# Coming to America

## U.S. Tax Planning for Foreign Individuals

By David Roberts and
Len Schneidman

Andersen Tax LLC, U.S.

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# Introduction

### Moving to the United States – Making the Right Moves

People moving to the United States (U.S.) especially those with substantial wealth, need to organize their financial affairs before landing here. For those who plan ahead, there can be significant tax savings.

### U.S. Tax System is Complex: Here Are the Basics

U.S. citizens and residents are subject to income taxes on worldwide income and, typically, transfer taxes on their worldwide assets. Anti-deferral rules will often cause income of foreign entities to be taxed to U.S. shareholders even though the earnings are not distributed. U.S. citizens and green card holders, remain subject to U.S. tax wherever they reside in the world and may suffer an exit tax if they seek to give up their status.

Non-residents, on the other hand, are, generally only subject to tax on income that is effectively connected with a U.S. trade or business (including gains on the sale of real property) and dividend payments from U.S. corporations (through withholding tax). Non-residents are generally subject to U.S. gift and estate tax only on certain U.S. situs assets, real or tangible.

| Federal Income Tax Rate Comparison | | |
|---|---|---|
| | **2016** | **2017** |
| Maximum Rate | 39.6% | 39.6% |
| Payroll Rate | 2.35%* | 2.35%* |
| Payroll Base | All Income | All Income |
| Long Term Capital Gain (>12 months) | 23.8%** | 23.8%** |
| Qualified Dividend | 23.8%** | 23.8%** |

* Includes additional 0.9% Medicare Tax on Wage / Self Employment Income above $250,000
** Includes additional 3.8% Tax on Net Investment Income above $250,000 threshold

| Overview of Federal Estate, Gift, Generation-Skipping Transfer (GST) Taxes for Individuals Domiciled in the U.S.* | | | | |
|---|---|---|---|---|
| Calendar Year | Estate Tax Exemption | GST Exemption | Gift Tax Exemption | Highest Estate/Gift Tax Rates** |
| 2016 | $5.45MM | $5.45MM | $14,000 | 40% |
| 2017 | $5.49MM | $5.49MM | $14,000 | 40% |

* For those not domiciled in the U.S., the exemption is limited to $60,000

** Does not include state-level taxes

# Residence

### Know Your Residency Status

An individual who is not a U.S. citizen (an *alien*) is treated as a U.S. tax *resident* (also known as a *resident alien*) during a particular taxable year, and, hence, is subject to U.S. federal income tax on a worldwide basis (unless an applicable treaty provides otherwise), if such individual (i) is a *lawful permanent resident of the U.S* at any time during such calendar year (the *green card test*), (ii) satisfies the *substantial presence test* discussed below, or (iii) makes an election to be treated as a U.S. tax *resident*. While this may seem straightforward, you must understand the exact date you become a *resident*.

Once you are a U.S. tax *resident*, you are generally taxed on your worldwide income and gains. The income tax residency rules for those who do not have U.S. citizenship or green card status are based on the number of days you are present in the U.S.

Knowing your residency start date and planning accordingly can help minimize first-year taxes and provide a window to take action prior to actually becoming a *resident*.

### First and Last Year of Residency

Generally, if an individual was not a *resident* of the U.S. at any time during the preceding year, he is treated as a *resident* in the current year as of the *residency starting date*, which is (1) for persons meeting the *substantial presence test*, the first day during the calendar year on which the individual is present in the U.S., (2) for persons meeting the *lawful-permanent-residence test*, the first day in the calendar year on which the person is present in the U.S. as a *lawful permanent resident*, or (3) for persons making the first-year election, the first day the person is treated as a *resident*.

An individual's residency ends on the last day he is present in the U.S. or the last day he is a *lawful permanent resident*, whichever is the later. During the last year of residency, however, he is considered a *resident* for part of the year only if, during the nonresident period, he has a *closer connection* to a foreign country than to the U.S. and is not a *resident* of the U.S. at any time during the following calendar year.

