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U.S. Estate Planning for Nonresident Aliens from Treaty Countries

A Comparison of Germany, Austria, France and the United Kingdom*

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If an individual is not domiciled in the United States for estate and gift tax purposes (hereinafter referred to as a "nonresident alien") and resides in a country with which the United States has an estate tax treaty, such a nonresident alien may avail himself or herself of estate planning techniques not available to other nonresident aliens, particularly if the treaty is one of the domicile-based treaties entered into since 1971 (as compared to the situs-based treaties entered into before 1971). This advisory will compare such techniques available to nonresident aliens who reside in Germany, Austria, France and the United Kingdom, all of which have modern, domicile-based estate tax treaties with the United States. Before analyzing these treaties, a review of how the federal estate and gift taxes operate with respect to nonresident aliens is in order.

Overview of the U.S. Estate and Gift Taxes as Applied to Nonresident Aliens

Domicile

For purposes of the U.S. estate and gift taxes, an alien is considered a U.S. resident if he or she is domiciled in the United States at the time of his or her death or at the time of a gift. If an alien enters the United States for even a brief period of time, with no definite present intention of later leaving the United States, he or she is deemed to be domiciled in the United States and, therefore, is considered a U.S. resident for estate and gift tax purposes.[1] Thus, an alien may be considered a nonresident for estate tax purposes and a U.S. resident for income tax purposes, or vice versa, since the estate tax residency test is the more subjective domicile test just described, while the income tax residency test is met if the alien satisfies an objective day count test known as the "substantial presence test" or holds a green card (i.e., is a lawfully admitted permanent resident of the United States).[2] (A discussion of the income tax residency tests is beyond the scope of this advisory.)

Under the estate and gift tax domicile rules discussed above, 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 leaving. This determination is a factual issue that focuses on many factors, none of which is

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1 Treas. Reg. §§ 20.0-1(b) and 25.2501-1(b).

2 *See* Code § 7701(b)(1)(A).

determinative. Some of the factors on which the IRS and courts focus[3] are: (i) the length of time spent in the United States and abroad and the amount of travel to and from the United States and between other countries; [4] (ii) the value, size and locations of the donor's or decedent's homes and whether he or she owned or rented them; [5] (iii) whether the alien spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.; [6] (iv) the situs of valuable or meaningful tangible personal property; [7] (v) where the alien's close friends and family are situated; [8] (vi) the locales in which the alien has religious and social affiliations or in which he or she partakes in civic affairs; [9] (vii) the locales in which the alien's business interests are situated; [10] (viii) visa status; (ix) the places where the alien states that he or she resides in legal documents;[11] (x) the jurisdiction where the alien is registered to vote; (xi) the jurisdiction that issued the alien's driver's license; and (xii) the alien's income tax filing status.

Assets Subject to U.S. Estate and Gift Tax

Generally, nonresident aliens are subject to federal estate tax only on "U.S. situs" property, with no credit for foreign death taxes paid.[12] (The foreign country may allow a credit against its death taxes for federal estate tax paid.[13]) Nonresident aliens are also subject to federal gift tax on lifetime gifts of U.S. situs property, but not on gifts of U.S. situs intangible property.[14]

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3 *See* Heimos, 837-2nd T.M., *Non-Citizens – Estate, Gift and Generation-Skipping Taxation*, Part III.C.4 for a more expansive list.

4 *Paquette Est. v. Comr.*, T.C. Memo. 1983-571.

5 *See Fokker Est. v. Comr.*, 10 T.C. 1225 (1948) and *Nienhuys Est. V. Comr.*, 17 T.C. 1149 (1952).

6 *Id*.

7 *See Farmers' Loan & Trust Co. v. U.S.*, 60 F.2d 618 (S.D.N.Y. 1932).

8 *See Nienhuys.*

9 *See Farmers' Loan* and *Nienhuys*.

10 *See Fokker.*

11 *See Fokker* and *Farmers' Loan.*

12 Sections 2101, 2103 and 2106 of the Internal Revenue Code of 1986, as amended (the "Code").

13 *See* German Inheritance Tax Law § 26 ErbStG; French Tax Code Article 784 A CGI; United Kingdom Inheritance Tax Act 1984 §§ 158 (treaty relief) and 159 (unilateral relief) (if unilateral relief is more favorable than treaty relief, the taxpayer chooses the former). To this author's knowledge, the Austrian inheritance tax law does not provide for an automatic tax credit with respect to inheritance tax paid in another country, unless a treaty provides otherwise. It is this author's understanding that in the absence of a tax treaty, under article 48 Bundesabgabenordnung (BAO) it is possible to apply for tax relief in Austria. The application must be filed with the Austrian ministry of finance, which may grant tax relief, either by a tax credit with respect to the foreign tax or by deducting the foreign tax from the taxable amount. The decision also depends on the way in which such a case would be treated in the other country.

