ADVISING THE FOREIGN PRIVATE CLIENT ON U.S. INCOME AND TRANSFER TAX PLANNING

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Introduction

- Planning ahead can minimize some of the potential tax consequences associated with investing in U.S. assets
- Pre-immigration tax planning is critical for individuals and families temporarily or permanently relocating to the United States.
- Three principal categories of U.S. tax considerations:
  - U.S. federal income tax considerations;
  - U.S. federal estate tax, gift tax and generation-skipping transfer tax considerations; and
  - State and local income (and, potentially, other) tax considerations.

Effective Global Tax Plan

- Facts concerning individuals and family involved
- Anticipated plans and intentions regarding investment in and/or stay in or ties to the U.S.
- Tax implications under the tax laws of all applicable foreign jurisdictions involved –
  - Current nationality, residence, tax home and whether tax treaties are applicable
  - Countries in which business or investment interests are located
- U.S. tax implications

Who Is Subject To Taxation By The US?

- CITIZENSHIP
  - U.S. Citizens are taxable on income, gift, estate and GST transfers on a WORLDWIDE basis
- RESIDENCY
  - Test for income tax purposes differs from that for transfer tax purposes
- SITUS OF ASSETS

U.S. Income Tax Treatment

- NON-RESIDENT ALIEN
  - U.S. Source FDAP Income:
    - 30% Flat Tax (or reduced treaty rate)
    - Withholding at Source
  - Effectively Connected Income:
    - Net Graduated Rates
  - Capital Gains (Non R.E. Assets)
    - Not Taxed
    - FATCA?
  - Most interest payments exempt (Portfolio Interest Exception)

- U.S. CITIZEN OR RESIDENT ALIEN:
  - Worldwide Income Regardless of Source
    - Net Graduated Rates
    - FTC

Residency - Key Factors

- Will the individual be treated as a U.S. “resident” at any time during his stay in the U.S.?
- When will such individual’s U.S. residence period, if any, begin
- If treated as a U.S. resident, will he be entitled to claim treaty benefits

U.S. Residency = U.S. Income Tax

Three Ways to Classify as a U.S. Resident

- Green Card
- Substantial Presence Test
- Affirmative Election

The "Green Card Test"

- Lawfully received a "green card"; and
- Such status has not been revoked (and has not been administratively or judicially determined to have been abandoned)
  - Rescission or abandonment of "green card" status must be affirmatively recognized
  - A green card holder does not cease to be a U.S. income tax resident if he simply leaves the United States and allows his green card to expire and become invalid without affirmatively abandoning it
  - If abandoned after having been a U.S. resident for 8 years, possible exposure to expatriation regime
- After June 16, 2008, green card holder also ceases being lawful permanent resident when "commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country" and notifies the IRS of "the commencement of such treatment" without waiving "the benefits of such treaty applicable to residents of the foreign country."

The "Substantial Presence Test"

- Physically present in the United States for

  (i) 183 days in the calendar year; or

  (ii) at least 31 days during that calendar year; and satisfies the *three-year look-back rule*

Three Year Look-Back Rule

– Sum of:
  - Number of days present in the current calendar year, plus
  - 1/3 days present in preceding calendar year, plus
  - 1/6 days present in second preceding calendar year,

  equals or exceeds 183

– Presence of no more than 121 days every year will not cause a person to be classified as a resident under substantial presence test

– An individual is treated as present in the United States on any day, or any fraction thereof, during which he is physically present in the United States (including days of departure and arrival)

Excluded Days

- An “exempt individual” for such day
- Reporting Requirements - IRS Form 8843 (Statement for Exempt Individuals and Individuals With a Medical Condition)
- Unable to leave the United States on such day because of a medical condition that arose while present in the United States

Exempt Individual

- A foreign government-related individual
- A teacher or trainee (2 years)
- A student (5 years, subject to extension)
- A professional athlete temporarily in the United States to compete in a charitable sports event (only when actually competing; does not cover training, promotion)

