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PRE-IMMIGRATION PLANNING FROM A TAX PERSPECTIVE

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Introduction

A foreign national may be subject to one of two drastically different systems of taxation by the United States depending on whether he or she is classified as a resident or a nonresident alien of the United States. The determination of residency status is critical. As a rule, classification as a nonresident foreign national may provide distinct tax advantages, but, in individual cases, the advantages of resident versus nonresident status may vary from year to year.

RESIDENT ALIENS

The rules defining residency for US income tax purposes are very specific, with only limited exceptions once the objective criteria or mechanical tests are met. Individuals classified as resident aliens are taxed on their worldwide income derived from any source. Tax rates are graduated and income is determined in the same manner as for US citizens.

NONRESIDENT ALIENS

Nonresident aliens are normally taxed only on income derived from US sources. US-source income that is considered "effectively connected" with a US trade or business, such as salary and other forms of compensation, is taxed at graduated rates. Taxable income from US trade or business entities can include some kinds of foreign-source income, as well as US-source income. US investment income is generally taxed at a flat 30% tax rate, which may be reduced by a tax treaty. Certain types of US-source investment income may be exempt from US tax.

TAX TREATIES

For many nonresident aliens, the burden of US tax is reduced by tax treaties between the United States and their home countries. Further, treaties may modify US income taxation (for example, in determining residency status) and should be reviewed in every tax-planning situation involving a foreign national.

FOREIGN INVESTMENT IN REAL PROPERTY

Gains on sales of US real property are taxable regardless of the residency status of the investor. Nonresident aliens, however, may have fewer opportunities to defer capital gains (for example, through such techniques as like-kind exchanges or corporate reorganization) than residents or citizens. Special reporting and withholding rules may apply when nonresident aliens own US real property or "US real property interests" (for example, stock in a US corporation whose principal assets are US real property).

ESTATE AND GIFT TAXES

In addition to federal income tax, foreign nationals may be subject to estate, gift, and generation skipping transfer taxes (sometimes referred to a US transfer taxes. For transfer taxes, the principal determinant is whether the foreign national has become a domiciliary of the United States. US domiciliaries are subject to US transfer tax with respect to their worldwide assets. In contrast, non-domiciliaries are subject to US transfer taxes only with respect to US-situs assets.

TAX PLANNING

Timing of income recognition and the length of stay in the U.S. can significantly affect a foreign national's US tax liability. Also, the tax basis (tax cost) of assets may not be computed for US tax purposes in the same way as in the foreign national's home country. Unrealized appreciation or loss inherent in investments should therefore be reviewed before beginning or ending a period of US residency. Additionally, the United States has a large and sophisticated body of rules dealing with the taxation of certain US resident shareholders on income earned by foreign corporations that they control (whether or not the income is distributed) and noncontrolled foreign corporations that are primarily investment vehicles, as well as with taxation of the income of certain trusts to their creators. It is almost impossible to mitigate the effects of these rules once one has become a US resident, but there may be planning opportunities if the rules are addressed before a move into the United States.

From a tax planning perspective, the principal factual determinants are whether the foreign national will become a U.S. income tax resident, and , if so, whether he or she will reside in the U.S. for a temporary period or intends to reside in the U.S. permanently or indefinitely. If U.S. residency will be for only a temporary period, U.S. income tax is likely to be the principal focus. If the foreign national intends to move to the U.S. permanently, pre-immigration estate planning is likely to be of equal importance.

IMMIGRATION, VISA, AND NATIONALITY CONSIDERATIONS

Certain similar terms have different meanings when they are used in the immigration context than when they are discussed for tax purposes. *Residency status for tax purposes is different from residency status for immigration purposes.* Under certain circumstances, a person may be a nonimmigrant for immigration purposes and yet be considered a US resident for tax purposes. For immigration purposes, a *nonimmigrant* is an alien temporarily in the United States who plans eventually to return abroad at the conclusion of his or her stay. A *lawful permanent resident* is an immigrant, holds a "green card," and has the right to reside permanently in the United States until he or she surrenders or abandons permanent residency.

Chapter 1 Resident Aliens

RESIDENT ALIENS DEFINED

A *resident alien* of the United States is a foreign national who meets either of two objective tests: the lawful permanent residence test or the substantial presence test. Internal Revenue Code ("IRC") section 7701(b)(1). An alien who meets neither test is a nonresident alien for federal income tax purposes for that year. (The test of residence is different for federal estate and gift tax purposes, and certain states may impose their own residency rules.)

Under the *lawful permanent residence test* (also known as the *green card test*), an individual is considered a resident alien from the day that he or she is admitted to the United States as a lawful permanent resident (that is, given a "green card") until the day that this status is officially revoked or judicially found to be abandoned. While the alien officially has lawful permanent resident status, he or she is considered a US tax resident even while living outside the United States. IRC section 7701(b)(6).

Under the *substantial presence test*, an individual must meet the following conditions to be considered a resident alien:

- He or she must be physically present in the United States for thirty-one days in the current year.
- He or she must be physically present in the United States for a weighted average of 183 days over a three-year testing period that comprises the current and the two preceding years. Days of US presence are computed under a weighting formula that counts the following non-exempt days of presence:
    - All days in the current year, plus
    - One-third of the days in the preceding year, plus
    - One-sixth of the days in the second preceding year. IRC section 7701(b)(3).

Exempt individuals may exclude some days from this calculation (see p. 2).

Several substantial presence test calculations are provided in Example 1.1.

The weighting formula permits an alien to spend up to 121 days each year in the United States without becoming an income tax resident. Also, the alien will not be considered a US resident for any year in which he or she has been present in the United States fewer than thirty-one days.

Example 1.1:
In each of the cases below, the individual will be considered a resident alien in the current year for federal income tax purposes under the substantial presence test.

Case	Days Present in the United States	Percentage (%)	Days Counted in Test
Case 1:			
Current year	183	100	183
First preceding year	0	33.33	0
Second preceding year	0	16.67	0
			183
Case 2:			
Current year	122	100	122
First preceding year	122	33.33	40.66
Second preceding year	122	16.67	20.34
			183
Case 3:			
Current year	60	100	60
First preceding year	360	33.33	120
Second preceding year	18	16.67	3
			183

A day of US presence is acquired if an individual is physically present in the United States at any time during the day. There is no minimum time needed for the day to count. IRC section 7701(b)(7)(A) and Treas. Reg. section 301.7701(b)-1(c)(2)(i). Days are excluded from the calculation for the following individuals:

- Exempt individuals (see below);
- Individuals who regularly commute to work in the United States from Canada or Mexico, IRC section 7701(b)(7)(B);
- Individuals who, while in transit between two points outside the United States, are physically present in the United States for under twenty-four hours during that trip, IRC section 7701(b)(7)(C); and
- Individuals who are not able to leave the United States because of a medical condition that arose while they were present in the United States, IRC section 7701(b)(3)(D)(ii) and Treas. Reg. section 301.7701(b)-3(c).

Figure 1.1 shows a decision tree that can be used in determining residency status.

Exempt Individuals. Exempt individuals are not considered to "present" in the United States for purposes of day counting, even though they may be physically located there. These individuals are

- Employees of foreign governments; IRC section 7701(b)(5)(B) and Treas. Reg. section 301.7701(b)-3(b)(2);
- Teachers or trainees with J visas; IRC section 7701(b)(5)(C) and Treas. Reg. 301.7701(b)-3(b)(3);

- Students with F and J visas, IRC section 7701(b)(5)(D) and Treas. Reg. 301.7701(b)-3(b)(4); and
- Professional athletes competing in charitable (as opposed to commercial) sports events, but only during actual competition, IRC section 7701(b)(5)(A)(iv) and Treas. Reg. 301.7701(b)-3(b)(5).

Except for professional athletes, the exempt status of an individual also applies to members of his or her immediate family. The teacher–trainee and student statuses are conditional on the terms of the visa that accords that status, even though the visa may remain in effect. For example, a student on an F visa who accepts unauthorized employment ceases to be exempt and becomes present for purposes of the substantial presence test even though the visa may remain in effect.

Closer-Connection Exception. A foreign national satisfying the substantial presence test may be taxed as a nonresident if he or she is present in the United States for fewer than 183 days during the current year (cases 2 and 3 in Example 1.1) and the foreign national can show that he or she has a tax home in a foreign country and a closer connection to that country than to the United States.

