Bloomberg BNA

Daily Tax Report®

Reproduced with permission from Daily Tax Report, 212 DTR J-1, 11/2/16. Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Foreign Taxpayers

In the first of a three-part series on tax planning for foreign buyers of U.S. homes, tax lawyers Carl A. Merino, Dahlia B. Doumar and Henry P. Bubel examine pros and cons of direct ownership. The authors also consider steps that can be taken to mitigate estate tax exposure. The series will demonstrate that ''there is no 'one size fits all' approach that works for everyone,'' they write.

Tax Planning for Foreign Couples Buying U.S. Homes: Direct Ownership

BY CARL A. MERINO, DAHLIA B. DOUMAR AND HENRY P. BUBEL

U.S. real estate has long attracted foreign investors, particularly in New York City, Los Angeles, Miami and other ''international'' cities.[1] Whether one is buying a pied-a-terre or an apartment for a child attending college in the U.S., or acquiring a more substantial real estate investment portfolio, it is critical to consider the tax implications of real estate ownership in the U.S.

Non-U.S. individuals are subject to federal (and often state) income taxes on gains from the sale of U.S. real estate and may be subject to estate taxes if they die owning the property (or holding certain rights with respect to the property). This series of articles and case studies explains, through the example of a nonresident couple buying a condominium apartment in New York City, how foreign investors might structure their ownership of U.S. real estate to reduce overall U.S. tax exposure and preserve their wealth for future generations.[2]

The first piece in this three-part series discusses some of the pros and cons of direct ownership and steps that can be taken to mitigate estate tax exposure. The second installment of this series discusses indirect ownership through a foreign corporation or partnership and the third installment covers ownership through a domestic or foreign trust.

As all three pieces make clear, there is no ''one size fits all'' approach that works for everyone. Among other things, the right ownership structure for a given couple or individual will depend on where they plan to live in the future, how long they intend to hold onto the property, their wealth succession plans and where they expect their descendants to reside. Moreover, any planning will need to take into account the couple's overall U.S. and foreign tax situation and likely will require input from tax advisers in their home country.

How Nonresidents Are Taxed in the U.S.

Income Taxes

U.S. citizens and resident aliens are subject to U.S. federal income taxes on their worldwide income. Resident aliens include ''lawful permanent residents'' (green card holders) and individuals who satisfy the

[1] ''U.S. Real Estate to Draw More Foreigners in 2016, Survey Finds,'' Bloomberg Business, Jan. 4, 2016.

Carl A. Merino is counsel at the law firm of Day Pitney LLP and based in the New York City office. Dahlia B. Doumar and Henry P. Bubel are partners at the New York City law firm of Patterson Belknap Webb & Tyler LLP. The authors regularly advise clients on cross-border tax matters.

The authors would like to thank their colleagues Matthew M. Kohley, Jenny L. Longman, Javiera Suazo, Brian J. Sweet and Richard R. Upton for their helpful comments.

[2] It is assumed for purposes of these case studies that neither spouse is eligible for tax exemptions or other benefits under an income, estate or gift tax treaty with the U.S.

COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

''substantial presence test'' (a formula based on the number of days present in the U.S. during the current and two immediately preceding calendar years).[3] Unlike U.S. citizens and residents, nonresident aliens generally are subject to federal income taxes only on the following types of income:

- income that is effectively connected with the conduct of a trade or business in the U.S., including business profits and operating income—taxed on a net basis at the federal level (minus applicable deductions) at graduated rates of up to 39.6 percent[4]; and

- fixed or determinable annual or periodical income (FDAP) from U.S. sources (generally, dividends, interest, rents, royalties and other portfolio income that isn't effectively connected with a U.S. trade or business)—taxed on a gross basis at the federal level and subject to withholding at the source at a flat rate of 30 percent.[5]

Taxes and withholding rates are reduced (and in some cases eliminated) for many types of income if the taxpayer is an eligible resident of a country with an income tax treaty in force with the U.S.

