American Bar Association
Section of Taxation
Committee on U.S. Activities of Foreigners and Tax Treaties

Planning for Mobile Executives and Business Owners Relocating to the U.S.

Boca Raton, FL
January 21, 2011

Panel

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NOTE: The slides were prepared by the private sector panelists and do not necessarily reflect government positions on the issues discussed below

Overview (1)

- This panel will consider issues affecting both the company and the executive or business owner who relocates to the U.S.
- Issues affecting the company include
  - Presence of an employee may cause company to be engaged in a U.S. trade or business and to have effectively connected income
  - Presence may cause company to have a permanent establishment for treaty purposes
  - The company may have to withhold income taxes and social security taxes and be liable for employer payroll taxes
  - Potential state tax issues

Overview (2)

- Issues affecting the executive or business owner:
  - Determination of U.S. Federal and state tax residency
  - Worldwide taxation
  - Treatment of personal services income, including benefits plans
  - Taxation of investment income, including application of anti-deferral rules
  - Social security taxation
  - Compliance and reporting (e.g., FBAR, Form 5471)
  - Estate and gift taxes and estate planning
  - Pre-residence planning
  - Issues arising on subsequent departure from the US, such as the expatriation rules of §§ 877A and 2801

Issues Affecting the Company

The Mobile Executive

- Foreign executives move to the United States in a variety of circumstances
  - Sending a key executive to expansion the business into the U.S.
  - Foreign multinationals send foreign executives to supervise or manage U.S. business
  - U.S. and foreign multinationals send foreign executives to gain experience of U.S. market or participate in research projects
  - Head of family or adult child moves to start up or supervise existing U.S. business
- The presence of executives in the U.S. may have tax consequences for the company

Making the Company a U.S. Taxpayer

- The statutory standard for taxability of the foreign company is whether it is engaged in a trade or business within the U.S. (ETB) and has income effectively connected with the business (ECI)
- This a low threshold (864(c)(3) – all U.S. source)
- The typical treaty raises this standard to having a permanent establishment (P/E) – e.g., office, management
- Presence of an employee in the U.S. raises the possibility that the foreign company will be ETB or that it will have a P/E, including an agency P/E if the employee has power to make contracts

ETB Issues

- Includes performance of personal services within the U.S. § 864(b).
  - Applies to foreign entities that provide personal services
  - 90-day/$3,000 *de minimis* exemption for individuals; amount enacted in 1966 – may cover some employees here just 1-2 days
- Employees' performance of services in U.S. does not automatically make foreign employer ETB. It depends on what employees are doing:
  - Performance of services for benefit customers will be attributed to foreign company and can make it ETB
  - Performance of services solely for benefit of foreign company (e.g., purchasing, research, oversight of U.S. subsidiary) may well not make company ETB (or there may be no ECI)
- MNE must be aware of § 875 (partnership's U.S. trade or business attributed to partners)

P/E Issues

- U.S. requires claim of P/E exemption by foreign company ETB to be made on a tax return (Form 1120F) with treaty-based return position disclosed on Form 8833
- Failure to file timely return may result in loss of deductions. § 882(c)(2); Treas. Reg. § 1.882-4(a)
  - Timely: 18 months after original due date – see Treas. Reg. § 1.882-4(a)(3).
  - Waiver for reasonable cause, including filing of protective return
- Case law (*Donroy*, *Unger*) applies § 875 principle to P/Es, so that P/E of partnership attributed to foreign partners

Payroll Tax Liabilities

- An employee performing personal services in the U.S. is ETB and potentially taxable on salary and other benefits attributable to such services
- Having an employee in the U.S. can therefore impose payroll tax obligations on the foreign company, even if the company neither is ETB nor has a P/E
  - This is potentially in any case where a MNE pays an executive for services performed in the U.S.

State Taxes

- State tax thresholds for taxing foreign companies is typically whether the company is "doing business" in the state
- State wage withholding generally required if "transacting business" in the state
- No single definition for "transacting" business
- Although subject to some constitutional and statutory limitations, this standard is very low, even lower than the federal ETB standard
- Treaties may not apply
- Frequently overlooked by foreign companies with early stage U.S. activities

Short Visits – The Conundrum for MNEs

- When an executive gets sent to work in the U.S., the executive can often avoid income taxation by a treaty article for dependent services (treaty with executive's country of residence v. employer's) if:
  - The executive is present in the U.S. for not more than 183 days in any twelve-month period; and
  - Remuneration (i) is paid by an employer who is not a U.S. resident and (ii) is not borne by a U.S. P/E
- Latter requirement risks employer becoming ETB
- To avoid this, the executive can be assigned to a U.S. subsidiary. But this subjects the executive to U.S. taxation, even without being a U.S. resident
- This can be an issue even for established MNEs

Short Visit Issues

- Treaty may not eliminate withholding requirement
- Employers often do not have control over short term travel to enable timely withholding computations
- May not have local payroll capabilities to facilitate U.S. dollar withholdings
- No U.S. ITIN or SSN; W-7s are awkward and numbers can take a long time to obtain
- U.S. States
  - Some have *de minimis* rules for nonresidents based on income or presence days; but no consistent standard
  - Withholding rules may not allow for *de minimis*
    - E.g. No *de minimis* days in NY for w/h on equity compensation

