Advanced Tax Planning for Nonresident Aliens: Pre-Immigration Strategies

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INTRODUCTION

• Individuals becoming United States taxpayers face a multitude of tax considerations upon commencement of U.S. status
  • Significant planning opportunities exist in the pre-U.S. taxpayer period
    • Vitally, opportunities largely evaporate once the individual is a U.S. taxpayer, incentivizing proactive efforts in the pre-immigration phase
  • Income tax planning opportunities exist for individuals regardless of net worth
    • For high net worth individuals, options are available to minimize prospective transfer tax exposure
INTRODUCTION

• Anna is referred to you by her immigration attorney for tax planning advice. Anna is a nonresident alien from Mexico planning to become a United States green card holder in late 2019.
  • She is married to a fellow nonresident alien; her spouse likely will become a U.S. green card holder but will not do so immediately.
    • Anna has two young children, both of whom are likely to live in the U.S. long-term.
  • Anna’s current net worth is roughly $8 million; she anticipates a significant inheritance from her parents. Anna and her husband are in their mid-40s.
    • Anna’s current assets include the following:
      • Investments in U.S.-domiciled companies;
      • An active wholly-owned Mexican business;
      • Stock holdings in other Mexican businesses;
      • Deferred compensation items; and
      • French real estate with significant appreciation.
NONRESIDENT ALIENS – INCOME TAX

• Under default rules, nonresident aliens are generally subject to United States tax on:
  • (1) income effectively connected with a United States trade or business, and
  • (2) fixed or determinable annual or periodic income

• Nonresident aliens are subject to U.S. tax only on income items sourced to the United States

  • Detailed sourcing rules for income items exist; for example, interest/dividend income is sourced to the payor’s location
    • Rent/royalties sourced to the place of use of the asset
    • Personal services sourced to where services performed
NONRESIDENT ALIENS – EFFECTIVELY CONNECTED INCOME

- Income effectively connected to a United States trade or business is subject to tax
  - “Trade or business” undefined in the Code/regulations – but profit-oriented activities carried on in the United States which are regular, substantial, and continuous are properly classified as a trade or business for these purposes
    - Macro-level – relatively light requirements to be considered engaged in a U.S. trade or business
  - Effectively connected income taxed by the United States at graduated rates, with deductions/credits available
  - Treaty modification to standard: “effectively connected with a U.S. trade or business” becomes “income attributable to a U.S. permanent establishment”
    - Similar – but (marginally) heightened - standard
NONRESIDENT ALIENS – FIRPTA

• Under the Foreign Investment in Real Property Tax Act of 1980, gain from disposition of United States real property interest by a foreign taxpayer is subject to tax
  • *Gains are automatically classified as ECI!*
  • United States real property interest: any interest in United States real property or an interest in a domestic corporation unless such corporation was not a United States real property holding corporation for the prior five years
    • United States real property holding corporation: corporation where more than 50% of the corporation’s assets are United States real property interests
  • Transferee must withhold on disposition at a rate of 15% of the amount realized
• **Vitally, aside from FIRPTA, nonresident aliens generally not subject to capital gains tax on U.S.-sourced gains**
NONRESIDENT ALIENS – FDAP INCOME

• Fixed or determinable annual or periodic income (“FDAP income”) also subject to tax by the United States (for income items sourced to the U.S.)
  • FDAP income functions as a catch-all for U.S.-sourced income items (aside from capital gains) not otherwise subject to U.S. tax
    • Includes interest (subject to expansive exceptions), dividends, rent, salaries, wages, premiums, annuities, compensation, remuneration, etc.
  • Interplay exists between ECI and FDAP income
    • US-sourced income is classified as effectively connected to a U.S. trade or business rather than FDAP if it satisfies an asset use test or a business activities test
• FDAP income generally subject to a flat 30% rate of tax (with tax collected through withholding by payors)
  • Deductions not permitted for FDAP income
NONRESIDENT ALIENS – INCOME TAX TREATIES

