Pre-Immigration Tax Planning is Critical for Foreigners Moving to the United States

By Seth J. Entin

The United States is an attractive destination for foreign persons moving away from their home countries. The instability in some Latin American countries is just one reason why the United States is seeing a rise in the number of high-net-worth foreigners establishing U.S. residency.

Florida in particular is an attractive destination for high-net-worth individuals. Among other things, Florida does not impose state or local income tax on individuals. This is in contrast to many other states. For example, New York imposes an income tax on individuals at rates of up to almost 9 percent, New York City imposes an additional income tax on individuals at rates of up to almost 4 percent, and California imposes an income tax on individuals at rates of up to 13.3 percent. And, under new U.S. federal income tax laws, the ability of an individual to deduct state and local income taxes against his or her federal income tax is extremely limited.

While the need for timely pre-immigration tax planning may not be readily apparent to a high-net-worth foreigner who is considering moving to the United States, the failure to plan until it is too late may have extremely costly tax consequences. Conversely, some foreigners have been pleasantly surprised to learn that, with proper planning, their exposure to U.S. taxation is not quite as intimidating as they had originally expected (particularly compared with the laws of their home country).

Take, for example, the case of Mr. X, who lives in Latin America and is not a U.S. citizen or tax resident. He has significant wealth of his own. Mr. X founded and owns Latin American companies that are now extremely valuable. Mr. X also owns a portfolio of stocks and bonds that has appreciated significantly. He owns some of these stocks and bonds in his own name, and some through a foreign corporation. Mr. X also stands to inherit significant wealth from his parents, who are not U.S. citizens or tax residents.

Mr. X is considering moving to the United States, while his parents will remain in Latin America. Such a move will cause Mr. X to be subject to a host of potential U.S. tax liabilities. But, with proper planning, Mr. X can take steps to significantly minimize his exposure to U.S. taxes once he becomes a U.S. citizen or tax resident.

It is critical, however, that this planning be implemented before Mr. X becomes a U.S. citizen or tax resident. After-the-fact planning will not achieve the same benefits. The rules for when Mr. X's U.S. residency starts for income and estate tax purposes are fairly technical. Sometimes individuals who are not familiar with the U.S. tax system are unpleasantly surprised to learn that they have already become U.S. tax residents without knowing it.

The following are some "big picture" examples of beneficial tax planning that Mr. X should consider. Pre-immigration U.S. tax planning is highly dependent on an individual's facts and circumstances, and can be rather complex. These examples are simply intended to provide a summary of a few key planning matters that may apply to a foreigner, such as Mr. X, who is moving to the United States.

- U.S. estate tax planning is critical. Without it, if Mr. X becomes a U.S. citizen or tax resident, his worldwide assets will be subject to the U.S. estate tax upon his death. The

U.S. estate tax is currently imposed at rates of up to 40 percent of the fair market value of an individual's assets. On the other hand, with planning involving a properly structured family trust, Mr. X may legitimately avoid those assets being subject to U.S. estate tax on his death.

- If, after moving to the United States, Mr. X inherits assets from his parents, those assets will become part of Mr. X's taxable estate, and will be subject to U.S. estate tax on his death (again, at rates of up to 40 percent of the fair market value of the assets). With a properly structured family trust created by Mr. X's parents, however, Mr. X's parents' assets may be legitimately kept out of Mr. X's taxable estate. Because Mr. X's parents will not be U.S. citizens or tax residents, this trust will be significantly different in nature from the trust that Mr. X creates.

- If Mr. X becomes a U.S. citizen or tax resident, he may also be subject to "double tax" on the earnings of his Latin American companies. That is, the companies will be subject to corporate tax in Latin America on their earnings, and possibly to withholding tax when they pay dividends to Mr. X. At that time, Mr. X will be subject to U.S. income tax on these earnings. Moreover, under recently enacted U.S. tax legislation, the U.S. *controlled foreign corporation* (CFC) regime will cause Mr. X to be taxed on a significant portion of these earnings even if they are not distributed to him as a divided. Assuming, for example, a 30 percent corporate tax rate in Latin America, the earnings of Mr. X's Latin American companies may be subject to an overall combined Latin American and U.S. effective tax rate of well over 50 percent. But, with proper planning involving converting the Latin American companies to entities that are eligible to elect and will elect to be treated as "pass-through entities" for U.S. tax purposes, Mr. X may be able to credit some or all of the Latin American income taxes against his IRS tax liability. This can reduce or eliminate double taxation.

- If Mr. X becomes a U.S. citizen or tax resident and then sells his assets, he will be subject to U.S. income tax on all of his gain – even the gain that has built-up while he was a nonresident. But, by making certain tax elections for the foreign companies or selling the assets in his portfolio and purchasing new investment assets, Mr. X may be able to realize the gain free of U.S. income tax before he becomes a U.S. resident.

- It can be highly inefficient from a U.S. tax standpoint for a U.S. citizen or tax resident to own "passive" investment assets through a foreign corporation. For example, this can cause *long-term capital gain income* and *qualified dividend income*, which is normally taxed to a U.S. individual at favorable tax rates, to be taxed to the individual at significantly higher "ordinary income" tax rates. Therefore, Mr. X should either liquidate the foreign corporation that owns his passive investment assets or make an IRS election for this entity to be deemed to be liquidated for IRS purposes prior to his becoming a U.S. citizen or tax resident (in some cases, this may involve converting the entity into a different type of legal entity).

- The U.S. tax law has a number of detrimental tax regimes that apply to U.S. citizens or tax residents with foreign investments. A key example is the dreaded *passive foreign investment company* (PFIC) regime, which can significantly increase the rate of U.S. income tax payable on income from certain "passive" foreign assets, such as some foreign mutual funds, hedge funds and private equity funds. Mr. X should review his portfolio of assets with a U.S. tax advisor to make sure to avoid exposure to these regimes.

- An individual who is a U.S. citizen or tax resident is required to file IRS forms to disclose items such as interests in and contributions to foreign entities, ownership of foreign financial assets and accounts, signature authority over foreign financial accounts, distributions from foreign trusts and gifts from foreign persons. If a U.S. individual fails to file the required forms, he may be subject to significant civil and criminal penalties. These reporting requirements are fairly complex, and Mr. X should arrange for the filing of all of these forms by an experienced certified public accountant by the applicable deadlines.

Any pre-immigration plan will have to be designed and implemented with great care. While this often requires significant work, the resulting tax savings may be significant.

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