by the private placement insurance policy (i.e. "control" the underlying assets of the policy). In this respect, either a domestic or offshore private placement policy may serve as a wrapper to move the situs of U.S. stock.



H. Foreign Corporation Wrapper to Change Situs

1. Estate Tax

As previously noted, when a foreign corporation owns U.S. assets, the situs of the foreign corporation is avoided, and U.S. estate tax should be avoided. However, when the foreign corporation was merely a holding company of U.S. securities, the Court of Claims held the assets were included in the non-resident alien's estate. *Henry Fillman v. U.S.*, 355 F.2d 633 (Ct. Cl. 1966). Also, please note that the Service is currently studying the issue of foreign corporation wrappers used to change the situs of U.S. assets.

2. Classified as a C Corporation

A foreign corporation is always classified as a "C" corporation. This is because an "S" corporation must be a domestic corporation for tax purposes. Further, a non-resident alien cannot own "S" stock without terminating the "S" election.

a. U.S. Real Estate

i. Held Individually

If real estate is sold individually by a non-resident alien, gain is treated as effectively connected to a U.S. trade or business. IRC § 897. In this respect, the gain is reported as a Section 1231 or capital gain.

ii. Foreign Corporation

If U.S. real estate is sold by a foreign corporation, the corporation pays tax on the gain based on the corporate tax rates, which are nine percentage points (34%-25%) higher than the individual (1231 or capital gain) rates. This additional income tax must be compared to the 46% estate tax computed on the fair market value of the property.

b. U.S. Intangibles

As noted in Taxation of a Foreign Person outline, a foreign person does not pay any capital gain tax on the sale of intangibles (i.e. securities). Furthermore, when the proceeds from the sale are distributed as dividends to the non-resident alien, no gain is recognized on foreign source income. Regardless of whether a non-resident alien owns intangibles either individually or through a foreign corporation no income tax is due from the sale of such intangible.

I. Foreign Partnership Wrapper to Change Situs

1. Situs

a. Foreign Corporation

As previously noted, situs of a foreign corporation is based where the corporation was incorporated.

b. Foreign Partnership

As also previously stated, a foreign partnership does not follow the same rule as a foreign corporation. Situs for a foreign partnership is based on where the partnership conducts business. Rev. Rul. 55-701. The revenue ruling indicates that a "look through" rule is not applied when determining the situs of a foreign partnership. In this regard, situs is an entity test.

i. Underlying Assets Are Only U.S. Situs Real Estate

At first glance, one might wish to take the position that if management of the business is conducted from abroad, the situs of the foreign partnership is outside the U.S. However, what happens if management is abroad, but all the underlying assets of the foreign partnership are U.S. real estate? If this is the case, the stronger argument appears to be that, the business of the partnership is actually conducted in the U.S. This is particularly true if the underlying U.S. real estate is rental or commercial real estate.

ii. Master Foreign Partnership

On the other hand, if the underlying assets of the foreign partnership contain assets from different jurisdictions, the foreign partnership may be commonly referred to as a "master foreign partnership." If more than one-half of the assets of the master foreign partnership represent assets that are outside the U.S., one may consider taking the position that the situs of the partnership is outside the U.S. If situs of the partnership is outside the U.S., the estate tax would be completely avoided. Furthermore, unlike the "foreign corporation wratpper" around U.S. real estate, the master foreign partnership would not convert capital gain to ordinary income as a tradeoff.

J. Foreign Insurance Wrapper to Change Situs

1. Change Situs of U.S. Mutual Funds

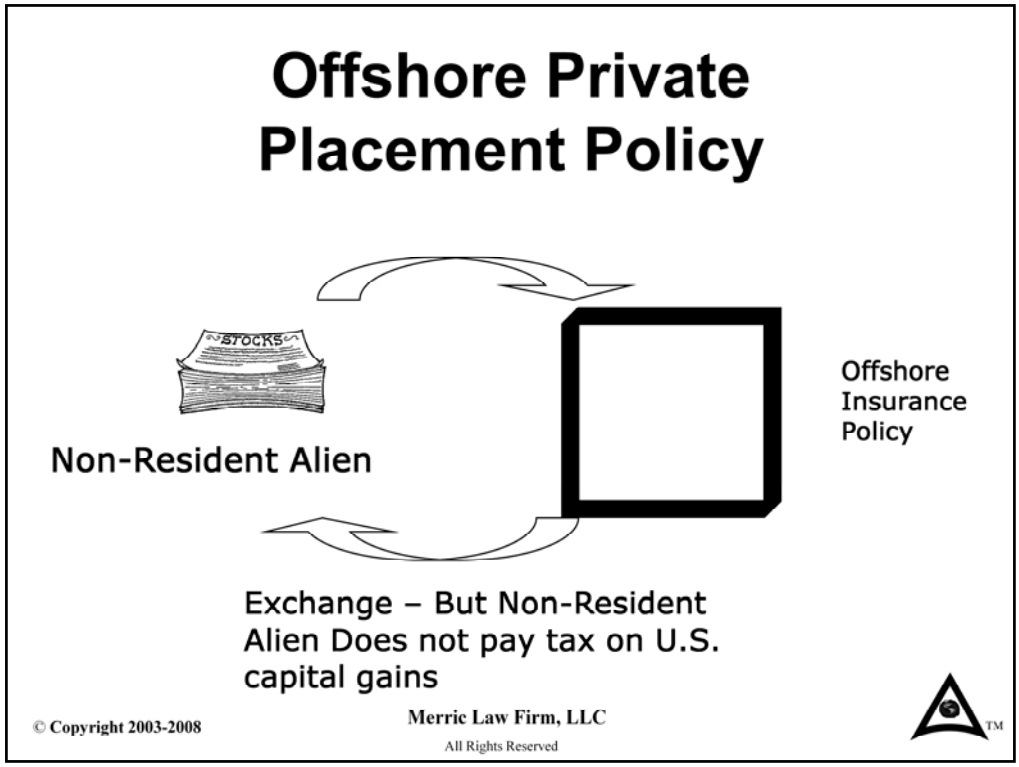
As previously noted, most domestic mutual funds situs are in the U.S., regardless of the underlying assets. Such assets may be held inside either an offshore or onshore domestic variable life insurance policy. Regardless of whether it is a U.S. or an offshore insurance policy, the situs of the insurance policy is considered outside the U.S.