Issues Affecting the Individual

Residence

- The first issue is whether the individual relocating to the United States will become a resident for various purposes and, if so, when:
  - Immigration
  - General Federal tax residence rules (section 7701(b))
  - Federal estate and gift tax purposes (domicile)
  - State tax purposes
  - Regulatory and reporting requirements, e.g., FBAR
  - Home country taxation (and other requirements)
- These rules are not uniform and coordination is erratic
- Timing is critical

Residence for Federal Income Tax Purposes

- Individual tax status
  - U.S. citizen
  - Resident alien (“RA”)
  - Nonresident alien (“NRA”)
- RA defined (section 7701(b))

Residence Test	Residence Begins (if not already resident under another test)
Lawful permanent resident (“green card” holder)	First day of U.S. presence as lawful permanent resident
Substantial presence test	First day of presence in year test first met
First year elections:	
Section 7701(b)(4)	First day of testing period (see slide 19)
Section 6013(g)	First day of taxable year
Section 6013(h)	First day of taxable year

Lawful Permanent Resident

- Individual "lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws"
- <u>Not</u> the same as issuance or receipt of green card
- Two ways to become a lawful permanent resident:
  - If already in the United States, adjustment of status
  - If outside the United States, following approval of petition, alien is given a visa to enter as a permanent resident, and becomes a permanent resident when granted entry
- Alien may not have actually received green card and temporarily relies on passport stamp made by Dept of State or USCIS

Substantial Presence Test

- The Test
  - Present 31 days during calendar year; and
  - days of U.S. presence during current year (CY) **+**
    1/3 days of U.S. presence during 1st preceding year **+**
    1/6 days of U.S. presence during 2nd preceding year
    ≥ 183
- Exceptions:
  - Foreign tax home/closer connection test (max CY < 183)
  - Medical conditions
  - Visa status exceptions – diplomats (including employees of international organizations), students, teachers (subject to time limitations)

Residence Elections

- First year election (section 7701(b)(4))
  - Not an RA in preceding year;
  - Is a RA in year following year of election; and
  - 31 days / 75% of "Testing Period" Test Satisfied
- NRA married to U.S. citizen or RA (section 6013(g) – couple can file joint return; NRA treated as RA for entire year
- Both spouses resident on last day of year (section 6013(h)) – couple can file joint return for whole year
- In all cases, treaty benefits must be waived

Residence and Tax Treaties

- Typical tiebreaker where RA also resident of foreign country (usually based on OECD model)
  - Resident of State where permanent home is available (which does not require owned or even rented home)
  - If permanent home available in both countries, test is where personal and economic relations are closer ("centre of vital interests")
  - If centre of vital interests cannot be determined, or no permanent home in either State, test is "habitual abode"
  - If habitual abode in both States or neither, test is nationality (not in all treaties)
  - Otherwise, question to be settled by mutual agreement
- China treaty theoretically requires mutual agreement, based on OECD model

Limited Effect of Treaty Nonresidence

- Treaty nonresidence may not be applicable for other than purposes of computing liability to income tax and withholding
- For example:
  - Treaty NRA counted to determine CFC status
  - Treaty NRA must file Form 5471 – see Treas. Reg. § 1.6038-2(j)(ii) limitations if no other U.S. shareholders
  - Presumably, treaty NRA is resident for purposes of foreign gift rules (section 6039F)
- This may all come as an unwelcome surprise to relocating executives and business owners

Other Tax Residence Rules

- Estate and gift tax: Domicile
  - Present in United States with no fixed intention to depart
  - Limited number of treaties with dual resident tiebreakers similar to income tax treaties
- State tax
  - Tests (and exceptions) vary – principal themes are domicile and extended periods of physical presence (e.g. 183 days)
  - Federal immigration status less important
  - Be careful for contradictions (e.g. homestead exemption for real estate tax purposes)

FBAR Residence (1)

- Current law and practice: Announcement 2009-51
  - Therefore, no statutory or regulatory definition
  - Section 7701(b) applies only for purposes of Title 26, not Title 31 where Bank Secrecy Act resides
- Internal Revenue Manual (IRM 4.26.16.3.1.1):
  - Agents should use "plain meaning of the term 'resident' (in this context, someone who is living in the U.S. and not planning to permanently leave the U.S.)"
  - Individual not a resident if he can show:
    - Not a lawful permanent resident at any time in year
    - Did not meet substantial presence test (CY = 183 or formula)
    - Did not file first year election under section 7701(b)(4)
  - Manual is silent on effect of tax treaties

FBAR Residence (2)

- IRS Public Statement in 2007
  - "Individuals can establish that they are not residents for FBAR reporting purposes if they can show that they are not 'resident aliens' for income tax purposes"
  - See report of IRS National Phone Forum Q&A (6/20/2007), Toscher and Stein, Journal of Tax Practice & Procedure (June–July 2008)
- FINCEN has proposed regulations on who is subject to FBAR (75 Fed. Reg. 8844 at 8845 3rd col.)
  - This would include residents as defined under section 7701(b), with slightly different definition of United States
  - Maddeningly, the proposal does not refer to treaties, so which part of Treas. Reg. § 301.7701(b)-7(a)(3) applies?