Establishing a foreign tax home and showing a closer connection to a foreign country than to the United States requires an examination of various facts and circumstances, such as the location of the individual's permanent home, family, business, and social and political relationships. This exception is unavailable when certain actions have been taken during the current year to change the foreign national's status to that of a permanent resident of the United States. See Treas. Reg. section 301.7701(b)-2.

Residency Period. In the year that a foreign national becomes a US resident (and sometimes in the year that he or she ceases to be a US resident), his or her tax status is that of a *dual-status alien*. For years in which a foreign national is both a resident alien and a nonresident alien, two returns are generally prepared, attached to each other, and filed simultaneously. One return reports income and deductions for the residency period, and the other reports income and deductions for the non-residency period. The includible income and deductions are different for each portion of a dual-status year.

Therefore, it is important to determine the starting and ending dates of the period of residence. The starting date depends on whether the individual qualifies under the green card test or under the substantial presence test. An alien who meets only the green card test becomes a resident on the first day that he or she is physically present in the United States as a lawful permanent resident. Under the substantial presence test, the starting date is generally the first day that the alien is physically present in the United States in the calendar year. However, a nominal presence of up to ten days is disregarded to allow the alien to conduct pre-move business or make house-hunting trips. This nominal presence period may be excluded only for determining the period of residency; these days must be counted in the calculations determining substantial presence. See Example 1.2.

Example 1.2:

Mr. A, a foreign national who has never before been a US resident, comes to the United States for the first time on 6 February 2005 and attends a business meeting until 10 February 2005, when he returns to his country. On 5 July 2005, he moves to the United

> States for the remainder of the year. Mr. A will be considered a US resident alien for 2005 under the substantial presence test (the five days in February plus the 180 days after his move causes the total days of presence to exceed 183). The period of residency begins on 5 July 2005. The trip in February is disregarded in determining the start of the residency period.

Possesses a green card?

A resident alien who meets the green card test is considered resident until the day that his or her status as a officially ends—that is, when he or she formally revoke resident status or when an administrative decision i s been abandoned. Until that time, the green card holder when out of the country. Treas. Reg. section 301.7701(b)-4.

Present in the United States for at least 31 days in current year?

Yes No

Meets substantial presence test (that is, physically present in the United States for 183 days in 3-year period, counted as all days in current year, plus one-third of days in preceding year, plus one-sixth of days in second preceding year)?

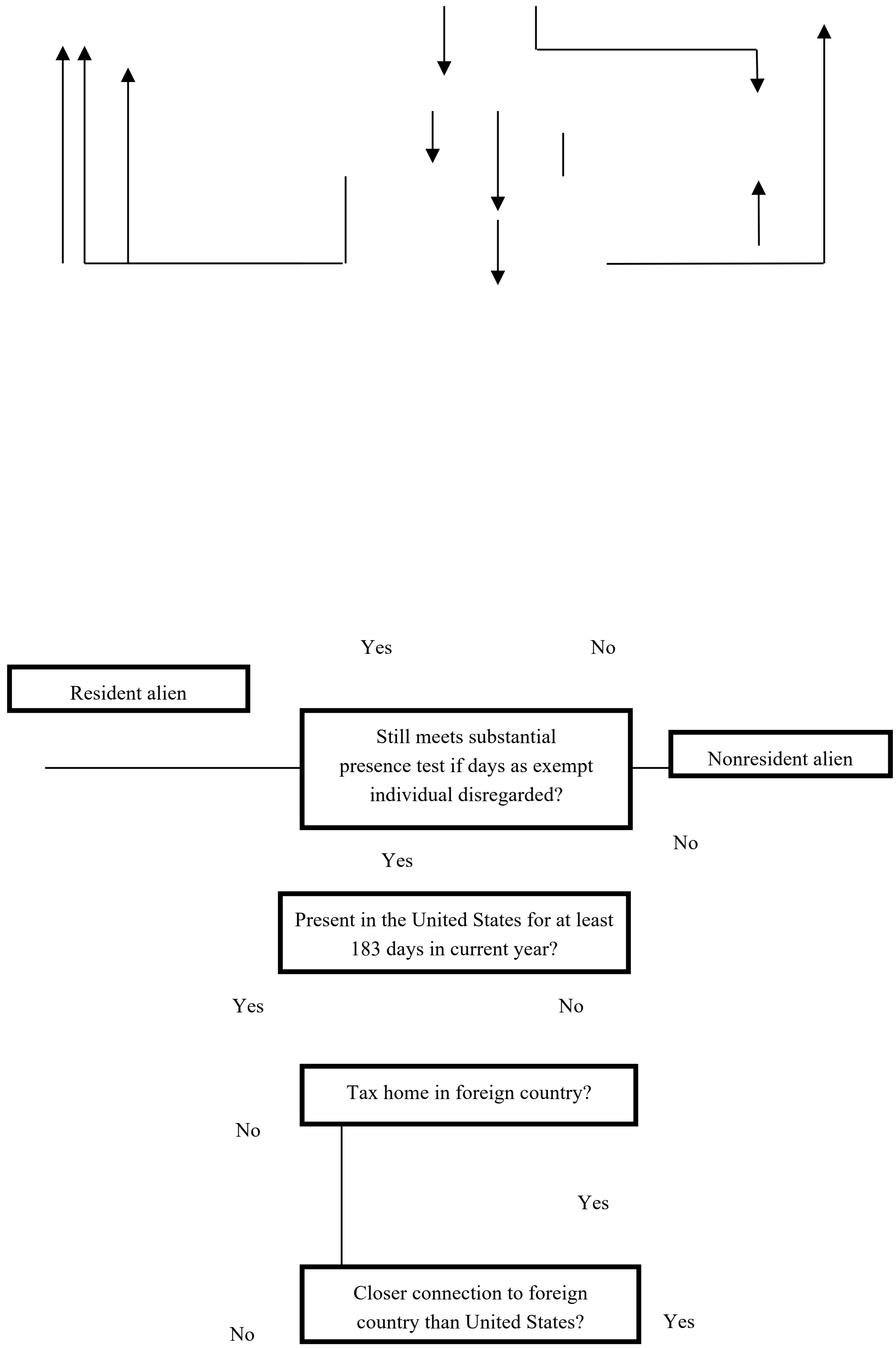
FIGURE 1.1
Determining Resident and Nonresident Alien Status

Yes

No

No

Yes


Yes
No
Resident alien
Still meets substantial presence test if days as exempt individual disregarded?
Nonresident alien
No
Yes
Present in the United States for at least 183 days in current year?
Yes
No
Tax home in foreign country?
No
Yes
Closer connection to foreign country than United States?
No
Yes

On the other hand, the treatment of a departing resident alien who does not hold a green card is subject to some variation, depending on the particular circumstances.

- If the individual does not meet the substantial presence test for the year of departure, the individual is simply a nonresident alien for the entire year.

- If the individual meets the substantial presence test, the individual is considered a resident alien for the entire year, unless the individual establishes (by filing Form 8840) that, following the departure date, the individual has a closer connection with a foreign country. If a closer connection is thus established, the last day of residence will be the day of departure, and the individual will be a dual-status resident for the year of departure.

The residency termination date for an alien meeting both the substantial presence test and the green card test is the later of the date on which the alien no longer has lawful permanent residence or the date on which the alien is last present for the substantial presence test. Up to ten days of US presence following departure will be disregarded in determining the cutoff date for being taxed as a resident.

Special First-Year Election to Be Treated as a Resident Alien. A special election is available to a foreign national who is unable to meet the substantial presence test in the year he or she arrives in the United States but wants to be taxed as a resident in that initial year. To make this election, he or she must satisfy all the following criteria:

- The foreign national was a nonresident for all of the preceding year.
- The foreign national meets the substantial presence test in the year following arrival.
- The foreign national is present in the United States for at least thirty-one consecutive days in the year of arrival.
- During the year of arrival, the foreign national meets the continuous presence test—that is, he or she is present in the United States for at least 75% of the days between the first day of the thirty-one-day period and the last day of the year of arrival. For purposes of applying the 75% test, up to five days of presence outside the United States can count as days of presence in the United States.

The US tax return containing the first-year residency election may not be filed until the foreign national has satisfied the residency requirement under the substantial presence test for the following year. Treas Reg. section 301.7701(b)-4(c)(3).

TAXATION OF RESIDENT ALIENS

Income Subject to Taxation. All income received by a US resident alien or US citizen, derived from any source, is subject to federal income tax unless specifically exempt or excluded. A resident alien is taxed at graduated rates after allowance for deductions.