• Tax treaties function to reduce a country’s taxing authority in situations covered by treaty terms
  • Under treaties, residents of a treaty country can be taxed at a reduced rate, or even exempted from tax, on specified items of income from the other country
    • i.e. withholding taxes on United States-sourced income
  • Goal with treaties is to facilitate global activities
  • Residency takes on importance in this realm – generally foreign persons are entitled to treaty benefits only when they are residents of one of the treaty countries
  • Treaties either provide an increased standard for tax by the U.S. (i.e. look for a “permanent establishment” rather than U.S. trade or business) or reduce the rate of tax (i.e. FDAP income items)
NONRESIDENT ALIENS – INCOME TAX

• What isn’t subject to U.S. tax?
  • Under the vast majority of circumstances, foreign-sourced gains are not subject to U.S. tax
    • i.e. sale of property located outside the United States
  • U.S. sourcing rules become critical, as they determine whether a NRA will be subject to tax
    • Some are fairly complex – i.e. multi-year compensation arrangements
    • General approach – look to U.S. statutes/regulations for covered income types; where a specific type of income not covered, draw parallels to covered items
Estate tax: nonresident aliens subject to tax on all property (whether tangible or intangible) sitused within the U.S.

- Subject to some exceptions (such as bank accounts not used in association with a U.S. trade or business)
- Real property and tangible personal property are sitused in accordance to where the assets are physically located
  - Shares of a corporation are sitused in the country in which the corporation is formed
- Nonresident aliens receive a $60,000 estate tax exclusion with a maximum 40% rate of tax applicable
Gift tax: nonresident aliens normally are subject to gift tax on lifetime gratuitous transfers of tangible property within the United States

- Generally comprising real property situated within the country and tangible personal property within the U.S. at the time of the gift, including hard currency or cash situated within the U.S.
- Intangible property (i.e. shares of a corporation) is not subject to gift tax for nonresident alien donors

- No specific gift tax exclusion for nonresident aliens, though the $15,000 per donee annual exclusion is available
NONRESIDENT Aliens – TRANSFER Taxes

• What isn’t subject to transfer tax?
  • Non-U.S. sitused assets are not subject to U.S. transfer tax when donor is a NRA
    • Foreign property, foreign holdings are not subject to U.S. transfer taxes
  • Intangible assets are not subject to gift tax for NRA donor regardless of situs
    • i.e. stock in a U.S. corporation generally will not be subject to gift tax
      • Reliance on ability to gift asset pre-death to remove from taxable estate an option, but carries risk (i.e. sudden death)
POLL QUESTION #1
• United States citizens and residents are taxable on their worldwide income
  • Sourcing determinations become less relevant – taxable on all income, whether domestic or foreign-sourced
• Foreign tax credits alleviate burdens of double taxation
  • Generally, citizens/residents utilize FTC rather than income tax treaties
    • Tax treaties contain “saving” clause, exempting citizens/residents from most treaty benefits
• United States taxpayers subject to capital gains on worldwide asset dispositions
U.S. TAXPAYERS – INCOME TAXES

• Who is a U.S. taxpayer?
  • Citizenship – persons born in the United States, naturalized in the United States, or (under specified circumstances) where parents were United States citizens at the time of their birth
  • Classified as a “resident” for United States income tax purposes if:
    • Lawfully admitted for permanent residence (green card holder); or
    • Meet substantial presence requirements
• Who is a U.S. taxpayer?
  • Substantial presence test: must be present in the United States for 31 days during the relevant tax year and the sum of days for the last three years (after use of applicable multipliers) exceeds 183
    • Applicable multipliers – multiply the numbers of days in the current year by 1, the first preceding year by 1/3, and the second preceding year by 1/6
    • Exceptions exist to substantial presence test: (1) closer connection to another country and (2) treaty tiebreaker provisions (where individual classified as a resident of multiple countries under treaty definitions for residency)
U.S. TAXPAYERS – INCOME TAXES

