



*Understanding the Estate Planning
and Financial Planning Issues
of the Non-Resident Alien*

Our mission at Fortune Strategies is to assist our foreign national clients in the following areas:

- *Understanding the USA transfer tax and income tax issues that impact them and their investments and investment returns.*
- *Selecting the right team of advisors (attorney, accountant, financial planner, insurance broker, bankers and portfolio managers).*
- *Presenting various options and solutions in the estate planning; insurance; and investment arena with their long-term benefits and costs.*
- *Assisting in selecting the solution that best fits the clients' unique situation.*
- *Assisting in the implantation of the estate planning, insurance and/or investment based solution as well as the on-going maintenance of the solution.*

The United States represents, for the majority of foreign investors, a country where security, predictability, stability and structure offer attractive investment opportunities in a world of increasing economic, social and political unrest. Foreign nationals continue to view the US as a desirable location for investments as well as short-term and/or long-term residency. Investment opportunity and personal safety issues have drawn the foreign investors to Miami, New York, Los Angeles, and San Francisco in droves.

The functional aspects of the US, as described above, are the result of a system of rules, laws and regulations which creates the stable structure that attracts the foreign investor. The very same system of rules, laws and regulations requires careful planning for the non-citizen as they increase their exposure to the US transfer taxes and income tax.

The US taxation system is enforced by the Internal Revenue Service, or the IRS, which is an independent contracted agency fully authorized by the USA Department of Treasury to collect any taxes due. The IRS has the power and the means through vast resources of full enforcement of the tax rules and regulations. Through the USA systems backed by tax treaties with numerous countries, the IRS has the ability to trace international transactions and transfers by US citizens and non-citizens alike. The IRS can seize property and impound income prior to due process (trial and court ruling).

The USA citizens have a healthy respect for the power and authority of the IRS; they avoid tax evasion. Tax avoidance through legal means is another story. The good news is that there are legal structures that minimizes and even eliminates taxation for the USA citizen as well as for the non-citizen. The message to the non-citizen is to have the same healthy respect for the USA tax system and adhere to the rules because to do otherwise can erode the very stability and predictability you seek. With the use of skilled advisors, put together the right structure, based on your personal circumstances and personal goals, that minimizes your tax exposure. Avoid the one size fits all approach to financial planning.

Resident or Non-Resident Alien Status: If you are a resident alien you are taxed on world-wide assets for estate tax purposes and world-wide income for income tax purposes. For income tax purposes, you are a resident alien if you have a green card or meet the substantial presence test. The substantial presence test is a bit complicated, one well known Miami based law firm advises their clients to spend less than 121 days a year in the US to avoid being classified as a resident alien. For estate and gift tax purposes, you are a resident alien if you are domiciled in the US. The question of legal domicile requires a fact-and-circumstance analysis that considers many issues, such as citizenship; location of investment assets; driver's registration; ability to vote; bank accounts; homes; etc.

With respect to the estate tax laws, the resident alien has a \$5,250,000* personal exemption and can also defer taxes to the death of the surviving spouse through a Qualified Domestic Trust (QDOT Trust) that qualifies for the unlimited marital deduction rules. With proper planning, a married couple can leave their children

*Indexed for inflation: \$5,340,000 in 2014

Relying on ownership of personal use real estate in a legal entity to avoid USA estate tax and maintain personal anonymity from the US income tax system may be problematic.

Failure to pay fair market rent to the entity for the use of the property could result in the following problems:

- *Income tax on the value of the rent as imputed dividend income*
- *IRS disallowance of deductions claimed for repair and maintenance eroding basis.*
- *Upon death of the property owner, the IRS determines that the foreign corporation is a sham and any beneficial tax status is dissolved*

\$10,680,000 of assets; assets in excess of that amount will be subject to a 40% estate tax. Again, taxes can be minimized through further planning.

The non-resident alien (NRA) is subject to a different set of rules: estate tax is levied on US situs property with a \$13,000 personal exemption which covers the tax on \$60,000 of assets with a 40% tax on assets in excess of \$60,000. While the estate tax system is punitive, the NRA needs to do his/her financial planning with both the estate and income tax system in mind. The NRA needs understand and address tax issues on three levels:

- The income tax system
- The transfer tax system (estate & gift taxes)
- Foreign Investment in Real Property Act of 1980 (FIRPTA)

These complex tax issues plus the personal goals and circumstances of each client needs to be addressed in structuring the correct financial plan for the non-resident alien. Careful consideration needs to be paid to the type of property held and its use.

