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Topic: Using Life Insurance in U.S. Estate Tax Planning for Non-U.S. Citizens & Residents.

MARKET TREND: As foreign nationals continue to view the U.S. as a desirable location for both long-term residence and investments, there is a growing interest in life insurance planning for these individuals to address the corresponding increase in their U.S. transfer tax exposure.

SYNOPSIS: Life insurance policies issued by U.S. carriers on the life of a non-citizen, non-resident of the U.S. (“NCNR”) receive different treatment for U.S. transfer tax purposes than some assets. A NCNR is subject to U.S. gift tax only on gifts of real and tangible property physically located in the U.S. at the time of the gift and to U.S. estate tax only on assets deemed to have a U.S. situs at the time of the NCNR’s death. A life insurance policy, whether insuring a NCNR or another person, is an intangible asset for U.S. gift tax purposes. Thus, a NCNR can give a policy to another person without imposition of gift tax, regardless of the policy’s cash value. For U.S. estate tax purposes, if the NCNR owns a policy insuring his or her life, the death benefits paid from the policy at the NCNR’s death are not U.S. situs property and are not subject to U.S. estate tax, even if issued through a U.S. carrier.

TAKE AWAY: Life insurance offers a relatively simple and straightforward technique to address the varied U.S. transfer tax planning needs of NCNRs. They can use life insurance to make gifts to family members who are U.S. persons, to offset or provide liquidity to pay U.S. estate taxes on U.S. situs property without inclusion of the policy proceeds in their U.S. estate, and as a pre-immigration tax planning tool. NCNRs who intend to become temporary or permanent U.S. residents or have U.S. real property, ownership interests in a U.S. business (including stock issued by a U.S. corporation), and/or family members who are U.S. citizens or residents may have particular interest in planning with life insurance.

Under the Internal Revenue Code (“IRC”), life insurance policies issued by U.S. carriers on the life of a non-citizen, non-resident of the U.S. (“NCNR”) receive different treatment for U.S. transfer tax purposes than some assets. Utilizing life insurance in planning for NCRSs requires a basic understanding of the U.S. transfer tax rules applicable to NCNRs and their impact on life insurance.

NCNRs AND THE U.S. TRANSFER TAX SYSTEM

Who is a NCNR? While U.S. citizens and residents¹ are subject to U.S. transfer taxes on their worldwide assets, NCNRs are subject to U.S. transfer taxes only on assets having a “U.S. situs” at the time of the gift or the NCNR’s death.

The determination as to who is a U.S. resident for U.S. transfer tax purposes differs from that for income tax purposes. A U.S. resident for U.S. transfer tax purposes is a non-citizen who has his or her “domicile” in the U.S. (i.e., the

individual currently resides in the U.S. with no definite present intent to leave).² Accordingly, a NCNR for U.S. transfer tax purposes is an individual who is not a U.S. citizen and does not have a U.S. domicile.

The determination of a person's domicile is subjective. The IRS considers the facts and circumstances surrounding the individual's contacts with the U.S. to assess whether the individual has established a U.S. domicile, including the amount of time the individual spends in the U.S., visa status, the location of banking and business connections, family residences, and family members and other social contacts, and written declarations the individual has made regarding his or her domicile.³

What Assets are Subject to U.S. Transfer Taxes? NCNRs are subject to U.S. estate and gift taxes only on U.S. situs assets (those located or deemed located in the U.S.). Note that the rules for determining an asset's situs can be complex, and, as discussed below, can differ depending on whether a U.S. gift or estate tax will apply. The U.S. GST tax applies only if the original transfer was subject to either U.S. gift or estate tax and was made to a "skip person" (e.g., a grandchild or more remote descendant)⁴

What Assets Are Subject to U.S. Gift Tax? NCNRs are subject to U.S. gift tax only on gifts of real and tangible property physically located in the U.S. at the time of the gift.⁵ These include:

- U.S. real property.
- Tangible personal property (automobiles, jewelry, art, furniture, etc., "TPP") physically located in the U.S.
- Domestic or foreign currency (held as bills or coins) physically located in the U.S., including in a safe deposit box.
- Cash gifts made in the U.S., including checks and wire transfers drawn on a U.S. bank account - even if the account is at a branch located outside of the U.S.