A foreign tax credit may be allowed as an offset against the US tax liability if the individual also pays non-US taxes on this income.

Deemed Income. US tax law contains a number of provisions, less commonly found in the tax laws of other countries, deeming US investors to have received income earned by foreign corporations that are controlled by US persons, by passive foreign investment companies, and by trusts that they have established for the benefit of U.S.

persons. These rules must therefore be considered carefully in evaluating US income tax status. See Example 1.5.

Example 1.5:
The following situations may cause a resident alien to have deemed income:

- *Grantor trust*. Before moving to the United States, Ms. B established a trust into which she placed certain investments (stocks, bonds, a rental property, and so forth). The trustee may accumulate income or may distribute it to any of the following: Ms. B, her husband, or their minor children. The trust will terminate after ten years, and the property will revert to Ms. B. Ms. B later becomes a US resident alien for income tax purposes. Her trust is considered a *grantor trust*, and she is subject to tax on all of its income at the time it is earned, regardless of whether it is distributed to her.
- *Controlled foreign corporation*. Ms. C (who is a resident alien) and two friends (both US citizens) set up a trading company, ABC Company, in a foreign tax haven. ABC Company buys products from their US manufacturing company and sells them around the world. ABC is a controlled foreign corporation, and Ms. C and her friends must include certain amounts of the income ABC Company earns from these sales in their US taxable incomes even if the tax-haven company pays no dividends to them.
- *Passive Foreign Investment Company*. Mr. D (who is a resident alien) buys shares of stock in a foreign mutual fund whose assets are primarily stocks and bonds. If Mr. D does not make an election to be taxed currently on his share of the corporation's income (or, in the case of some publicly traded funds, on the annual increase in the stock's value), he will be taxed on certain distributions from the fund (or on gain from the sale of the stock) with an added interest charge extending back over his entire holding period.

Foreign Tax Credit. Income taxes paid by a resident alien to a foreign country may be deducted as an itemized deduction or may be credited against the resident alien's US tax liability. Since claiming foreign taxes as credits reduces the US tax liability on a dollar-for-dollar basis, it will generally produce a lower net tax liability than would claiming an itemized deduction. An intricate series of limitations applies to the foreign tax credit. Foreign taxes paid on one type of income cannot be used as credits against US tax on other types of income. Any unused credits may be carried back for two years and forward for five years to reduce US tax incurred on non-US income.

TAX TREATIES

The United States has negotiated tax treaties with other countries to reduce the burden of double taxation. A treaty may override the income tax laws of the United States for items covered by the treaty. Any item not specifically addressed by the treaty will be taxed in accordance with US income tax laws.

Generally, treaties do not change the US taxation of a US citizen or resident. However, treaties may specifically define or modify residency status for purposes of the tax rules in the treaty. In general, an individual is considered resident in the country in which he or she is subject to taxation. In some situations, that individual may be considered a resident by both treaty countries under their domestic laws. Many treaties include tiebreaker rules to determine the country of residence for treaty purposes. The tiebreaker rules override the domestic laws of each country and are based on such factors as the location of the individual's permanent home and his or her economic and personal relationships.

Individuals who are considered US resident aliens under either the green card or substantial presence test may be able to use treaties to reduce US taxation. For example, a green card holder living abroad and qualifying as a resident of the treaty country under the tiebreaker rule of the treaty may qualify for a US tax exemption or reduction to the extent provided in the treaty. However, the treaties can be used to reduce US taxation only in specific situations.

Green card holders are cautioned that filing Form 1040NR (the nonresident return) with a disclosure statement claiming residence in a foreign treaty country could adversely affect their continuing qualification for the green card.

Dual-resident foreign nationals claiming treaty benefits must file Form 1040NR as nonresident aliens with respect to that portion of the tax year for which they were considered nonresident. The return must contain Form 8833, *Treaty-Based Return Position Disclosure Under IRC sections 6114 or 7701(b)*. Penalties could apply for failure to file this form or a similar statement.

An individual who is a US resident under a treaty may also use the treaty's rules to reduce taxation in the other country when appropriate. For example, a US resident alien may be able to claim a reduced withholding tax rate on interest and dividend income generated in his or her home country, provided that he or she is deemed to be a US resident under the treaty between the United States and the home country.

Chapter 2 Nonresident Aliens

TAXATION OF NONRESIDENT ALIENS

As illustrated in Table 2.1, nonresident aliens are taxed separately on income from US sources that is not effectively connected with a US trade or business (for example, investment income) and on income that is effectively connected with a US trade or business (for example, business and compensation income). IRC sections 871(a) and (b). Generally, the source of income is the geographic location where the related services are performed and where the income-producing asset is located. The nonresident alien tax base is compared to the resident alien tax base in Figure 2.1.

TABLE 2.1
Taxation of Nonresident Aliens

Type of Tax	Type of Income
Tax at graduated rates	Income effectively connected with a US trade or business
Tax at 30%-or-lower treaty rate	US-source income that is not effectively connected with a US trade or business and is fixed or determinable annual or periodic income—generally, US-source investment income
No tax	Foreign-source income of a nonresident alien not engaged in a US trade or business and certain categories of U.S. investment income such as bank deposit interest and interest on "portfolio indebtedness".

FIGURE 2.1
Comparison of Resident and Nonresident Alien Tax Bases

Resident Alien Tax Base	Nonresident Alien Tax Base

All US employment income	Some US employment income
All foreign employment income	
All US passive income	Some US passive income
All foreign passive income	
All US capital gains	US real estate gains
All foreign capital gains	
Some income earned by controlled foreign corporations	

Income Not Effectively Connected with a US Trade or Business. A nonresident alien's US-source income that is not effectively connected with a US trade or business is subject to tax at the flat rate of 30% of gross income (see Table 2.1); no deductions are allowed. Treaties may reduce this flat rate.

Income subject to this 30% tax includes interest, dividends, royalties, rents, and other fixed or determinable annual or periodic income. IRC section 871(a). An exception is provided for portfolio income on certain US registered bonds and bank accounts. IRC sections 871(h) and (i). This interest is not taxed unless it is effectively connected with a US trade or business.

Except in the case of real property investments, a nonresident alien's US-source net capital gains—gains in excess of losses from the sale of investment property—are not subject to taxation unless the alien is in the United States for at least 183 days during the year. (Because an individual who is present in the United States for this period of time is normally a resident under the substantial presence test and under the tiebreaker rules of treaties, this tax principally affects exempt individuals such as diplomats, teachers, and students.) IRC section 871(a)(2). The general exemption for capital gains applies regardless of the number of transactions or amount of gain realized during the year. See Example 2.1.

Example 2.1:

Ms. B, a citizen of the Netherlands who is a nonresident alien, periodically visits the New York offices of her company's subsidiary. During 2005, she makes five trips to New York and spends a total of 128 days in the United States. During her trips to New York, Ms. B sells stock, and her net profit on twenty separate transactions totals $10,000. (None of the stocks constituted US real property interests. See Chapter 6.) She will not be liable for any US tax on this profit. (Note that she could be taxed on compensation earned during her visits to the United States, as discussed under the heading "Effectively Connected Income," if the provisions of an income tax treaty do not apply.)

The United States has extensive withholding provisions to ensure the collection of income taxes imposed on nonresident aliens. Ordinarily, the 30% (or lower treaty rate) will be deducted from payments made to the nonresident alien. (If withholding is not deducted, the nonresident alien must file a tax return and pay the tax due; otherwise, the withholding agent (the person paying the income) is liable for the tax.) A tax return may be filed after year-end to request a refund of excess withholding.

Effectively Connected Income. Nonresident aliens are taxed separately on income arising from the activities of—or assets used in—a US trade or business. This income, less allowable deductions, is taxed at the graduated rates that apply to US citizens and resident aliens. IRC section 864(b).

The term *trade or business* is not specifically defined. Whether the income arises from a trade or business depends on the nature of the activities and the economic interests in the United States. Business income generally includes the following:

- An individual's compensation for personal services performed in the United States. An exception applies if the amount earned is less than $3,000 and is paid by a foreign employer to a nonresident alien who is in the United States for fewer than 90 days during the year. Tax treaties may extend the period for up to 183 days and may increase or eliminate the $3,000 ceiling.
- Income and profits from the operation of a business in the United States.
- Income from the sale of the capital assets of a US business or from the sale or disposition of US real property.
- Income from real property operated as a business or held for investment (see Chapter 3).
- Income from a partnership engaged in a US trade or business.

