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Foreign Taxpayers

Jenny Longman and Henry P. Bubel of Patterson Belknap Webb & Tyler write that non-U.S. individuals contemplating residence in the country should be aware that their U.S. tax picture could in certain cases be vastly improved with a little planning. The authors outline planning opportunities for those who take up temporary tax residency in the U.S., as well as issues relevant to green card holders.

U.S. Tax Planning for Temporary Residency in the Country

BY JENNY LONGMAN AND HENRY P. BUBEL

The relatively strong U.S. economy continues to attract many non-U.S. individuals to take up residence in the U.S., under a number of immigration statuses.

Whether such individuals have entered the U.S. under an entrepreneurial visa (such as an H-1B) or a visa that grants the individual exempt status for purposes of U.S. tax residency, such as an F visa, these individuals and their foreign advisers should be aware that their U.S. tax picture could in certain cases be vastly improved with a little planning.

This article focuses on planning for individuals who take up temporary tax residency in the U.S., but also includes a discussion of certain issues relevant to green card holders, because in our experience, what starts off as a green card issuance accompanied by an intent to permanently reside in the U.S. may well end in abandonment of the green card; precisely when that legal permanent resident status is abandoned can be critically important.

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U.S. Tax Residence

General

The Internal Revenue Code defines a resident individual as any lawful permanent resident of the U.S. or any alien individual who satisfies the ''substantial presence'' test.[1]

The first prong, commonly referred to as the ''green card test,'' is determined exclusively by the individual's immigration status, without reference to time spent in the U.S.

An individual meets the substantial presence test in any calendar year if that individual is present in the U.S. at least 31 days during that calendar year, and the sum of the number of days on which that individual was present in the U.S. during the current year and the two preceding calendar years equals or exceeds 183 days, using a multiplier formula (giving greater weight to the current year and less weight to the preceding years).[2] As a practical matter, an individual will meet the substantial presence test if the individual is present in the U.S. for 122 days per year on average.

Special rules apply to the first and last year of residency. Generally, for a green card holder, U.S. tax residency starts on the first day that the individual is present in the U.S. as a lawful permanent resident (that is,

[1] I.R.C. Section 7701(b)(1).
[2] I.R.C. Section 7701(b)(3).

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the first time the individual enters the U.S. on the green card, or if already present in the U.S., on the date of issue of the green card).

For an individual taxed as a resident under the substantial presence test, his or her U.S. tax residence doesn't begin until the first date when the individual was actually present in the U.S. (with some exceptions for short visits to the U.S. before the longer-term stay).[3]

An individual who satisfies both tests becomes a resident on the earlier of the first day the individual is physically present in the U.S. as a lawful permanent resident or the first day the individual is present for purposes of the substantial presence test.[4]

An individual's residency termination date for his or her last year of U.S. tax residency is generally the last day of the year (meaning the individual wouldn't have a split year as a dual status individual), unless the individual can establish that his or her tax home was in a foreign country for the remainder of the year and that he or she maintained a closer connection to that foreign country than to the U.S.[5]

Special Treaty-Based Rules

Where an individual is treated as a tax resident of the U.S. and a jurisdiction with which the U.S. has an income tax treaty, the individual may be able to claim treaty benefits such that the individual won't be treated as a U.S. resident under the treaty.

However, the individual would still be considered a U.S. person for other purposes of the Internal Revenue Code, such as the determination of whether a foreign corporation is a ''controlled foreign corporation'' for purposes of Section 957.[6] Note that others, such as other U.S. shareholders of a controlled foreign corporation, won't benefit from that individual's treaty position.

Planning Surrounding First Year of Tax Residence

General

A green card holder's U.S. tax resident status begins upon issuance of the green card as long as the individual is present in the U.S. at that time, which would result in a ''short year'' of U.S. tax residence.

