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How the U.S. Gift Tax Applies to Foreign Nationals

Gifting assets is an effective way to transfer wealth to younger generations, family members or others. This is particularly true in years like 2020 when asset values may have suffered significant decreases, creating an opportunity to make larger gifts at lower valuations.

Foreign nationals residing in countries with a wealth or estate tax can take advantage of gifting to lower future tax bills[1]. How the U.S. gift tax applies to those not ordinarily subject to U.S. taxes is often misunderstood. This article addresses the rules surrounding the U.S. gift tax and highlights strategies that foreign nationals should consider to eliminate or mitigate its impact.

Determining U.S. Transfer Tax Residency

Like with any of the U.S. transfer taxes[2], it is important to ascertain the tax domicile of the taxpayer. Whether a person is a U.S. resident or not for U.S. transfer tax purposes will hinge on a facts and circumstances test. The key to U.S. transfer tax residency is the concept of "domicile" and whether one is considered to be domiciled in the U.S. due to an intent to remain indefinitely in the U.S. The test is subjective and the case law has provided some surprising results[3]. Some of the factors courts have considered include green card or the type of visa an individual holds; location of principal residence and family members; location of business; declarations of residency in documents such as voter's registration, driver's license, wills or deeds; where a person maintains financial accounts; and where the center of their social life lies.

Rules of the U.S. Gift Tax

While some countries tax the receiver of the gift (the "donee"), the U.S. taxes the gift giver (the "donor"). The U.S. gift tax will apply differently in accordance with whether the donor is a U.S. domiciliary or not.

U.S. domiciliaries are subject to transfer taxes on their worldwide assets. U.S. domiciliaries also enjoy a large unified gift and estate tax exemption on the transfer of their assets, which is equal to $11.58 million in 2020[4].

[1]Argentina, France (wealth tax no longer applies to financial assets and is only levied on real estate), Spain, Colombia, Switzerland, and Italy all have some form of wealth taxes.

[2]These are the estate, gift and generation-skipping transfer taxes.

[3]See *Estate of Khan v. Commissioner*, T.C. Memo. 1998-22 where a Pakistani citizen who lived most of his life and died in Pakistan was found to be a U.S. domiciliary for purposes of the U.S. estate tax. Even though his wife and family still lived in Pakistan, the Tax Court felt he did not reestablish a domicile in Pakistan and other factors showed evidence of an intention to live in the U.S. indefinitely, such as his obtaining a U.S. green card and Social Security number; creating a U.S. Last Will and Testament; and holding significant business interests in the U.S. In the *Estate of Nienhuys v. Commissioner*, 17 T.C. 1149 (1952), a Netherlands citizen with a green card who was living and died in the U.S. was found to be domiciled in the Netherlands as evidence showed he always intended to return to the Netherlands and was only living in the U.S. because Germany had invaded the Netherlands. This case turned on the principle that once acquired a domicile is presumed to continue until it is shown to have been changed. In *Paquette v. Commissioner*, 46 T.C.M. 1400 (1983), the decedent was found domiciled in Canada at the time of his death. Even though he had purchased a vacation home in Florida which he visited annually over the course of 20+ years and no longer owned a home in Canada upon his death, he maintained numerous contacts with Canada. For example, he filed income tax returns and voted there, held a Canadian driver's license and passport, held most of his investment assets there and also purchased, registered and insured his car there.

[4]Note that this exemption will sunset in 2026 when it will revert to the 2017 value of $5 million indexed for inflation. However, with a change of government possible this year there are tax proposals on the table which could reduce the exemption to $3.5 million earlier.

On the other hand, non-U.S. domiciliaries will be subject to transfer taxes on U.S. situs assets only, but have no exemption available to them for lifetime gifts and are taxable on the first $1 of these transfers. The gift tax rates range from 18% to 40% and reach the highest rate at $1 million of value. In addition to the unified exemption, both U.S. and non-U.S. domiciliaries have an annual exclusion of $15,000 per donee available to them.

The rules for U.S. situs assets have some nuances but, in general, U.S. situs assets are real and tangible assets located in the U.S. (think Miami vacation home or a sculpture in that Miami home). Some intangible assets, such as stock of U.S. corporations, will not be subject to gift tax but are subject to the U.S. estate tax. The chart below illustrates U.S. situs assets subject to U.S. transfer tax for non-U.S. domiciliaries. Where a treaty exists between the U.S. and another country, the situs of certain assets and exemptions applied may be changed by the treaty[5].

Asset Type	Gift Tax	Estate Tax
U.S. Real Property Interest	✔	✔
Stock of U.S. Corporations*		✔
Stock of Non-U.S. Corporations		
Tangible Personal Property in the U.S. (e.g., currency, art, jewelry, furniture)	✔	✔
Shares of U.S. Mutual Funds*		✔
Shares of Foreign Mutual Funds		
American Depositary Receipts (ADRs)		
Special deposits (e.g., deposits with brokerage houses, custody accounts)	✔	✔
Deposits in U.S. banks (or foreign branch of a U.S. bank)**		
Cash in a safe deposit box in the U.S.	✔	✔
Debt obligations of U.S. citizens or residents	✔	✔
Debt obligations of U.S. corporations		
Debt obligations of U.S. government		
U.S. Exchange Traded Fund (ETF)***	✔	✔

* It is important to note that U.S. stocks and other securities are treated as U.S. situs for purposes of the U.S. estate tax only and may be gifted during life with no U.S. gift tax consequences.

** There is an argument that a gift of cash in the form of a check drawn against a U.S. bank or a wire transfer of funds into the U.S. account of a U.S. donee may be treated as a transfer of currency located in the U.S.

*** A U.S. ETF structured as a corporation of mutual fund in the U.S. situs asset but they can be structured as partnerships, grantor trusts or other vehicles that may be classified differently.

[5]The U.S. has 15 estate and gift tax treaties globally with Australia, Austria, Canada, Denmark, Finland, Germany, Greece, Ireland, Italy, Japan, Netherlands, Republic of South Africa, Switzerland and the United Kingdom.

Opportunities to Drive Tax Efficiency

Non-U.S. domiciliaries can eliminate or mitigate the impact of the U.S. gift tax by considering the following strategies:

- **Maintain documentation relating to domicile** – As the matter of domicile is very fact-specific, it is important to keep good records showing one's ties to another country in the event there is any uncertainty as to the individual's present intent not to remain indefinitely in the U.S.
- **Limit gifts of U.S. situs assets to non-U.S. citizen spouses** – Unlike transfers between U.S. citizen spouses, which fall within the unlimited marital deduction exception[6] and are not subject to gift tax, transfers to non-U.S. citizen spouses of U.S. situs assets will only be allowed an annual $157,000 exclusion (in 2020). Gifts in excess of this amount will be subject to U.S. gift tax. It should be noted that U.S. state and local taxes may also apply to any transfers of U.S. situs assets and may also need to be reviewed.
- **Use non-U.S. vehicles to hold U.S. situs assets** – The gift tax will only apply to non-U.S. domiciliaries for gifts of U.S. situs assets. The nature of a U.S. situs asset can be converted by holding that asset within a non-U.S. vehicle that blocks the U.S. estate tax, such as an offshore private investment company or foreign trusts that are not tax transparent.

[6] Internal Revenue Code Section 2056