2. Domestic or Offshore Variable Insurance Policy

The non-resident alien may use either a domestic or offshore variable insurance policy to move the situs outside of the U.S.

3. Transfer of Property in Lieu of a Cash Premium

Offshore variable life insurance policies will generally accept marketable securities in lieu of a cash payment for the premium. It should be noted that the exchange of any property in lieu of the payment of a cash premium is a taxable transaction. There is not any IRC Section that turns off gain recognition similar to IRC § 351 (for corporations), IRC § 721 (for partnerships), IRC § 1031 (for like kind property) and IRC § 1035 does not apply. However, as noted in the Income Taxation of a Foreign Person Outline, a non-resident alien for income tax purposes does not pay tax on any U.S. capital gains. Therefore, the transfer of appreciated securities as an "in kind" premium results in no income tax to the non-resident alien.



4. Are the Previous Wrappers Better Options?

a. Advantages of the Foreign Corporation or Master FLP

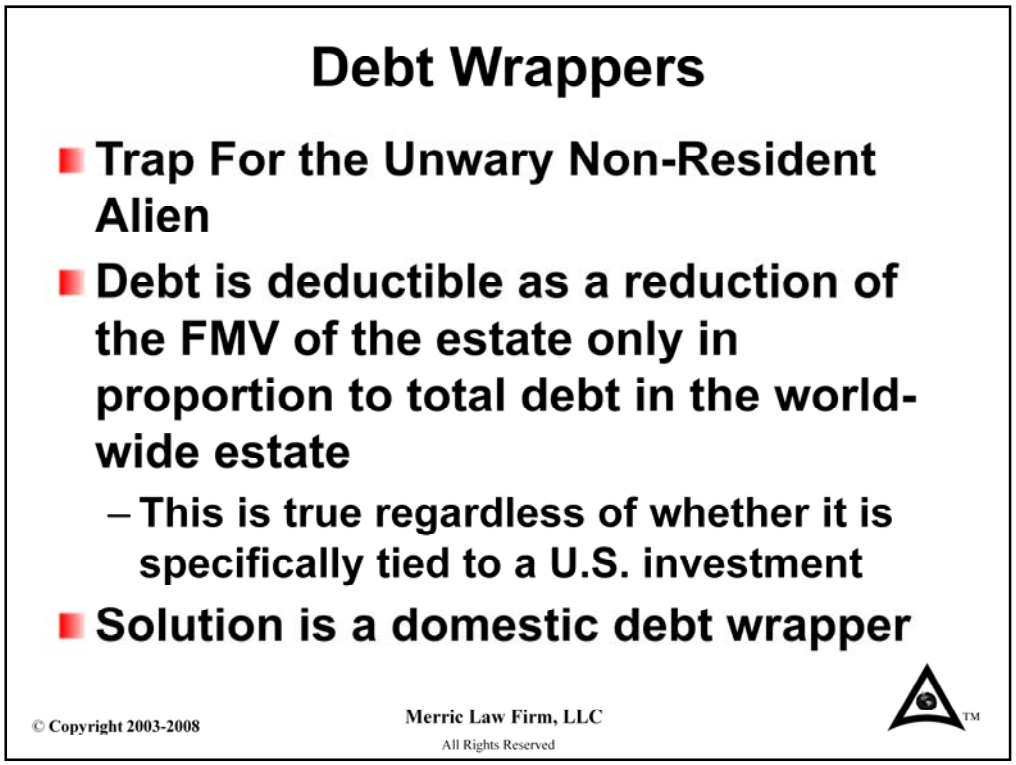
With either a foreign corporation wrapper or a master foreign limited partnership wrapper, most likely situs may be changed to outside the U.S. In this case, a non-resident alien may easily avoid any U.S. estate tax. Furthermore, with a foreign corporation or a master foreign limited partnership, the non-resident alien may select and control the specific investments. This is not the case with a variable life insurance policy.

b. Advantages of the Offshore Variable Life Insurance Policy

Conversely, as previously noted there is the one case where the Service was successful in challenging a foreign corporation that was used merely as a wrapper. There is also the disagreement among professionals regarding exactly where the business of a foreign partnership is conducted. Finally, the Service has announced that it is studying the issue of foreign corporations and master limited partnership when such entities are used merely to change situs for a non-resident alien. Therefore, the offshore variable life insurance policy that holds only securities or mutual funds would be less subject to scrutiny.

5. Avoid Purchase of the Client's Assets With the Policy

As discussed in the Merric Descent to the Dismal Decay of Taxpayer Decadence outline, most (if not all) offshore variable life insurance policies that purchase a client's highly appreciated assets with a private annuity or installment sale are strongly subject to attack by the Service. For this reason, estate planners need to be wary of these type of transactions. Furthermore, whenever a variable life insurance policy is utilized to select specific stocks (where the acquisition is directed by the owner of the policy, the owner will be deemed to control the policy. If this is the case, the variable life insurance policy will fail the definition of insurance.