The individual would be required to file a U.S. resident income tax return (Form 1040, U.S. Individual Income Tax Return) that covers the period between the green card issuance date and Dec. 31 of that year, as well as Financial Crimes Enforcement Network (FinCEN) Form 114, Report of Foreign Bank and Financial Accounts (also known as the ''FBAR''), if the individual owns foreign accounts that meet certain thresholds. There is almost complete overlap between U.S. residency for purposes of income tax return filing and FBAR filing; the differences concern residents of U.S. territories.

For an individual who becomes a U.S. tax resident under the substantial presence test, the calendar year during which the individual first enters the U.S. may be split into a nonresident and resident portion (assuming the substantial presence test is met during that first year of entry). In that case, the individual, as a dual status taxpayer, is treated as a nonresident until his or her residency start date, and taxed as a U.S. resident from the residency start date until Dec. 31 of that year.

Where an individual intends to arrive during the second half of the calendar year (such that the individual's day count would be less than 183 days), there is much opportunity for pre-U.S. tax resident-related planning during that calendar year. Although U.S.-source income would be subject to U.S. taxation for the full year, which may or may not trigger a nonresident income tax filing requirement (on Form 1040-NR, U.S. Nonresident Alien Income Tax Return), that individual's foreign income should remain outside the U.S. tax net for the entire year.[7]

Thus, individuals who enter the U.S. with nonresident visa status in the latter half of the year are effectively granted a form of a ''grace period'' insofar as their U.S. income tax reporting is concerned,[8] but green card holders who arrive during the latter half of the year remain fully responsible for U.S. tax compliance from the day of arrival following issuance of the green card.

In either case, these individuals should consider carefully their worldwide asset holdings to prepare for their upcoming worldwide U.S. taxation. There may be instances where an individual would wish to accelerate a non-U.S.-source income tax recognition event so that it occurs prior to U.S. tax residency (but should do so only after evaluating his or her home country tax consequences). Individuals should be aware that any in-

Income Tax Considerations For Would-Be U.S. Residents

Foreign taxpayers contemplating temporary U.S. residency should consider tax planning opportunities before making the move. Considerations include:

- Sale of highly appreciated stock pre-immigration can avoid U.S. tax on capital gains.
- Check-the-box elections for flow-through entity treatment of an entity prior to U.S. residency can avoid controlled foreign corporation or passive foreign investment company treatment.
- Foreign irrevocable trusts can pose challenges—distributions of accumulated income to a U.S. person are taxed very unfavorably and foreign trust reporting rules are burdensome.
- If an individual is treated as a tax resident of the U.S. and a jurisdiction with which the U.S. has an income tax treaty, the individual may be able to take a treaty position to lessen his or her U.S. tax burden.

[3] I.R.C. Section 7701(b)(2)(A)(iii).
[4] Treas. Reg. Section 301.7701(b)-4(a).
[5] Treas. Reg. Section 301.7701(b)-4(b)(2).
[6] Treas Reg. Section 301.7701(b)-7.
[7] See Treas. Reg. Section 1.871-13(b).
[8] But note that their U.S. source income would be subject to tax.

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vestment assets held in foreign entities may prove problematic without pre-immigration planning.

For example, as explained further below, it may be more favorable for those investment assets to be held in entities treated as flow-throughs for U.S. income tax purposes to avoid application of the ''passive foreign investment company'' (PFIC) rules under Section 1291 of the tax code and Subpart F, Sections 951-965. If a flow-through holding structure isn't possible, then there may be other elections available to mitigate these rules to some extent.

Individuals should also consider estate and gift planning opportunities that may exist prior to their arrival in the U.S., discussed in more detail below.

Basis Step Up

For individuals resident in countries that don't tax capital gains, or for individuals with home country capital loss carryforwards that it may make sense to utilize, one very simple pre-immigration strategy would be to sell highly appreciated stock. The stock could be repurchased, which would allow the individual to step up his or her basis in that stock to a value approximating the stock's fair market value on the date of arrival in the U.S.

Future appreciation would of course be subject to U.S. capital gains tax once that individual becomes a U.S. resident, but the pre-arrival appreciation could be saved from U.S. capital gains taxation (as well as the net investment income tax and any state and local tax).