Personal Use Real Estate: If a piece of real estate is used personally by the client or by their family members for more than 14 days a year, the property is deemed to be personal use property by the IRS code.

We meet with Mr. Z and his wife (originally from Italy) in their home with panoramic views of the beach in Santa Barbara. During our meeting when I asked Mr. Z about the value of his home and the possible estate tax issues. He said that his \$5,000,000+ home was not owned by him, but is owned by a US based LLC which in-turn is owned in a foreign corporation and was therefore not part of his estate. My next question was to ask how much rent he pays per month for the home. Why would I pay rent was his reply? That is an understandable response since he had bought and paid for the property.

How can one argue that your property is owned by an entity (not you) and not subject to estate taxes (because you do not own it) and yet you have unfettered use of the property rent free? The IRS will not buy the story as demonstrated in the recent case *G.D. Parker, Inc., Petitioner, v. Commissioner of the Internal Revenue, Respondent*. While this case dealt with many tax code violations, on the issue of rent it was held that Mr. Parker did not pay his corporation rent for the use of two homes owned by the corporation; the IRS deemed that the fair market rent value is therefore a distribution to Mr. Parker from the corporation and is subject to income tax as dividend income. Such dividends are subject to a 30% withholding requirement for NRAs. The IRS further disallowed deductions claimed for repair and maintenance expenses which eroded Mr. Parker's basis in the property. The triggering event was the sale of the properties. So, the question to Mr. Z with a home in Santa Barbara: If you continue to use the property without rent and the fair market rent of your home is \$10,000 a month or \$120,000 a year and the IRS catches up with you in 10 years; what does the 30% tax plus penalty and interest amount to on \$1,200,000 (a \$500,000 plus tax bill) and is that a price you are willing to pay?

Direct ownership of real estate is the least complex structure. The cost of creating and maintaining legal structures and the potentially higher income tax that applies to entity ownership should be compared to the cost of direct ownership and the use of life insurance to mitigate the estate tax.

This approach should be considered when the NRA is looking to purchase real property that will or may become a personal use residence. It should also be considered if the NRA's investment in real estate is going to be modest or limited in amount of value.

Most importantly, the direct ownership approach should be considered when the client has an aversion to complexity.

The answer is to either pay the rent to the entity or to choose some other method of planning other than to own your personal use property in a domestic entity owned by a foreign corporation. A much easier and perhaps a more cost effective approach may be warranted, such as the ownership of the real estate individually or in a revocable trust with insurance to pay the estate tax. Mr. Z (in his mid-50's) can buy life insurance to pay the estate tax for an annual premium of \$ 3,800 /per \$1,000,000 of term life insurance or \$12,000/per \$1,000,000 of permanent life insurance.

Investment Real Estate:

Though tangible properties can be easy to purchase for foreigners, there are a number of potential tax traps for the unwary investor. Purchasing the real estate through the right structure to meet each individual's needs is the key to a well-structured financial plan to minimize the impact of taxes.

Direct ownership of US real property by a NRA is the least complex structure and has some advantages, which include:

- Maximum capital gain rate (20% if held for more than 1 year)
- The transaction is more transparent and is less subject to IRS scrutiny
- Avoidance of unintended income tax issues such as US branch profits tax
- Lowest cost to maintain

The disadvantages of direct ownership include:

- Direct owner will be required to file a individual US income tax return because the real property creates an assumption of a business or trade
- Inclusion in the taxable estate of the direct owner and subject to estate taxes at 40%
- Tangible assets are subject to US gift tax rules
- Possibly no confidentiality
- US withholding tax
- No limited liability

Direct ownership is less complex; avoids the costs of creating and maintaining entity structures; and the tax issues are certain and straight forward. The asset will be part of the taxable estate at death; however the estate obligation is easily handled efficiently and cost effectively through the use of life insurance to fund the cost of the estate taxes.

Ownership of US real property by a non-resident alien through a domestic entity with the domestic entity owned by a foreign corporation is the planning approach that is in vogue today.