14 Code §§ 2501(a)(1) and (2) and 2511(a).

U.S. situs property includes the following: (i) real property located in the United States;[15] (ii) tangible personal property located in the United States[16] (including cash,[17] U.S. Treasury Bills,[18] cars, furniture, jewelry, artwork, etc.); (iii) shares of stock issued by a U.S. corporation; [19] (iv) subject to certain exceptions (set forth below), any debt obligation, the primary obligor of which is a U.S. person or the United States, a state or any political subdivision of the United States, or the District of Columbia, or any agency or instrumentality of any such government; [20] (v) property that is gratuitously transferred by a nonresident alien decedent while he or she is alive, by trust or otherwise, if (A) the nonresident alien decedent retained for his or her life (or for a period that cannot be ascertained without reference to his or her death) some type of possession, control, or enjoyment of said property or its income or the right to designate who will possess or enjoy the property; (B) possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest in the property that exceeds 5 percent of the value of the property at the time of the decedent's death; (C) said property was, on the date of the nonresident alien decedent's death, subject to his or her right to alter or revoke the transfer (or if such a power was relinquished by the nonresident alien decedent within three years of the date of his or her death); **or** (D) if the decedent transferred within the three year period prior to his or her death an interest in property that would have been included in his or her estate under any of the foregoing rules, **and** if the property so transferred was situated in the United States at the time of the transfer or at the time of the decedent's death; [21] and (vi) an interest in a partnership, if (A) the partnership does not qualify as a separate legal entity under the law of the jurisdiction where it was established or is dissolved on the death of one partner, and the underlying assets of the partnership are situated in the United States [22] or (B) if the partnership is a separate legal entity under the laws of the jurisdiction where it was established and it survives the death of a partner and the partnership carries out its business in the United States.[23]

15 Treas. Reg. § 20.2104-1(a)(1).

16 Treas, Reg. § 20.2104-1(a)(2).

17 *See* Treas. Reg. §§ 20.2104-1(a)(7)(ii) and 25.2511-3(b)(4)(iv), which provide that currency is not a debt obligation of the United States, implying that it is tangible personal property. See also Rev. Rul. 55-143, 1955-1 C.B. 465, where the decedent died with funds that he had placed in a safe-deposit box, and the IRS held that "[s]ince the funds in the safe-deposit box on the date of decedent's death [did] not represent moneys deposited with a person carrying on the banking business within the meaning of section 863(b) of the Code, they [were] includible, for federal estate tax purposes, in the decedent's gross estate situated in the United States." *See Blodgett v. Silberman*, 277 U.S. 1 (1928), where the Supreme Court held ". . . that money, so definitely fixed and separated in its actual situs from the person of the owner . . . is tangible property. . . ." *See* also PLR 8138103 and PLR 7737063 (cash is tangible property).

18 PLR 8138103.

19 Code § 2104(a) and Treas. Reg. § 20.2104-1(a)(5).

20 Treas. Reg. § 20.2104-1(a)(7).

21 Code § 2104(b).

22 See *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir 1934).

23 See Rev. Rul. 55-701, 1955-2 C. B. 836 and GCM 18718, 1937-2 C. B. 476).

Examples of assets that are deemed to be situated outside of the United States are: (i) shares of stock issued by a foreign corporation; [24] (ii) deposits with persons carrying on the banking business, deposits or withdrawable accounts with a federal or state chartered savings institution (if the interest on such accounts is withdrawable on demand subject only to customary notice requirements) and amounts held by an insurance company under an agreement to pay interest thereon, as long as, in each case, the interest on such deposits or amounts is not effectively connected with the conduct of a trade or business in the United States by the recipient thereof; [25] (iii) deposits with a foreign branch of a domestic corporation or partnership engaged in the commercial banking business; [26] (iv) "Portfolio Debt Obligations," as long as the decedent was a nonresident alien for income tax purposes (a Portfolio Debt Obligation will be considered U.S. situs property if the decedent was a resident for income tax purposes, even if he or she was a nonresident alien for estate tax purposes); [27] and (v) proceeds from a life insurance policy on the nonresident alien decedent's life.[28]