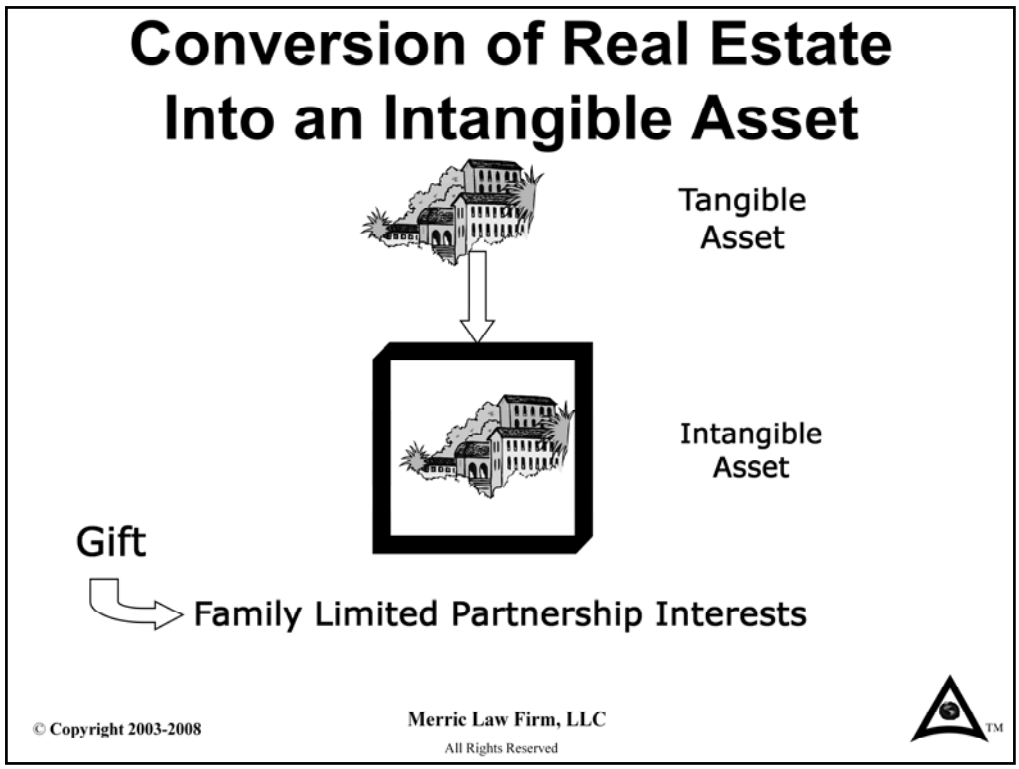
K. Debt Wrappers

1. Trap For the Unwary Non-Resident Alien

A non-resident alien is limited to deducting only a proportion of their debt against a U.S. estate. IRC§ 2106(a)(1); Treas. Reg. § 20.2016-2(a)(2). The proportion of the debt is based on the non-resident alien's U.S. situs assets divided by their world-wide assets. This creates two problems. First, even if a U.S. debt is specifically tied to a U.S. investment (i.e. a mortgage on real estate), the mortgage may only be partially deductible against the estate. Second, such a rule creates a practical problem with many non-resident aliens. While a non-resident alien does not mind disclosing their U.S. assets, most non-resident aliens are private in nature and do not wish to disclosed his or her world-wide assets.

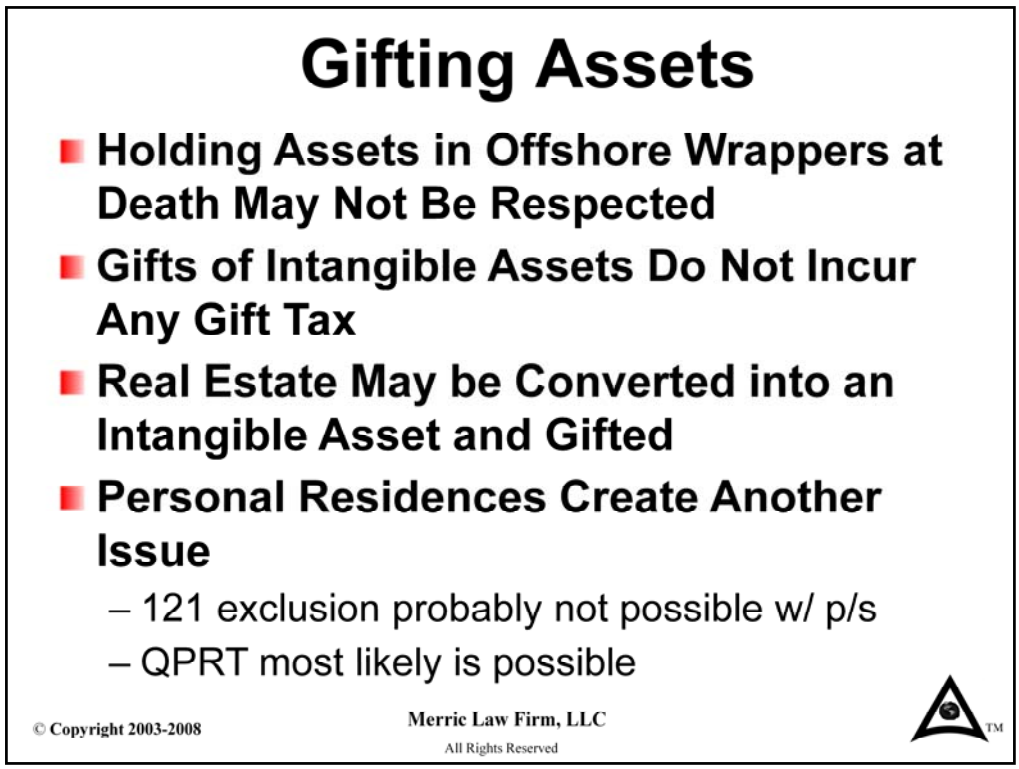
2. Domestic Debt Wrappers

In order to solve this problem, typically a domestic entity such as a family limited partnership or a limited liability company may be used to place the debt and the related asset in one entity so that both would be valued at an entity basis for U.S. estate purposes. For example, assume that the non-resident alien owns an apartment building with a FMV of $5 million and the mortgage is for $3 million. The apartment building, subject to the mortgage, should be transferred to a domestic partnership or domestic LLC. Not only may the client make gifts of minority interests, but the partnership interest will now be valued net of the debt. In other words, by wrapping U.S. debt to specific assets through a domestic partnership or domestic LLC, a non-resident alien is able to deduct 100% of the debt against his or her estate, The non-resident alien is no longer limited to a percentage of the debt based on the ratio of his U.S. situs and world-wide assets.



L. Conversion of a Tangible Asset to an Intangible

Real estate is a tangible asset. However, a partnership interest or a membership interest is an intangible asset. Intangible assets may be gifted without incurring a gift tax. Therefore, if real estate is transferred into either a partnership or limited liability company, has the interest that will be transferred been converted into an intangible asset? Most likely, this is what will occur. Moreover, the Service may always raise a substance over form type of argument if real estate is transferred to an FLP and immediately gifted to the non-resident alien's children. If the estate plan calls for gifting assets, rather than holding them until the death of the non-resident alien, a domestic FLP or domestic LLC may be an optimal solution to converting a tangible asset into an intangible asset.



M. Gifting Assets

1. Issues with Wrappers

As previously noted, foreign wrappers may provide an effective method of holding U.S. situs assets until the non-resident alien's death, and still escape estate taxation. However, as also previously noted, the Service is currently analyzing this issue to determine whether it will continue to allow the foreign corporation wrapper and the master foreign partnership wrapper to change the situs of U.S. assets. In this respect, a non-resident alien may wish to also employ traditional estate planning gifting techniques.