Medical Condition

- *General Requirements:*
  - Intent to Leave
  - Inability to Leave
  - Due to medical condition that arose while present in the United States
- An individual who seeks treatment in the United States regarding an *existing* medical condition will not be entitled to exclude his days of presence in the United States based on the medical exception
- Days during which the individual originally intended to be present in the United States, before the medical condition arose, are *not* governed by the medical exception

Exception for Days in Transit

- In transit between two points outside the United States *and*
- Physically present in the United States for less than 24 hours
- Must solely pursue activities that are substantially related to completing his travel to a foreign point of destination (*e.g.*, waiting for connecting flight)
  - Reg. § 301.7701(b)-3(d)

Substantial Presence – Additional Exceptions

- U.S. Possession/Commonwealth/Territory
  - Presence in Puerto Rico, Northern Mariana Island, Guam, American Samoa, and the Untied States Virgin Islands is not counted.
- Regular Commuter
  - U.S. presence is tied to the person's employment. Person must come from Mexico or Canada.
  - Commuter is required to make daily round trips (home-work-home), and more than 75% of the person's work days must be attributable to the job

The "Closer Connection" Exception

- Present in the United States on *fewer than 183 days* during such year, *and*
- Has a *"tax home"* in a foreign country, *and*
- Has a closer connection to such foreign country than to the United States
- Provided that:
  - No pending application for adjustment of status
  - No steps are taken to apply for status as a lawful permanent resident of the United States
- Must file IRS Form 8840

"Closer Connection" Exception, cont'd.

- "Tax Home"
  - Location of principal permanent place of business,
    - or, in the absence of such principal place of business, regular place of abode
  - Tax home must be located in the same jurisdiction with respect to which he has closer connection and must usually be in existence for the entire taxable year

“Closer Connection” Exception, cont’d.

- “Closer Connection” - more significant contacts with the foreign country (facts and circumstances) - Reg. §301.7701(b)-2(d)
  - Residence designated on forms and documents
  - The location of the individual’s home
  - The location of the individual’s family
  - The location of personal belongings, such as cars, furniture, clothing and jewelry
  - The location of the social, political, cultural or religious organizations with which the individual is associated
  - Driver’s license
  - Where he votes

Residency Starting Date

- Green card test, but not the substantial presence test - first day in the calendar year on which such individual is present in the United States as a lawful permanent resident
- Substantial presence test - the first day during the calendar year on which the individual is present in the United States
- Both - the earlier of the applicable dates

De Minimis Exception

- Not exceeding in the aggregate 10 days,
  - tax home in a foreign country, and
  - a closer connection to such foreign country than to U.S.
- Days need not be consecutive, but may not exceed in the aggregate 10 days
- None of the days in a continuous period of more than 10 days may be excluded
- Only for purposes of determining the residency starting date (does not apply for purposes of the substantial presence test)

No Lapse Rules

- A U.S. resident for any part of the current year and a U.S. resident during any part of the preceding calendar year – considered taxable as a U.S. resident as of the beginning of the current year
- A U.S. resident for any part of the current year and a U.S. resident for any part of the following year - taxable as a resident through the end of the current year
- Reg. § 301.7701(b)-4(e)

Elective Residence- § 7701(b)(4)

- Not a U.S. resident in the calendar year immediately preceding the election year,
- A U.S. resident in the calendar year immediately following the election year, and
- Is present in the United States for a period of at least 31 consecutive days in the election year and present in the United States during 75% of the testing period (beginning with the first day of such 31-day period and ending with the last day of the election year)
  - U.S. residence commences on the first day of the earliest such 31-day period with respect to which the 75 percent test is satisfied
- Used by individuals who immigrate to the U.S. during a tax year, but who do not otherwise qualify as U.S. residents until following year.