Taxing the Individual

Federal Income Taxation of NRAs

- ECI taxed at graduated rates (U.S. source salary, partnership income, sole proprietorship income
- 30% tax (or lower treaty rate) on US source passive investment income
- US-source interest usually exempt under section 871(h) (portfolio interest) and (i) (bank interest)
- Capital gains from trading in U.S. securities usually exempt
- Sale of U.S. real property at a gain – taxed as deemed ECI
- Most foreign-source income is exempt

State and Local Income Tax of NRAs

- Resident status for state and local income tax purposes may not be the same as for Federal income tax purposes
- If a state nonresident, state income tax on most investment income may generally be avoided
- If a state nonresident, personal service income which is considered to have been earned outside the state may not be taxed

But If NRA Becomes RA . . .

- U.S. tax on worldwide income, including services and investment income
- Implementation of U.S. anti-avoidance and compliance rules designed towards U.S. residents investing abroad, not necessarily recently arrived or short term residents
- In general, no mark-to-market for basis or other relief for capital assets on initial date of residence
- Widespread lack of understanding and application for what can be complex rules – limited educational information available from IRS or state tax authorities

Taxable Year

- RA may adopt fiscal year (Treas. Reg. § 301.7701(b)-6))
  - Tax year not previously established
  - Fiscal year used in home country and for books and records
  - Fiscal year must be a calendar month end (§ 441(e))
  - Otherwise, calendar year.
- Taxable year coincident with home country taxable year may make sense and should be part of pre-residence planning or, at least, soon after arrival.
- Calendar year wage withholding available only on fiscal year return beginning in calendar year (§ 31(a)(2))
- Determination of residence under § 7701(b) still made on calendar year basis

Taxation of Personal Services Income

Personal Services Income

- Forms of compensation to consider
  - Cash salaries are fairly straightforward
  - Assignment benefits
  - Deferred Compensation – bonuses and equity
  - Benefits plans and fringe benefits
    - Pension plans, health and welfare plans
    - Employees often remain on their home country plans, out of their choice or the company's choice

Taxation of Benefits Paid to NRAs

- Assignment Benefits (e.g. housing, car)
  - Generally sourced on a geographic basis (e.g. housing provided by employer in U.S. is U.S. source)
  - May qualify as nontaxable travel expense reimbursement if <1 year assignment (§ 162(a)(2))
- Deferred compensation (e.g. bonus, equity)
  - Generally allocated on a time basis
  - Foreign source portion not taxable
  - U.S. source portion taxable in U.S. (§ 864(c)(6) and § 871(b))
    - Taxable even if NRA no longer in U.S. at time of taxing event
    - Subject to section § 3402 withholding

Taxation of Equity Received by NRAs

- Non-qualified stock options/Restricted stock grants
  - Sourcing generally determined from grant date to vest date (Treas. Reg. § 861-4(b)(2)(ii)(F)). Three treaties use period from grant date to exercise date (Canada, UK, Japan)
  - Employer required to withhold on U.S. ECI (§ 864(c))
  - Pre-arrival § 83(b) election may avoid U.S. sourcing for stock grant
    - However, no subsequent basis step-up for FMV at grant
    - Consider time & manner for making election (§ 83(b)(2))
- Incentive Stock Options
  - No tax on exercise provided compliant with §§ 421 and 422 (no disposition w/in 2 years of grant/1 yr of exercise)
  - Income for AMT purposes at exercise
  - No tax on disposition if remains NRA

Taxation of Equity Paid to NRAs

- Treas. Reg. § 1.861-4(b)(2)(ii)(C)(1)(i) alternative sourcing methodology
  - Satisfy the IRS that the alternative method more properly sources the compensation under the facts & circumstances
  - If ≥ $250,000 compensation in tax year must provide a statement explaining:
    - Compensation element
    - Alternative sourcing method
    - Computation
    - Comparison of dollar amount determined pursuant to alternate method versus that determined by the time or geography rules of the regulations

Foreign Retirement Plans of Aliens

- Nonqualified Defined Contribution Plans
  - § 402(b)(1) - Employer plan contributions taxable if:
    - Plan is *funded* for U.S. tax purposes, and
    - Employee's interest in the plan is *vested* in whole or part.
  - § 402(b)(4) - Plan earnings taxable if:
    - Plan is discriminatory under U.S. rules (not broad based), and
    - Employee highly compensated ($110,000 for 2010). § 414(q)
- Nonqualified Defined Benefit Plans
  - If funded, not broad based and EE highly compensated
  - Change in present value of accrued vested benefit is taxable
- Treaty relief for contributions – see next slide

Treaty Articles on Pension Contributions

- Austria
- Belgium
- Canada
- France
- Germany
- Ireland
- Italy
- Netherlands
- South Africa
- Sweden
- Switzerland
- United Kingdom
- Chile (pending)
- Rules and Variations:
  - Employee must have been contributing before relocation
  - Location (Switzerland – miscellaneous article)
  - Deductible or excludible
  - Time limits (some 5 years)
  - Independent contractors often not covered
  - Competent authority agreements listing qualified plans
  - Treatment of U.S. citizens in U.K./Canada commuter rule