If an individual is no longer engaged in a US trade or business but continues to receive income effectively connected to that business, the income that the individual receives may still be considered effectively connected (see Example 2.2). Similarly, assets used in a trade or business will generate effectively connected income if sold any time within ten years after the business ceases.

Example 2.2:

Mr. A, a foreign national, is in the United States on a three-month assignment and receives compensation of $12,000 in 2005. He returns to his home country on 15 December 2005. In 2006, he receives a bonus of $4,000 related to his services in the United States. The compensation of $12,000 is considered effectively connected income and is taxed at the graduated rates in 2005. The bonus of $4,000 is also considered effectively connected income

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and is taxed at the graduated rates in 2006.
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Deductions from Income. Unlike the flat tax on gross income not effectively connected with a US trade or business, the tax on effectively connected income is applied to net income. The deductions that can be taken by the nonresident alien against effectively connected income are limited to personal exemptions, contributions to US charities, casualty and theft losses, and other expenses that are related to the earning of effectively connected income. Examples of such related expenses are travel expenses incurred in performing services in the United States while temporarily away from home, contributions to individual retirement accounts, and state and local income taxes imposed on effectively connected income.

The standard deduction is not allowed to nonresident aliens. *Available deductions may be disallowed if tax returns are not filed on a timely basis*.

Filing Status. Individuals who are nonresident aliens at any time during the tax year normally are not eligible to claim head-of-household status and generally may not file a joint tax return. They must use the single filing status or, if married, must file separate tax returns. However, a nonresident alien who is married to a citizen or resident of the United States may elect to file a joint tax return

Foreign Tax Credit. Under very unusual circumstances, a nonresident alien may be subject to US income tax on income earned outside the United States. Should this occur, any resulting US tax liability may, in most circumstances, be offset by any foreign income tax that is also incurred on this income.

TAX TREATIES

Most tax treaties will either eliminate or reduce withholding requirements on US income, such as dividends, interest, and royalties, received by nonresident aliens. Therefore, the applicable treaty, if any, should be reviewed to determine whether the flat 30% tax rate is reduced for the specific type of income. It is also necessary to establish that the recipient is a qualified resident of the treaty partner country.

Chapter 3 Foreign Investment in Real Property

A foreign investor may purchase real property within the United States in a variety of ways: in his or her own name; through a US corporation, partnership, or trust; or through a foreign legal entity. The income and estate tax consequences of owning or selling property will vary depending on the vehicle through which the actual investment is made. Among corporate owners, foreign corporations may be subject to the US branch profits tax, while a US corporation will not. A foreign investor who owns the real property directly or through a US corporation or partnership will also likely be subject to US estate and gift taxes, although ownership through a properly structured trust or through a foreign corporation may mitigate this exposure.

In the following discussion, it is assumed that the individual purchased real property in his or her own name.

TAXATION OF INCOME FROM US REAL ESTATE

Property Owned by Nonresident Aliens. As previously discussed, US-source rent received by a nonresident alien that is not effectively connected with a US trade or business is subject to tax at the statutory rate of 30% of gross income or, if applicable, a lower tax treaty rate. (US tax treaties do not normally provide for a lower tax rate for rental income from real property.) Such rent can result in an extremely disadvantageous tax position if the property has expenses associated with it, as shown in Example 3.1. Contrast this example with Example 3.2.

Example 3.1:

Ms. B, a nonresident alien, holds US residential real estate for rent. In this case, her rental activities do not constitute a trade or business. During 2005, she receives rental income totaling $15,000 and incurs real estate taxes, mortgage interest, and other expenses that total $12,000. Because her income is not effectively connected with a US trade or business, her US tax for 2005 would be calculated on a gross basis as follows:

Gross income of $15,000 × 30% = $4,500

Example 3.2:

Assume the same facts as in Example 3.1, except that the rental activities do constitute a US trade or business. In this case, the expenses of carrying the property may be offset against the rental income. The net rental income will be effectively connected income and taxed at graduated rates, as follows:

Gross income	$15,000
Expenses	(12,000)
Taxable income	3,000
Tax (at 10% rate)	$ 300

If the individual in this example has other effectively connected income or losses, such as salary or losses from other real estate activities, they may generally be aggregated with the income in this example (although some limitations may apply).

Whether a nonresident alien's rental income is subject to the 30% gross tax or to the graduated rates on a net basis depends on whether the owner's rental activity is a US trade or business. To be considered a trade or business, rental activities and maintenance of the property must be regular and continuous, and the owner or the owner's agents must be involved in advertising for renters, repairing, and so forth. In other words, the business of renting property results from activities beyond the mere holding of the property and collection of rents. The rental of one small property may not be a trade or business. Furthermore, "net" lease arrangements, under which the tenant pays all expenses and merely pays net rent to the owner, are often considered not to be US trades or businesses.

Election to treat real property income as income connected with a trade or business. The inability to claim deductions against rental income, as shown in Example 3.1, can be a severe disadvantage to nonresident alien property owners. U.S. income tax law provides an election to treat property income as effectively connected even though it would not be in the absence of the election. (A foreign corporation is eligible to make a similar election.) By making this election, the owner is able to calculate his or her tax liability on a net basis. IRC section 871(d).

The individual makes this election by filing a statement with his or her tax return. The election cannot be made until gross income from real property is reportable, and it applies to all real property located in the United States and held for the production of income.

Property Owned by Resident Aliens. As previously discussed, no distinction is made in the tax treatment of resident aliens between income that is effectively connected with a US trade or business and income that is not effectively connected with a US trade or business. Thus, the net of rental income (gross rental income minus rental expenses) will be added to other taxable income received from worldwide sources and taxed at graduated tax rates.

DEPRECIATION

The cost of purchasing rental property is not itself a rental expense. However, the portion of the purchase price attributable to buildings, improvements, and other depreciable parts of the property may be recovered through depreciation deductions taken over the life of the property. Depreciation is not an optional deduction; it must be claimed each year. The property owner cannot postpone taking the deduction until some later time.

SALE OF PROPERTY BY RESIDENT ALIENS

The gain or loss on the sale of residential rental property is the difference between the net selling price (sales price less expenses of sale) and the adjusted basis of the property. A property's *adjusted basis* is its original cost less the total amount of depreciation expenses claimed during its life. (The calculation of a gain or loss is illustrated in Example 3.4.)

Example 3.4:

Ms. B, a resident alien, purchased real property for $200,000. She later sells the property for $300,000 (net of expenses of sale). Total improvements made to the property amounted to $10,000, and depreciation claimed during the years it was operated as a business totaled $95,000. The gain on the sale would be determined as follows:

Net selling price (net of sale expenses)	$300,000	

Adjusted basis:		
Original purchase price	$200,000	
Improvements	10,000	
Accumulated depreciation	$(95,000)	(115,000)
Gain realized		$185,000

A gain will normally be treated as a long term capital gain and will be taxed at graduated rates, limited to the maximum individual capital gain tax rate of 15% on long-term gains. Short-term capital gains are subject to tax at graduated rates. (Special rules apply, however, to the sale of a principal residence; see below.) Losses on the sale of property used in a trade or business are capital losses and, with restrictions, may be deductible, but losses on the sale of a personal residence or property not held for the production of income are not deductible.

SALE OF PROPERTY BY NONRESIDENT ALIENS

In general, a gain or loss from a sale or other disposition of US real property interests (USRPIs) by a nonresident alien is treated as if it were effectively connected with a trade or business within the United States, *regardless* of the property's actual use. All nonresident alien individuals—regardless of whether they engaged in a trade or business or elected to treat real property income as effectively connected with a trade or business—will be treated alike when taxed on gains from sales of real property. IRC section 897.

Real property for this purpose can consist of—but is not exclusively limited to—undeveloped land, buildings, residential dwellings, options on land, and real estate partnerships. Taxable US real property *interests*, however, also include stock and other equity interests in certain US corporations that own real property.

Any gain from the disposition of a USRPI will be taxed at the graduated rates, limited to a maximum tax of 15% if the USRPI is a capital asset and the gain is long-term. As with resident aliens, losses can be offset against gains only if the property was actually used in a business or income-producing property; personal-use property does not generate a deductible loss.

Upon purchasing a USRPI from a nonresident alien, the purchaser may be required to withhold 10% of the proceeds, to be applied against the seller's tax on the gain. The IRS may agree to lower the rate of withholding if the expected tax would be less than the otherwise required 10%. Withholding does not apply if the sale or exchange falls within a few narrowly defined tax-free exchanges (although reporting may be required) or if the purchaser acquires the property for use as his or her residence and the purchase price does not exceed $300,000. IRC section 1445.