2. Intangible Assets

As stated earlier, intangible assets may be gifted without incurring any gift tax. In this respect, if a non-resident alien is willing to release dominion and control over these assets (and none of the estate tax rules bring the property back into the non-resident alien's estate), U.S. estate tax is completely avoided.

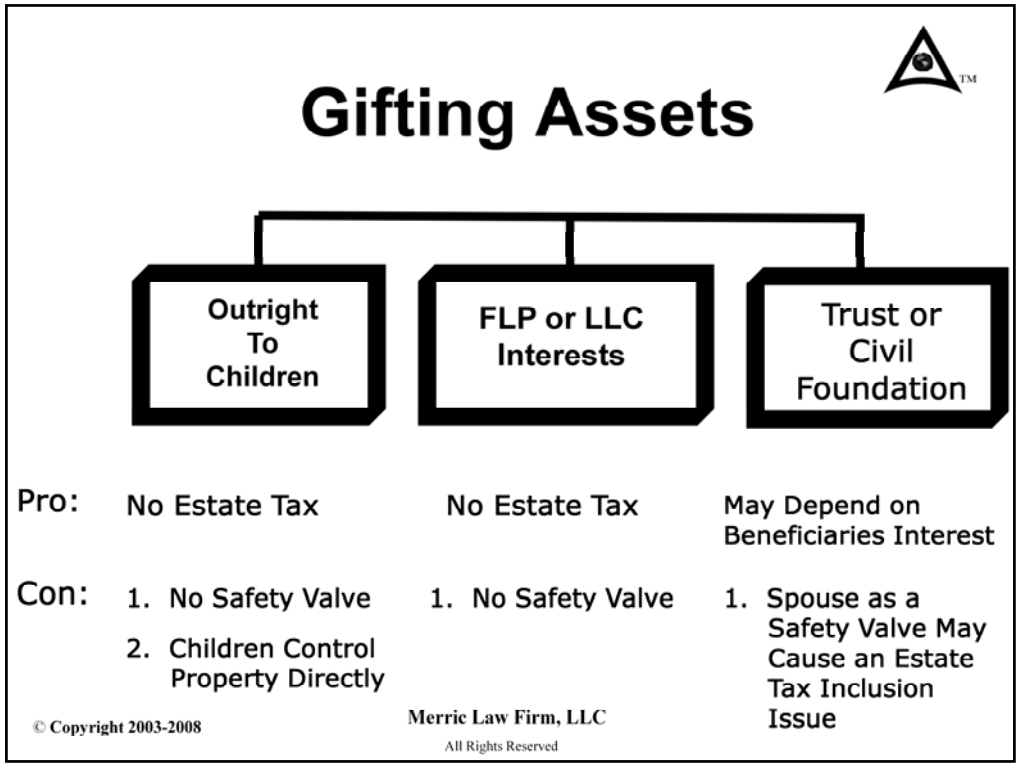
3. U.S. Real Estate Not in a Foreign Wrapper

a. Domestic LLC or Partnership Wrapper

As aforementioned before, interests in a domestic LLC or FLP may still be gifted to a non-resident alien without incurring any gift tax. Subject to refinancing the mortgage (i.e. a transfer to an entity will generally trigger the due on sale clause), most real estate may be easily gifted through a domestic FLP or domestic LLC wrapper.

b. Personal Residences

Similar to estate planning with a citizen, a personal residence creates several other issues if it is not a rental property. First, if the personal residence is transferred to a FLP or LLC, the IRC § 121 (i.e. half million dollar exclusion) of gain on sale is lost. PLR 200119014 revoking PLR 200004022. Second, it is questionable whether the deduction for interest on a residence under IRC § 163(h)(3) may be deducted by a partnership. A literal reading of the Code appears to say it is a personal deduction. For further planning discussions with personal residences please see the upcoming QPRT discussion.



4. Gifting Assets to Whom

Assets may be gifted outright to the non-resident alien's children, in the form of either domestic or offshore flp or llc interests, or to a trust (or civil foundation).

a. Outright to Children

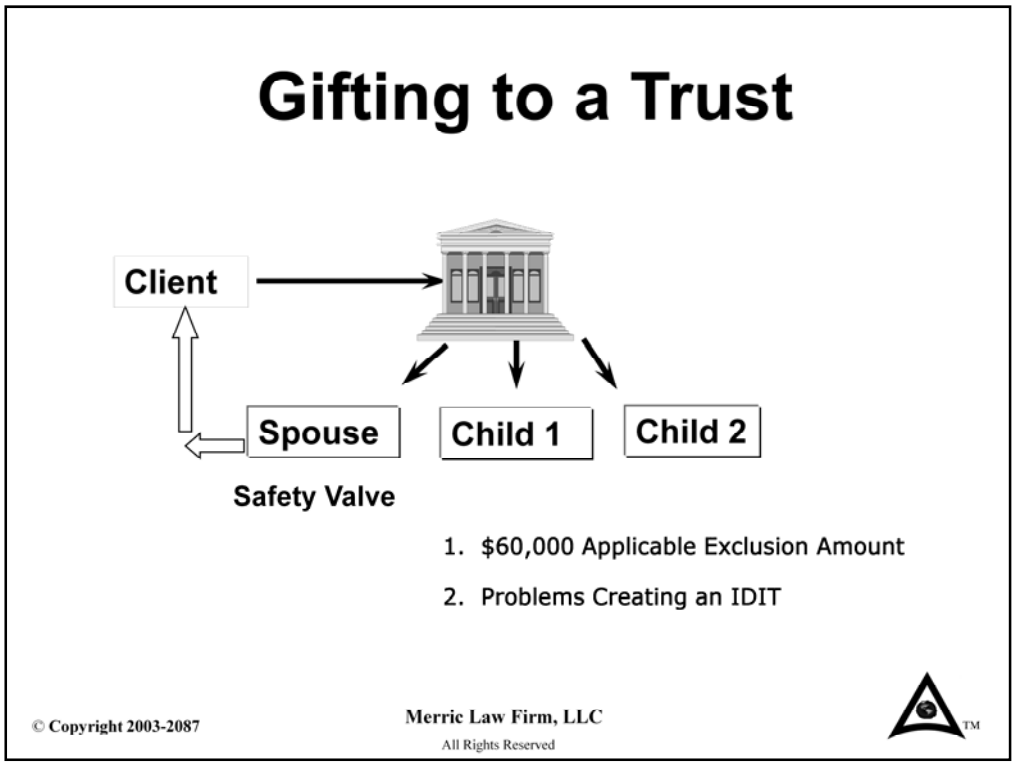
Gifts of intangibles outright to children incur no gift tax, nor are the gifts included in the non-resident alien's estate. However, with an outright gift, there is no safety valve. As discussed in the Modular Approach to Estate Planning Outline, a safety valve is a mechanism where in an emergency the donor may still receive benefit of the assets that have been gifted. The most common example of a safety valve is the donor's spouse is listed as a discretionary beneficiary of a trust. Further, most parents do not wish to relinquish control over most of their assets until they pass away.