NQ Deferred Compensation – § § 409A & 404A

- Section 409A specifies:
  - Timing for deferral election
  - Timing for distribution
  - No offshore trust arrangement
  - Written plan requirement
- Violations
  - Amounts deferred are included in income
  - Additional 20% tax plus Interest surcharge
- Exceptions (Treas. Reg. § 1.409A-1(a)(3) & (b))
  - Foreign social security plans
  - Plans covered by § 402(b) – separate trust assets
  - Participation in certain foreign broad based plans
  - Deferrals that would be excluded by code or treaty
- Section 404A – no deduction until "properly taken into account"

NQ Deferred Compensation of NQ Entity § 457A

- Nonqualified entity
  - Any foreign corporation unless
    - 80% of income is ECI, or
    - Subject to comprehensive foreign income tax (country with which U.S. has income tax treaty)
  - Any partnership unless
    - Substantially all income allocated to persons other than foreign persons not subject to comprehensive foreign income tax and tax exempt organizations (§ 457A(b))
    - Additional 20% tax and Interest surcharge NQ deferred compensation of a NQ entity
- Taxable unless subject to future performance of service
- Exception - § 457A(d)
  - Does not include payments w/in 12 months of year end

U.S. Social Security and NRAs (1)

- FICA and FUTA – generally apply to all wages earned in U.S.
- Difficult for foreign employers to comply in many circumstances, e.g., NRA on a U.S. business trip
- Generally NRAs not subject to self-employment tax (§ 1402(b))
- Limited Code exemptions (e.g., foreign government employees, international organization employees, students, etc.)
- www.ssa.gov/international/ is an excellent resource

U.S. Social Security and NRAs (2)

- Totalization agreements may provide exemption
  - Eliminate imposition of social security taxes on the same income by more than one country
    - Generally require such taxes to be paid in one jurisdiction to avoid tax in the other
    - Exemption generally permitted where NRA intends to remain less than 5 years in jurisdiction (some extensions may be available)
  - Provide "totalization" of benefits where NRAs contribute to social security in 2 countries
  - 24 agreements in force; Mexico signed 2004 unlikely to enter into force

Taxation of Investment and Other Income

Sale of Alien's Personal Residence

- Sale of home in foreign country
  - Potential income tax if sold after alien becomes a RA; § 121 exclusion can apply to foreign home
  - Possible foreign exchange gain on the home or the mortgage; Rev. Rul. 90-79
  - Step-up in tax basis for Canadians who become RA and sell their Canadian home; Canada-US tax treaty Article XIII.6
- Sale of U.S. home when leaving the US
  - Gain subject to tax under section 897 (FIRPTA) if NRA on closing date.
  - 10% gross withholding under section 1445 unless apply for withholding reduction certificate from IRS
  - Section 121 exclusion may apply

Investment Income – Resident Alien

- Taxed on worldwide income at graduated rates, with foreign tax credit (FTC) for foreign income taxes
- Rental income from renting out home abroad
- Gains from trading all U.S. and non-U.S. securities
  - CAVEAT: Historical cost basis applies, with basis converted into dollars at exchange rate on purchase date
  - Planning to “step up” the basis of appreciated assets before becoming a RA
- Problem of installment sales made before the individual became a RA. See TAM 8708002 and PLR 9412008, deeming an election to have occurred for pre-residence installment sales

Foreign Anti-Avoidance Rules

- Controlled foreign corporation (CFC) rules (section 951 et seq.), and Form 5471 reporting – attribution rules
- Passive foreign investment company (PFIC) rules of section 1291 et seq. – foreign mutual funds and closely held foreign investment companies – annual filing of Form 8621; PFIC "departure tax" in Prop. Treas. Reg. § 1.1291-3(b)(2)
- Foreign trusts – § § 643(a)(6), (h) and (i); 667 and 668; 672(f); 679; 684, etc.; see also Forms 3520 and 3520-A

Subpart F Planning and Prevention

- When an NRA who owns all or a share of a privately held company will become an RA, some planning is desirable:
  - The company may be or become a CFC
  - If the CFC already owns a U.S. subsidiary, a "sandwich" structure may be created, leading to multiple levels of taxation as well as unexpected application of section 956
  - As an individual, the RA will generally not be entitled to FTCs on income earned by the CFC
  - The CFC may have retained earnings or unrealized gains that will be subject to U.S. taxation even though they arose before the NRA became an RA
  - There will be Form 5471 reporting and, if the RA will be in control of the CFC, potential FBAR reporting requirements

PFICs

- Many new RAs own PFICs
  - Normal home country collective investment vehicles
  - QEF elections often impossible because funds will not provide information
  - Many funds may prohibit U.S. resident holders
  - Consider selling funds pre-residence; may be difficult or even impossible under fund rules or if funds held through home country tax-advantaged savings plan
- PFIC rules also affect family-controlled investment companies where U.S. shareholders are in minority
  - Check-the-box (see next slide) and QEF elections may be possible

