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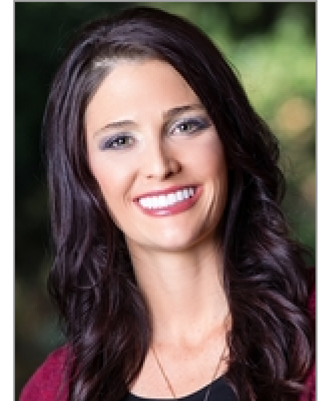
The Colossal Cost Of Poor International Estate Planning



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Law360, New York (February 18, 2016, 10:28 AM ET) -- When it comes to international estate planning and taxation, what you don’t know, or don’t do, can cost your estate fortunes. The failure or refusal to plan by a decedent during his or her lifetime will adversely impact the heirs. Choosing not to engage in the planning process translates into increased revenue for the IRS and other government agencies and a decreased inheritance for one’s beneficiaries.

Gloria was referred to me by her certified public accountant following the death of her brother, Juan. Like many of my clients, Gloria was the executor of Juan’s estate and wanted to know what she should do following his death. What was her role as executor? What were the legal and tax obligations for his estate? What steps did she need to take to ensure she was administering his estate correctly?

The good news is that Gloria scheduled a consultation with me to understand the ramifications of her brother’s passing and what steps needed to be taken. The bad news is that her brother, Juan, had shunned the idea of estate and tax planning during his lifetime. His staunch refusal to engage in the planning process cost his estate and his heirs substantially more than it otherwise would have.

Juan had been a successful entrepreneur and business owner in Mexico. He was an extremely hard-working individual who had built his wealth over his lifetime. At the time of his death, his estate valued approximately $5 million. His estate included a business that had offices and operations in both the U.S. and Mexico. He had numerous investments and bank accounts in the U.S., as well as investments, bank accounts and real property in Mexico. He spent a substantial amount of time in both the U.S. and Mexico, and he had family in both locations.

This demographic constitutes an ever-increasing percentage of the American populace. They are people who live and own assets in multiple jurisdictions and often have family in various locations as well. They may originally be from another country and now residing in the U.S., or residing in another county with assets in the U.S. They may be from the U.S. and residing in a foreign country, with assets and family in both jurisdictions. This ever-increasing international clientele require a unique expertise. They have to navigate legal and tax regimes in multiple jurisdictions. Maneuvering the complex labyrinth of one country’s tax code is challenging enough, but for those who choose to live and or invest around the world, they must take into account the law and tax of two or more countries.

For those who choose to plan, this complexity opens the opportunity for increased tax savings and long-term financial gains. However those who refuse to plan often inadvertently subject themselves, their estates, and their heirs to a costly maze of never-ending tax bills. Many times, for example, there are tax treaties between countries that allow the savvy planner to avoid double taxation. Learning about these treaties and other tax savings measures requires working with planning professionals knowledgeable in these areas. For the clients who refuse to invest in these professional services during their lifetimes, their estate almost always loses more money than it would have, had proper planning occurred.

Before Juan passed away in Mexico, he did not take any steps to either understand his estate tax obligations in both jurisdictions or minimize his tax liability in either jurisdiction. Even though he had spent substantial time in the U.S., he had not taken any steps to establish his domiciliary there. In Juan's case, with proper planning, he could have easily switched his domiciliary to the U.S., which would have allowed him to leave his heirs his entire U.S. estate free of estate tax. Unfortunately, in Juan's case it was too late, and the vast majority of his U.S. assets were subject to the estate tax.

The U.S. estate and gift tax law differs depending on whether a person is a citizen or resident of the U.S. versus a noncitizen alien. IRS Code Section 2001 states, "A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a *citizen or resident* of the United States" (emphasis added).

The definition of U.S. citizen is fairly straightforward. The definition of resident, however, requires a bit more investigation. For U.S. federal income tax purposes, resident means someone who lives in a place. Specifically, it means someone who has physical presence in the U.S. for a certain number of days. For estate and gift tax purposes, however, the IRS has a different definition. For estate and gift tax "resident" means "domiciliary." Interestingly enough, determination of "domiciliary" is not an objective test but rather a subjective one.

Treasury regulations provide the following definition:

> "A 'resident' decedent is a decedent who, at the time of his death, had his domicile in the United States ... A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile affect such a change unless accompanied by actual removal." (Treas. Reg. Section 20.0-1 (b) (1)).

The determination of residency for estate tax purposes is subjective and hinges on "intent." Numerous cases have occurred where the key issue is establishing the requisite intent. The service will often assert that the decedent either was or was not a resident or domiciliary, depending on which characterization would generate the largest tax bill.
This begs the question of how estate and gift taxes are calculated if the person is not a citizen or a resident. In the case of noncitizen aliens, the taxation regime is dramatically different. Code Section 2101 (a) states, "Except as provided in section 2107, a tax is hereby imposed on the transfer of *the taxable estate (determined as provided in section 2106)* of every decedent nonresident not a citizen of the United States" (emphasis added).

Code Section 2106 (a) then provides a definition of taxable estate " ... For purposes of the tax imposed by section 2101, the value of the taxable estate of every decedent nonresident not a citizen of the United States shall be determined by deducting from the value of that part of his *gross estate which at the time of his death is situated in the United States* ... " (emphasis added).

Unlike U.S persons, i.e. citizens and residents, noncitizen aliens will only be taxed on those assets that are determined to be situated within the U.S. Determining what assets are situated within the U.S. for purposes of the estate and gift tax is a complex process that requires substantial expertise. Certain assets are excluded, such as "deposit" accounts with U.S. banks, with "deposits" needing to be furthered defined. Some assets are excluded, such as life insurance on the life of the decedent noncitizen aliens, whereas other assets are excluded from gift tax but not the estate tax.

The difference between being taxed as a U.S. citizen or resident versus being taxed as a noncitizen alien is dramatic. In the case of the former, the applicable exclusion amount is $5.4 million, indexed for inflation. This exclusion can be combined for married couples, i.e. for citizens and residents, the surviving spouse can have up to a $10.8 million applicable exclusion. The caveat, of course, is that if a person is being taxed as a citizen or resident, the entirety of their assets are included in the estate tax calculation.

For nonresident aliens, the maximum exclusion is $60,000. Nonresident aliens can pass a measly $60,000 to their heirs without paying estate taxes. If one is taxed as a noncitizen alien, however, they only owe tax on U.S. assets. This is, of course, subject to the specific rules regarding the taxation of noncitizen alien assets situated in the U.S. as mentioned above. The assets located outside of the U.S. are beyond the reach of the IRS.

Understanding the above analysis can assist in the planning process. In the case of Juan, if he had started planning early enough, he could have established his domiciliary in the U.S. In this case, this would have been beneficial given the value of his U.S. assets versus his Mexican assets. He could have passed his entire U.S. estate tax free to his heirs. His refusal to plan caused his estate to be taxed on virtually all U.S. assets, except the $60,000 deduction for which he was eligible as a nonresident alien.

However, it is important to note that determining residency is only one way that planning can be used to make effective choices to minimize estate and gift tax bills for international clients. There are many nuances and details that need to be considered in the planning process. There are, for example, significant details regarding which assets are subject to estate and gift tax and when they are subject. Furthermore, the legal and tax codes of all jurisdictions involved must be understood and addressed. Anyone who has global assets, or has clients with global assets, should consult a professional trained in international estate and tax planning.

—By Manya Deva Natan, SSS Legal and Consultancy Services

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