Individuals with more complicated investment structures might in some situations (depending on their home country's tax laws and other factors) restructure their holdings in a manner that would provide a basis step up to the foreign individual. For example, in a ''busted'' Section 351 transaction, the individual would take steps to avoid the default rules of a carryover basis (at historical cost), such that the individual's basis in stock and the transferee corporation's basis in assets could be stepped up to fair market value.

Check-The-Box Elections

Certain entities, referred to as ''eligible entities,'' may elect to be treated as flow-through entities (a partnership or disregarded entity) for U.S. tax purposes.[9] For foreign eligible entities with limited liability, the default status for U.S. tax purposes is corporation,[10] which is often unfavorable. Under the right circumstances, an election can be made prior to the start of an individual's U.S. tax residency so that certain rules that would apply if the entity were a corporation will be inapplicable.

Although in theory the Internal Revenue Service could challenge the effectiveness (or at least the effective date) of the election, citing the ''relevancy rules'' of Treasury Regulations Section 301.7701-3(d), it is hard to imagine the applicability of that rule in a post-Foreign Account Tax Compliance Act (FATCA) era, where entities many tiers removed from the U.S. must provide FATCA classifications to financial institutions around the world.

Structuring Related To Offshore Investment Entities

Various anti-deferral regimes may apply to foreign corporations that can result in phantom income to their owners and other adverse tax consequences. Without a check-the-box election to change the classification of a foreign entity from the default status of corporation to a partnership or disregarded entity, that entity may either be treated as a controlled foreign corporation that may subject the U.S. tax resident owner to Subpart F rules, or a passive foreign investment company with respect to the U.S. tax resident owner, depending on the ownership structure.

Controlled Foreign Corporations

A controlled foreign corporation (CFC) is any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of the corporation entitled to vote, or of the total value of the stock of the corporation, is owned (under various indirect and constructive ownership rules beyond the scope of this article) by ''United States shareholders'' on any day during the taxable year of the foreign corporation.[11]

A United States shareholder for this purpose is a U.S. person who owns, or is considered as owning applying special rules, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.[12]

Generally, CFC status is best avoided, as it can result in substantial phantom income to U.S. shareholders, taxable at ordinary rates.

Passive Foreign Investment Companies

Where the U.S. ownership of a foreign corporation isn't high enough to trigger CFC status, a foreign corporation holding mostly passive assets, assets that produce a certain threshold of active income, or less than 25 percent investments in active corporations, will generally be characterized as a passive foreign investment company, or PFIC.[13]

The PFIC rules are complicated and beyond the scope of this article, but are disadvantageous to the U.S. holder of PFIC stock, and generally result in phantom income, or distributions taxed at ordinary rates and/or interest charges. In addition, distributions from PFICs aren't eligible for the lower U.S. tax rates applicable to qualified dividends.

Suggestions for Dealing With CFC or PFIC Status

It is possible that under the right circumstances, treatment of an entity as a CFC and not a passthrough could benefit the ultimate U.S. shareholder, so it shouldn't be assumed that a check-the-box election is always the right answer.

For example, suppose that during the U.S. tax resident's first year of residency, his or her wholly owned CFC incurs $200,000 of capital loss and $100,000 of bond interest. Without making a check-the-box election, the entity is treated as a corporation, and hence a CFC, and the capital loss is netted against the bond interest, resulting in a net loss of $100,000 (and a $100,000 earnings and profits deficit to be carried forward).

Had the entity checked the box to be treated as a disregarded entity for U.S. income tax purposes, the owner would have what might be a largely unusable

[9] See Treas. Reg. Section 301.7701-2.
[10] Treas. Reg. Section 301.7701-3(b)(2).
[11] Section 957(a).
[12] Section 951(b).
[13] See Section 1297.

capital loss, and $100,000 of includable bond interest. Although the U.S. tax resident certainly has a choice in tax classification of the entity, there are limitations in making the election; a change in classification can only be made once every five years, so the election can't be toggled on and off.

