Foreign Nationals in the U.S. – Invest AND Protect Your Assets

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The U.S. real estate market has arguably gained in investment appeal in the last twelve months or so due to the downturn in the market. Indeed, its lustre shines ever brightly for some foreign investors due to exchange rate considerations and the relatively low long-term federal capital gains rate at 15%. Even on a revenue basis, the deductibility of mortgage interest and real estate taxes (subject to Alternative Minimum Tax restrictions) is a compelling reason to buy for some foreign nationals living in the U.S. for a period of even just a few years.

Do the foreign national investors know, however, that the full value of their U.S. home could be exposed to U.S. federal *estate* tax rates of up to 45%! Are they aware that certain states also impose "death" taxes on assets situated within their state?

Domicile Reigns

Upon the death of one who is not "domiciled" in the U.S. (broadly defined to be someone whose *permanent* home is outside the U.S.) estate tax is imposed on all assets "situated" in the U.S. including but not limited to a principal residence or other real estate here. U.S. stock holdings and, if applicable, any U.S. pension or 401(k) investments may also be subject to estate tax. Estate tax definitions should not be confused with income tax treatment. It is perfectly possible – indeed common - for an individual regarded as resident for income tax purposes to be considered non-domiciled (sometimes similarly referred to as "nonresident") for estate tax purposes.

So what's the issue? What about the $2,000,000 individual estate tax exemption available to U.S. citizens and other U.S. estate tax residents (including most green card holders), and which will increase to $3,500,000 in 2009? Regrettably, foreign nationals not domiciled here **do not** qualify for any increase in exemption. Instead, the exemption available remains at a mere $60,000 with no legislative plans to increase the amount. Any applicable estate tax treaty between one's home country and the U.S. may help, but there are special conditions to the application of all such treaties. Moreover, notwithstanding such treaties (of which there are less than twenty, unlike the plethora of income tax treaties) in-country real estate investments often remain exposed to U.S. estate tax liability.

Ah, but what if that $1,000,000 home is fully leveraged by a full recourse mortgage (i.e. one for which you are personally liable when in default) - won't that eliminate the taxable estate? Unfortunately, no it will not. Estates of non-domiciliaries are allowed a deduction for recourse debts only to the extent of the ratio of U.S. assets to worldwide assets. So, if in addition to the U.S. home, the decedent held property and other estate taxable assets outside of the U.S. worth $2,000,000 (including life insurance proceeds), only 33% [1/(1+2)] of the mortgage would be deductible in computing the U.S. estate tax. Worse

still, in order to obtain any deduction at all, the estate's executor must disclose to the Internal Revenue Service the fair market value of the decedent's worldwide assets. Such disclosure is often impractical and almost universally undesirable.

But for married persons, presumably these issues only come into play on the death of both spouses in a tragic common accident? Surely a spouse can bequeath assets to his/her spouse on a tax-free basis and avoid these problems? Once again, the 'normal' rules do not apply if the recipient spouse is a non-U.S. citizen. There is typically no escape from estate taxation via a transfer between spouses as there is no marital deduction for transfers to a non-U.S. citizen spouse. In fact, these rules apply whether the decedent spouse bequeathing the assets is a foreign national or a U.S. citizen. The rationale for the tax authorities is that, absent these rules, the estate tax deferred assets transferred to a non-U.S. citizen will leave the U.S. tax net, never to be recaptured.

The Corporate Dimension

In the international assignment context, such estate tax exposure faced by a foreign national assignee may not be his or hers alone. Many employers have international assignment tax policies in place that seek to apportion tax liabilities between the employer and the assignee. The methodologies run from laissez-faire to tax "protection" to tax "equalization" and variations thereon. The critical point here, however, is that the vast majority of such tax policies address the treatment of income, social security and other periodically imposed taxes. Generally, they do not even acknowledge transfer taxation issues, including the impact of estate and gift taxes. As remote as the possibility is, what happens if the unthinkable happens and an assignee dies while on assignment holding assets that create additional – and possibly significant - estate tax liabilities? Who is liable?