Why Election May be Advantageous

- May reduce tax if most income is from U.S. sources (e.g., because some would otherwise be taxed at 30 percent rate often applied to non-business income of NRAs). Also permits some exemptions and deductions
- Assume A comes to U.S. in June 2012, intends to stay and work for 2 years. If A begins earning salary in U.S. and buys a U.S. home in June, may be advantageous to be taxed as resident to obtain dependency exemptions, home mortgage interest deduction, deduction for property taxes, etc.

Other Elections

- Married foreign individual - Sections 6013(g) and (h)
  - Can be combined with 7701(b)(4) election if only one spouse meets 31 consecutive day test, e.g.
- Can elect under regs to make election on behalf of dependent child who also meets requirements for election
  - Obtain dependency exemption (otherwise barred by section 152(b)(3))

Income Tax Treaties

- A “dual resident” may be able to claim treaty benefits to avoid classification as a U.S. resident for U.S. federal income tax purposes
- Income tax treaties contain a “tie-breaker” provision
- First, where permanent home is available to him, or if permanent home in both countries, where personal and economic relations are closer (center of vital interests)
  - Second, where he has an habitual abode
  - Third, nationality/citizenship
  - Fourth, competent authorities

Income Tax Treaties, cont'd.

- Treaty foreign residents are taxed as NRAs
- Must file Form 1040NR and attach Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b))
- If no tax liability, so that no 1040NR is filed, file Form 8833 with IRS Service Center where 1040NR would have been filed

Summary

- U.S. “residency” has substantial U.S. tax consequences
- Usually beneficial to avoid U.S. residency where possible
- Look to closer connection exception, excluded days, treaties
- If residency is anticipated, pre-planning is essential

U.S. Federal Income Tax of Trusts, Grantors and Beneficiaries

- "Foreign trusts" vs. "domestic trusts"- § 7701(a)(30)(E)-
- Domestic if *both*
  - *court test* - "a court within the United States is able to exercise primary supervision over the administration of the trust" *and*
  - *control test* - "one or more United States persons have the authority to control all substantial decisions of the trust"
- "Grantor trusts" (transparent) vs. "nongrantor trusts"

U.S. Federal Income Taxation of Trusts, Grantors and Beneficiaries, cont'd.

- A "domestic" nongrantor trust - generally taxed in the same manner as a U.S. individual, subject to a deduction for "distributable net income" ("DNI")
- A "foreign" nongrantor trust - generally taxed in the same manner as a nonresident alien; *i.e.*, the trust is taxed only on its ECI and certain other types of U.S.-source income
- U.S. persons receiving distributions from income of a nongrantor trust – generally taxed on such amounts under general rules of § 662 (*see* Reg. § 1.672(f)-1(a)(1))
- Distributions of accumulated income and gains from a foreign nongrantor trust – subject to the "throwback rules"

Grantor Trusts

- Generally disregarded for most purposes - grantor is treated as directly owning all of the trust's assets and earning its income
  - *See* Rev. Rul. 87-61, Rev. Rul. 85-13
  - *See also* Rev. Rul. 2007-13, situation 1, Rev. Rul. 2004-64
- Distributions from a grantor trust to beneficiaries other than the grantor are generally treated as gifts, and thus non-taxable to recipient, even if U.S. beneficiary
  - Rev. Rul. 69-70

Grantor Trusts, cont'd.

- Sections 671-677 – a trust is generally a grantor trust if grantor retains certain sufficient powers over or interests in the trust
- Section 672(f) - grantor trust rules apply with respect to a foreign trust only to the extent that they result in amounts being currently taken into account in computing the income of a U.S. person

Grantor Trusts, cont'd.