Check-the-Box Planning

- Check-the-box election often possible and desirable for privately held company owned by impending RA
  - Eliminates CFC and PFIC issues
  - Clears out pre-residence E&P and steps up basis of assets, with no home country tax effect
  - Flow-through of FTC
  - Eliminates section 956 issue (on pre-immigration loan by foreign corporation to U.S. subsidiary)
  - Reporting still required (on Form 8865 or 8858) but not conditional on cooperation from entity post-election
  - Election can even be made after alien becomes RA, but best if effective date of election predates residence
- Alternative: Consider § 962 election (RA elects to be taxed like a corporation on CFC earnings)

Foreign Trusts

Foreign Trusts

- The advisor must determine if impending RA is the settlor, grantor, beneficiary and/or trustee of any foreign trust must determine if trust is or will become grantor trust
  - Section 672(f) (not if foreign grantor, with exceptions for revocable and grantor/spouse only benefit trusts)
  - Section 679(a)(4) (NRA grantor becomes RA within 5 years)
  - Regular grantor trust rules
- For trust that will continue as non-grantor trust:
  - Determine distributable net income and undistributed net income (even if accumulated pre-residence)
  - Set up U.S. trust accounting
  - Consider distribution policies
  - Consider "decanting" or other planning to move trust to U.S.

