US Estate and Gift Tax for US Residents or Citizens

The US imposes at tax on the gratuitous transfer of wealth from one person to another during life (gift tax), and from one generation to another (estate tax). This system of taxation is collectively called the federal transfer tax system and is composed of three taxes: a gift tax that applies to transfers that occur during one's lifetime, an estate tax that applies to transfers after death, and a generation-skipping tax that can occur either during lifetime or after death and is applied when one attempts to avoid the gift or estate tax at each generation.

Without the gift tax, you could avoid the estate tax by giving your property away before you die. Without the estate tax, people could avoid the tax by giving all of their property away after they die. And without the generation-skipping tax, people could avoid the tax that would occur at the next generation by transferring their property to a third generation, typically their grandchildren. Therefore, it makes sense that these tax systems are unified in some way. The unification of the federal gift and estate taxes became effective back in 1976, and since that time, they have been sometimes referred to as the federal unified transfer tax system because the same tax rates are used to determine both estate and gift tax liability.

For income tax purposes, there are US persons (residents or citizens) and nonresident aliens (nonresidents that are also noncitizens). For transfer tax purposes, there are three categories of individuals: US citizens, US domiciliaries, which are resident aliens, and US non-domiciliaries, which are nonresident aliens.

The tests that are used to determine tax residency for income taxes are different than those tests used to determine residency for transfer taxes. For transfer tax purposes, a concept of "domicile" becomes very important. Having domicile has nothing to do with the number of days you are present in the US, whereas the number of days you are present in the US is the major test for residency, under the income tax rules. Domicile on the other hand has to do with your intent. Your intent to live and stay in the US indefinitely, determines your domicile. The concept of domicile is very subjective, yet very important because if you are deemed to be a US domiciliary, you will be subject to US estate taxes on your worldwide assets.

The IRS does not define the term "domicile" in terms of objective standards. Instead, there are Treasury (the IRS is an organization within the Department of the Treasury) regulations that provide a subjective set of tests based on one's intent to remain indefinitely in the US The regulations use factors such as: (1) the duration of stay in the U.S. and other countries, (2) the frequency of travel between the U.S. and other countries and between places abroad, (3) the size, cost, and nature of the individual's houses or other dwelling places and whether those places are owned or rented, (4) the area in which the houses or other dwelling places are located, (5) the location of expensive and cherished personal possessions, (6) the location of family and close friends, (7) the location of the person's church and club memberships and where he or she participates in community activities, (8) the location of the any business interests, (9) declarations of residence or intent made in visa or green card applications, wills, deeds, trusts, letters, and other documentation, (10) motivations such as the avoidance of the miseries of war or political regression, and (11) visa status. A noncitizen for income tax purposes may be considered to be a US domiciliary for transfer tax purposes.

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If you are a US citizen or US domiciliary, you will be entitled to a lifetime unified tax credit that can be used to offset U.S. estate and gift taxes. The credit for 2015 is $2,117,800 and is based on a corresponding applicable exclusion amount of $5.43 million (in 2015). The credit is equivalent to the tax on the exclusion amount of $5.43 million. Thus, for a U.S. citizen or domiciliary, you can have a net taxable estate of up to $5.43 million before any taxes would be incurred. For couples, the amount of assets you can pass without tax is $10,860,000. The exemption is adjusted for inflation each year. The estate tax rate is 40%.

The IRS allows "portability" of your exclusion amount, which means that rather than being limited to $5.43 million for each person, the couple has $10.86 million to use over both lives. Portability is important for couples whose assets are not equally split between them. Without portability, if one person had assets of $7 million and the other person had assets of $3.86 million, there would be tax to pay when the person with the $7 million of assets died.

The estate tax is calculated on your taxable estate, which includes your gross worldwide assets including:

1. Typical assets such as securities, real estate, businesses and personal property;
2. Life insurance proceeds payable to your estate or, if you owned the policy payable to your heirs;
3. The value of certain annuities or pensions payable to your estate or your heirs; and
4. The value of certain property you transferred out of your estate, within the three years before your death.

Less, allowable deductions, which include:

1. Funeral expenses paid out of your estate,
2. Debts you owed at the time of death,
3. The value of property passing to your spouse (this is known as the marital deduction and applies to citizens only),
4. Charitable deductions made from you estate to a qualified charity (most Canadian charities qualify, but are subject to a limit), and
5. State death taxes (a small number of states have a separate death tax)

The resulting number is your taxable estate, against which your estate tax is calculated. Once the tax is calculated a credit of up to $2,117,800 is applied. The credit is the tax that would result on a taxable estate of $5,430,000, the exemption for 2015, as noted above. If your assets exceed the exemption amount, the tax rate is 40%.

Gift Tax

Certain gifts made during life are exempt from tax. Exceptions to the gift tax are:

1. Annual gift exclusion of $14,000, per person, per year (adjusted for inflation);
2. Payment of school tuition paid directly to the educational institution;
3. Payment of medical expenses paid directly to the medical institution; and

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4. Gifts to a US citizen spouse

Any gifts that do not fall under one of the exemptions above is considered a taxable gift. A taxable gift requires the filing of a gift tax return on Form 709. The gift will not result in a tax until the total of the lifetime gifts exceed the exclusion amount of $5,430,000 (2015). Instead, any taxable gifts reduce the exclusion amount by the amount of the gift. So if you were to make $100,000 of taxable gifts during your life, your exclusion amount would be reduced to $5,330,000, barring any adjustments due to inflation. Gifts to a US-citizen spouse are unlimited during life and at death.

Non-citizen Spouse
Gifts to a non-citizen spouse are limited to $147,000 per year for 2015. This amount is adjusted each year for inflation. Similar to gifts made to a non-spouse, if you exceed the annual limit, a gift tax return must be filed and your exclusion amount will be reduced.

At death, a spouse can transfer an amount to a non-US citizen spouse up to the exemption amount ($5,430,000) without tax. This differs from a US citizen spouse that can receive an unlimited amount at death or during life. Tax on transfers of amounts in excess of the exemption amount can be deferred through the use of a Qualified Domestic Trust (QDOT). The purpose of the QDOT is to assure the government will eventually get their tax, even if the non-citizen spouse leaves the US and dies years later in a foreign country. There are a number of rules regarding the QDOT that we will not get into here, but you should keep this in mind with talking to your advisors.

Resources:

IRS site for Estate and Gift Taxes

Form 706-QDT

Form 706-NA - Nonresident estate tax return

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