b. Gifts of FLP or LLC Interests

A gift of FLP or LLC interests to the children does not incur any gift tax. However, the non-resident alien is still subject to the same estate tax inclusion issues under IRC § 2036 through IRC § 2038. Therefore, proper planning should still result in the partnership interests being excluded from the client's estate for U.S. purposes. However, similar to an outright gift, there is no safety valve with this structure.

c. Gifts to Trusts or Civil Foundations

The gift to a trust allows the possible use of a safety valve – the spouse of the settlor. This issue is addressed on the following page.



N. Gifts to a Trust or Civil Foundation

Generally, a civil foundation is classified as a trust for income tax purposes. *Estate of* Swan, 247 F.2d 144 (2nd Cir 1957). There does not appear to be any direct authority how a civil foundation is taxed for estate planning purposes.

1. Gifting

a. Intangible Property

As previously stated, almost all U.S. intangible property may be gifted without incurring any U.S. gift tax. Further, as also previously discussed, in may be possible to convert U.S. real estate into an intangible asset through the use of a domestic FLP or domestic LLC wrapper.

b. Applicable Exclusion Amount

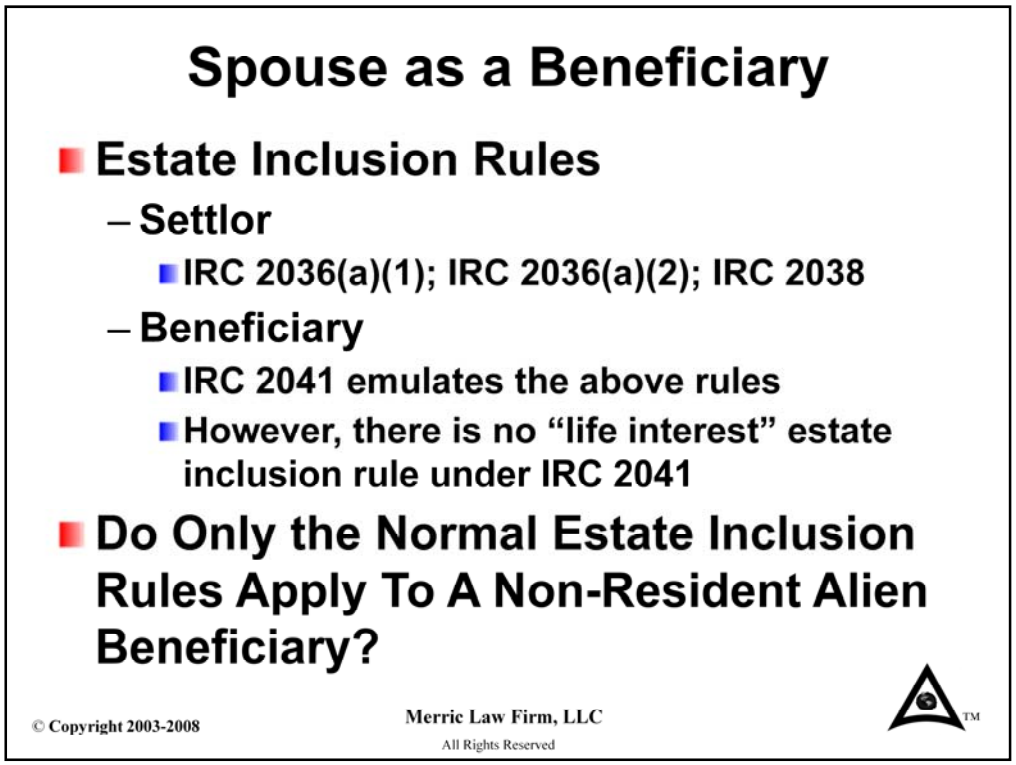
Unfortunately, the same is not true for real estate owned individually and tangible personal property. The amount of these type of properties a non-resident alien may gift is greatly reduced when compared to a citizen or resident alien. Instead of a $1 million applicable exclusion, a non-resident alien is limited to $60,000.

2. Inability to Utilize an IDIT

A non-resident alien is further limited in leveraging the amount of gifts. This is because the grantor trust rules will not apply to a non-resident alien unless: (1) the trust is revocable or (2) during the life of the grantor, a trust that benefits only the grantor and his or her spouse. IRC § 672(f)(1). Unless a planner is willing to risk the use of a rainy day trust, there does not appear to be a method to create a grantor trust for a non-resident alien.

3. Generation Skipping Transfer Tax

A non-resident alien receives a $2 million GSTT exemption. Treas. Reg. § 26.2263-2(d).