• Importantly, special tax rules come into play for U.S. taxpayers with interests in foreign corporations
  • Technically, the foreign corporation is respected as a separate taxpayer; however, current inclusion (irrespective of corporate distributions) can be required for U.S. shareholders
    • Subpart F/GILTI regimes create current inclusion for significant income amounts if ownership thresholds met
    • Passive foreign investment company ("PFIC") rules do not require ownership thresholds, and carry potential for punitive tax ramifications on dispositions/excess distributions
• United States citizens/domiciliaries taxable on transfers of worldwide assets, whether during life or at death
  • However, given a lifetime exclusion of roughly $11.4 million (as per TCJA increases)
  • Treated as a domiciliary for estate/gift tax purposes when maintaining a United States domicile – person is a United States resident with no present intention of leaving
    • Facts and circumstances determination – look to length of stay, ties to U.S. versus other countries, etc.
    • Imposes an elevated standard for presence-based tax as compared to income tax requirements!
  • Unlimited marital exclusion inapplicable for noncitizen spouses (even if domiciliaries/residents)
• Special rules can apply to interests in/transfers to foreign trusts
  • United States beneficiaries of foreign nongrantor trust are subject to tax via the “throwback” rule on accumulated distributions
    • Replicates PFIC tax – creates punitive tax ramifications
  • For foreign trusts created by a nonresident alien who becomes a United States citizen or resident within five years of transfers to the trust, the trust is treated as a grantor trust if it has any United States beneficiaries
    • Importantly, this rule applies for income tax purposes – but NOT transfer tax purposes
POLL QUESTION #2
Nonresident aliens have a narrower scope for income tax purposes than residents/citizens – not subject to U.S. tax on non-U.S. sourced gains/income

- United States citizens/residents taxable on income earned worldwide
- Functionally means that non-U.S. sourced income/gains recognized prior to being classified as a U.S. taxpayer will avoid U.S. tax imposition
  - If income/gains recognized post-residency, subject to U.S. tax
    - Importantly, no step-up in assets occurs upon residency/citizenship commencement!
      - So pre-residency/citizenship built-in gains still subject to U.S. tax if disposition occurs after becoming a U.S. taxpayer
Like with income tax, nonresident aliens see a more narrow scope for transfer tax purposes.

- However, comparatively miniscule exemptions exist, creating exposures for transfers which would be innocuous if a citizen/resident.
- In the pre-immigration context, planning for transfer tax exposure (if a long-term stay is contemplated) focuses on whether a possibility of transfer tax exposure will exist once given the larger exclusion amount.
  - Of note – focus should be the potential for transfer tax exposure rather than exposure based on current net worth/exclusion amounts.
    - TCJA increases in exclusion amounts are temporary; sunset after 2025, at which time the exclusions move to $6 million.
    - Individuals can also get further appreciation in existing assets/increases in net worth after becoming a citizen/resident.
INCOME TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• From an income tax perspective, pre-immigration planning focuses on exploiting tax disparities between nonresident aliens and residents/citizens
  • Goal in planning is to minimize prospective global tax liability
    • For individuals contemplating a status change which would make them U.S. taxpayers, options center on removing as much income as possible from future United States tax scope
      • Two primary mechanisms – (1) income acceleration and (2) basis step-ups
INCOME TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• No step-up in basis for existing assets on residency/citizenship
  • Taxpayer thus subject to tax on pre-residency built-in gain
    • Importantly, no limitation on pre-residency losses – if loss realized post-residency, this loss can be used for U.S. tax purposes to offset gains
• United States uses U.S. tax rules to determine basis of pre-existing assets (rather than using rules of the former jurisdiction of residence)
  • Generally, transactions that would not have been taxable in the United States are disregarded for basis step-up purposes
    • i.e. usually no recognition for exit taxes paid to prior home country
INCOME TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• For existing assets, sale/reacquisition strategies are often advantageous to achieve a basis step-up
  • Sale causes built-in gain to be recognized (without imposition of U.S. tax), with the reacquisition providing a basis step-up to offset future U.S. tax
    • Functional considerations are relevant for legitimacy purposes – need to ensure true transactions are undertaken
  • Assets with built-in losses can be held until after residency/citizenship to shelter future income
• For any transactions, need to consider ramifications in other relevant jurisdictions
Income acceleration (from foreign sources) is also beneficial, to ensure income is recognized prior to becoming a U.S. taxpayer (and subjecting the foreign income to U.S. tax)