The law also provides that nominal presence either before or after the period of residence is disregarded for purposes of determining whether the foreign national is present in the U.S. Nominal presence is defined as any period not exceeding 10 days in which the *alien* has a *closer connection* to a foreign country than to the U.S.

### The *Green Card Test*

In general, an individual is treated as a *lawful permanent resident of the U.S.* at any time if,

- Such individual has the status of having been lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with the immigration laws, and
- Such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

Once an individual has been granted an alien registration receipt card (*i.e.,* a green card) in accordance with the U.S. immigration laws, resident status is deemed to continue.

### The *Substantial Presence Test*

In general, an individual who is not a U.S. citizen or a green card holder will be treated as a U.S. tax resident during a particular calendar year, and, hence, will be subject to U.S. federal income tax on a worldwide basis, if he is physically present in the U.S. for (i) 183 days or more during that calendar year, or (ii) at least 31 days during that calendar year *and* satisfies the *substantial presence test* under the three-year look-back rule discussed below.

An alien individual will satisfy the *substantial presence test* under the three-year look-back rule if the sum of (i) the number of days of his physical presence in the U.S. in the current calendar year, (ii) one-third (1/3) the number of days of his physical presence in the U.S. in the first preceding calendar year, and (iii) one-sixth (1/6) the number of days of his physical presence in the U.S. in the second preceding calendar year, equals or exceeds 183 days. Therefore, presence of no more than 121 days in any year will satisfy the weighted-average test.

It should be noted in this regard, that for purposes of the *substantial presence test* set forth above, an individual is treated as present in the U.S. on any day, or any fraction thereof, during which he is physically present in the U.S. (*i.e.,* if an individual is physically present in the U.S. even for part of a day, including days of departure and arrival, such day will be counted as one full day for purposes of the test set forth above.)

Case Study #1

- Assume A relocates to the U.S. from Germany on July 15, 2015.
- A was in the U.S. for 45 days in 2014 and 60 days in 2013.
- A spent 7 days in the U.S. in March 2015.
- Under the *substantial presence test*:
  - A has 170 days in 2015.
  - A has 15 days in 2014 (1/3 of 45).
  - A has 10 days in 2013 (1/6 of 60); Total of 195 days = ***Resident.***
- Starting date: We can ignore the trip in March 2015 as it is less than 10 days.

### Excluded Days

For purposes of determining whether a foreign individual satisfies the *substantial presence test*, a foreign individual will *not* be treated as present in the U.S. on any day, even though physically present in the U.S., if such individual is (i) an *exempt individual* for such day, or (ii) unable to leave the U.S. on such day because of a medical condition which *arose* while such individual was present in the U.S.

An individual is an *exempt individual* for any day if, for such day, such individual is

- A foreign government-related individual
- A student (based on the visa issued and time limits)

In order to avoid U.S. *resident* status, a foreign individual who wishes to rely on the exceptions regarding exempt individuals and individuals with medical conditions must file, on or before the due date of the applicable U.S. federal income tax return, U.S. Internal Revenue Service (IRS) Form 8843 (Statement for Exempt Individuals and Individuals With a Medical Condition), and set forth the information required to support the applicable exemption.

### Closer Connection Exception

A foreign individual who meets the *substantial presence test* will not be considered a U.S. tax resident for that year if such individual (i) is present in the U.S. on *fewer than 183 days* during such year, and (ii) establishes that, for such year, he has a *tax home* in a foreign country *and* has a *closer connection* to such foreign country than to the U.S., provided however, that he, at no time during such year, (i) has an application for adjustment of status pending, or (ii) takes other steps to apply for status as a *lawful permanent resident of the U.S.*

For this purpose, an individual's *tax home* is the country in which his principal permanent place of business is located, or, in the absence of such regular or principal place of business, his regular place of abode. If the individual has neither a permanent place of business nor a permanent place of abode, his *tax home* is the country where he works.