Although nonresident aliens are also subject to gift tax on gifts of U.S. situs property, gifts of U.S. situs *intangible property* by a nonresident alien are generally exempt from the gift tax.[29] Property that is not considered intangible property, and is therefore subject to federal gift tax when given away by a nonresident alien, includes: (i) real property situated within the United States;[30] (ii) tangible personal property situated within the United States at the time of the gift;[31] and (iii) U.S. or foreign currency or cash situated within the United States at the time of the gift.[32]

Property that is considered intangible personal property and is therefore not subject to federal gift tax when given by a nonresident alien includes: (i) shares of stock issued by a U.S. or foreign corporation;[33] (ii) debt obligations, including a bank deposit, the primary obligor of which is a U.S. person, the United States, a state, or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government;[34]

24 Code § 2104(a) and Treas. Reg. § 20.2105-1(f).

25 Code § 2105(b)(1) and Treas. Reg. § 20.2105-1(h).

26 Code § 2105(b)(2) and Treas. Reg. § 20.2105-1(j).

27 Code § 2105(b)(3). Portfolio Debt Obligations are bonds, debentures, notes or other forms of debt which meet specific requirements under Code § 871(h).

28 Code § 2105(a).

29 See Code §§ 2501(a)(1) and (2) and 2511(a).

30 Treas. Reg. § 25.2511-3(a)(1) and (b)(1).

31 Treas. Reg. § 25.2511-3(a)(1) and (b).

32 Treas. Reg. § 25.2511-3(b)(4)(iv) (provides that currency is not a debt obligation for purposes of applying the gift tax to the transfer of property owned by a nonresident alien; Treas. Reg. § 25.2511-3(b)(2) and (4) provide that debt obligations are intangibles).

33 Code § 2511(b)(1) and Treas. Reg. §25.2511-3(b)(3).

34 Code § 2511(b)(2) and Treas. Reg. § 25.2511-3(b)(4).

and (iii) interests in U.S. or foreign partnerships (although there is some debate on whether partnership interests are intangible personal property).[35]

Estate and Gift Tax Credits and Deductions

The estate of a nonresident alien receives a credit of only $13,000 against the federal estate tax (the equivalent of a $60,000 exemption).[36] There is no credit for gifts made during the lifetime of a nonresident alien. Nonresident aliens do, however, receive the benefit of the so-called annual exclusion from gifts (currently $12,000 per donee).[37]

The estate of a nonresident alien may deduct from the gross estate the value of property passing to the decedent's surviving spouse, to the same extent as the estate of a resident alien or U.S. citizen.[38] Consequently, if the nonresident alien decedent's spouse is a U.S. citizen, a marital deduction will be permitted if all of the requirements of Code § 2056 (covering bequests to surviving spouse) are satisfied.[39] If the surviving spouse is not a U.S. citizen (regardless of whether he or she resides in the United States), as with the estate of a resident alien or U.S. citizen, in order for the estate of the nonresident alien to take advantage of the marital deduction, the provisions of Code § 2056(d) must be satisfied (which provides that a bequest to a surviving spouse will not qualify for the marital deduction unless the property is held in a qualified domestic trust, as provided in Code § 2056A, or unless the surviving spouse becomes a U.S. citizen within a specified period of time after the decedent's death).[40] In addition, the gift tax marital deduction is generally not allowed for property passing to a spouse who is not a U.S. citizen, except that a donor can give his or her non-U.S. citizen spouse up to $100,000 per year (indexed for inflation to $120,000 for 2007) without the imposition of any gift tax.[41]

As to other deductions, estates of nonresident aliens are entitled to deduct a portion of the expenses, losses, indebtedness and taxes set forth in Code Sections 2053 and 2054, which include funeral and administration expenses, claims against the estate, mortgages on, and indebtedness with respect to, property included in gross estate and uninsured casualty losses suffered by the estate.[42] The portion of these expenses that the nonresident alien's estate may

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35 For authorities and commentaries that support the proposition that a partnership interest is an intangible see *Blodgett v. Silberman*, 277 U.S. 1, 11 (1928), PLR 7737063 (6/17/1977); 2 Rhoades and Langer, U.S. International Taxation and Tax Treaties, § 33.01[2][iii] (1998); Stafford Smiley, *Dispositions of U.S. Partnership Interests by Nonresident Aliens*, Business Entities, Summer 1991; Robert F. Hudson, Jr., *The Tax Effects of Choice of Entities for Foreign Investment in U.S. Real Estate and U.S. Businesses*, Business Entities, March/April 2002. For authority that indicates the IRS may question whether a partnership interest is an intangible asset, see Rev. Proc. 2007-7, 4.01(26), 2007-1 I. R. B. 227 (which states that the IRS will not ordinarily issue a ruling or determination letter on this issue).