Taxes and withholding rates are reduced (and in some cases eliminated) for many types of income if the taxpayer is an eligible resident of a country with an income tax treaty in force with the U.S.

Additionally, certain types of income earned by nonresident aliens (and foreign corporations) are nontaxable under the Internal Revenue Code if they aren't earned in connection with a trade or business carried on in the U.S. by the holder, including interest on bank deposits and ''portfolio'' interest (for example, interest on most types of bonds).[6] Gains from the sale by a non-U.S. person of most types of assets other than inventory and interests in U.S. real estate are similarly nontaxable.[7]

Note that the 3.8 percent Medicare tax on high-income earners doesn't apply to nonresident aliens.[8]

Investments in U.S. Real Estate. Notwithstanding the general non-taxability of capital gains of non-U.S. persons, gains from the disposition of real estate situated in the U.S. are taxable under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) even if the property is held solely for personal use or (nonbusiness) investment purposes.[9]

There usually is no treaty relief available because FIRPTA preempted existing treaty provisions that excluded gains from the sale of real estate when it was enacted and newer treaties generally allow the ''source'' country to tax gains or other income from real estate situated therein. However, assuming the seller doesn't hold the property as inventory (for example, as a developer), the gains generally will be taxed at the long-term capital gain rate of 20 percent at the federal level (plus any applicable state or local income taxes) if the property has been held for more than one year and hasn't been depreciated.

If the property has been depreciated (for example, because it was rented out), its basis will be reduced and a portion of the gain attributable to such reduction in basis will be taxed at a 25 percent rate at the federal level.[10] However, the owner will already have enjoyed a tax benefit from the depreciation (i.e., offsetting rental income that otherwise would have been taxed at a higher rate).

If the property has been held for one year or less, or the seller is a developer, then graduated rates will apply. No losses are allowed if the property is held for personal use.

FIRPTA Withholding Tax. The buyer may be required to withhold 15 percent of the gross consideration paid for U.S. real estate, whether or not such consideration is paid in cash.[11] Unless the property has greatly appreciated in value, the amount withheld may exceed the seller's actual tax liability. The foreign seller would have to file a tax return to obtain a refund of the excess taxes withheld.

- **Planning Point:** The buyer and seller may be able to obtain a withholding certificate from the Internal Revenue Service, reducing the amount of FIRPTA tax that must be withheld by the buyer, by filing IRS Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests.

Rental Income and Net Election. If an apartment or other real property is rented out other than as part of an active rental business, the rent generally will be taxed at a 30 percent rate without any offsetting deductions.

However, nonresidents may elect to be taxed on a net basis (as if the rent was active business income).[12] Although higher marginal rates may apply, the offsetting

[3] See Section 7701(b) of the Internal Revenue Code of 1986, as amended. There are a number of exceptions to the normal day-counting rules, including for individuals visiting the U.S. on certain visas (for example, students, teachers and diplomatic staff) and individuals who can establish a closer connection to another country.

[4] See Section 871(b). Note that per Section 874(a), no deductions are allowed if the taxpayer fails to file a U.S. federal income tax return.

[5] See Sections 871(a) and 1441.

[6] See Sections 871(h), 871(i), 881(c) and 881(d).

[7] The carve-out for capital gains doesn't apply to individuals who are present in the U.S. for 183 days or more during a calendar year. See Section 871(a)(2). Ordinarily, being present in the U.S. for that many days in a calendar year would cause an individual to become a statutory resident for income tax purposes. However, as discussed in note 3, individuals present on certain types of visas (including student, teaching and diplomatic visas, among others) may be present in the U.S. for longer periods without becoming residents for income tax purposes. Such an individual may nonetheless be subject to capital gains tax in the U.S. on otherwise exempt gains if he or she has a ''tax home'' (e.g., a principal place of work or business or regular place of abode) in the U.S. See Section 865(g)(1)(A)(i)(II).

[8] See Section 1411(e).

[9] See Sections 897, 1445.

[10] See Section 1250. As discussed later, no depreciation deductions would be allowed without a ''net election'' under Section 871(d).

[11] See Section 1445(a).