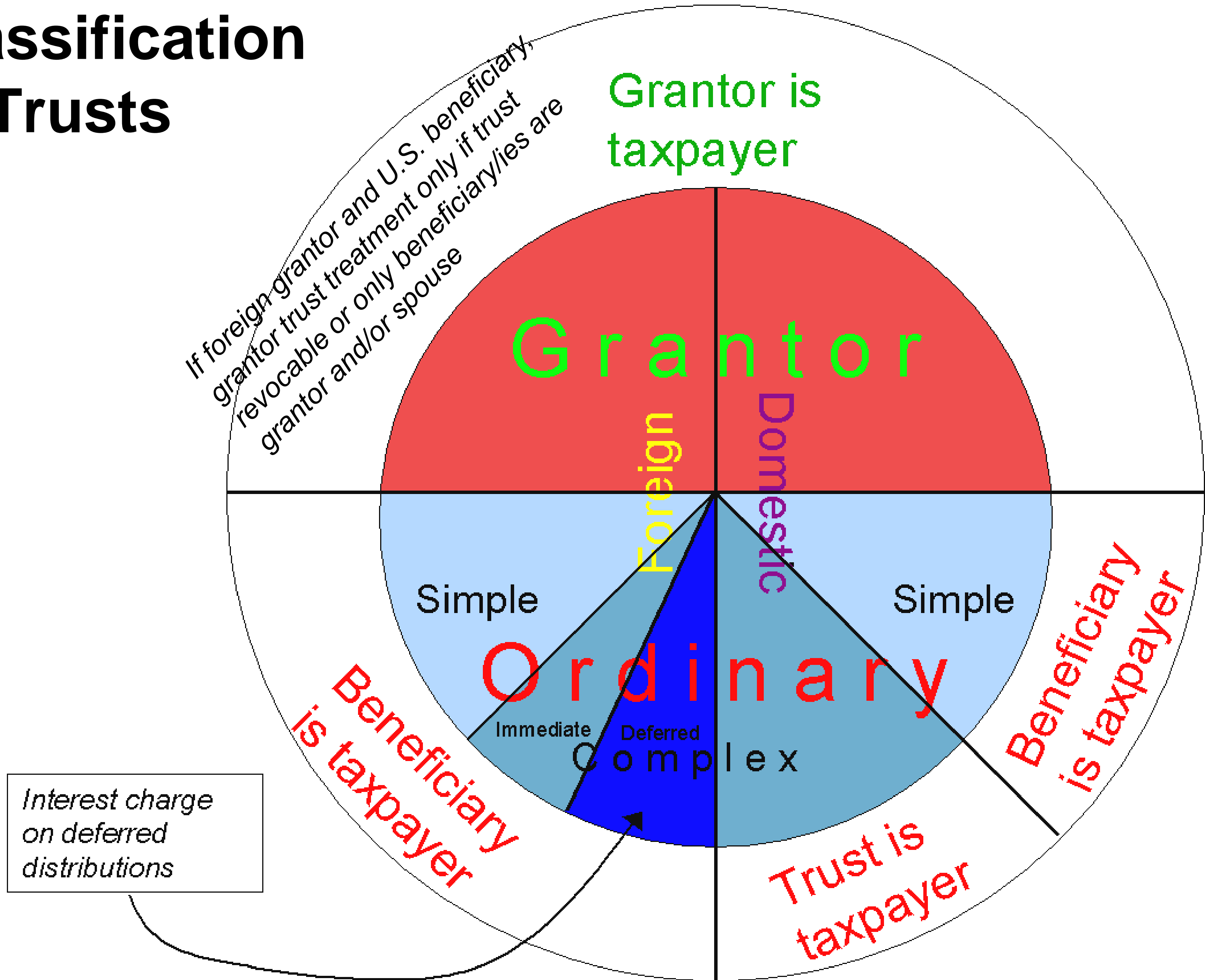
Trust Tax Concepts

- Trust is either "**domestic**" or "**foreign**"
  - Foreign if governed by non-U.S. law (court test) or U.S. person does not control all substantial decisions (control test) – § 7701(a)(30) and Treas. Reg. § 301.7701-7
- A trust may be a "**grantor trust**"
  - Only the *grantor* is subject to U.S. tax on trust income
  - The grantor is essentially the person who funded the trust
- Alternatively, trust may be an "**ordinary trust**" – in which case *trust* and *beneficiaries* are the taxpayers
  - Trust is taxed like an individual
  - Therefore, a foreign trust is treated as an NRA, taxable on:
    - U.S. source investment income (but not capital gains, except real estate) at flat rate of 30%
    - Income effectively connected with a U.S. trade or business at regular U.S. rates up to 35%

Simple and Complex Trusts

- If an ordinary trust requires current distributions of income, it is a **“simple trust”**.
  - Trust is entitled to deduct amounts to be distributed
  - Beneficiaries pay tax on trust income on current basis
  - Character of income and other tax attributes are the same in the hands of beneficiary
- If the trust does not require current distributions, it is a **“complex trust”**
  - Beneficiaries taxable only when they receive distributions
  - If trust is foreign, accumulation distributions are not entitled to capital gains treatment and tax subject to interest charge
  - Character of income is the same

Classification of Trusts



Grantor Trust – Before and After Grantor's Death

Time ↓	Before Grantor's Death	After Grantor's Death
Income earned	All trust income is treated as grantor's – but foreign and favored U.S. income not taxed	All trust income is treated as trustee's – but foreign and favored U.S. income not taxed
Income actually (or required to be) distributed to U.S. beneficiary in year earned	Distribution treated as gift by grantor to beneficiaries • No U.S. income tax • No U.S. gift tax if made outside United States	• Taxable to beneficiary when distributed • Capital gains treatment available
Income accumulated and distributed to U.S. beneficiary in later year		• Taxable to beneficiary when distributed • Capital gains taxed as ordinary income • Interest on deferred tax • FTC and U.S. tax credits

Taxation of Ordinary Trust Distributions

- **Beneficiaries** taxed on trust distributions made out of DNI ("distributable net income"). Distributions treated as made:
  - First, from DNI of current year (taxable)
  - Then, from the earliest year for which there remains DNI (taxable - plus interest charge)
  - Finally, from trust corpus (nontaxable)
- Current distributions can be ordinary income or capital gain
- Accumulation distributions from foreign trust
  - Ordinary income - even if paid out of capital gains
  - Subject to interest on deferred tax at tax late payment rate
  - Carry credits for U.S. and foreign taxes paid by the trust
- Good recordkeeping is vital – Form 3520

Tax Attributes of Distributions

- If Trust only distributes a percentage of DNI of particular year, tax attributes associated with income (capital gain or ordinary, foreign source or U.S. source) and associated credits for foreign or U.S. taxes paid by the Trust are divided proportionately
- Similarly, if DNI is distributed to more than one beneficiary, tax attributes divided proportionately to total distributions to beneficiary within the year – may be some room to maneuver here using concept of "separate shares".
- Example:
  - Trust has current year DNI 100 (60 capital gain, 40 ordinary income)
  - Trust distributes 80.
  - Result, 60% x 80 = $48 capital gain; 40% x 80 = $32 ordinary income; undistributed $20 will all become part of UNI

Reporting and Compliance

Returns

- As full U.S. taxpayer, must file income tax returns on Form 1040 (as well as applicable state returns)
- First year return where individual is RA for only part of the year, return is on Form 1040 with Form 1040NR attached as schedule to show income tax computation for part of taxable year during which alien was an NRA. Treas. Reg. § 1.6012-1(b)(2)(ii)
- No joint return permitted during split year. Joint returns are permitted only if election is made under § 6013(g) or (h), in which case alien is filing as RA for entire year

Many aliens don’t know that “alien” means non-citizen!

RAs Must Report!

- Right from the beginning, RAs are subject to the full rigor of U.S. reporting regimes
- The IRS has taken no steps to target new residents for education on these responsibilities and, in our experience, there is widespread lack of knowledge about these issues in the tax preparer profession
- Examples of reporting requirements:
  - Interests in foreign corporations and other entities – Forms 5471, 8865 and 8858
  - Interests in PFICs – annual reporting now required
  - Foreign trust and gift reporting – Forms 3520 and 3520-A
  - New foreign financial account reporting
  - FBARs

Withholding on Payments by RA

- RA is subject to all withholding requirements generally applicable to U.S. withholding agents. Some items that may come as a surprise:
  - Alimony paid by a RA to a NRA – subject to 30% withholding under section 1441, unless exempt by treaty
  - Mortgage interest paid by RA to foreign bank on alien's foreign home – subject to 30% withholding under section 1441, unless reduced or eliminated by treaty; because of bank loan exception, interest is not portfolio interest
- Note that 1042/1042-S reporting not required if payment made by individual not in course of business and payment is exempt; but RA must still obtain Form W-8BEN from foreign payee