36 Code § 2102(b)(1).

37 Code § 2503(b)(1).

38 Code § 2106(a)(3).

39 Treas. Reg. § 20.2106-1(a)(3).

40 *Id.*

41 Code § 2523(i).

42 See Code § 2106.

deduct is determined by multiplying the expenses by a fraction, the numerator of which is the value of gross estate situated in the United States and the denominator of which is the value of all property, wherever situated, included in the gross estate.[43] Whether the amounts that are to be deducted were incurred in the United States is irrelevant for purposes of the deduction.

Consequently, a note secured by a mortgage on U.S. situs property is only partially deductible, notwithstanding the fact that the mortgaged property is includible in full. If, however, the property is subject to a mortgage to which the mortgagor has no personal liability, only the value of the property less the mortgage or indebtedness is included in the gross estate, thus, in effect, giving a 100 percent deduction of the mortgage.[44]

Treaty Impact

The United States has estate and gift tax treaties with the following countries: Australia, Austria, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland and the United Kingdom. Each of these treaties alters in some respect the rules discussed above with respect to the application of the estate and gift taxes to nonresident aliens who reside in these countries and should, therefore, be reviewed before rendering any estate or gift tax advice for such persons. By way of example, this advisory will focus on the estate and gift tax treaties between the United States and Austria, France, Germany and the United Kingdom, all of which are domicile-based treaties.

Domicile

Under the estate tax treaty between Germany and the United States (the "German Treaty"), a person is deemed to be domiciled in the United States if he or she is a resident or citizen of the United States, and he or she is deemed to be domiciled in Germany if he or she has his or her domicile or habitual abode in Germany or if he or she is deemed for other reasons to be subject to unlimited tax liability for the purposes of the German inheritance and gift tax.[45] Under the estate and gift tax treaty between Austria and the United States (the "Austrian Treaty"), a person is deemed domiciled in the United States if he or she is a resident thereof under U.S. law and is deemed domiciled in Austria if he or she is a resident thereof for Austrian tax purposes.[46] Under the estate and gift tax treaty between the United States and France (the "French Treaty"), a person is deemed domiciled in the United States or France according to the law of each country.[47] Finally, under the estate and gift tax treaty between the United Kingdom and the United States (the "U.K. Treaty"), a person is deemed domiciled in the United States if he or she was a resident of the United States or if he or she was a U.S. citizen and had been a resident of the United States at any time during the

43 Code § 2106 and Treas. Reg. § 20.2106-2(a)(2).

44 Treas. Reg. § 20.2053-7.

45 German Treaty, Article 4(1).

46 Austrian Treaty, Article 4(1).

47 French Treaty, Article 4(1).

preceding three years and is deemed domiciled in the U.K. if he or she was domiciled there in accordance with the law of the U.K. or is treated as being domiciled there for the purposes of the tax that is the subject of the treaty.[48]

If an individual is deemed to be domiciled in both countries under the above rules, subject to overriding rules under the French, German and U.K. treaties, the treaty "tie-breaker" provisions of all four treaties will apply, all of which are relatively similar.[49] Under these rules, the individual who has dual domicile will be deemed to be domiciled in the country where he or she has a permanent home, or if he or she has a permanent home in both countries or neither country, in the country where his or her personal and economic relations are the closest ("center of vital interests"). If it cannot be determined where his or her center of vital interests is the closest, he or she will be deemed to be domiciled in the country in which he or she has a habitual abode and if he or she has habitual abodes in both countries or neither country, he or she will be deemed to be domiciled in the country of which he or she is a citizen.

With the exception of the Austrian Treaty, all of the treaties at issue have provisions that override the treaty tie-breaker rules. These overriding provisions enable a citizen of the country at issue to retain his or her residency status in that country for estate and gift tax purposes for a period of time, regardless of whether he or she meets the residency requirements in the other country under its laws or under the aforementioned treaty rules.