A nonresident alien disposing of his or her US real estate investment should consider a number of other special rules. For example, if the property is sold on an installment basis, the IRS will not generally refund any portion of the 10% tax withheld until the gain is reported in full. Also, if the nonresident alien holds the US real estate in a US partnership, the purchaser will not be required to withhold the 10% tax on the disposition. However, the managing partner of the partnership will be required to withhold 15% of the gain allocable to the nonresident alien partner, regardless of whether any cash is distributed from the partnership.

Chapter 4 Other Taxes

STATE AND LOCAL INCOME TAXES

Almost all of the fifty states, the District of Columbia, and even some cities levy some form of personal income tax that is separate and distinct from the income tax imposed by the federal government. The tax base may be broader or narrower than that used by the federal government. California's "unitary" tax is a well-known example of a broad tax base. On the other hand, the states of New Hampshire and Tennessee have personal income taxes but apply them only to passive investment income (that is, interest, dividends, and capital gains).

State income taxes are independent of each other as well as of the federal tax. This can lead to double or even multiple state taxation of the same income. Double taxation is usually prevented by a credit, which is allowed on the tax return of the state of residence for taxes paid to the state that is the source of income.

State income taxes are generally levied on the worldwide taxable income of residents of the state. For nonresidents, they are levied on income from sources within the state. The states use various rules for apportioning income to the state, including a proration of worldwide income. This apportionment can affect the tax rate applied as well as the amount of income subject to tax. An individual who moves into a state and becomes a resident will usually be taxable as a nonresident for the period before the move (on income from sources within the state) and as a resident for the period after the move (on income from all sources).

State Residency Rules. Residency for state tax purposes may not be defined in the same manner as residency for federal income tax purposes. In dealing with a particular state, it will therefore be important to review the residency rules. For example, California defines the term *resident* as a person domiciled in the state or physically present in the state other than for a temporary or transitory purpose. An individual who is present in California for more than nine months in the tax year is presumed to be a resident. New York, on the other hand, defines *resident* as a person who is domiciled in the state or who (1) maintains a permanent place of abode in the state and (2) spends more than 183 days of the tax year in the state.

Most states use a combination of three tests to determine residency:

1. Domicile
2. Whether a permanent place of abode is maintained within the state
3. The number of days physically present within the state

These apply equally to both US citizens and foreign nationals. For example, a Japanese executive who is transferred from Tokyo to Los Angeles on a temporary business assignment is subject to the same California residence tests as the American executive who is transferred from New York to Los Angeles on a temporary business assignment.
Treaties that the United States has with foreign countries generally have no direct control over state taxation.

The method of taxation and the rates imposed by each of the states varies widely. States that impose a tax based on personal income generally follow federal law in computing taxable income. The extent of state conformity to federal law is wide-ranging and includes many deviations from the federal computation of taxable income. Some states directly piggyback on the federal income tax. For example, some states impose its income tax as a percentage of the federal income tax of residents and nonresidents, including estates and trusts. Other states adopt federal taxable income as the starting point for computing state taxable income.

While adopting the federal definition of taxable income, most states provide for various adjustments in determining state taxable income. Some common variances from federal taxable income include the taxation of state pension income, Social Security income, and interest on state and local bond interest. In addition to providing variances from federal taxable income in the computation of state taxable income, states also provide different itemized and standard deductions than what is allowed for federal purposes.

SOCIAL SECURITY TAX

Compensation for services performed within the United States as an employee is subject to US social security tax (7.65% on earnings up to $90,000 for 2005 and $94,200 for 2006 , with an additional tax of 1.45% on the remainder), regardless of the citizenship or residency of either the employer or employee. The employer pays a tax of equal amount. Self-employed individuals are subject to a social security tax as well (15.3% on the first $90,000 for 2005 and $94,200 for 2006 of net self-employment income and 2.9% on the remainder). Nonresident aliens are exempt from social security on self-employment income.

TOTALIZATION AGREEMENTS

Income tax treaties do not cover social security taxes, so even if a nonresident alien is exempt from US income tax under an applicable treaty, any US-source earnings will still be subject to social security tax. As a practical matter, however, the IRS does not normally enforce the social security tax provisions in cases in which the foreign national is exempt from income tax.

The United States has entered into social security totalization agreements with several countries that may eliminate duplicate coverage (taxes) and provide for "totalized" benefits for individuals who cannot qualify for full social security benefits in one country or the other.

ESTATE AND GIFT TAXES

Residence for transfer tax purposes does *not* have the same meaning as it does for income tax purposes. Residence for purposes of the US transfer tax means domicile. To be domiciled in the United States, a foreign national must reside here and intend to continue doing so indefinitely. The IRS will consider several factors in determining one's domicile, including duration of stay in the United States, location of family and friends, location of business interests and social affiliations, and any declarations of intent in such documents as visa applications, wills, deeds of gift, or trust instruments. Holding a green card, combined with substantial U.S. presence, will likely be considered strong evidence of U.S. domicile because the foreign national must declare that it is his or her intention to reside in the United States in order to obtain the green card. In contrast, a foreign national temporarily assigned to the United States, and present in the United States under a non-immigrant work visa of limited duration, is less likely to be domiciled in the United States for US transfer tax purposes.

The United States imposes a transfer tax on all gifts and all property included in the estates of US citizens and domiciliaries. In the case of non-domiciliaries, the estate tax generally applies only to US-situs property, including tangible and intangible property located in the United States and stock or debt issued by US persons. IRC sections 2104 and 2105. Gift tax generally applies to non-domiciliaries only on tangible property located in the US. IRC section 2501(a)(2). Not all of the situs rules are self-evident, and careful planning may be required to avoid unanticipated results. The fair market value of the assets at the time of the transfer or date of death (or the alternate valuation date) is the basis for the tax for citizens, residents, and nonresidents alike.

The taxable estate is derived by reducing the gross estate by allowable deductions. These deductions include expenses incurred in administering the estate, certain taxes, certain indebtedness, and charitable contributions. Most deductions for the estate of a non-domiciliary must be prorated between the US-situs assets and the foreign-situs assets. One of the most significant exceptions to this rule applies to non-recourse debt. Generally, the deduction for indebtedness must be allocated as described above. However, if the non-domiciliary decedent was not personally liable for a particular mortgage, only the value of the property subject to the mortgage, reduced by the amount of the mortgage, is included in the taxable estate. Thus, in effect, a deduction for the entire amount of the mortgage is permitted.

Estate and gift tax rates currently range from 18-45%. The rates are the same for US citizens, US domiciliaries and non-US domiciliaries. The maximum tax rate is 45% for 2007 through 2009, but then is scheduled to increase to 55% in 2011. Under the 2001 legislation, if no Congressional action is taken before 2010, the estate tax will be repealed for the 2010 tax year only, but the gift tax will remain in effect. The estate and gift tax bases for US citizens and domiciliaries and non-US domiciliaries are illustrated in Figure 4.1.

FIGURE 4.1
Comparison of
Estate and Gift Tax Bases

US Citizen/Domiciliary Transfer Tax Base	Non-Domiciliary Transfer Tax Base
US real estate	US real estate
Foreign real estate	
Stocks of US corporations	Shares in US corporations*
Stocks of foreign corporations	
Deposits with all investment companies	Shares in U.S. mutual funds **
All deposits in US commercial banks or savings and loans	Deposits in US commercial banks or savings and loans but only if connected with a US trade or business
All debt obligations	Obligations of US debtor which do not qualify for portfolio debt exemption **
Proceeds of insurance policies	

* For US estate tax only. For gift tax purposes, these assets are intangible assets and are therefore not subject to US gift tax.

**Temporarily, exempt to the extent that underlying assets of mutual fund could be exempt. See IRC section 2105(d).

Non-domiciliaries with US assets over $60,000 in value may be subject to substantial US taxes on their estates because the exclusions and deductions permitted are not as favorable as those permitted to US citizens and domiciliaries. Credits or treaty provisions may reduce this liability, depending on the status and terms of any existing treaty with the country of domicile. As of 1 January 2006, estate tax treaties or estate and gift tax treaties are in effect with the countries shown in Table 4.2.