One of the main advantages of the ownership of real estate through this mechanism is that it avoids inclusion of the property in the NRA's estate as long as the entities are structured and operated correctly. Further shares of entity can be gifted without US gift tax as the shares of a US corporation are intangible property.

Fortune Strategies is a firm specializing in the life insurance industry with over 45 years of service. We represent all the well-rated carriers both in the US and off-shore.

We are not married to any one concept; any carrier or financial institution; or any product choice. Our job is to look for the right insurance carrier and product to meet the client's needs. We present the client the best options based on their financial needs and their medical health and assist them in making the most appropriate choice to meet their and their family's financial situation.

We assist the client in the process of establishing trusts and/or other entities necessary to own the insurance in order to avoid transfer taxes or to create asset protection.

We contact our clients yearly to review their plan and to assist in handling any annual maintenance issues dealing with the administration of insurance, the insurance trust or the client's investments.

A secondary advantage of the entity approach is that the non-resident alien can avoid filing US income tax returns. A corporate tax return will be filed. That anonymity with the US tax system is often the driving force in the planning process. This benefit, however, comes at a price tag that needs to be clearly understood by the client.

Other advantages include:

- No US withholding tax
- No US branch profits tax (30% tax on top of income taxes due)
- Some confidentiality
- Limited liability

The disadvantages:

- No maximum capital gains tax (rates of 15% to 35% will apply)
- Potentially two levels of tax; the corporate and then tax on distributions to the NRA will be treated as dividend income.
- Highest cost to maintain.

It is more than the cost of creating and maintaining legal entities for each property, it is that there are potentially two levels of income tax as a corporate return is required and distribution to the NRA from the LLC may be subject to taxes as well. Tax considerations include that there is no maximum capital gains tax rate (15-35%).

The negative aspects of the dual entity approach—the cost and complexity and the potentially higher income tax might make this approach less cost effective for the NRA with modest real estate holdings. The direct ownership approach coupled with insurance could prove to be more economical and efficient. However for the NRA that plans to develop a significant real estate investment portfolio certainly is the best candidate for the entity approach. Generally, entities for each property should be established.

The Role of Life Insurance in the Estate Plan:

Besides being an effective tool to create the liquidity to pay the estate tax obligation for cents on the dollar, insurance may be an appropriate solution to a number of issues that can arise in the estate and financial planning process.

Planning for Children who are US residents or citizens:

Mr. M. from Argentina runs a family owned winery in his homeland. Three of his four children live in Argentina and work in the family business. One daughter went to medical school in the US and is now a well-known oncologist at a cancer center in the United States; she married a USA citizen and has become a citizen as well. One of Mr. M's estate planning objectives was to create fair and balanced distribution plans for each of his children. It was obvious that the Argentina based heirs would receive more value from certain assets than would the USA based heir. Life insurance on Mr. M was used to create a USA based asset for the USA based child in lieu of receiving a share of certain Argentina based assets.

Life insurance can be an effective tool for legacy enhancement.

Mr. S, a client, wanted to maximize the wealth he would leave his children. We showed Mr. S, a 58 year old non-smoker the following results of investing in a life insurance policy on his life in order to enhance his legacy wealth.

What does it take to net Mr. S's children a \$1.00 after estate taxes of 40%? The answer: \$1.66

What does it take to net Mr. S's children \$1.00 if there is no estate tax? The answer: \$1.00. What does it take (in cost to life expectancy-age 85-to net his children \$1.00 tax free from an insurance policy? The answer: .29 cents

Estate Equalization:

Mr. and Mrs. F are clients in Italy. Mrs. F, an American citizen, met Mr. F, an Italian citizen, while they were in college in Connecticut. They married and Mrs. F moved to Italy and is a dual citizen. Fifty plus years later, they have four grown children and numerous grandchildren. Mr. F owns and manages an import business that has the sole distribution rights in Italy for many international manufacturers such as Pentax Camera; Bosch & Lomb; and Parker Pen. Two sons have been active in the family business for years, whereas the two daughters have not been involved in the business at all.