- Desire where possible is to accelerate income payment to the period before residency
  - Example: Distributions from deferred compensation plans
- Focus is generally on when income is paid, based on U.S. recognition rules
POLL QUESTION #3
INCOME TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

- Interests in foreign corporations can be subject to special tax rules/ramifications in the United States
  - Anti-deferral mechanisms (i.e. Subpart F, GILTI) can cause immediate inclusion of foreign-sourced income
    - Worse, PFIC rules can create punitive tax consequences and remove benefits of tax provisions (i.e. Section 245A)
  - Cognizance is required as to how foreign entities will be classified/taxed by the United States
INCOME TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• Foreign-domiciled entities generally are able to elect their entity classification for United States tax purposes
  • EXCEPTION: Per-se corporations (as listed in the Regulations)
  • Default rules for classification exist, which hinge on the limited liability of owners/members
    • If limited liability for owner/owners – association taxable as a corporation
    • If no limited liability for at least one owner – partnership if multiple members, disregarded entity if one
  • Elections out of default rules are available - can elect to be a partnership, corporation, or disregarded entity
    • Election made on Form 8832 – initial election required within 75 days of entity becoming “relevant”
INCOME TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• Which entity structure works best?
  • Classification as a foreign passthrough means not subject to GILTI/Subpart F/PFIC rules
    • *BUT this is because deferral options are eliminated!*
  • Makes sense to simulate prospective income to get a sense of anticipated GILTI/Subpart F inclusions
    • For foreign holdings which would be classified as PFICs, most often makes sense to get rid of the holding entirely (particularly if elections to mitigate tax consequences are unavailable)
  • Importantly, if requirements are met, entity classification election can provide a basis step-up for underlying assets/deemed distribution of E&P without U.S. tax
POLL QUESTION #4
TRANSFER TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• High net worth individuals will benefit from income acceleration/basis step-up; however, any gain realized becomes part of their taxable estate (even if not subject to income tax)
  • Current lifetime exclusion is $11.2M per person; however, uncertainty exists as to prospective exclusion amount
  • For individuals who could be subject to estate/gift tax (based on *either* current or anticipated net worth), pre-immigration planning should seek to minimize prospective transfer tax exposure
    • Goal – make transfers of non-U.S. tangible property and worldwide intangible property to remove them from the pre-immigrant’s estate
      • With any transfers, need to be cognizant of any tax ramifications in jurisdiction of current residence/jurisdiction where assets located!
TRANSFER TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• Option – gifts of assets to remove them from future estate
  • Removes assets from estate; however, also removes ability of donor to benefit/profit from those assets moving forward
    • Pre-immigrant should not functionally be put in a position where they will not have enough funds for their future needs/desires
  • Gifts to family members often are the most palatable option for outright gifts
    • Option to explore: gift to noncitizen spouse
      • For noncitizen spouses, unlimited marital exclusion does not apply, incentivizing pre-immigration transfers
TRANSFER TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

- Another option available is transfers to trusts
  - “Drop-off” trusts typically utilized in this context – pre-immigrant makes transfers to a nongrantor trust to remove assets from their estate (if constituting completed gifts)
    - Need to ensure trust and gifts are properly structured
      - For example, need to ensure significant benefits are not retain by the grantor (to ensure no argument exists that grantor retain control of assets)
    - Trust can be either domestic or foreign; where the trust prospectively could have U.S. beneficiaries, a domestic trust is often preferable to avoid “throwback” rule
TRANSFER TAX PLANNING OPPORTUNITIES IN THE PRE-IMMIGRATION CONTEXT

• Issue with drop-off trust: while it removes assets from estate, grantor remains subject to income tax on assets based on aforementioned special rules for pre-immigrants
  • Insurance policies thus become an appealing asset for drop-off trusts, as income from policy’s investments and death benefits are not subject to tax
    • Private placement life insurance is especially appealing – permits a larger range of investment options and easier access to funds than traditional life insurance policies
      • Private placement life insurance policies which are non-modified endowment contracts permit funds up to the policy’s basis to be withdrawn tax-free, with funds exceeding basis able to be loaned at friendly rates