TABLE 4.2
Estate and Gift Tax Treaties

Country	Type of Treaty
Australia	Separate estate and gift
Austria	Combined estate and gift
Canada[a]	Estate only
Denmark	Combined estate and gift
Finland	Estate only
France	Combined estate and gift
Germany	Combined estate and gift
Greece	Estate only
Ireland	Estate only
Italy	Estate only
Japan	Combined estate and gift
Netherlands	Estate only
Norway	Estate only
South Africa	Estate only
Sweden	Combined estate and gift
Switzerland	Estate only
United Kingdom	Combined estate and gift

a. Although the United States and Canada do not have a separate estate tax treaty, taxes upon death are covered within the provisions of the US-Canada income tax treaty.

Gifts made to a spouse who is a US citizen are exempt from gift tax due to an unlimited marital deduction. Gifts made to a non-citizen spouse, however, do not qualify for this marital deduction. An increased annual exclusion for gifts of a "present interest" is available for transfers to a Non-US citizen spouse. Gifts in excess of $125,000 in 2007 (amount increases annually) are subject to US transfer tax. IRC section 2523(i).

With respect to estates, property passing to a US citizen spouse is eligible for an unlimited marital deduction and thus exempt from estate tax. Property passing to a surviving non-citizen spouse does not qualify for the marital deduction, unless the bequest is to a qualified domestic trust. These trusts must meet a number of requirements, the effect of which is to enforce the transfer tax at the time property is distributed from the trust or at the death of the non-US-citizen surviving spouse, whichever occurs first. IRC sections 2056(d) and 2056A.

Chapter 5 Pre-Immigration Tax Planning

THE NEED FOR TAX PLANNING

Various actions that resident and nonresident aliens take can affect the amount of tax they will pay in the United States. Tax planning, therefore, is essential for foreign nationals who are or will become subject to taxation by the United States.

This chapter presents several fundamental planning ideas. Whether an idea applies depends on variables previously discussed, such as length of stay in the United States, the nature and extent of income, status, and country of citizenship and residency. Note that the planning ideas covered in this chapter focus on reducing U.S. tax exposure. In some circumstances, the approaches discussed below might result in increases of foreign tax, possibly even in excess of US tax savings. It is therefore essential that, before an individual moves to the United States or establishes a US business or investment presence, foreign taxation be considered as well.

MANAGING RESIDENCY

A non-resident alien is subject to U.S. income tax only with respect to limited types of income: income that is effectively connected with the conduct of a trade or business within the United States and certain limited categories of U.S.-source investment income. Foreign-source investment income and fairly broad classes of U.S.-source investment income are exempt from U.S. income taxation. In contrast, a U.S. resident is subject to U.S. taxation on worldwide income, including in many cases investment income earned through foreign holding companies (controlled foreign corporations) and trusts which are classified as grantor trusts. Thus, the foreign national should consider limiting U.S. presence so that he or she does not become a U.S. income tax resident. Assuming the foreign national does not have a green card, the foreign national could spend up to 121 days in the United States each year without becoming a U.S. resident.

In limited cases, a foreign national will remain a non-resident alien by virtue of the foreign national's visa status. Days of U.S. presence under certain "exempt" visa categories are not counted toward U.S. tax residency, such as student or teacher visas and certain international organization and foreign-government-related visas. The exemption from the substantial presence test applies not only to the primary visa holder, but also to members of the immediate family who are permitted to accompany the visa holder. Thus, an individual who is considering living in the US should carefully review with immigration counsel whether the individual or his or her spouse could qualify for entry under one of these tax-preferred visa categories. In all cases, the US tax status is conditioned upon the visa holder complying with the terms of the visa.

Obtaining a green card is likely to cause a foreign national to be considered a US domiciliary for estate and gift tax purposes, and thus should be avoided if other visa categories are available and practical. The later relinquishment of a green card could have adverse income and transfer tax consequences under the expatriation tax rules of IRC section 877, which are beyond the scope of this outline.

TIMING OF INCOME RECOGNITION

Foreign nationals are subject to normal US accounting rules. They recognize income in the amounts and at the times prescribed in US tax law, even though this income may pertain to activity that had no US connection. For example, income earned by a cash-basis taxpayer *before* becoming a resident but received by him or her *after* becoming a resident will be subject to US income tax in the year received. See Example 5.1.

> ***Example 5.1:***
>
> Mr. A, a citizen and resident of Germany, purchased 100 shares of ABC Company stock for Euro 10,000 in September 2000. He enters the United States on a two-year assignment in January 2005 and sells the ABC Company stock in July 2005 for Euro 9,600. Fair market value of the ABC Company stock was Euro 9,000 in December 2003.
>
> Mr. A's basis in the stock for US tax purposes is Euro 10,000, translated at the September 2000 exchange rate of approximately 0.865 to equal $8,650. His sales price is translated at the July 2005 rate of approximately 1.2 to equal $11,500, resulting in a gain for US tax purposes of $2,850. Had he sold the original ABC Company stock in December 2003 and repurchased it prior to entry in the United States, Mr. A would have had a Euro 1,000 loss in Germany and would have entered the United States with a $11,050 basis (Euro 9,000 translated at the December 2003 rate of approximately 1.227). This strategy would have reduced his US gain on the stock sale from $2,850 to $450.

Some possible ways to plan the timing of income recognition include

- Exercising stock options before US residency begins;
- Accelerating the receipt of bonuses or other deferred compensation to a date before—or deferring it until a date after—the period of US residency;
- Deferring recognition of losses until the period when US residency begins, and paying deductible expenses when a US resident;
- In the case of privately-owned foreign corporations, accelerating the payment of a dividend while the shareholder is a non-resident alien (since earnings accumulated prior to US residency but paid as a dividend after the US residency start date would be subject to US taxation);
- Obtaining a step-up in the tax basis of assets before US residency begins, as discussed in more detail below; and
- Selling a foreign residence before US residency begins, to avoid US tax on any gain.

SALE OF PRINCIPAL RESIDENCE

Rules enacted in 1997 appear to place nonresident aliens on the same footing as resident aliens and citizens with respect to the disposition of a principal residence. In general, up to $250,000 ($500,000 for taxpayers who are married and file joint returns) of gain from the sale of a principal residence can be entirely excluded from income, provided that the home in question has been owned and used as a principal residence for at least two of the five years preceding the sale. A pro-rata portion of the exclusion is available for taxpayers who fail to meet the two-year use test by reason of a change in employment, health, or other unforeseen circumstances. If, for example, a taxpayer is transferred by an employer and must sell a house that has been occupied for only one year, the taxpayer will be entitled to one-half the maximum exclusion (i.e., to $125,000, or to $250,000 if the taxpayer is married and files jointly). For purposes of the exemption, it is not important whether the taxpayer is a resident alien or a nonresident alien at the time of sale. However, a recoverable withholding tax may be applied if the seller is nonresident. A nonresident seller might wish to seek a withholding tax waiver.

The rules are not entirely clear and complications can arise in several different circumstances (where the residence has been rented for a period, for instance, or where gain from the sale of a previous residence has been deferred).

At least two other considerations deserve specific mention in connection with the sale of a personal residence. The first is the effect of the potential exchange gain or loss. As seen in Example 5.1, which illustrates the sale of securities, the taxpayer's basis in the residence is determined at the time of purchase, while the sales proceeds are determined by using the exchange rate at the date of sale. The second consideration is the effect of the exchange rate in paying off the mortgage. There may be an exchange gain on the mortgage that cannot be offset by a loss on the sale of the residence.

Estate planning for US real estate is discussed below at "Pre-Immigration Estate Planning".

STEP-UP IN TAX BASIS OF ASSETS

Whether a foreign national is able to obtain a step-up in tax basis before U.S. residency will depend upon the nature of the assets, the ownership of the assets (e.g. through holding companies or in trust), and the tax effects in the foreign jurisdiction of obtaining a step-up for U.S. tax purposes. The following are examples of actions or transactions which can result in a basis-step-up for U.S. tax purposes. In all cases, the non-US consequences must be carefully considered:

- *File check-the-box elections:* Where assets are held in a foreign holding company which is eligible to file a "check-the-box" election, the filing of the election effective prior to U.S. residency is treated as a deemed liquidation of the company, which results in a step-up in basis of the underlying assets. The check-the-box election results in a deemed liquidation only for U.S. tax purposes, and will not have any adverse consequences under tax laws of the foreign jurisdiction.
- *Sale and repurchase publicly traded securities:* The foreign national could sell the securities and repurchase them shortly thereafter, but prior to the assumption of U.S. residency. The taxpayer must consider the non-U.S. tax consequences of this sale and repurchase approach.
- *Sale between spouses:* Generally, gain is not recognized on a sale of a appreciated assets between spouses and the "purchasing" spouses takes a carry-over basis in the asset. However, if the purchasing souse is a non-resident alien, gain will be recognized.
- *Sale between non-*grantor trusts: Gain is recognized for US tax purposes upon a sale by one non-grantor trust to another. In the case of a trust established by a non-resident alien, the trust will constitute a non-grantor trust unless it qualifies under one of the narrow exceptions set forth in IRC section 672(f). However, one must carefully consider the collateral

consequences of such a sale, including: (i) the realization of "distributable net income" ('DNI"), and if accumulated, "undistributed net income" ("UNI"); (ii) the effect on DNI and UNI accounts if the grantor becomes a US resident within five years of having made gratuitous transfers to the trust (see IRC section 679(a)(4)); and (iii) the tax consequences of later trust distributions to US and non-US beneficiaries.