- Exceptions (§ 672(f)(2)):
  - revocable trust- absolute power to revest, exercisable solely by grantor (can provide for consent of another, but only if related or subordinate and subservient to grantor)
  - only amounts (income and corpus) distributable during lifetime of grantor are amounts distributable to the grantor or the spouse of the grantor
  - certain trusts established to pay compensation and certain trusts in existence as of September 19, 1995 ("grandfather rule")
- No exception to the extent a U.S. beneficiary of the trust has made direct or indirect transfers to the foreign settlor - U.S. beneficiary is treated as the owner of the trust to the extent of such transfers

Residency (Domicile)

- TRANSFER TAXES:
- Gift, Estate and GST taxation
  - Relevance: Worldwide or Situs Taxation
  - Function of Domicile: Acquired by living there, even briefly, with no definite or present intention of leaving U.S.
    - *cf.* "Residency" (income tax purposes)
  - How determined: Facts & Circumstances
    - Time spent U.S./abroad
    - Size / location / use of homes
    - Family, friends, contacts

Residency (Domicile), cont'd.

- Immigration Status
  - Est. of *Khan*
  - Rev. Rul. 80-209
  - Rev. Rul. 80-363
  - Est. of *Jack*
- A subjective test

Residency (Domicile), cont'd.

- Gift and Estate Tax Treaties
  - U.S./U.K. Treaty (Article 4 Fiscal Domicile)
    - Available permanent home
    - Center of vital interests
    - Habitual abode
    - Nationality
    - Competent Authorities

Estate Tax Rules For NRAs

- U.S. TAX ON U.S. SITUS ASSETS
  - Real Property
  - Tangible Personal Property Located in U.S.
  - Certain Debt Obligations
  - Stock in U.S. Corporations
  - Certain Intangible Property with U.S. Connection

Estate Tax Rules For NRAs, cont'd.

- NON-U.S. SITUS ASSETS
  - Stock in Foreign Corporations
  - Insurance proceeds on NRA's life
  - Portfolio debt

Gift Tax Rules For NRAs

- LIMITED DEFINITION OF U.S. SITUS ASSETS
  - U.S. Real Property
  - Tangible Personal Property Located in U.S.
  - What's missing: stock in U.S. corporation!

Transfers To Noncitizen Spouses

- BEQUESTS TO NONCITIZEN SPOUSE: NO MARITAL DEDUCTION
  - QDOT Exception
- GIFTS TO NONCITIZEN SPOUSE
  - Current Annual Exclusion $133,000 ($139,000 for 2012)

Transfers To Non-citizen Spouses QDOTs

- All income to spouse for life
- Only spouse may received principal distributions
  - Taxable
  - Hardship exception
- At least one trustee must be U.S. citizen or domestic corporation
  - Must have power to withhold tax on principal distributions
- QDOT election
- QDOT of $2 million or more
  - Additional security requirements

Transfer Taxes

- U.S. CITIZENS AND DOMICILED ALIENS
  - Estate, Gift and GST taxes
  - On Worldwide Assets
  - Current Maximum Rate
    - 35%
  - Current Exclusion
    - $5.5 million ($5,120,000 for 2012)
- NON-DOMICILED ALIENS
  - Estate Tax: Only U.S. situs assets - $60,000 exemption; Current maximum tax rate of 35%
  - Gift Tax: Only U.S. situs tangible assets – annual exclusion; no unified credit; $136,000 ($139,000 for 2012) exemption for gifts to non-U.S. citizen spouse
  - GST Tax generally avoided

Pre-Immigration Income Tax Planning

- Avoiding U.S. Residence Status
  - exceptions for "exempt individuals"
  - a treaty tie-breaker
  - the closer connection exception
- Planning for the "grace period" – gain generally foreign source income per section 865(a)(2) while still treated as nonresident alien

Income Recognition and Acceleration

- Individuals generally compute taxable income based on the cash method of accounting
- Accelerate the receipt of *non-U.S.-source* income in order to cause the recognition of such income during non-U.S. residence period
  - –Note foreign tax implications

Gain Recognition and Loss Deferral

- No automatic basis “step up” or “step down” upon becoming a U.S. resident
- So seek to obtain basis step-ups prior to obtaining U.S. residency, to wipe out gain
- Dispose of appreciated assets in taxable transactions (from U.S. perspective) to unrelated or related persons
- Avoid recognition of losses on depreciated assets; preserve them for later U.S. use
- Must consult foreign counsel for implications