The overriding domicile provisions of the German Treaty are the most liberal of the treaties set forth above. Under the German Treaty, if an individual, at the time of his or her death or at the time of making a gift was a citizen of one of the contracting countries and not a citizen of the other and, under the respective laws of each jurisdiction, is deemed to be domiciled in both countries, but the individual has not been domiciled in the other contracting country for more than 10 years, he or she will be deemed to be domiciled in the contracting country of which he or she is a citizen for purposes of the treaty.[50]

The overriding domicile provisions of the French Treaty have a subjective element that is not found in the German Treaty and have a shorter time period. Under the French Treaty, if an individual, at the time of his or her death or at the time of making a gift was a citizen of one of the contracting countries and not a citizen of the other and, under the respective laws of each jurisdiction, is deemed to be domiciled in both countries, but the individual has been domiciled in the other contracting country for less than five years out of the previous seven years, he or she will be deemed to be domiciled in the country of which he or she is a citizen if (i) he or she had a clear intention to retain domicile in the country of which he or she is a citizen, or (ii) he or she was in the other contracting country by reason of assignment of employment (or by reason of renewal of an assignment of employment) or as the spouse or other dependent of a person present in that other contracting country for such a purpose.[51]

48 U.K. Treaty, Article 4(1).

49 German Treaty, Article 4(2); French Treaty, Article 4(2); Austrian Treaty, Article 4(2); and U.K. Treaty, Article 4(4).

50 German Treaty, Article 4(3), as amended by Article 1 of the Protocol to the German Treaty (the "German Protocol").

51 French Treaty, Article 4(3).

The overriding domicile provisions of the U.K. Treaty do not have the subjective element of the French Treaty, but have an income tax residency element not found in the other treaties. Under the U.K. Treaty, if an individual was at any time domiciled in both contracting countries under the general domicile rules of the treaty and was a citizen of the U.K. but not of the United States and had not been a resident in the United States for income tax purposes in seven or more of the 10 taxable years ending with the year in which that time falls, he or she will be deemed to be domiciled in the U.K. at that time.[52] Likewise, if an individual was at any time domiciled in both contracting countries under the general domicile rules of the treaty and was a citizen of the United States but not of the U.K. and had not been a resident of the U.K. in seven or more of the 10 income tax years ending with the year in which that time falls, he or she shall be deemed to be domiciled in the United States at that time.[53] Therefore, although an alien's residency status for income tax purposes is just one of the multitude of factors that is considered when assessing his or her domicile status under general U.S. estate and gift tax law principles, his or her income tax status plays a more significant role in the determination if he or she is a citizen of the U.K.

The benefit of all of these treaties is that they allow aliens who were formerly residents of the country at issue to establish themselves in the United States for a period of time without worrying that they will immediately be subject to the U.S. estate and gift tax system, which, comparatively speaking, is more costly than the transfer tax systems in other countries.[54]

Although a full discussion of the U.S. expatriation tax is beyond the scope of this advisory, it is worth noting that both the German Treaty and the French Treaty provide that the provisions of the treaty shall not preclude the United States from taxing in accordance with its law the estate of a decedent or the gift of a donor who, at his or her death, or at the time of the making of a gift was a former long-term resident of the United States whose loss of such status had as one of its principal purposes the avoidance of tax, but only for a period of 10 years thereafter.[55] This provision was included in these two treaties before the expatriation rules were revised in 2004 by removing the need of a principal purpose of tax avoidance in order for the expatriation rules to apply. Since 2004, if a non-U.S. citizen has been a lawful permanent resident of the United States (i.e., green card holder) for income tax purposes in at least eight of the preceding 15 years before expatriating, he or she will be considered a "long term resident" for purposes of the expatriation tax regime, and will be subject to the regime for a period of 10 years after expatriating, if (i) his or her average annual net income tax liability for the five years preceding expatriation exceeds $124,000, (ii) his or her net worth is $2 million or more on the date of expatriation, or (iii) he or she fails to certify under penalties of perjury that he or she complied with all of his or her U.S. tax obligations for the five preceding years or fails to provide evidence of such compliance if requested by the secretary of Treasury, regardless of his or her motivation for leaving the United States.[56]

52 U.K. Treaty, Article 4(2).

53 U.K. Treaty, Article 4(3).

54 The top inheritance tax rate in Austria is 15 percent (for dispositions to one's spouse or children), in France is 40 percent (for dispositions to one's spouse or children), in Germany is 30 percent (for dispositions to one's spouse and descendants), and in the U.K. is 40 percent.

55 German Treaty, Article 11(1), as amended by Article 4 of the German Protocol; French Treaty, Article 1(4), as amended by Article I of the Protocol to the French Treaty (the "French Protocol").