[12] See Section 871(d).

 COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

deductions for property taxes, depreciation and other expenses may greatly reduce the effective tax rate.[13] The election is made with the nonresident owner's federal income tax return.[14]

State and Local Income Taxes. Many states and some localities tax individuals who reside out-of-state (or outside of the locality where applicable) on income from sources within the state or locality, including gains from the sale of real estate situated therein.

For example, the sale of a New York City apartment by a nonresident would be subject to New York state personal income taxes, as well as New York state and city real estate transfer taxes.[15]

Estate and Gift Taxes

U.S. citizens and residents are subject to U.S. federal estate taxes at death on all of their assets, wherever situated. In contrast, nonresidents who aren't U.S. citizens are subject to estate taxes only with respect to ''U.S. situs'' assets, which include real and tangible personal property (such as artwork, other collectibles and furniture) situated in the U.S., as well as certain designated types of intangible property.[16] The federal estate tax is imposed at rates of up to 40 percent.

The estate tax is backstopped by a gift tax at the same rate for gifts made during an individual's lifetime. In general, a nonresident individual who isn't a U.S. citizen is subject to U.S. federal gift taxes only with respect to real and tangible personal property situated in the U.S.[17] Gifts of intangible property by such a nonresident aren't subject to the gift tax.

■ **Planning Point:** U.S. estate and gift taxes don't always apply to the same assets. For example, stock in a U.S. corporation held at death would be includible in a non-U.S. decedent's estate as a U.S. situs asset. However, with certain exceptions, a non-U.S. individual could make a gift of the same stock during his or her lifetime without triggering gift taxes because stock is intangible property.

Residence for Gift and Estate Tax Purposes Residence for U.S. estate and gift tax purposes is based on ''domicile''—i.e., the place where an individual intends to reside indefinitely.[18]

The determination of an individual's domicile requires a facts-and-circumstances inquiry, as one would need to consider the individual's overall ties to both the U.S. and his or her home country (or possibly another jurisdiction) for clues as to such individual's long-term plans.

Exemption Limited to $60,000 for Non-U.S. Decedents. U.S. citizens and residents are entitled to a combined gift and estate tax exemption equivalent amount of $5,450,000 (for individuals who die in 2016).[19] However, the exemption is reduced to $60,000 for nonresident individuals who aren't U.S. citizens.[20]

Moreover, gifts to a spouse who isn't a U.S. citizen aren't eligible for the unlimited gift tax marital deduction, and estate property passing to a surviving spouse isn't eligible for the unlimited estate tax marital deduction if the surviving spouse isn't a U.S. citizen.[21]

Thus, relatively insignificant holdings in the U.S. (including tangible personal belongings) can trigger estate taxes.

■ **Planning Point:** All individuals are eligible for an annual gift tax exclusion of $14,000 per donee and up to $148,000 for a non-citizen donee spouse, which can allow for significant interspousal transfers over time.[22]

State-Level Estate and Gift Taxes (New York). Some U.S. states also impose estate and gift taxes. For example, New York state imposes an estate tax at rates of up to 16 percent on real and tangible personal property situated in New York held by individuals who are domiciled outside of the state at death.[23]

Nonresidents are eligible for a much larger estate tax exemption in New York than at the federal level.

However, nonresidents are eligible for a much larger estate tax exemption in New York than at the federal level. The New York exemption amount is $4,187,500 for individuals who die on or after April 1, 2016, and before April 1, 2017. It increases to $5,250,000 on April 1, 2017, and will match the federal exemption amount for U.S. citizens and residents beginning in 2019.

Nondomiciliaries of New York are entitled to the same exemption in New York as New York domiciliaries, regardless of whether or not they are U.S. persons for federal estate tax purposes.

Note, however, that if the value of an out-of-state decedent's New York situs assets exceeds the New York state exemption amount by more than 5 percent, New York estate taxes may apply to the entire New York estate (not just the portion that exceeds the exemption amount).