A foreign individual who wishes to avoid U.S. *resident* status based on the *closer connection* exception must attach a completed IRS Form 8840 (Closer Connection Exception Statement for Aliens) to his U.S. federal income tax return for the applicable taxable year, or, if no such return is required to be filed, file such form with IRS by the due date for filing IRS Form 1040NR (U.S. Nonresident Alien Income Tax Return)

### Treaty Tie-Breaker

If an individual is a considered a U.S. resident and is also considered a resident of a foreign jurisdiction that has a tax treaty with the U.S., the treaty tie-breaker rules may apply to determine whether the individual is a resident of either the U.S. or the foreign country. The typical treaty tie breaker article provides that the individual:

a) Shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);

b) If the State in which he has his center of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national; and

d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement

### Residency Status and Estate and Gift Taxes

It is also important to understand how residency status impacts your estate and gift tax position. Unlike the income tax residency rules, exposure to gift and estate taxes for resident aliens is determined based on domicile and, therefore, is influenced by your actions. Moreover, you could also be exposed if you move to the U.S. and your actions imply an intention to remain here indefinitely, such as discontinuing ties with your home country. In addition, applying for U.S. citizenship or a green card could expose your worldwide assets to U.S. estate and gift taxes.

# Pre-Residency Income Tax Planning

### Consider Accelerating or Deferring Income

If you are moving from a jurisdiction with a lower tax rate than the U.S., consider accelerating the recognition of income — such as dividends paid by closely held foreign corporations or deferred compensation for services performed outside the U.S. — prior to becoming a *resident*. In this way, you avoid being taxed at higher U.S. rates. Conversely, if moving from a jurisdiction with a higher tax rate, consider deferring recognition of the income until after you move to the U.S.

Case Study #2

- Mr. Martinez is currently a non-resident *alien*, but will become a U.S. *resident* under the *substantial presence test* in 2016. For services performed outside of the U.S., he is due $1 million of compensation income, which has not yet been paid.
- <u>Potential planning</u>: Mr. Martinez should consider accelerating the receipt of the $1 million of income prior to becoming a U.S. *resident*, in order to avoid subjecting the compensation to U.S. income tax (the effect of accelerating the income in the current country must also be considered).

### Realize Gains or Losses

While timing of income recognition is limited to those few who have such control, the timing of when to realize capital gains or losses can usually be more readily determined.

The same objective applies when deciding whether to accelerate the gain or loss; however, it is important to note that, absent a specific treaty article, capital gains realized once you are a U.S. tax *resident* carry the original cost basis. For example, someone who bought XYZ stock 20 years ago for $2 and moves to the U.S. before selling it for $50 will pay U.S. capital gains tax on the entire $48 gain, not just the portion that occurred after U.S. residency was established.

The same applies to founders of startups that have low or no tax basis in their company stock and subsequently sell at a huge gain. Selling securities (and possibly buying them back) prior to a move could purge this potential taxable gain. Losses that have accrued can be realized after becoming a *resident* and carried forward to offset against future U.S. capital gains. If there is not a liquid market for the asset (*e.g.,* non-U.S. real estate), more complex strategies can be employed.

Case Study #3

- Mrs. Huang is a non-resident *alien* living abroad with her U.S. citizen spouse. In 2016, she will obtain a green card and move to the U.S. Mrs. Huang has $5 million of unrealized gain in appreciated securities that she is considering selling.
- <u>Potential planning</u>: Depending on how Mrs. Huang's home country taxes gains from the sale of securities, it may be beneficial to recognize the $5 million of gains in 2015, prior to becoming a U.S. *resident*, in order to avoid subjecting the unrealized appreciation to U.S. income tax.
- Remember the importance of foreign law as some jurisdictions may apply a mark-to-market exit tax.

### Case Study #4

- Assume the same fact pattern as Case Study 3, except that Mrs. Huang instead has a $5 million unrealized loss in depreciated securities.
- Potential planning: Mrs. Huang should consider the U.S. tax benefits of delaying recognition of the losses from the sale of the securities until after she becomes a U.S. *resident* in 2016.

## Review Your Foreign Holdings

The U.S. tax rules that address foreign investments are complex, and geared towards limiting the ability of U.S. *residents* to defer income taxes. This is achieved principally by maintaining full transparency through onerous reporting requirements.