56 Code § 877(a)(2).

Notwithstanding the "principal purpose" language of the aforementioned provisions of the German and French Treaties, it would seem that these provisions may still prevent the treaties from applying to former long-term residents.[57] Therefore, citizens of Germany and France who are seeking to avoid the U.S. estate tax under 10 year and five out of seven year domicile provisions of the treaties and who are lawful permanent residents of the United States for income tax purposes, should consider whether they will stay in the United States prior to being a lawful permanent resident of the United States in eight out of the preceding 15 years, even if he or she has not yet satisfied the 10 year or five out of seven year domicile provisions.[58] Since the eight out of 15 year provision of the expatriation tax is based on whether someone is a permanent resident for *income tax* purposes, it is possible to satisfy long-term residence test, while still not being considered a U.S. domiciliary for estate tax purposes (and thus not satisfying the ten year test of the German Treaty or the five out of seven year test of the French Treaty), since one can hold a green card for a year and not be present in the United States (and therefore not be considered a domiciliary for estate tax purposes).

Assets Subject to U.S. Estate and Gift Tax under the Treaties

The domicile-based treaties at issue generally reserve transfer taxation for the country of domicile. This affords the resident of a country with a domicile-based treaty estate planning opportunities not available to residents of countries with which the United States does not have transfer tax treaties or with which the United States has older, situs-based treaties. Under the domicile-based treaties, however, certain property may be taxed by the country in which it is situated. Even the domicile-based treaties at issue can differ in this regard, which may afford even greater planning opportunities for residents of one of these countries over another.

Under the German Treaty, immovable property (essentially real property and property accessory to it) situated in the United States and owned by an alien domiciliary of Germany, business property of a permanent establishment situated in the United States and owned by an alien domiciliary of Germany and an interest owned by an alien domiciliary of Germany in a partnership that owns either of the aforementioned types of property may be subjected to U.S. estate and gift tax.[59] Generally, any other property of an alien domiciliary of Germany, including cash, tangible personal property and debt obligations situated in the United States and shares of stock in U.S. corporations may only be taxed by Germany.[60]

Under the Austrian Treaty and U.K. Treaty, immovable property (referred to as "real property" in the Austrian Treaty) situated in the United States and owned by an alien domiciliary of either of these countries and business property of a permanent establishment situated in the United

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57 This is confirmed by Section V of the Joint Committee on Taxation Explanation of the Proposed [French] Protocol.

58 In this regard it is important to note that the test for whether one is a long-term resident under Code § 877(e)(2) is whether the person was a lawful permanent resident of the United States *in* at least eight taxable years during the period of 15 taxable years before expatriating. Therefore, a person who has been a permanent resident for six years and two days can meet the "eight" year test, because if a person is a permanent resident for one day in any calendar year, he will be considered a permanent resident *in* that year. As such, citizens of Germany and France who rely on the 10 year and five out of seven year provisions of the treaties may need to consider their domicile status before the end of the sixth year.

59 German Treaty, Articles 5, 6, and 8.

60 German Treaty, Article 9.

States and owned by an alien domiciliary of either of these countries may be subjected to U.S. estate and gift tax.[61] Generally, any other property of an alien domiciliary of Austria or the U.K., including cash, tangible personal property and debt obligations situated in the United States and shares of stock in U.S. corporations and, perhaps, also including an interest in a partnership that owns U.S. real estate or business property of a permanent establishment (discussed in greater detail below), may only be taxed by Austria or the U.K., as the case may be.[62] Neither of these treaties has a specific provision with respect to partnerships, unlike the German Treaty.

Prior to the French Protocol, which entered into force on December 21, 2006, the French Treaty had provisions with respect to immovable property or real property that were similar to the treaties set forth above.[63] The French Protocol revised the definition of real property to include ". . . shares, participations and other rights in a company or legal person the assets of which consist, directly or through one or more other companies or legal entities, at least 50 percent of real property situated in one of the Contracting States or of rights pertaining to such property. These shares, participations and other rights shall be deemed to be situated in the Contracting State in which the real property is situated."[64] This leads to the conclusion that an interest in a corporation, limited liability company or partnership, at least 50 percent of which is comprised of U.S. situs real property, will be considered U.S. situs property under the treaty. Moreover, under the French Treaty, in the article that subjects to U.S. estate tax business property of a permanent establishment, the definition of "permanent establishment" is ". . . a fixed place of business through which the business of an enterprise is wholly or partly carried on," and, unlike the other treaties at issue, ". . . if an individual is a member of a partnership that is engaged in an industrial or commercial activity through a fixed place of business, he will be deemed to have been so engaged to the extent of his interest therein."[65] In addition, under the French Treaty tangible movable property, other than currency, owned by an alien domiciliary of France that is situated in the United States is subject to the U.S. estate and gift taxes. Any other property of an alien domiciliary of France may only be taxed by France.