[13] As previously noted, depreciation deductions reduce the owner's basis in the property, potentially increasing taxable gains on a subsequent sale, the ''recaptured'' portion of which generally will be taxed at a 25 percent rate.

[14] The election generally remains in effect for subsequent years unless revoked. Procedures for making and revoking an election are discussed in Treasury Regulations Section 1.871-10. Note that in the case of a partnership, it is the individual (or corporate) partners, rather than the partnership itself, who make the election.

[15] New York City's resident income tax doesn't apply to individuals who aren't New York City residents.

[16] See Sections 2101(a), 2103, 2104(a); Treas. Reg. Section 20.2104-1(a)(5).

[17] See Sections 2501(a), 2511(a).

[18] See Treas. Reg. Sections 20.0-1(b)(1) and (2).

[19] The exemption amount is indexed for inflation and takes into account gifts made during the decedent's lifetime.

[20] See Section 2102(b).

[21] See Sections 2056(d), 2523(i). U.S. residence (even green card status) isn't sufficient ''U.S.'' status for the unlimited deduction. Only citizens are eligible. Note that this also can be an issue for U.S. citizens married to non-citizen spouses if the U.S. citizen dies first.

[22] See Section 2523(i); Rev. Proc. 2015-53. Both exclusions are indexed for inflation.

[23] New York doesn't have a gift tax, but certain lifetime gifts made while an individual is a resident of New York may be pulled back into his or her New York estate.

Estate and Gift Tax Treaties. The U.S. has estate and/or gift tax treaties in force with Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland and the U.K. However, real estate situated in the U.S. generally remains subject to U.S. gift and estate tax jurisdiction under most treaties.

A number of U.S. estate tax treaties give eligible residents of the other treaty country a prorated portion of the $5,450,000 exemption afforded to U.S. decedents based on the ratio of U.S. situs assets to total assets worldwide (if higher than the $60,000 exemption equivalent amount otherwise available to a non-U.S. decedent).[24] The benefit of this prorated exemption generally is limited if most of the decedent's assets are situated offshore.

For purposes of simplicity, we have assumed that no estate tax treaty applies in the case studies discussed below and in the next installments of this series.

Case Studies: Purchase of New York City Apartment

The case studies below and in the next two installments analyze the purchase of a condominium apartment in New York City by a nonresident alien couple.[25] Each spouse is a nonresident for income, gift and estate tax purposes and neither spouse is a current or former U.S. citizen, long-term resident or New York domiciliary.[26] Except where specifically indicated, there is no applicable estate, gift or income tax treaty.

The simplest ownership option is for the couple to buy and hold the apartment directly.

The apartment is purchased, either directly or through one or more intermediate entities, for $5 million cash (including any transaction costs borne by the buyer) and without any financing. The apartment appreciates in value to $8 million by the time of any potentially taxable event, such as a sale or death.

It is assumed that 2016 income and estate tax rates will apply and that the apartment will have been owned for more than one year at the time of any taxable disposition, so that gains potentially may be taxed at long-term capital gain rates (if the apartment isn't held through a corporation). It also is assumed that the closing costs for any subsequent sale, including the broker's commission, attorneys' fees and New York state and city real estate transfer taxes, will total 8 percent of the purchase price ($640,000), reducing the amount realized to $7.36 million.[27]

Regardless of the ownership structure chosen, the couple also will need to plan for ongoing costs of ownership, including property taxes and monthly maintenance fees.

The example below walks through the pros and cons of direct ownership and potential options for mitigating estate tax exposure. In the second and third installments of the series, we will cover various indirect ownership structures, including the use of one or more corporations, partnerships or trusts.