- *Sale by non-resident alien to non-grantor trust:* Gain is recognized for US tax purposes upon a sale by an individual to a non-grantor trust, whether or not the selling individual is the grantor of the trust.

PLANNING FOR FOREIGN ENTITIES

Before becoming a US resident, the non-resident alien must assess the US tax status of each foreign entity in which he or she has an ownership interest, together with ownership interests of family members and persons who are considered to be related under the stock ownership attribution rules. The first step in that assessment process is to determine the entity classification under the US tax laws, that is, whether the entity is a corporation, partnership, trust, disregarded entity, or perhaps not an entity at all (an agency or nominee arrangement.) See especially Treas. Reg. section 301.7701-1, -2, -2T, -3, and -4 and Commissioner v. Bollinger, 485 U.S. 340 (1988). The next step is to determine the classification of the entity under the US anti-deferral rules as a result of the foreign national's assumption of US residency—specifically, in the case of a foreign corporation, whether that foreign corporation will be classified as a "controlled foreign corporation" ("CFC") or "passive foreign investment" (PFIC"), and if so, the tax consequences to the US resident and other US shareholders. See IRC sections 951 through 965 and IRC sections 1291 through 1298. In the case of a foreign trust, it will be necessary to analyze whether the trust is a grantor or non-grantor trust and whether that status will change as a result of US residency. See IRC section 679(a)(4). It is only after this preliminary assessment of the tax status of foreign entities is performed that the foreign national can begin to consider planning alternatives.

CONTROLLED FOREIGN CORPORATIONS.

A foreign corporation is classified as a CFC if more than 50% of the voting power or value is owned collectively by 10% voting US shareholders, that is, considering only US shareholders who own at least 10% of the voting power of the foreign corporation. IRC section 957. (Special rules apply for insurance companies.) If the foreign corporation is classified as a CFC, the 10% voting US shareholders are taxed annually on the "Subpart F income" of the CFC at ordinary income rates, even if dividends are not distributed. Stock ownership attribution rules apply in determining whether a US shareholder is a 10% voting US shareholder and whether a foreign corporation is a CFC. IRC section 958(a) and (b), and IRC section 318. Subpart F income includes generally passive income such as interest, dividends, rents, royalties, and capital gains. IRC section 954(c). Limited exceptions are available for income subject to high foreign taxes, and income derived from the active conduct of the rental or royalty business or from the active conduct of a banking, financing, or insurance business. IRC sections 954(c)(2), (h), and (i).

If a foreign corporation will constitute a CFC after the commencement of US residency, but the income will not constitute Subpart F income (for example, due to the active trade or business exceptions), it may not be necessary to take any actions with respect to the CFC except perhaps to pay pre-immigration dividends of pre-immigration earnings and profits. However, even without Subpart F income, if the foreign national intends to stay in the US permanently or for a very long period, it may be preferable to make a check-the-box election for the CFC (assuming it is an eligible entity) prior to US residency. In that case, the foreign entity will be classified as a partnership or disregarded entity, and income, deductions, and foreign tax credits would then flow-through to the US resident. This approach is more likely to be advantageous if the CFC pays substantial foreign taxes for which the individual US resident owner could claim a foreign tax credit in the case of a partnership or disregarded entity, but not in the case of a dividend distribution from a CFC.

If the foreign corporation will constitute a CFC, but the income will constitute Subpart F income taxable to the US resident shareholder, a pre-immigration check-the-box election will often be the better course. For example, if the foreign national owns his or her investment portfolio through a tax-haven corporation, upon commencement of US residency, the US resident shareholder will be subject to US taxation on the interest, dividends, and capital gains earned by the CFC at ordinary income tax rates. Furthermore, pre-residency unrealized appreciation in the portfolio will be subject to US taxation upon a sale of the investment by the CFC after the commencement of US residency. A check-the-box election effective prior to the residency start date will result in a step-up in the tax basis of the portfolio and will cause the foreign corporation to be treated as a flow-through entity for US tax purposes (a disregarded entity if only one member and a partnership if more than one member). The income will then flow-through to the US resident but the character of the income will be preserved, which is important in the case of long-term capital gains and qualified dividends.

PASSIVE FOREIGN INVESTMENT COMPANIES

A foreign national who owns stock in a company classified as a *passive foreign investment company* (PFIC) may be subject to an interest charge on "excess" distributions from the company. In general, a foreign company is a PFIC if 75% or more of its income consists of passive income or 50% or more of its assets produce passive income. IRC section 1297. A foreign entity will be classified as a PFIC only if it is a corporation under US tax principles. Thus, it will be necessary to analyze the nature of the foreign investment fund under the entity classification standards mentioned above. For example, many foreign funds are constituted as unit investment trusts, but will be classified as corporations (and hence PFICs) except is certain limited circumstances. See Treas. Reg. section 301.7701-4(b) and -4(c). An excess distribution is, in general, the amount received that exceeds 125% of the average amount received on that stock in the preceding three years. In addition, if a US resident sells or exchanges shares in a PFIC, any gain will be subject to US taxation at ordinary income rates and an interest charge will be imposed based upon the number of years that the US resident held the shares in the PFIC.

If the foreign national intends to remain in the United States for an extended period, it is generally advantageous to make a "qualified electing fund" ("QEF") election with respect to the interest in the fund. IRC section 1295. With a QEF election, the US resident will be taxed annually on his or her share of the fund's earnings, with a flow-through of the investor's share of capital gains, and any gain upon disposition of shares in the QEF/PFIC will be eligible for capital gains treatment. Finally, with a QEF election, the PFIC interest charge will not apply. The problem is that many foreign funds are closed to US resident investors and, in any case, would be unwilling to provide the information necessary for the US resident to report PFIC earnings. A foreign national who is contemplating US residency should then dispose of the PFIC shares prior to becoming a US resident.

If the foreign national will remain a US resident for only a brief period (for example, two or three years), it may be preferable to retain the PFIC shares without making a QEF election. During the period of US residency, the foreign national would be subject to US taxation (plus an interest charge in the case of an excess distribution) on actual distributions made by the PFIC. Under present law, the termination of US residency is not a deemed disposition of the PFIC shares, but the IRS does possess the authority to issue regulations treating the termination of US residency as a deemed sale of PFIC shares.

FOREIGN TRUSTS

Prior to US residency, it is important to analyze the US tax status of any foreign trust with respect to which the foreign national has made gratuitous transfers (i.e., gifts) or is a beneficiary. If the foreign national has made gifts to a foreign trust, the foreign national is considered to be a "grantor" with respect to the trust. When the grantor then becomes a US resident, the foreign trust may be classified as a grantor trust depending upon whether the foreign national made gifts to the trust within 5 years of becoming a US resident (see IRC section 679(a)(4)) or whether the grantor has retained certain powers over the trust which would trigger grantor trust status under the grantor trust provisions that are generally applicable to US grantors of any trust, whether foreign or domestic (see IRC sections 673 through 677)). The US resident grantor of a grantor trust is generally subject is US taxation on the income and gains of the trust. IRC section 671.

If the foreign national is not a grantor of the foreign trust, but is a beneficiary, the US tax consequences to the beneficiary upon becoming a US resident will depend upon whether (i) the trust is a grantor trust (with a foreign or US grantor), (ii) the trust is a foreign non-grantor trust, or (iii) the US resident beneficiary possesses a power to withdraw trust income or corpus of the trust.

IF "GRANTOR TRUST"

A trust with a foreign grantor will constitute a grantor trust only under the following alternative circumstances:

(1) The trust is revocable by the foreign grantor alone or with the consent of a related person who does not have an interest in the trust.
(2) During the lifetime of the foreign grantor, distributions may only be made to the grantor or the grantor's spouse.
(3) Certain grandfathered trusts as discussed below.