Gifts of intangible property by a NCNR are not subject to U.S. gift tax, even if the intangibles have a U.S. situs (such as U.S. stocks and bonds).

What Assets Are Subject to U.S. Estate Tax? NCNRs are subject to U.S. estate tax on assets that have or are deemed to have a U.S. situs at the time of the NCNR's death.⁶ These include:

- U.S. real property.
- TPP physically located in the U.S.
- Domestic or foreign currency (held as bills or coins) physically located in the U.S., including currency held in a safe deposit box.
- Stock of a U.S. corporation or company, regardless of the physical location of the stock certificates.
- U.S. registered mutual funds (including money market funds).
- Nonbank cash deposits, such as cash and certificates of deposit held in U.S. brokerage firms⁷
- Deposits with a U.S. branch of a foreign bank.
- Certain contract rights enforceable against U.S. persons.

Cash deposits with a U.S. bank are not subject to U.S. estate tax, regardless of whether the account is held at a domestic or foreign branch.⁸

Tax Rates, Credits, and Deductions. NCNRs are subject to the same transfer tax rates applicable to U.S. persons – graduated estate and gift tax rates of up to 40% and a flat 40% GST tax rate. However, the credits and deductions available to a NCNR in determining his or her U.S. transfer tax liability are more limited, and include the following:

U.S. Gift Tax

- Gifts made by NCNRs are eligible for the gift tax annual exclusion (\$14,000 per donee in 2013),⁹ but NCNRs do not have a lifetime unified credit to offset other taxable gifts.¹⁰
- Gifts to a U.S. citizen spouse qualify for the unlimited gift tax marital deduction, but gifts to a non-U.S. citizen spouse do not (regardless of the spouse's residency or domicile). Instead, an increased gift tax annual exclusion (\$143,000 in 2013¹¹) applies to gifts to non-citizen spouses, with any excess being subject to U.S. gift tax.
- Gift splitting is not available to a NCNR, even if his or her spouse is a U.S. citizen.¹²

U.S. Estate Tax

- The \$5,250,000¹³ estate tax exemption is not available to NCNRs. Rather, the U.S. estate tax credit for a NCNR is limited to \$13,000, which shelters only \$60,000 in assets.¹⁴
- The unlimited estate tax marital deduction is available for bequests to non-citizen spouses only if the assets are placed in a qualified domestic trust (a so-called "QDOT").¹⁵
- Worldwide debts and administration expenses may be taken as deductions only in the proportion that the U.S. estate bears to the NCNR's worldwide estate. To take such deductions, the NCNR's worldwide assets must be disclosed on the U.S. estate tax return – something most NCNR estates are reluctant to do.
- The charitable deduction is only available for bequests to U.S. charities.

U.S. GST Tax. NCNRs do not have a separate exemption from the U.S. GST tax.

See the attached chart for a summary of the U.S. transfer tax rules applicable to NCNRs.

TRANSFER TAX TREATMENT OF LIFE INSURANCE POLICIES AND PROCEEDS

A life insurance policy is an intangible asset for U.S. gift tax purposes, regardless of the identity of the insured or whether the policy was issued by a U.S. carrier. Accordingly, a NCNR's gift of a life insurance policy, whether the policy insures the life of the NCNR or another person, is not subject to U.S. gift tax.¹⁶

For U.S. estate tax purposes, proceeds from a policy owned by a NCNR that insures only the NCNR's life are not U.S. situs property and thus are not subject to U.S. estate tax on the NCNR's death even if the policy was issued by a U.S. carrier.¹⁷ However, if the NCNR owns a policy issued by a U.S. carrier that insures the life of another person, or a survivorship policy that insures the NCNR and another person, that policy is deemed to be U.S. situs property even if the other insured also is a NCNR. The value of that policy will be included in the NCNR's U.S. estate for U.S. estate tax purposes if the NCNR predeceases the other insured.¹⁸