Direct Ownership Scenario

The simplest ownership option is for the couple to buy and hold the apartment directly. This option is tax-efficient from an income tax standpoint if the property is later sold at a gain because the gains would be taxed at the 20 percent long-term capital gain rate at the federal level (plus New York state personal income taxes).[28]

However, absent further planning, there would be a significant estate tax inclusion if either spouse died owning the apartment, although there would be a partial step-up in basis at death, reducing taxable gains on any subsequent sale. Regardless of whether the property is sold before or after either spouse dies, the seller would have to file both federal and New York state income tax returns to report any gains from the sale.[29]

■ **Planning Point:** If only one spouse has sufficient liquidity to make the purchase, he or she should consider making a cash gift from an offshore bank account to the other spouse prior to the purchase so that both spouses can pay their respective shares of the purchase price.[30] Otherwise, the first spouse may be deemed to have made a taxable gift of 50 percent of the property—a U.S. situs asset—to the other spouse, which could be subject to gift tax to the extent it exceeds any available annual gift tax exclusion.

---

[24] The proration requirement is spelled out in some treaties and imposed by the code for others. Section 2102(b)(3)(A) provides that, to the extent required by any treaty obligation of the U.S., the exemption amount available for U.S. residents will be prorated for nonresidents based on the ratio of U.S. situs assets to total worldwide assets.

[25] Another common form of home ownership in New York City is the cooperative apartment, in which the owners are stockholders of a co-op corporation that owns the underlying property. Because of their corporate attributes, co-op shares potentially may be treated differently than condominium apartments for federal gift tax and New York estate tax purposes. However, many co-op boards restrict ownership to individuals who will use the property as a primary residence and prohibit ownership by trusts and entities, so we have assumed that the couple would purchase a condominium apartment.

[26] Individuals who give up their citizenship and ''long-term residents'' (valid green card holders for eight of the last 15 years) who cease to be lawful permanent residents may be subject to an exit tax under Section 877A, as well as a special transfer tax regime under Section 2801 on subsequent gifts and bequests to U.S. persons.

[27] New York City imposes a transfer tax of 1.425 percent on the seller. (The rate is 2.625 percent in the case of commercial real estate or if two or more apartments are sold at the same time.) New York state imposes a 0.4 percent transfer tax on the seller and a 1.0 percent ''mansion'' tax (where consideration on the sale of a residence exceeds $1 million) on the buyer. The buyer and seller are each liable for transfer taxes that the other fails to pay. The broker's commission typically is 5 percent to 6 percent of the purchase price.

[28] As previously noted, a 25 percent federal tax rate (not including state income taxes) would apply to a portion of the gain if the property has been rented out and its tax basis has been reduced by depreciation.

[29] New York state and city real estate transfer tax returns also would be required to report the transfer.

[30] The gift of cash from a U.S. bank account is potentially taxable in the U.S. However, the IRS has held informally that the gift of cash by a non-U.S. person from an offshore bank account generally isn't subject to gift tax. See PLR 8210055 (Dec. 10, 1981).

 COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

It is important to keep careful records of both spouses' contributions. Most couples take title to real estate in New York as ''tenants by the entirety,'' New York's default form of marital property ownership. If one spouse dies, the other spouse automatically becomes the sole owner. However, if the surviving spouse isn't a U.S. citizen, the entire property is included in the decedent's estate unless the executor can show that the surviving spouse paid for his or her share, in which case only the portion funded by the decedent would be included in the decedent's estate.[31]

It is assumed for purposes of the analysis below that both spouses have contributed equally to the purchase price.

Sale of Apartment (Before or After Death of Spouse)

The tax consequences of direct ownership depend in part on whether the property is sold while both spouses are still alive. Any gains from the sale of the apartment would be taxable at the federal and state level in either case, but there would be a partial step-up in basis (reducing taxable gains on a subsequent sale) if either spouse dies while owning the property, albeit at the cost of an estate tax inclusion.[32]

Sale While Both Spouses Still Alive. Assuming the property was never rented out or depreciated (which would have reduced basis) and no capital improvements were made (which would have increased basis), the couple's combined basis would be $5 million and the taxable gain would be $2.36 million—$7.36 million realized ($8 million sale price net of closing costs) minus the $5 million basis.