If the trust constitutes a grantor trust with a foreign person treated as owner, distributions of income, capital gains, or principal (capital) to U.S. beneficiaries will not be subject to U.S. income tax, although such distributions are subject to informational reporting. See IRC section 672(f).

IF "NON-GRANTOR TRUST"

If the trust does not constitute a grantor trust, distributions of income and gains to the U.S. beneficiaries will be subject to U.S. income tax and informational reporting. The specific U.S. income tax treatment depends upon whether the distribution is treated as having been made from current year income and gains or accumulated income and gains. If the distribution is from current year income and gains, the character of the income and gains will flow through to the U.S. beneficiaries. For example, if the Trustee distributes a current year gain to a U.S. beneficiary, the U.S. beneficiary will pay U.S. income tax on the gain at the more favorable capital gains tax rate (assuming the asset sold was held for more than 1 year). In contrast, distributions of accumulated income and gains are taxed at the higher ordinary income rates, plus an interest charge is imposed as a disincentive to accumulating income offshore. A distribution in excess of all current year and accumulated income and capital gains will constitute a tax-free return of trust principal (capital).

Distributions are treated as deriving from the following tiers of income and gains, even if designated differently by the Trustee: (1) current year income/gains to the extent thereof, (2) accumulated income/gains beginning with the earliest year of accumulation to the extent thereof, and (3) return of capital. IRC sections 666, 667, and 668.

If the foreign trust lends cash or marketable securities to a U.S. beneficiary or a person related to a U.S. beneficiary, the principal amount of the loan will be treated as a distribution to the U.S. beneficiary unless the loan is structured as a "qualified obligation." A qualified obligation is defined as: a written obligation, the term of which does not exceed 5 years and which meets certain specific IRS requirements. The U.S. beneficiary must report the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding. IRC section 643(i) and Notice 97-34, 1997-2 C.B. 422.

IF "GRANDFATHERED GRANTOR TRUST"

Under a "grandfathering" rule, certain trusts that qualified for grantor trust status under prior law, but which would not otherwise qualify for grantor trust status under the new law, can continue to be treated as grantor trusts with a foreign grantor. In order to be grandfathered, the trust must have been in existence on September 19, 1995, and the trust must have qualified as a grantor trust because the grantor or the grantor's spouse is within the class of beneficiaries (or in some circumstances could be added to the class of beneficiaries by the Trustee). Additions to the trust made after September 19, 1995 and income and gains deriving from such additions will not qualify for grantor trust treatment under the grandfather rule.

SPECIAL RULE FOR PRE-IMMIGRATION TRUSTS

If a non-resident alien makes a gratuitous transfer to a foreign trust, and within 5 years of the transfer, commences US residency, the trust will be classified as a grantor trust if any US person is a potential beneficiary. IRC section 679(a)(4). Thus, the US resident grantor will be subject to US tax on the foreign trust's income and gain. Any trust income/gain which is realized during the 5 year pre-immigration period is treated as trust corpus and therefore is not taxed to the US resident grantor upon the assumption of U.S. residency or to the US beneficiaries of the trust upon distribution. IRC section 679(a)(4)(B).

The general grantor trust rules of IRC sections 673 through 677 apply to pre-immigration trusts as well. Thus, even if the special pre-immigration trust rule of IRC section 679(a)(4) does not apply (for example, because the foreign trust was funded more than 5 years prior to the residency start date), a trust can be classified as a grantor trust upon the grantor's commencement of US residency if the grantor has retained a power or economic interest defined in IRC section 673 through 677. For example, if a non-resident alien funded a discretionary foreign trust in 1990 for the benefit of his children, with a power granted to the institutional trustee to add charitable beneficiaries, and the grantor became a US resident on January 1, 2007, the trust would constitute a grantor trust under IRC sections 674(a) and (c) from the date of US residency and subsequent trust income and gains would be taxed to the US resident grantor. Any pre-immigration accumulated income or gains would constitute UNI of the trust, which would be taxable upon distribution to US beneficiaries.

Pre-immigration planning in the above case may involve amending the trust to neutralize provisions which would otherwise cause grantor trust status when the grantor becomes a US resident.

If the grantor remains a foreign person, but a foreign trust beneficiary becomes a US resident, it is first necessary to analyze the US tax status of the trust based upon the limited definition of grantor trust status where the grantor is a foreign person. If the foreign trust is classified as a grantor trust with a foreign grantor, the receipt of trust distributions by the US resident beneficiary will not be subject to US taxation, but is subject to informational reporting. However, if the foreign trust is a non-grantor trust, distributions to the US beneficiary are taxable, but, in the case of UNI accumulated prior to the US beneficiary's residency start date, are not subject to the interest charge of IRC section 668.

Pre-immigration planning in the above context may include distributions of UNI to the beneficiary prior to his or her residency start date, distributions to other foreign beneficiaries or other foreign trusts so as to reduce or eliminate UNI in the trust for the benefit of the US beneficiary, and under appropriate circumstances a re-settling of the foreign trust by the foreign grantor. See IRC section 643(h) and Treas. Reg. section 1.643(h).

APPLICATION OF IRC SECTION 684 UPON GRANTOR'S TERMINATION OF US RESIDENCY

If a foreign trust has become a grantor trust as a result of the grantor becoming a US resident (see preceding discussion), it is likely that grantor trust status will terminate upon the grantor's termination of US residency because of the limited definition of grantor trust status in the case of non-resident grantors. The termination of grantor trust status is treated as an out-bound transfer of assets by the US grantor to a non-grantor foreign trust immediately prior to the termination of US residency, and the US grantor is required to recognize gain (but not loss) on the deemed transfer of appreciated assets. IRC section 684 and Treas. Reg. section 1.684-2(e).

In the above circumstances, the US resident grantor who intends to terminate US residency could consider a trust distribution of appreciated assets to a beneficiary prior to the termination of US residency since the deemed sale rule of IRC section 684 does not apply to appreciated assets owned by an individual who terminates US residency. Alternatively, the foreign trust could distribute appreciated assets to a US non-grantor trust prior to the grantor's termination of US residency.

PRE-IMMIGRATION ESTATE PLANNING

The nature and extent of pre-immigration estate planning will depend upon whether the foreign national will reside in the United States for only a temporary period or whether he or she intends to reside in the United States indefinitely or permanently.

If the foreign national will become a US income tax resident for only a few years (for example, a work assignment under a non-immigrant visa category), it is unlikely that the foreign national will be considered domiciled in the United States for US estate and gift tax purposes. For a non-domiciliary, the US estate tax base is limited to US-situs assets, which includes principally US real estate, tangible personal property located in the United States, shares in US corporations, and certain categories of debts having US obligors. In light of the limited scope of the US estate tax for non-domiciliaries, US estate tax exposures can usually be managed through a combination of: (i) life insurance coverage (even if not in trust since life insurance proceeds are excluded from the gross estate of a non-domiciliary); (ii) lifetime gifts of intangible property (such as US stocks and bonds) either to an individual or in an estate tax-protected trust since the US gift tax does not apply to lifetime gifts of US intangible property made by non-domiciliaries; and (iii) the use of foreign entities to own US-situs assets, thus converting US-situs assets to non-taxable foreign-situs assets, although such an approach is not without its own income tax and estate tax risks.

If a foreign national intends to reside in the United States indefinitely or permanently, he or she will likely be considered to be domiciled within the United States for US gift and estate tax purposes. Pre-immigration estate tax planning in this context means pre-domiciliary estate planning. Because of the limited scope of the US gift tax in the case of non-domiciliaries, it is possible to make irrevocable tax-free gifts to individuals or in trust prior to be becoming a domiciliary. Furthermore, the generation skipping transfer tax does not apply to gifts made by non-domiciliaries if the gift itself was not subject to US gift tax. Treas.Reg. section 26.2663-2. This limited application of the generation skipping transfer tax to gifts by non-domiciliaries permits the funding of a properly structured multi-generational trust prior to becoming a US domiciliary without the imposition of US transfer taxes.

Structuring the ownership of personal use US real estate presents special issues for foreign nationals due to the US-situs of the property. Generally, individual ownership is preferable from an income tax perspective since any gain upon sale may be eligible for the principal residence exclusion and the preferential long-term capital gains rate. However, trust ownership or entity ownership may be preferable from an estate tax perspective. Any detailed discussion of the structuring of ownership of personal use US real estate is beyond the scope of this outline.

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