O. Spouse as a Beneficiary

1. Estate Inclusion Rules For Citizens and Resident Aliens

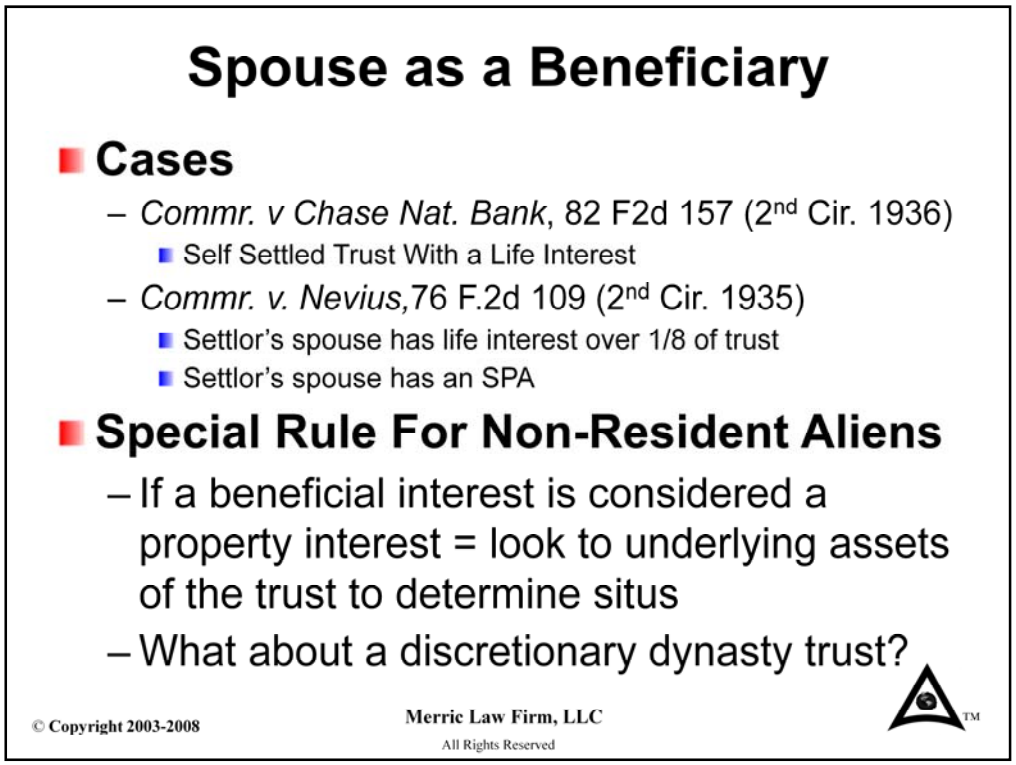
When a U.S. person settles a trust, the primary estate inclusion issues are IRC § 2036(a)(1); IRC § 2036(a)(2); and IRC § 2038. As related to the a spouse of the settlor (i.e. beneficiary), the primary estate inclusion rule is IRC § 2041. In essence, IRC § 2041 and the underlying Treasury Regulations emulate almost the same treatment for a beneficiary as for the settlor. Nonetheless, there is one key difference, IRC Section does not include an interest held for life. Therefore, a beneficiary should be able to hold a life interest without an estate inclusion issue.

2. Does the Same Rule Apply to a Non-Resident Alien's Spouse

Unfortunately, the author is aware of only two cases on point. Both of them are early cases (before 1936) and, both cases are under the predecessor code sections to the IRC of 1958. The first case appears to be consistent with the estate inclusion rules for a U.S. person. In spite of this, the second case appears to either be bad law or a new rule of estate inclusion that applies only to beneficiaries of a foreign trust and a non-resident alien spouse or beneficiary. Additionally, to complicate the issue, is that almost all authors on this subject merely skim the issue without addressing it – they cite the holding of the case with no discussion whatsoever.

Even with a foreign trust, the situs of the underlying assets determine whether such assets are included in the Settlor's estate. Therefore, if the settlor's spouse is a beneficiary, and he or she dies, are the U.S. situs assets held by the foreign trust included in the settlor spouse's estate?

This would not be the case for a U.S. person settling a domestic trust with a citizen or resident alien spouse. IRC § 2036 and 2038 do not apply to beneficiaries, rather the parallel section of IRC § 2041 applies. IRC § 2041 does not have a retained life interest rule, and there is no special rule that looks to the underlying assets for estate inclusion.



3. Cases

1. Commr. v. Chase Nat. Bank, 82 F2d 1157 (2nd Cir. 1936)

In *Chase Nat. Bank*, the settlor, a non-resident alien, created a self settled trust for her and her three daughters. The settlor reserved a life interest in the trust. Under current Code analysis, the settlor retained a life interest, and under IRC Section 2036(a)(1), the trust property to the extent the situs is determined in the U.S. was included in the settlor's estate.

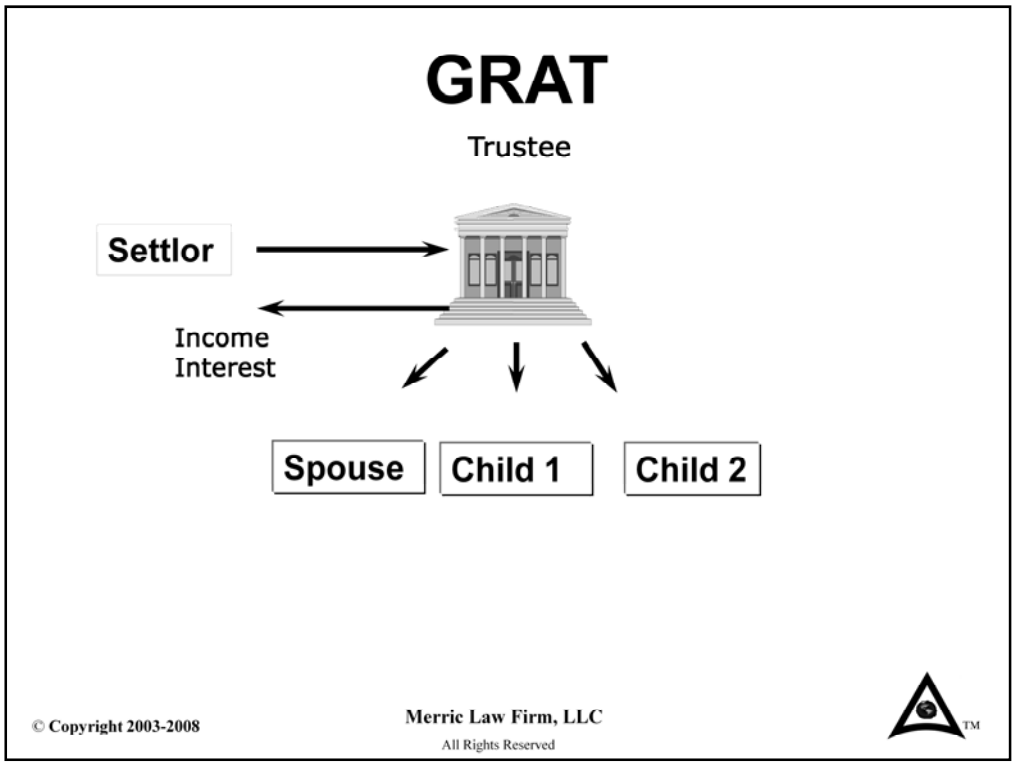
2. Commr. v. Nevius, 76 F.2d 109 (2nd Cir. 1935)