Example 1: H and W, both NCNRs, are the insureds under a survivorship policy issued by a U.S. carrier that has a cash value of \$500,000. H holds the policy. If H predeceases W, the policy's cash value will be included in H's U.S. estate and subjected to U.S. estate tax because the policy did not insure only H. However, if the policy passes to W following H's death, the death benefits will not be subject to U.S. estate tax upon W's death because W, as a NCNR, held a policy insuring only her life, which is not U.S. situs property.

LIFE INSURANCE PLANNING OPPORTUNITIES FOR NCNRs

Like U.S. persons, NCNRs can use life insurance to offset U.S. estate tax on U.S. assets, provide liquidity for the payment of such taxes, enhance the amount of assets the NCNR can pass to his family members at death, and make lifetime gifts to family members who are U.S. persons. In addition, a gift of a policy by NCNRs generally is not subject to U.S. gift tax and the proceeds from a policy owned by and insuring the NCNR's life are not subject to U.S. estate tax at the NCNR's death. A NCNR also can use life insurance for pre-immigration

planning as a means to defer the imposition of U.S. income tax if the NCNR wishes to reside in the U.S. on a temporary or permanent basis.

Liquidity and Asset Replacement. The relative security of the U.S. economy attracts investors from all over the world, and the recent drop in real estate prices has encouraged further investment in U.S. real estate. As indicated above, however, if a NCNR owns U.S. real property or stock in a U.S. company, such assets will be subject to U.S. estate tax upon the NCNR's death. Although the NCNR can set up complex domestic and offshore structures in estate planning, life insurance can be used in comparatively straightforward and simple ways to do such planning. The NCNR can purchase life insurance on his or her life and the proceeds, which are not subject to U.S. estate tax, can be used to offset and provide liquidity for the U.S. estate tax liability.

Example 2: Y, a NCNR, owns a beach house in Santa Barbara, California, worth \$25,000,000. Although Y is wealthy, most of his wealth is tied up in closely held businesses in Asia, and Y's liquid assets will be needed for operation of the businesses following his death. Upon Y's death, the U.S. estate tax liability will be \$9,921,800. Y could acquire a \$10,000,000 policy on his life without using an irrevocable life insurance trust ("ILIT") to provide the necessary liquidity required to pay the U.S. estate taxes.

Gifts to U.S. Family Members. A properly structured and funded ILIT can be an effective way for a NCNR to make lifetime gifts to U.S. family members and enhance the funds that pass to such family members at the NCNR's death, while providing a structure that can continue for multiple generations without the imposition of U.S. transfer taxes.

Example 3: B, a NCNR, has children and grandchildren who are U.S. citizens. B creates a Delaware dynasty trust and funds it with \$5 million in intangible assets, which transfer is not subject to U.S. gift tax (and thus no U.S. GST tax). The trustee uses the trust assets to pay premiums on a \$16 million policy insuring B's life.¹⁹ The investments within the policy will grow without imposition of U.S. income tax. The trustee can take withdrawals of cash value from the policy, up to the trust's basis in the policy, without imposition of tax or policy loans to make distributions to the beneficiaries without imposition of tax. Upon B's death, the trust will receive the policy proceeds which are not subject to U.S. income and transfer taxes and can hold these proceeds for multiple generations of B's U.S. family members without the imposition of U.S. transfer taxes.

NCNRs also can give a life insurance policy directly to a U.S. person without imposition of U.S. gift tax. The beneficiary can take withdrawals from the policy, up to the NCNR's basis in the policy without imposition of tax. The assets in the policy grow without imposition of U.S. income tax, and upon the NCNR's death, the beneficiary receives the policy proceeds without imposition of U.S. estate tax. With these income tax planning considerations, a NCNR may also consider using a private placement product in combination with his or her U.S. transfer tax planning.