Estate and Gift Taxes

Federal Estate Tax and Gift Tax Rules

- NRA subject to estate tax only on U.S. "situs" assets. §§ 2104-2105
- NRA subject to gift tax only on gift of U.S.-situs "tangible" property
- RA subject to gift and estate taxes on worldwide assets (same as U.S. citizen). FTC allowed for foreign death taxes but not against gift tax unless allowed by treaty
- Residence depends on "domicile", which is a subjective concept, compared to § 7701(b)
  - Lawful resident and illegal immigrant likely to be domiciled
  - Non-immigrants often remain non-domiciled for FET/FGT, even if income tax residents
  - *Elkins v. Moreno*, 435 U.S. 647 (1978); Rev. Rul. 80-36, 1980-2 C.B. 249; *Estate of Robert A. Jack v. United States*, 54 Fed. Cl. 590 (2002) (government allowed to show that decedent intended to stay in U.S. in violation of visa).

Special Problems

- US bank accounts and “portfolio interest” bonds may lose their foreign situs for FET because of the alien’s RA status; IRC §§ 2105(b)(1), (3) and (4). Keep all large bank accounts outside the US
- Municipal bonds have a U.S. situs
- US equities (i.e., stock in U.S. corporations) are U.S.-situs under § 2104(a). Foreign holding company can avoid estate tax, but create income tax issues (e.g., loss of capital gains treatment)
- Unexercised stock option rights probably U.S.-situs
- Personal assets in U.S. are taxable: Not just U.S. home, but tangibles (e.g., jewelry and art works)

Marital Deduction

- Special rules where surviving spouse not a U.S. citizen even if survivor has a green card and would be subject to expatriation rules
- Marital deduction available with "qualified domestic trust" (QDOT) under section 2056A where alien spouse remains abroad or becomes an RA but not a citizen

Gift and Estate Tax Treaties

- "Old" (pre-1971) vs. "new" (post-1970) tax treaties
- "New" treaties (seven of them) do the following:
  - Override domicile rules for a certain number of years if alien remains subject to death tax in home country
  - Exempt all assets from gift and estate tax except for U.S. business assets and real property (thereby exempting U.S. stocks and bonds and US-situs personal property)
  - Enhanced marital deduction rules in some new treaties
- "Old" treaties more limited and generally address situs issues
- Treaties can increase $60,000 exemption amount up to $5,000,000 amount for citizens and residents (typically proportionately to worldwide assets)
- Special rules in Canada-US income tax treaty (Canada has no estate tax but taxes capital gains on death)

Pre-Residence Planning

Checklist of Planning Considerations (1)

- Residence and Immigration Status
  - Accurately time the beginning of U.S. tax residence for both income tax and transfer tax purposes
  - As explained below, consider appropriate immigration status is appropriate, given punitive expatriation rules
- General income tax planning
  - Choice of taxable year
  - To the extent necessary and possible, deal with income and gains held in deferred compensation plans
  - Accelerate collection of non-U.S. income
  - Accelerate gains not subject to U.S. tax
  - Defer realization of losses

Checklist of Planning Considerations (2)

- Investments and Trusts
  - Deal with holdings in foreign corporations, especially corporations that might become CFCs or PFICs following the beginning of residence
  - Deal with trusts that are already in existence, whether formed by the prospective resident or by the new immigrant's family members
  - Make gifts to spouse to equalize estates, and to children and grandchildren

Departure

Tax Consequences of Departure

- No departure tax for alien who was income tax resident under substantial presence test or who is not a “covered expatriate”
- Section 121 can apply to later sale of principal residence, notwithstanding FIRPTA
- Earnings attributable to U.S. services or pre-departure installment sale taxed to NRA. § 864(c)(6)
- Gain on sale of business property used in U.S. business and sold by NRA within 10 years after being removed from U.S. business treated as ECI. § 864(c)(7)

Expatriation Rules

- Inbound aliens must be counseled on expatriation rules of § 877A and § 2801
- Affects whether they choose to apply for green card, since rules only apply to "expatriates"
- "Expatriate":
  - U.S. citizen relinquishes citizenship
  - Alien who was lawful permanent resident **in** (meaning as little as a day) 8 of preceding 15 years and
    - ceases to be lawful permanent resident; or
    - claims to be NRA under income tax treaty

Definition of “Covered Expatriate”

- “Covered Expatriate”
  - Average annual net income tax of > $147,000 (for 2011) for the five tax years preceding expatriation. Rev. Proc. 2010-40; 2010-46 I.R.B. 1
  - Net worth $2 million or more at date of expatriation (not indexed for inflation)
  - Any expatriate who fails to certify 5-years of tax compliance
- Exceptions
  - Dual citizen at birth who did not meet “substantial presence” test for more than 10 years before relinquishment
  - Person under 18½ relinquishes U.S. citizenship and did not meet “substantial presence” test for more than 10 years before relinquishment (no parallel rule for green card holders)