Foreign Currency Issues

- U.S. dollar considered functional currency
- U.S. perspective always in dollars
- Thus need to convert any appreciated foreign holdings to USD to compute gain/loss
- Can produce unexpected results

Actual or Deemed Liquidation of a Foreign Holding Company

- Taxable liquidation of a foreign holding company – stepped up basis in the shares of the subsidiaries; no tax on foreign source gain (unless FIRPTA, ECI)
- Other benefit – potential for reduced tax rates for capital gains (15%) upon the sale of the subsidiaries (if CFC, PFIC, only if "qualified foreign corporation")
- Caution:
  - Non-corporate subsidiaries (current inclusion, ECI)
  - FIRPTA

Actual or Deemed Liquidation of a Foreign Holding Company, cont'd.

- Actual liquidation of a foreign company
  - Corporate and securities law ramifications
  - May be adverse tax consequences in foreign individual's country of residence, jurisdiction where holding company is incorporated, and jurisdictions where the subsidiaries are incorporated
- Deemed liquidation
  - Check the Box Election, Form 8832
  - Conversion to a flow-through entity
- If possible, effect the liquidation after departure from former country of residence but before beginning of U.S. residence period

Actual or Deemed Liquidation of Foreign Holding Company, cont'd.

- Deemed liquidation deemed to occur immediately before close of the day immediately prior to effective date of election
- Deemed liquidation generally preferable to formal liquidation
- Not feasible for "per-se corporation." May be possible to convert to different entity type to accommodate check-the-box election
  - Use local attorneys to consult and implement

Conversion of Foreign Operating Company to Flow-Through Entity

- U.S. federal income tax on current basis
- If operating at a loss, losses flow through
- Steps up adjusted basis of entity's assets- important, e.g., if contemplating sale
- Foreign tax credits flow through. If high foreign tax rates, this is significant
- If entity generates significant Subpart F income, flow-through treatment might be preferable

Sale to Related Person

- Sale to spouse who is neither citizen nor resident of U.S. at time of sale (Sec. 1041(a))
  - Caution:
    - Sham transaction
    - Applicable law concerning marital property and intra-family transfers
    - Form of consideration (cash, note)
- Sale to bona-fide limited partnership (or other foreign entity treated as partnership for U.S. federal income tax purposes)
- Election out of the installment sale rules (PLRs - a nonresident alien will be deemed to make the election out of the installment sale rules)

Constructive Sale Under Section 1259; Wash Sale

- Constructive Sale – Section 1259
  - "Appreciated financial positions"
  - Enter into offsetting financial transactions

- "Wash Sale" of Appreciated Positions
  - NRA may sell appreciated publicly-traded stock and securities and thereafter, repurchase similar stock and securities
  - Best to wait for some period in between sale and purchase
  - How long? Tension between tax and market risk

Anti-Deferral Provisions

- Determine classification of each entity for U.S. federal tax purposes
  - Flow through (to obtain FTC, where losses expected, availability of preferential capital gains rates)
  - Corporation (if no Subpart F income so that deferral is possible; for temporary residents, deferral = exemption)
  - Note: Entity classification of foreign entities is effective also for U.S. federal estate and gift tax purposes
- Determine applicability of U.S. anti-deferral tax regimes for each entity
  - CFC
  - PFIC
- Possible Deemed sale upon loss of U.S. resident status
  - This also applies where a section 6013(g) election to be taxed as a resident is terminated. *See* Prop. Reg. § 1.1291-3(b)(2)

Evaluate Trusts

- Change in situs (U.S. or foreign) or classification (grantor or non-grantor) (Section 679)
- Avoid undesirable investments (from tax perspective), such as shares in PFICs
- Evaluate investment strategies and patterns of distributions by the trusts (deferring distributions to a non-U.S. residence period; avoid the throwback rules)