Some of the clear benefits to alien residents of treaty countries like Germany, Austria and the U.K. are that they can own a U.S. business or real property through a corporation formed in a U.S. jurisdiction and, generally speaking, shelter that property from U.S. estate tax. The same goes for alien residents of France who own a U.S. business through a U.S. corporation (as noted above, under the French Protocol, generally speaking U.S. situs real property cannot be so sheltered).

Since shares of stock in a U.S. corporation owned by a nonresident alien[66] are generally subject to the U.S. estate tax, residents of countries with which the United States does not have domicile-based treaties can only achieve such estate tax protection by owning shares of stock in a foreign corporation that owns shares of stock in a U.S. corporation, which ultimately

[61] Austrian Treaty, Articles 5 and 6.

[62] Austrian Treaty, Article; U.K. Treaty, Article 5.

[63] French Treaty, Articles 5 and 6.

[64] French Treaty, Article 5, as amended by Article III of the French Protocol.

[65] French Treat, Article 6(2).

[66] Code § 2104(a).

owns the U.S. situs real property or business. The downside to the use of this structure is that the entity may be considered a "personal holding company" ("PHC"). The PHC rules are generally intended to prevent the avoidance of shareholder level taxes by the accumulation of certain types of earnings by certain closely-held corporations (this is beyond the scope of this advisory). The rules impose a penalty tax at the corporate level on the "undistributed personal holding company income" of a PHC.[67] Even if the PHC rules are inapplicable, this structure results in double taxation (see discussion below).

Nevertheless, even if an alien is a resident of a country like Germany, Austria or the U.K., owning a business in the United States or U.S. situs real property through a U.S. corporation is not an ideal solution. Since such a corporation would not be able to make an election to be treated as a so-called "S corporation" under Section 1362(a) of the Code (because a corporation may not make such an election if any of its shareholders are nonresident aliens),[68] which election generally avoids taxation at the corporate level,[69] the earnings of the corporation would be taxed at both the corporate level and the individual level when dividends are paid.[70] In addition, the corporation would not receive preferential capital gains tax treatment, otherwise available to an individual.[71]

In light of the foregoing, another solution might be to hold the U.S. situs real property or business through a partnership or limited liability company that is taxed as a partnership.[72] Due to the general provisions of the Code discussed above, gifts of such interests should be sheltered from the gift tax, assuming that a partnership interest qualifies as an intangible asset.[73] Without treaty protection, however, an interest in a partnership that holds U.S. situs property would still be subject to the U.S. estate tax.[74]

As discussed above, the German Treaty allows the United States to tax an interest in a partnership that holds U.S. situs real property or a business interest, and, generally speaking, under the French Protocol and Article 6 of the French Treaty, the French Treaty does the same. The Austrian and U.K. Treaties, however, do not have provisions similar to that of the German and French Treaties that subject real property and business property that is indirectly held through a partnership to the estate tax.

The silence of the Austrian and U.K. Treaties with respect to ownership of real property and business interests through a partnership, can support an argument that alien residents of these countries can, perhaps, shelter U.S. situs real property and business interests from the U.S. estate tax by owning them through a partnership. Although not determinative, this argument is bolstered by the fact that there are specific carve-outs for partnership interests and interests in a company under both the German and French Treaties. Aliens of Austria and the U.K. and of

67 Code § 540.

68 Code § 1361(b)(1)(C).

69 Code § 1363(a).

70 Code §§ 11 and 301(c)(1).

71 Code § 1201(a).

72 *See* Treas. Reg. § 301.7701-3.

73 See discussion at footnote 35.

74 See discussion at footnotes 22 and 23.

other countries with which the United States has similar treaties, who are reticent to hold assets through a corporation, for the reasons discussed above, may be willing to hold the assets through a partnership, and rely on the lack of partnership language in the treaty as support for excluding the partnership interest from the purview of the U.S. estate tax.