Ignoring any deductions or credits, the New York state personal income tax would be $208,152 (8.82 percent) and the federal tax on the capital gain would be $472,000 (20 percent), for an overall income tax burden of $680,152.[33]

Sale After Death of One Spouse. The one-half interest already owned by the surviving spouse still would have a cost basis of $2.5 million (half the original purchase price), while the basis of the half owned by the decedent would be stepped up to $4 million (half the date of death value) because it was acquired from a decedent by reason of the decedent's death and includable in the decedent's estate. This would increase the total basis to $6.5 million and reduce the taxable gain from $2.36 million to $860,000.[34]

Assuming no deductions or credits, New York state personal income taxes would be $58,910 (6.85 percent)[35] and the federal capital gains tax would be $172,000 (20 percent).[36]

Although this reduces the combined federal and state income tax bill from $680,152 to $230,910, the federal estate tax on the decedent's half of the apartment would be $1,532,800 (assuming there are no other U.S. situs assets subject to estate tax), increasing the overall income and estate tax burden to $1,763,710. There would be no New York estate tax due because the decedent's $4 million share of the apartment is below the current $4,187,500 threshold in New York.[37]

Estate Tax Mitigation Strategies

There are a number of options for mitigating the potential estate tax bill from direct ownership, including the purchase of life insurance, provisions for qualified domestic trusts and the use of nonrecourse debt. For many couples, life insurance may be the most viable option of the three.

Life Insurance. Either spouse could purchase a term life insurance policy with sufficient coverage to defray the expected estate tax due upon death. Although certain types of intangible property issued by U.S. persons are considered U.S. situs assets for estate tax purposes, proceeds paid on an insurance policy on the life of a nonresident/noncitizen decedent are excluded from the decedent's estate without regard to whether the issuer is a U.S. insurance carrier, the proceeds are payable to the decedent's estate or the decedent dies owning the policy.[38]

In some cases, a non-U.S. insurance policy may be the most practical option for covering both spouses, but a U.S. policy may be more desirable from an income tax standpoint if the couple later establishes residence in the U.S.

However, an insurance policy on the life of another person owned by a decedent or payable to his or her estate may be subject to estate taxes if the policy is issued

[31] Sections 2040(a), 2056(d)(1)(B); Treas. Reg. Sections 20.2040-1(a)(2), 20.2056A-8(a). A foreign couple might take title to real estate as ''tenants in common'' (i.e., without rights of survivorship) in order to avoid a potential inclusion of the entire property in a decedent spouse's estate, but they would lose some credit protections in the process and could also subject the decedent's share of the property to probate.

[32] Note that basis may be stepped down if the property has lost value.

[33] Although state income taxes are potentially deductible for federal income tax purposes, we have assumed that any deduction would be eliminated by the alternative minimum tax (AMT) and other limitations on itemized deductions. We also have assumed that neither spouse will be eligible for the qualified principal residence exclusion under Section 121. Note that real property transfer taxes already were treated as part of the closing costs, reducing the amount realized.

[34] See Sections 1014(a), (b)(9). Note that in a jurisdiction where community property laws applied the entire property would receive a step-up in basis, not just the portion included in the decedent's estate. See Section 1014(b)(6).

[35] In the case of a nonresident alien individual or couple, the higher marginal tax rate of 8.82 percent doesn't apply if New York taxable income is below $1,062,650.

[36] The portion of the property acquired from the decedent would be deemed to have satisfied the holding period requirements for long-term capital gain treatment regardless of when it was sold. See Section 1223(9).

[37] Note that artwork and other personal effects could push the New York estate above this threshold and increase the federal estate tax bill as well.

[38] Such amounts are treated as non-U.S. situs assets. See Section 2105(a); Treas. Reg. Section 20.2105-1(g).

by a U.S. insurance carrier. For example, if either spouse bought an insurance policy from a U.S. carrier on the life of the other spouse and then predeceased the other spouse, the cash surrender value of the policy could be includable in his or her estate.[39]

In contrast, policies issued by non-U.S. carriers wouldn't be considered U.S. situs assets under the general situs rules, which treat intangible property that is ''not issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit'' as not having a U.S. situs.[40]

In some cases, a non-U.S. insurance policy may be the most practical option for covering both spouses, but a U.S. policy may be more desirable from an income tax standpoint if the couple later establishes residence in the U.S.[41]

For a younger couple that doesn't plan to hold the apartment indefinitely and where the primary concern is an unexpected death, an inexpensive term insurance policy may be the most practical solution to address estate tax exposure. If the property is to be held indefinitely, then a whole life policy may be a better option. Although more expensive than term insurance, a whole life policy, perhaps with variable investment features that track the performance of one or more investment funds, could be a useful (and tax-advantaged) wealth transfer vehicle in its own right.