Pre-Immigration Trusts

- Section 679(a)(4) - a non-U.S. individual who becomes a U.S. person will generally be treated as the owner of any property which he transferred to a foreign trust within the five-year period prior to his U.S. residency starting date
  - Rule does not apply if the foreign trust does not have any U.S. beneficiaries after grantor's U.S. residency starting date
- Pre-immigration trust
  - reduce U.S. estate tax exposure
  - "drop-off" assets
  - grantor can be purely discretionary beneficiary

Estate Tax Planning

- Domicile is determined based on all facts and circumstances – Minimize risk of U.S. domicile
- Minimize holding of U.S.-situs assets
  - Consider transferring all or part of U.S.-situs assets to foreign corporation prior to relocation to the United States - sham corporation; income tax consideration.
- Consider acquiring, through a life insurance trust, term life insurance policy to protect against any estate tax exposure
- Nonrecourse debt
- Consider application of tax treaties

U.S. Gift Tax

- NRNC
  - $13,000 and other annual gift tax exclusions
  - No unified credit
  - No marital deduction for gifts made to a spouse who is not a U.S. citizen. (increased exemption for foreign spouses - $136,000 for 2011; $139,000 for 2012)
- NRNC should avoid gifts of tangible U.S.-situs property
- Review gift tax implications of jointly owned property and accounts
- Consider making gifts of non-U.S.-situs assets prior to relocation to the United States

U.S. Exit Tax and Related Succession Tax

- Sections 877A and 2801- effective for expatriations on or after June 17, 2008
  - Applies to citizens who relinquish citizenship and to "long-term residents" who give up their green cards (i.e., green card holders for at least 8 of prior 15 years)
  - Under § 877A, mark-to-market regime replaces prior 10-year "alternative tax" on US source income
  - A "covered expatriate" is deemed to sell all worldwide property for FMV on the day before expatriation date, and is taxed on net gains >$600,000 (indexed post-2008)- $636,000 in 2011; $651,000 in 2012
- Notice 2009-85 provides additional guidance

Exit Tax, cont'd

"Covered Expatriate"

- Average annual net income tax of > $147,000 for 2011($151,000 for 2012) for the five tax years preceding expatriation
- Net worth $2 million or more at date of expatriation (not indexed for inflation)
- Fail to make 5-year tax compliance certification (Form 8854)

Exit Tax, cont'd

- "Proper adjustment" for any gain or loss subsequently realized on property deemed sold to account for gain or loss on deemed sale (determined w/o regard to $600,000 exclusion)
- Limited basis step-up for property owned by person when she first became US resident under section 7701(b) (i.e., including residency based on substantial presence though section 877A applies only to green card holders)
- Covered expatriate can irrevocably elect to defer payment on specified assets until actual sale or exchange, failure of security to be adequate, or death
    - Must provide "adequate security"
    - Must irrevocably waive US tax treaty benefits
    - Interest accrues on unpaid tax at underpayment rate (currently 3%)

Exit Tax, cont'd

- Exceptions for certain deferred compensation items that are classified as "eligible" and for interests in certain nongrantor trusts
  - Subject to 30% withholding tax instead
  - Form W-8CE

§ 2801: New Succession Tax

- Gifts and bequests to US persons from covered expatriate under Section 877A taxed to recipient at highest gift or estate tax rate
  - Exceptions for gifts within annual exclusion or entitled to charitable or marital deduction
- Imposes a tax on the receipt by any U.S. person of a "covered gift or bequest," which is defined as any direct or indirect gift or bequest from a "covered expatriate" within the meaning of section 877A
  - No time limit
  - Allows a reduction, which is in effect a credit, for gift tax or estate tax paid to a foreign country with respect to a covered gift or bequest

State and Local Tax Considerations

- Can be significant
- Different rules determining *whether* and *when* an immigrating individual will be treated as a "resident" of a particular State or locality
- Sales and use taxes (art)


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FOR
ICE
UNFORTUNATELY,
polar bears can't read.

THANK YOU!