If a ''qualified electing fund'' (QEF) election is made pursuant to Section 1295, then the U.S. tax resident preserves some ability to benefit from lower rates, but is still in a position far less favorable than a passthrough. Generally, if a QEF election is available, it is beneficial, not only for rate purposes, but also for more favorable basis rules.[14]

Foreign Trusts

Often, we see foreign revocable trusts that can be revoked or otherwise dealt with prior to a settlor's or beneficiary's U.S. tax residency relatively easily. Foreign irrevocable trusts generally pose greater challenges and should be reviewed carefully prior to the settlor's or beneficiary's entry into the U.S.

Where a nonresident alien individual who is a beneficiary of a foreign non-grantor trust becomes a U.S. tax resident, there can be unfavorable income tax treatment applicable to trust distributions that may merit a decanting of the trust or a domestication of the trust—and at the very least, very careful monitoring of trust distributions must be undertaken by the trustee. Distributions of accumulated income to a U.S. person from a foreign trust are taxed very unfavorably and are best avoided.[15]

A nonresident considering settling a foreign trust should strongly consider doing so prior becoming a U.S. tax resident, or consider settling a U.S. trust instead.

Although capital gain income may be allocated to the corpus of a domestic trust for purposes of computing ''distributable net income,'' that isn't true of a foreign trust.[16] Thus, if capital gains earned by a foreign trust aren't distributed currently, their later distribution to a U.S. tax resident will trigger application of the throwback rules to that U.S. resident beneficiary, and not only will cause the beneficiary to be taxed at a higher rate of tax, but there will also be a punitive interest charge in addition to the tax due.

In addition to the unfavorable income tax rules, there are also burdensome foreign trust reporting rules that carry significant penalties for failure to file.[17]

A nonresident considering settling a foreign trust should strongly consider doing so prior becoming a U.S. tax resident, or consider settling a U.S. trust instead. Sections 679 and 684 set forth complicated and unfavorable rules applicable to foreign trusts settled by U.S. persons, including potential recognition of gain upon the transfer of assets to a foreign trust.

A nonresident that is a beneficiary of a non-grantor foreign trust will likely benefit from the trust's restructuring into a U.S. trust in connection with that beneficiary's change of status.

Domesticating a foreign trust can be as easy as appointing a U.S. resident trustee, depending on the local jurisdiction. A trust's residence for U.S. tax purposes is determined under Treasury Regulations Section 301.7701-7, commonly referred to as the ''court and control'' test. Under these rules, a trust is a U.S. person if:

- a court within the U.S. is able to exercise primary supervision over the administration of the trust (the court test), and
- one or more U.S. persons have the authority to control all substantial decisions of the trust (control test).

The addition of one or two U.S. resident trustees (if permissible under the foreign jurisdiction's laws and the trust instrument) may be enough to establish jurisdiction over the trust in the trustees' state of domicile, and, if the U.S. trustees are given sufficient powers, would tip the ''control'' portion of the test in favor of the U.S. as well.

The throwback rules mentioned above don't apply to domestic trusts—so if it is desired that the trust accumulate income in lieu of distributing annual income to a U.S. resident beneficiary, a trust domestication or the formation of a new U.S. trust for the benefit of that individual may be preferable.

Gift and Estate Tax Planning

A typical pattern we see is where the elder generation desires to plan for the newly U.S. or newly becoming U.S. younger generation. A detailed overview of cross-border estate and gift planning is beyond the scope of this article, but we mention a few possibilities that cross-border families should consider here.

It is possible to structure foreign or domestic trusts that can benefit the younger U.S. generation such that the U.S. beneficiaries won't be subject to any U.S. income tax during the life of the foreign relative grantor. Once the grantor passes, the trust becomes its own taxable entity, and, assuming the beneficiary remains a U.S. person, he or she is taxed on any income carried out by trust distributions to him or her.