■ **Planning Point:** Either spouse could create and fund an irrevocable trust with cash from a foreign bank account and the trust could then buy insurance on the lives of both spouses. Because there is no (U.S.) tax limit on the amount of cash that could be gifted to a trust from a foreign bank account, a life insurance trust could be used for more than just covering the estate tax costs of owning real property in the U.S. and could be a powerful tool for multigenerational wealth transfers in its own right.

[39] This could also be an issue with survivorship policies.

[40] See Treas. Reg. Section 20.2105-1(e).

[41] Life insurance policies issued by non-U.S. insurance carriers can be problematic from an income tax standpoint in the hands of a U.S. citizen or resident (or dual citizen or resident) if such policies aren't designed to qualify as life insurance for U.S. income tax purposes. A U.S. person who owns an insurance policy that flunks one of the actuarial or other definitional tests for life insurance may be taxed currently on the inside build-up in the policy and may also be treated as owning some of the underlying assets, many of which could be foreign mutual funds subject to the passive foreign investment company rules. A policy issued by a non-U.S. carrier generally wouldn't present the same issues for a non-U.S. owner (and may offer some estate tax advantages because it wouldn't be a U.S. situs asset) but could become a trap for the unwary if the owner later becomes a U.S. citizen or resident.

Qualified Domestic Trusts. Another possible option that could defer the estate tax until the death of the surviving spouse is to make provisions in each spouse's will for a qualified domestic trust (QDOT).

However, for many couples this option won't be as viable as life insurance. For example, if the QDOT's assets exceed $2 million, then either a U.S. bank must serve as trustee or a bond or letter of credit must be posted to secure potential estate taxes due.[42] Moreover, income may only be distributed to the surviving spouse during his or her lifetime and any principal distributed will be subject to the estate tax.

Nonrecourse Debt. The apartment also could be mortgaged in order to reduce the net value of U.S. situs assets includable in either spouse's U.S. estate. Note, however, that unless financing can be arranged on a nonrecourse basis, the debt will be allocated pro rata among all of the decedent's assets, greatly reducing the tax benefits of leveraging the condominium and requiring disclosures of non-U.S. situs assets on the decedent's U.S. federal estate tax return.

This option may be more viable in states like California where mortgages can be obtained on a nonrecourse basis than in states like New York where mortgages are typically recourse to the property owner. It also may be feasible where another family member or entity is able (and willing) to loan money on a nonrecourse basis.

Pros and Cons of Direct Ownership

The direct ownership model has the benefit of simplicity in that there are few additional administrative or carrying costs separate and apart from the property taxes and maintenance fees one would have to pay for the apartment itself under any ownership structure.

Direct ownership also is efficient from an income tax standpoint because it preserves favorable long-term capital gain rates at the federal level. However, the estate tax cost if either spouse dies before the property is sold is very significant.

In situations where obtaining life insurance isn't a significant challenge—for example, where the couple is in reasonably good health and not too advanced in age—direct ownership, coupled with life insurance, might make the most sense and also avoid unnecessary complexity.

However, some individuals may be uncomfortable with direct ownership from a tax or liability standpoint or may have difficulty obtaining the necessary insurance (or nonrecourse financing). Others may have more complicated succession plans in mind. In the coming articles of this series, we will discuss possible alternative structures for such individuals, including the use of foreign ''blocker'' corporations, partnerships and trusts.

[42] See Treas. Reg. Section 20.2056A-2(d).

 COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. DTR ISSN 0092-6884