Mark-to-Market Rules – Section 877A

- Exit Tax
  - Applicable to expatriations occurring on or after June 17, 2008
  - Under § 877A, mark-to-market regime replaces prior 10-year "alternative tax" on U.S. source income under § 877
  - A "covered expatriate" is deemed to sell all worldwide property for FMV on day before expatriation date and is taxed on gains >$600,000 (indexed; 2010 = $627,000; 2011 = $636,000)
  - Section 877A does not address character. Unclear how $600,000 exclusion to be allocated among different classes of assets, gain on which may be subject to varying tax rates (e.g., capital gain vs. collectibles gain)
    - Presumably, allocation will be pro rata across income classes

Exceptions to Mark-to-Market Regime

- "Deferred compensation items"
  - Interests in qualified and non-qualified U.S. and foreign retirement and deferred compensation plans, other deferred compensation, and interests in property for performance of services to extent not previously included under § 83
  - Exception for deferred compensation for non-U.S. services while covered expatriate not U.S. citizen or RA
  - Tax on "eligible deferred compensation" deferred until includible in gross income under U.S. rules; collected by means of 30% withholding tax
    - Deferred compensation is "eligible" if paid by U.S. payor or foreign payor electing, under terms acceptable to IRS, to be treated as U.S. payor
    - Covered expatriate must waive applicable tax treaty benefits and notify payor of status
    - Risk of double taxation, although tax credits may be available

Exceptions to Mark-to-Market Regime (cont'd)

- Non-eligible deferred compensation present valued and treated as received day before expatriation
  - "Restricted property" under § 83 treated as transferable and no longer subject to substantial risk of forfeiture
  - Double taxation risk – likely no tax credit in foreign country
- "Specified tax deferred account" treated as received day before expatriation
  - Includes, e.g., IRAs, qualified tuition plan, Coverdell education savings account, health savings account and Archer MSA plans; doesn't include SEPs and simplified retirement accounts (treated as deferred compensation and not specified tax deferred accounts)
- Adjustments made on subsequent distributions; no early distribution penalties

More Guidance on Section 877A

- Notice 2009-85, 2009-45 I.R.B. 1
  - Background regarding general application of § 877A
  - Determining whether an individual is subject to § 877A
  - Operation of the mark-to-market regime
  - Interaction of § 877A and § 877 as well as §§ 367, 684, 897; termination of deferrals (§§ 1031, 1033; time to pay tax)
  - Deferred compensation items and specified tax deferred accounts
  - Rules for interests in nongrantor trusts
  - Filing and reporting requirements of expatriates who are covered by section 877A
  - No guidance yet on § 2801
- Form 8854 (Expatriation Information Statement)
- New Form W-8CE (Notice of Expatriation and Waiver of Treaty Benefits)

Section 2801: New Succession Tax

- U.S. persons receiving gift or bequest from covered expatriate taxed at highest gift or estate tax rate
  - Exception for annual exclusion gifts (currently $13,000) or entitled to charitable or marital deduction (QDOT necessary?)
  - Exception for property shown on <u>timely</u> gift tax return of covered expatriate or included in gross estate of covered expatriate and shown on <u>timely</u> estate tax return
  - Credit for foreign gift or estate/inheritance taxes
- Transfers in trust:
  - If domestic trust (or foreign trust electing to be treated as domestic), tax paid by trust
  - If foreign trust, U.S. recipient pays tax on distribution portion attributable to covered expatriate's prior transfer in trust; in computing income tax on distribution, can deduct section 2801 tax attributable to income (gee, thanks!)

More on Section 2801

- Scope
  - Applies to gifts of wealth created long after expatriation
  - Applies to gifts to recipients who may have become U.S. persons long after death of covered expatriate and who may not even have been born at time of expatriation
- Compliance
  - U.S. recipient may be unaware of covered expatriation
  - Indirect covered gifts
- Treaty interactions – “new” and even “old” treaties may override § 2801
- Guidance is on the IRS Priority Guidance Plan – see http://www.irs.gov/foia/article/0,,id=181687,00.html

Post-Departure Compliance

- Replace any Form W-9 with Form W-8BEN
- Where applicable, provide Form W-8ECI to avoid withholding on business income
- Wage withholding will continue
- 30% withholding on independent services, subject to treaty relief
- File split-year return in year of departure (Form 1040NR, with Form 1040 as schedule)
- Stop using Turbotax!

Advising Intending RAs About Subsequent Departure

- Impact on prospective immigrants –
  - Will wealthy individuals stop applying for green cards or even moving to the United States? If already here, will they leave before 8th year? Might such decisions entirely consume estimated revenues?
  - We advise against obtaining a green card in most circumstances where long-term renewable non-immigrant visa available (L-1, E-1 or E-2, O) and other factors do not compel need for green card (some job qualifications, need to obtain residence for teenage children), at least until it is clear that the move to the U.S. is permanent
- U.S. policy (not just tax policy) now seems to be
  - We welcome foreign money but not foreigners
  - Along with your tired and poor, we no longer want your rich (and certainly no one yearning to be taxfree)

Advising Potential NRAs

- If alien does obtain a green card:
  - Take snapshot and obtain valuations of pre-immigration assets as step-up given for purposes of mark-to-market tax
  - Keep track of years and decide whether to cross 8 year-threshold – remember, a year counts if present with a green card for as little as one day

Our Presentation Would Not Be Complete Without . . .

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