The reporting for those distributions varies depending on whether the trust is structured as a domestic or foreign trust; in the case of a trust that is created as a foreign trust by the grantor, we highly recommend domesticating that trust upon the grantor's death assuming U.S. beneficiaries remain at that time.

[14] For example, if a U.S. decedent dies holding shares of a QEF, his or her heirs will receive a basis step-up, whereas if there are shares of a Section 1291 fund, the heirs would inherit a carryover basis. See Section 1291(e).

[15] See Sections 665-668, referred to as the ''throwback rules.'' The throwback rules are beyond the scope of this article.

[16] See Section 643(a)(6)(C).

[17] A U.S. beneficiary of a non-grantor foreign trust may be required to file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, and a foreign trust treated as owned by a U.S. person must file Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner (Under Section 6048(b)).

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U.S. beneficiaries are also at an advantage in the case of a trust created by a foreign relative with respect to generation-skipping transfer tax; if structured properly, the family can avoid imposition of estate tax/GST tax upon every generation.

There are state income tax advantages that can be retained at the point of domestication. Although state tax rules for taxing trusts vary widely, if structured properly, a trust created by a foreign grantor can avoid becoming subject to state income taxes upon domestication (with the exception of income sourced to a particular state). The state tax savings can be substantial over a period of many years, particularly if the trust accumulates income in lieu of distributing it to a beneficiary subject to both federal and state levels of tax.

Non-trust structuring may also be beneficial in the context of temporary U.S. residency. In the case where a nonresident alien intends to remain domiciled outside of the U.S., but, in connection with a temporary move to the U.S. may acquire U.S. situs assets, a foreign holding structure is often beneficial to avoid adverse U.S. estate tax consequences.

Leaving the U.S.

In General

The rules applicable to U.S. residents leaving the U.S. vary depending on whether the individual is a ''long-term resident.'' A long-term resident is an individual who is a lawful permanent resident of the U.S. in at least eight taxable years during the period of 15 taxable years ending with the taxable year that includes the date the green card was abandoned.[18]

Like expatriating U.S. citizens, long-term residents are subject the rules under Section 877A, which may result in a mark-to-market tax on the departing resident's worldwide assets. These rules are quite harsh, and any green card holder coming up on the residency threshold is strongly advised to consider whether that individual wishes to remain in the U.S.—leaving a year earlier, if an option, may in some cases save substantial funds and headache. The details of Section 877A are beyond the scope of this article, but suffice it to say that its application should be avoided if at all possible.

[18] Section 877(e)(2).

It should be noted that long-term residency may be avoidable if a green card holder can claim to be a resident of a foreign country under an income tax treaty, but this must be done through a filing with the IRS.[19]

Adding Insult to Injury After Departure: FIRPTA and Inability to Use Passive Capital Loss Carryforwards

A former U.S. tax resident who continues to own U.S. real property may expect to be able to offset later-realized gain on that real property against capital losses accumulated in the U.S. while a resident. Assuming those losses derive from non-real estate investment activity (which is often the case), it is highly unlikely that he or she can offset the real property gains, which are taxed under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

Tax code Section 897(a)(1)(A) provides that gain or loss of a nonresident alien individual from the disposition of a U.S. real property interest is taken into account under Section 871(b)(1) (that is, income taxation at graduated rates on a net basis) as if the taxpayer were engaged in a trade or business within the U.S. during the taxable year and as if such gain or loss were effectively connected with such trade or business. Under that regime, deductions are allowed against effectively connected income only if and to the extent that they are connected with income that is effectively connected with a conduct of a trade or business within the U.S.[20] Non-effectively connected losses may not offset effectively connected income.

Given the limitations above, a departing U.S. resident should engage in planning to better utilize any accumulated capital losses and understand that they may otherwise go unused.

Conclusion

Although the rules discussed above are complicated, in the right circumstances, they can be used to the nonresident alien's advantage. There are many possibilities to consider that can produce significant income and estate tax advantages—but those possibilities must be acted upon before it is too late!

[19] See Sections 877A(g) and 7701(b)(6).
[20] See Section 873(a).