Estate and Gift Tax Credits and Deductions under the Treaties

With certain qualifications, generally speaking both the German Treaty and the Austrian Treaty allow for direct deductions of debts that relate to the property owned by an alien resident of the treaty country that may be taxed by the United States under the treaty.[75] This places alien residents of those countries in a much better position with respect to deductions than an alien resident of a non-treaty country who, as discussed above, may only deduct a fraction of the debts based on the value of his or her U.S. situs property to the value of his or her worldwide property.[76] The U.K. and French Treaties only allow a deduction for debts in accordance with U.S. law, so there is no real treaty benefit in this regard.[77]

Due to the German Protocol and the French Protocol, both the German Treaty and the French Treaty now provide benefits with respect to property passing to an alien's surviving spouse that are not available under either the U.K. or Austrian Treaties, affording greater planning opportunities. The Austrian Treaty does not provide for any deductions or exemptions for assets passing to the surviving spouse, so the spouse would be subject to the general U.S. estate tax rules in this regard.[78] The U.K. Treaty merely provides that property that passes to the spouse from a decedent or transferor who was domiciled in or a citizen of the U.K. will qualify for the marital deduction in the United States to the extent that such a deduction would have been allowed if the decedent or transferor was a U.S. domiciliary.[79] Consequently, under both the Austrian and U.K. Treaties, if the spouse is not a U.S. citizen, he or she will be subject to the requirements that the assets be left in a qualified domestic trust, in order for the marital deduction to apply on death, and he or she will not be able to receive more than $120,000 per year from his or her spouse without the imposition of U.S. gift tax.[80]

Prior to the German Protocol, the German Treaty provided that property that passes to the spouse from a decedent or donor who was domiciled in or a citizen of one of the contracting countries, which may be taxed by the other country under the treaty, shall be included in the taxable base only to the extent its value (after deductions) exceeds 50 percent of the value of all property that may be taxed under the treaty.[81]

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75 German Treaty, Article 10(1); Austrian Treaty, Article 8.

76 Code § 2106 and Treas. Reg. § 20.2106-2(a)(2).

77 U.K. Treaty, Article 8(1) and French Treaty, Article 9(1).

78 The Report of the Senate Foreign Relations Committee on the Estate and Gift Tax Treaty with the Republic of Austria notes that a marital deduction was not deemed to be important due to Austria's low transfer tax rate on dispositions to a surviving spouse.

79 U.K. Treaty, Article 8(2).

80 *See* discussion at footnotes 38 to 41.

81 German Treaty, Article 10(4).

In addition to maintaining the marital exclusion discussed above,[82] the German Protocol provides that the value of the decedent's taxable estate will be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes to the surviving spouse and that would qualify for the U.S. marital deduction if the spouse were a U.S. citizen. This deduction is permitted if the decedent and his spouse were domiciled in either the United States or Germany, and, if they are both domiciled in the United States, at least one of them is a German citizen and if the executor waives any other benefits of any other estate tax marital deduction (such as use of a qualified domestic trust) on the estate tax return. The marital deduction under the German treaty, after the 50 percent reduction discussed above, is limited to the lesser of the value of the property or the applicable exclusion amount (currently $2,000,000).[83] Under the French Protocol, the French Treaty now has a 50 percent marital exclusion and a marital deduction similar to those of the German Treaty.[84]

Under the German Protocol and the French Protocol, the estate of an alien decedent who was domiciled in the foreign country at the time of his or her death is granted a unified credit against the U.S. estate tax equal to the greater of (i) a proportionate share of the unified credit then in effect for U.S. residents based on a fraction of the property of the decedent situated in the U.S. estate tax over the worldwide property of the decedent, and (ii) the unified credit allowed to the estate of a nonresident alien under U.S. law.[85] The Austrian Treaty and the U.K. Treaty do not provide for such an increased unified credit.

Conclusion

If a nonresident alien is fortunate enough to be domiciled in a country with which the United States has an estate and gift tax treaty, particularly a domicile type treaty, such as those analyzed above, he or she has many planning alternatives available that are not available to other nonresident aliens. Due to the subtle differences from one domicile-based treaty to another, and because some have recently been amended by protocol, it is very important to review each treaty when rendering advice to an alien domiciled in a particular country. These subtle differences can significantly impact the type of planning structures that are available to a particular nonresident alien.

82 *See* Joint Committee on Taxation Explanation of Proposed Protocol to the Convention Between the United States and Germany.

83 German Treaty, Article 10(6), as amended by Article 3 of the German Protocol.

84 French Treaty, Article 11(2) & (3), as amended by Article VI of the French Protocol.

85 German Treaty, Article 10(5) and French Treaty, Article 12(3), as amended by Article 3 of the German Protocol and by Article VII of the French Protocol, respectively.

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