In *Nevius*, the settlor created a trust for the benefit of his spouse, a non-resident alien, and children. The settlor's spouse received a one-eighth life interest and a special power of appointment to direct the one-eighth interest between the settlor's children. The SPA was never exercised. Nevertheless, the Second Circuit concluded that the spouse had an equitable interest to the extent of one-eighth of the trust, and the underlying U.S. situs assets were included in her estate. Conversely, such a reading appears to be an additional rule for a non-resident alien, because IRC § 2041 does not have a life interest rule. Further, the spouse of the settlor was not the settlor so IRC § 2036(a)(1) life interest rule does not apply. In this respect, the author thinks this case is merely bad law. Yet, it is almost universally accepted in the prevailing literature.

4. Special Rule For Non-Resident Aliens?

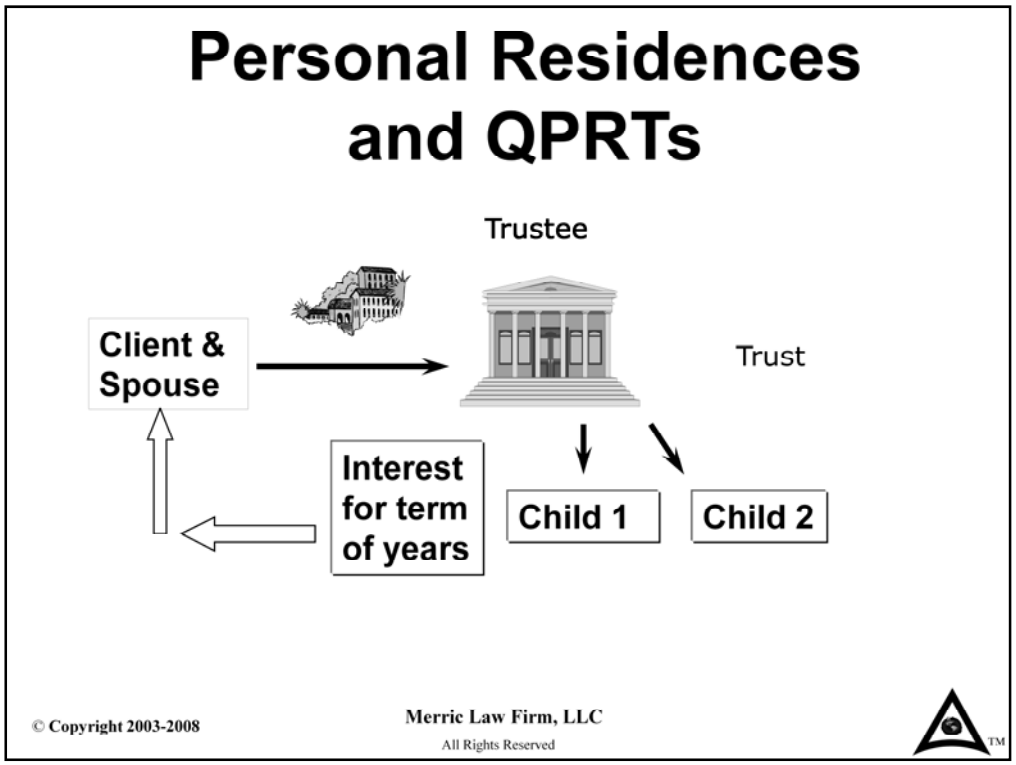
If there is a special rule for a non-resident alien, can the estate planner draft around the issue? For example, may the estate planner draft a discretionary dynasty trust. In this case, the equitable interest is not even a property interest. It has a zero value, even in a Bankruptcy. This being the case, how could a discretionary dynasty interest result in any estate inclusion issue.

Furthermore, Judge L. Hand in his concurring opinion in *Nevius* noted that had the spouse merely held an SPA, he would have had a hard time including the underlying U.S. situs property in the non-resident alien spouse's U.S. estate. In this respect, SPAs should probably be avoided.



P. GRAT

Due to a non-resident alien's limited applicable exemption amount, a tiered grantor retained annuity trust may be the option of choice. In this respect, a GRAT allows the non-resident alien to leverage his or her $60,000 applicable exemption amount.



Q. Personal Residences

Personal residences create a couple of nuances for a non-resident alien.

1. IRC Section 121 Exclusion of Gain on Sale

First, it is uncertain whether a non-resident alien is entitled to the IRC § 121 exclusion of gain on sale ($500,000 joint; $250,000 individual). At first glance, it appears that nothing limits a non-resident alien from availing himself or herself from the exclusion. However, if the non-resident alien's principal residence is in the U.S., this is a strong indication of a present intent to stay in the U.S. Therefore, under a facts and circumstances analysis such foreign person should most likely be classified as a resident alien for estate tax purposes. On the other hand, a second residence is not entitled to the IRC § 121 exclusion.