True, many employers' international assignment tax policies discourage the purchase of a principal residence in the assignment host location. However, it is unlikely that such a policy is an effective legal shield against some level of potential employer liability absent specific reference in a letter of assignment as to how such potential liabilities should be treated. An employer could very well be exposed to additional tax liabilities simply by omission. The value of coordination between employment counsel and tax counsel coupled with an effective communication strategy with assignees speaks for itself.

Going Local

Once again, in the same manner that tax and compensation policies may focus on allowance phase-outs and the weaning off any income tax reconciliation program in place, localization also raises the specter of a fundamental shift in the estate planning issues facing foreign national assignees, particularly in the context of application for permanent resident status. The treatment of foreign pension arrangements, for example, has attracted increasing attention in the last couple of years due to detrimental changes in the cost basis treatment of such plans for income tax purposes upon distribution. This is but part of the picture, however. With permanent residence status, very often also comes

the inclusion of foreign assets into the U.S. estate tax as a domiciliary for U.S. estate tax purposes. While the exemption amounts are considerably higher, the assets within the tax horizon very often broaden equally, if not disproportionately. To be informed, such decisions should be met by careful pre-planning at the departure gate. Indeed, there may be some very effective tax strategies available to such individuals, the timeliness of which is of the absolute essence.

Protecting Those Assets – Yours and Theirs

The tax rules outlined – and the risks they pose - all seem very unfair, if not scary in their application. But what are some of the key procedural and tax technical solutions available?

Policy review and comprehensive letters of assignment would seem essential from the perspective of clarifying who is liable for any additional estate liability arising from an assignment. Other practical measures taken by some employers are to engage the services of tax advisors and estate planners with respect to these specific issues at the option of at least certain (perhaps more senior) groups of assignees. At minimum, a simple recommendation to assignees that are intending to purchase U.S. real estate, or otherwise are localizing, that they should seek comprehensive income and estate tax planning advice is a valuable - and perhaps critical - first step.

The foreign national should also give serious consideration to exploring whether a U.S. Will is advisable in circumstances where he/she purchases US estate taxable assets (even if additional to – and coordinated with - a Will in his/her country of domicile). Indeed, in any event, if he/she has accompanying children while on assignment here, a U.S. Will may be critical to avoiding potential guardianship issues in the event of a fatal accident common to both spouses. The kids come first! In addition, if an individual transfers assets to his/her non-U.S. citizen spouse, the estate tax due may at least be deferred via a properly drafted Will incorporating what is known as a Qualified Domestic Trust (QDOT). Such a trust may be created in life or shortly after the death of the first spouse.

Estate tax risks facing non-domiciliaries may also be hedged very effectively with life insurance proceeds. Indeed, life insurance vehicles are extremely versatile tools for the protection against both income and estate tax liabilities in a number of situations. They also carry the advantage for estate tax non-domiciliaries that they are per se not estate taxable on death benefits paid (whether obtained through a U.S. insurance carrier or not).

Lastly, a foreign national could try negotiating a “non-recourse” debt with his or her mortgage lender. A non-recourse debt is one with respect to which a lender has a lien only on the asset securing the loan, without recourse to the borrower’s other assets. The advantage of this mechanism is that it permits a full deduction for the value of the debt against the estate taxable real property asset. Compare this to a recourse loan situation noted above of requiring worldwide disclosure of assets in order to qualify merely to prorate the offset of mortgage debt on the ratio of U.S. to worldwide assets.

In summary, understanding how the estate tax rules apply to a foreign national's circumstances is the first notch in an action plan to mitigate any potential adverse estate tax consequences.

The moral of the story? While that new dream home looks attractive, the foreign national should avoid creating a potential estate tax and administration nightmare for those left behind!

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