It is crucial that you understand how foreign holdings will be taxed and reported. For example, it is not uncommon for wealthy individuals outside of the U.S. to hold their investments through an offshore company. If you own such an interest in a foreign company, becoming a U.S. tax *resident* may have adverse tax consequences. The income could be taxed each year at the highest rates, even if no income is distributed. Or you could be subject to a second level of U.S. income tax after paying foreign taxes.

Careful consideration should be given as to whether it makes sense to liquidate the company prior to becoming a U.S. *resident*, although that is often not practical and may carry a tax cost in the country from which you are moving.

Subject to certain conditions, it may be possible to force a deemed liquidation by electing to treat the company as a pass-through entity such as a partnership for U.S. tax purposes. This has the same tax effect as if the company sold its assets thereby potentially getting a step up in the tax cost basis prior to becoming a U.S. resident while still maintaining the entity's legal form. In this way, the income is taxed each year but many of the complex reporting requirements associated with a foreign holding company are avoided. One bonus: These rules only apply for U.S. tax purposes, so the country from which you are moving or the jurisdiction of incorporation will typically not view this as a taxable event.

### Case Study #5

- Mr. Petit is a non-resident *alien* and is planning to become a U.S. *resident alien* in the near future. Mr. Petit owns a foreign corporation, which holds several highly appreciated non-U.S. situs assets.
- Potential planning: Mr. Petit may benefit from a *check-the-box* election to treat the foreign corporation as a disregarded entity or partnership. If the election is made while Mr. Petit is a non-resident *alien*, the basis of the entity's assets may be stepped up to fair market value as of the date of the election without any U.S. or foreign income tax impact.

# Pre-Domicile Transfer Tax Planning

### Consider Gifting Assets Before Moving

If you plan to be in the U.S. indefinitely and accordingly may face exposure to estate and gift taxes, consider making an irrevocable gift to a non-U.S. relative or a discretionary trust prior to moving.

Those assets should be removed from your taxable estate. This can be attractive for wealthy individuals whose estate will be in excess of the current $5,450,000 lifetime exclusion from transfer tax. A gift of assets to a discretionary trust prior to moving will generally not use up any part of this lifetime exclusion. That said, income earned in the trust will probably remain taxable to you unless you had set up and funded the trust more than five years prior to moving to the U.S.

#### Case Study #6

- Ms. Meyer is a non-resident *alien* with substantial wealth. She is planning to establish domicile in New York soon to be closer to her grandchildren. Ms. Meyer intends to leave large bequests to her family.
- <u>Potential planning</u>: Depending on the transfer tax laws of her current country of residence, prior to establishing U.S. domicile Ms. Meyer should consider gifting strategies to dispose of assets prior to becoming subject to the U.S. gift tax regime.

#### Case Study #7

- Mr. Aydin is a non-resident *alien* with no intention of becoming a U.S. *resident*. Mr. Aydin has substantial wealth held in foreign corporations, including operating companies, and he intends to leave his fortune to his son and grandson, who are both U.S. citizens

  <u>Potential planning</u>: Instead of making outright gifts to the son or grandson, which would bring the assets into the U.S. income tax net and make them subject to inclusion in their U.S. taxable estates upon their death, Mr. Aydin should consider, *e.g.,* transferring the foreign corporations to a revocable foreign grantor trust. The trust could continue for the life of the son and grandson. During Mr. Aydin's lifetime he would be treated as owner of the trust assets for U.S. tax purposes. Distributions to the son or grandson during Mr. Aydin's life would be treated as gifts so not subject to U.S. transfer tax as long as made from a non-U.S. account. Those gifts would need to be reported on a Form 3520 (Annual Return to Report Transactions With Foreign Trusts and Receipts of Certain Foreign Gifts). Additional planning should be considered after Mr. Aydin's death to optimize the tax treatment.

# Final Thoughts

Remember, it is important to weigh any planning ideas against your personal and business objectives. Pay careful attention to how U.S. tax planning interacts with tax treaties and the tax and property laws in other countries.

For more information, visit *International Wealth* on andersentax.com.