Life insurance also may allow the NCNR to develop an estate distribution structure that avoids the forced heirship regimes found in many countries, like France, Germany, Italy, Spain, Japan, many Latin American countries, and the United Kingdom (to a more limited extent).

Pre-Immigration Planning. Life insurance can serve a valuable function when a NCNR is preparing to move to the U.S. on either a temporary or permanent basis. Prior to immigrating to the U.S., NCNRs generally seek to structure their assets to reduce the impact of U.S. income and transfer taxes. Typically, prior to establishing U.S. residency, a NCNR will create a self-settled irrevocable trust for the benefit of the NCNR and his or her family, and will transfer a significant portion of his or her assets to the trust. With proper planning, this may shift the assets out of the NCNR's estate for U.S. transfer tax purposes. If the trustee also invests the assets in life insurance, then the trust and its beneficiaries can benefit from the U.S. income tax rules

associated with life insurance, as noted above.

A similar strategy, using a foreign non-grantor trust and a policy issued by a foreign insurer, can be used if the NCNR intends to be resident in the U.S. only temporarily. If the foreign trust is properly structured, when the NCNR leaves the U.S., the trustee would have the discretion to terminate the trust and distribute the assets to the NCNR. Alternatively, the NCNR could hold the policy directly (purchased, of course, prior to becoming a U.S. resident). The funds will grow without imposition of U.S. income tax, the NCNR can take withdrawals from the policy up to the NCNR's basis without imposition of tax, and in the event the NCNR dies while in the U.S., as long as the NCNR is not deemed to be domiciled in the U.S., the proceeds will not be subject to U.S. estate tax.

PRACTICAL CONSIDERATIONS REGARDING POLICY OWNERSHIP

Although a NCNR can hold life insurance issued by U.S. carriers directly without being subject to U.S. estate tax, U.S. carriers may refuse to issue policies directly to the NCNR or to provide coverage in the desired amount.

The NCNR also may be reluctant to disclose all his or her assets or undergo a medical exam (in the U.S.) as part of the underwriting process. In addition, the NCNR will need to apply for and take delivery of the policy in the U.S. These factors will need to be considered as part of the planning process, along with possible tax issues in the NCNR's home country and the impact of any gift, estate, or income tax treaty between that country and the U.S.²⁰

TAKE AWAYS

- Life insurance offers a relatively simple and straightforward technique to address the varied U.S. transfer tax planning needs of NCNRs.
- A NCNR's gift of a life insurance policy, whether the policy insures the life of the NCNR or another person, is not subject to U.S. gift tax.
- Proceeds from a policy owned by a NCNR that insures only the life of the NCNR are not U.S. situs property and thus are not subject to U.S. estate tax on the NCNR's death even if issued through a U.S. carrier. In addition, these proceeds generally are paid without imposition of U.S. income taxes upon the death of the insured.
- Thus, NCNRs can use life insurance to make gifts to family members who are U.S. persons, to offset or provide liquidity to pay U.S. estate taxes on U.S. situs property without inclusion of the policy proceeds in their U.S. estate, and as a pre-immigration tax planning tool.
- NCNRs who intend to become temporary or permanent U.S. residents or have U.S. real property, ownership interests in a U.S. business (including stock issued by a U.S. corporation), and/or family members who are U.S. citizens or residents may have particular interest in planning with life insurance.