While Mr. and Mrs. F wanted their four children to be treated fairly, they wanted the two sons to inherit the family business and the daughters to inherit more non-business assets. Italy, like many European countries, operates under the forced heirship rules established centuries ago under the Napoleonic code. The rules demand that assets be divided equally between the children. To facilitate Mr. and Mrs. F's plan to leave the business to the sons, we arranged a binding buy-sell agreement between the children that stated that the sons would buy the daughters' share of the business at a value based on a formula. A life insurance policy on Mr. F's life was created to fund the agreement.

For citizens from countries with forced heirship rules (France, Germany, Italy, Spain, Japan, many Latin American countries, and to some extent, the United Kingdom), life insurance is a useful tool to help create fair and customized distribution plans that meet the specific needs of the heirs.

For Second Families and Significant Others:

In the United States divorce is easy due to the QDRO rules (no tax on property division upon divorce) and divorce is common place. In some countries, people are reluctant to divorce because of stronger religious influences and because of taxation on property settlements. Many European countries and Latin American countries will tax the appreciation of assets during property division in a divorce settlement. For this reason, it is not uncommon to for the parties to live separate lives without divorcing.

A second family with a significant other and the significant other themselves many have no or limited rights with respect to inheriting home land assets. Life insurance is a good tool to make certain that the people you care about are provided for adequately.

Armed with years of experience and a deep understanding of your culture, language and your very unique needs, Fortune Strategies can assist you to develop and execute investment strategies based on the background and needs of you and your family. Through a wide range of services and products from internationally based financial institutions, Fortune Strategies Financial Rock can help you meet your goals and fulfill your dreams for your objectives now and for generations to come.

The objectives of wealth preservation and wealth growth require more than just personal opinions. It takes ability based on skill through experience, to see and take advantage of real opportunities. Through the advice of Fortune Strategies, you have access to major markets, industries and companies around the world.

To Maintain Liquidity in the US to Pay for Expenses Associated with Other US- Based Assets:

Life insurance has some unique benefits that make it a useful tool in the financial and estate planning process:

Cash values: The cash value inside a life insurance policy accumulates on a tax-deferred basis. A policy owner can receive distributions from a life insurance policy through a withdrawal of basis or loan against the policy without income tax. Cash value accumulation can be an effective method of long-term savings or investing that creates a tax free pool of money in the US with a fair rate of return. The NRA can utilize the funds to help support or another investment. The NRA can also create a reliable stream of income for his or his own personal use in the future.

Death Benefit: The death benefit of an insurance policy is paid to a named beneficiary income tax free (free of USA income tax). If owned correctly, life insurance proceeds can also be free of USA transfer taxes. The USA citizen has to create special trusts to own insurance and avoid estate inclusion. The NRA can own a policy on their life without inclusion for estate tax purposes, because it is an intangible asset. Further because life insurance is an intangible asset, the NRA can gift a policy to his heirs; there is no gift tax on the gift. Life insurance, is therefore, a useful tool in providing liquidity to fund the maintenance cost on other assets, such as real estate, that will be inherited by the NRA's heirs.

Coupling a life insurance policy owned in a irrevocable life insurance trust (ILIT) may add flexibility to the estate plan involving a QDOT trust for a non-citizen spouse. The ILIT allows for the needs of other beneficiaries, whereas the QDOT trust (qualifying for the unlimited marital deduction rules) allows only the surviving spouse to the receive income benefits during his or her lifetime. The ILIT can allow for income to any beneficiary. Further the ILIT can allow principal distributions to any beneficiary, inclusive of the spouse. The ILIT can provide principal distributions to the surviving spouse for health, maintenance, education and support without subjecting the principal to transfer taxes during the spouse's life or upon her death. Principal distributions from the QDOT to the spouse are subject to estate tax.

Legacy Enhancement:

If you have more wealth than what you will not consume during your lifetime, the portion of wealth in excess of your need is custodial wealth. Investing a portion of that custodial wealth or legacy wealth into life insurance policy can substantially leverage your children's after tax inheritance. Here are some salient points to consider:

- Life insurance proceeds can be arranged to be free of transfer taxes and income taxes
- Life insurance can be a guaranteed asset that is not correlated to the stock or real estate market.
- Life insurance can be used to assure a beneficiary of a specific or guaranteed amount of assets and/or income (or standard of living).



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