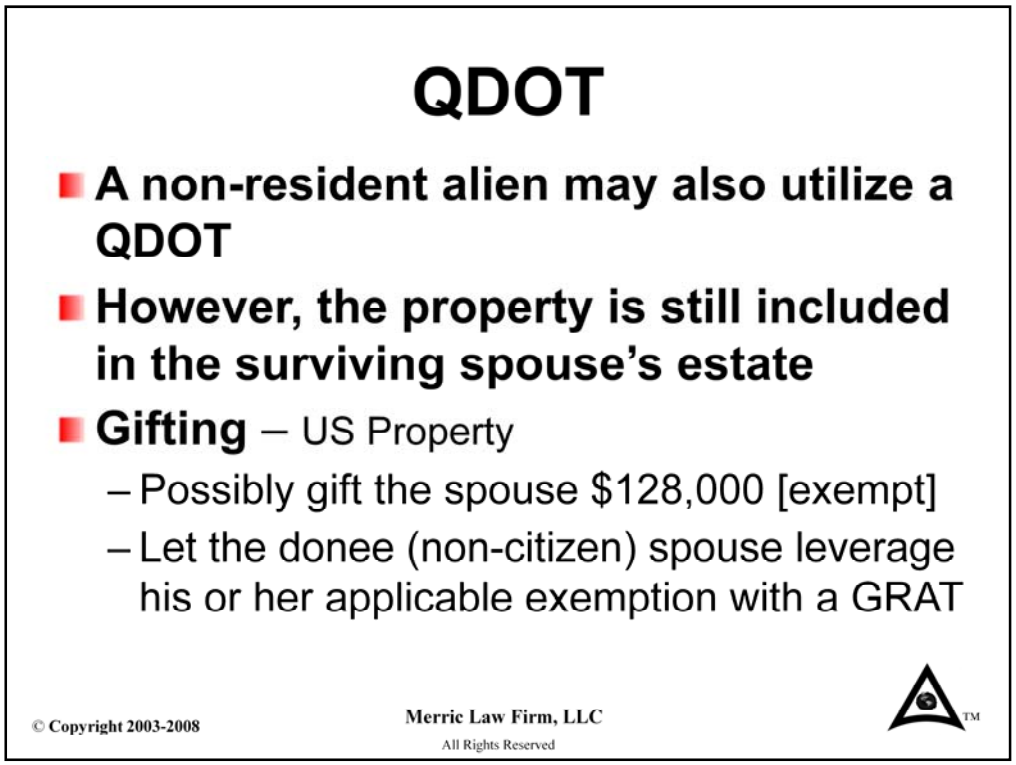
2. Non-Rental Personal Residence

a. No Mortgage

If there is no mortgage on the personal residence, the residence may possibly be wrapped with a foreign corporation, master foreign partnership or a domestic FLP and LLC. Even if there is a mortgage, there is the issue of whether the interest is deductible under IRC § 163(h)(3) for an entity.

b. QPRT

A non-resident alien may also use a QPRT to further leverage the transfer of a personal residence. But Remember, a non-resident alien is limited to a $60,000 applicable exemption amount. Therefore, you may wish to consider having both husband and wife jointly settle a QPRT. Please note that the settlors of a QPRT that is classified as a grantor trust may utilize the Section 121 exclusion. Yet, as the grantor trust rules were previously discussed relating to a non-resident alien, it may be possible to make the QPRT a grantor trust during the term of life interest.



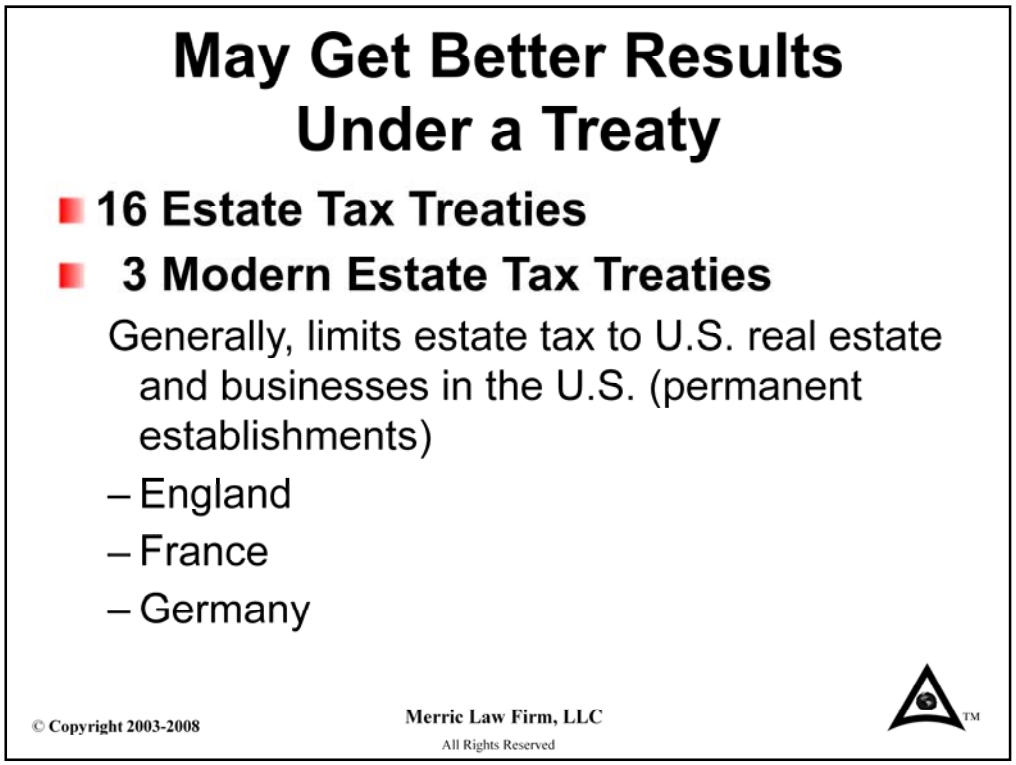
R. QDOT

1. Deferral of Tax to the Death of the Surviving Spouse

Similar to a non-citizen spouse, a non-resident alien may also utilize a QDOT. However, it should be noted that the U.S. sourced property will still be included in the surviving spouse's estate. In this respect, a QDOT only defers tax until the death of the surviving spouse.

2. Gifting to the Surviving Spouse

Similar to a non-citizen spouse, a non-resident alien may gift up to $128,000 (indexed 2008) of U.S. source assets without incurring any U.S. gift tax. Remember for gift tax purposes, only U.S. real estate and tangible personal property is sourced as U.S. property. The donee spouse may settle his or her own irrevocable trust, possible a GRAT to obtain the greater leverage.



S. Treaty Relief

While there are sixteen estate planning treaties, only three modern treaties appear to provide much U.S. estate tax relief. Under these three treaties, usually only U.S. real estate is taxable and U.S. businesses (i.e., permanent establishments). Sometimes, the non-resident alien also receives a proportionate unified credit based on the non-resident alien's U.S. property compared to his or her world-wide property.

Many times may change the situs of property – stock of U.S. corporation held by German citizen. German treaty TAM 9128001. U.S. – Denmark treaty, U.S. stock not subject to U.S. estate taxation if held by Danish resident.

Also, credit on death may be increased to $1 million x U.S. assets/ world-wide assets.