Comparison of U.S. Transfer Tax Application to U.S. Citizens/Residents and NCNRs

	U.S. Citizens & Residents	NCNRs
Assets Subject to U.S. Gift Tax	Worldwide assets	Real & tangible personal property located in the U.S.
U.S. Gift Tax Annual Exclusion	\$14,000*	\$14,000*
U.S. Gift Tax Marital Deduction	Gift to U.S. citizen spouse: Unlimited Otherwise: \$143,000* per year	Gift to U.S. citizen spouse: Unlimited Otherwise: \$143,000* per year
U.S. Lifetime Gift Tax Exemption	\$5,250,000*	None
Gift-Splitting	Yes	No
Assets Subject to U.S. Estate Taxes	Worldwide assets	U.S. situs assets
U.S. Estate Tax Exemption	\$5,250,000* (less lifetime taxable gifts)	\$60,000
U.S. Estate Tax Marital Deduction	U.S. citizen spouse: Unlimited Otherwise: Need a QDOT	U.S. citizen spouse: Unlimited Otherwise: Need a QDOT

*2013 amount. Subject to annual adjustments for inflation.

NOTES

¹ IRC § 7701(a)(30).

² Treas. Regs. § 20.0-1(b)(1); Treas. Regs. § 25.2502-1(b).

³ See, *Estate of Khan v. Commissioner*, T.C. Memo 1998-22, 75 T.C.M. (CCH) 1597 (1998).

⁴ Treas. Regs. § 26.2663-2(b).

⁵ IRC §§ 2501(a)(2), 2511(b).

⁶ IRC § 2103.

⁷ IRC § 2104(c).

⁸ RC § 2105(b). A full discussion of the property situs rules for U.S. transfer tax purposes is beyond the scope of this article. For a more comprehensive review, see Diana S.C. Zeydel and Grace Chung, "Estate Planning for Noncitizens and Nonresident Aliens: What Were Those Rules Again?," 106 *Journal of Taxation* 1, January 2007.

⁹ The federal gift tax annual exclusion is \$10,000, indexed for inflation after 1998 in \$1,000 increments. IRC § 2503(b).

¹⁰ See, IRC § 2505(a).

¹¹ The federal gift tax annual exclusion for gifts to a non-citizen spouse is \$100,000, indexed for inflation after 1998. IRC § 2523(i).

¹² IRC § 2513(a)(1).

¹³ The federal gift and estate tax exemption is \$5,000,000, indexed for inflation after 2011 in \$10,000 increments. IRC § 2010(c)(3).

¹⁴ IRC § 2102(b).

¹⁵ IRC § 2056A. A QDOT must meet the requirements of a marital deduction trust and several additional requirements. At least one trustee must be a U.S. citizen or domestic corporation. An election to treat the trust as a QDOT must be made on the U.S. estate tax return filed for the NCNR's estate.

¹⁶ It is uncertain, however, whether such gift avoids inclusion in the NCNR's estate under IRC § 2035 for U.S. estate tax if the NCNR dies within three years of the gift. IRC § 2104(b) provides that "any property of which the decedent has made a transfer, by trust or otherwise, within the meaning of [IRC] sections 2035 to 2038, inclusive, shall be deemed to be situated in the United States, if so situated either at the time of the transfer or at the time of the decedent's death." While IRC § 2105(a) specifically excludes life insurance proceeds from inclusion in a NCNR's U.S. estate, a gift of a policy issued by a U.S. carrier might be a transfer of something other than an "amount receivable as insurance" (e.g., rights to surrender the policy), which could trigger U.S. estate tax inclusion under IRC § 2035 if the NCNR dies within 3 years of the gift. Although a lifetime transfer should not produce a more onerous U.S. estate tax result than actual retention of the policy until death, the statute is not clear.

¹⁷ IRC § 2105(a).

¹⁸ Treas. Regs. § 20.2104-1(a)(4); Treas. Regs. § 20.2105-1(e).

¹⁹ The policy and premiums will be structured to ensure it is not treated as a modified endowment contract.

²⁰ This report provides an overview of the gift and estate tax rules applicable to NCNRs and does not contain a complete analysis of all relevant tax authorities. Any life insurance structure for a NCNR will be subject to the potential tax consequences in the NCNR's home country, which should be reviewed with local tax counsel prior to the implementation of any insurance or other tax planning.

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