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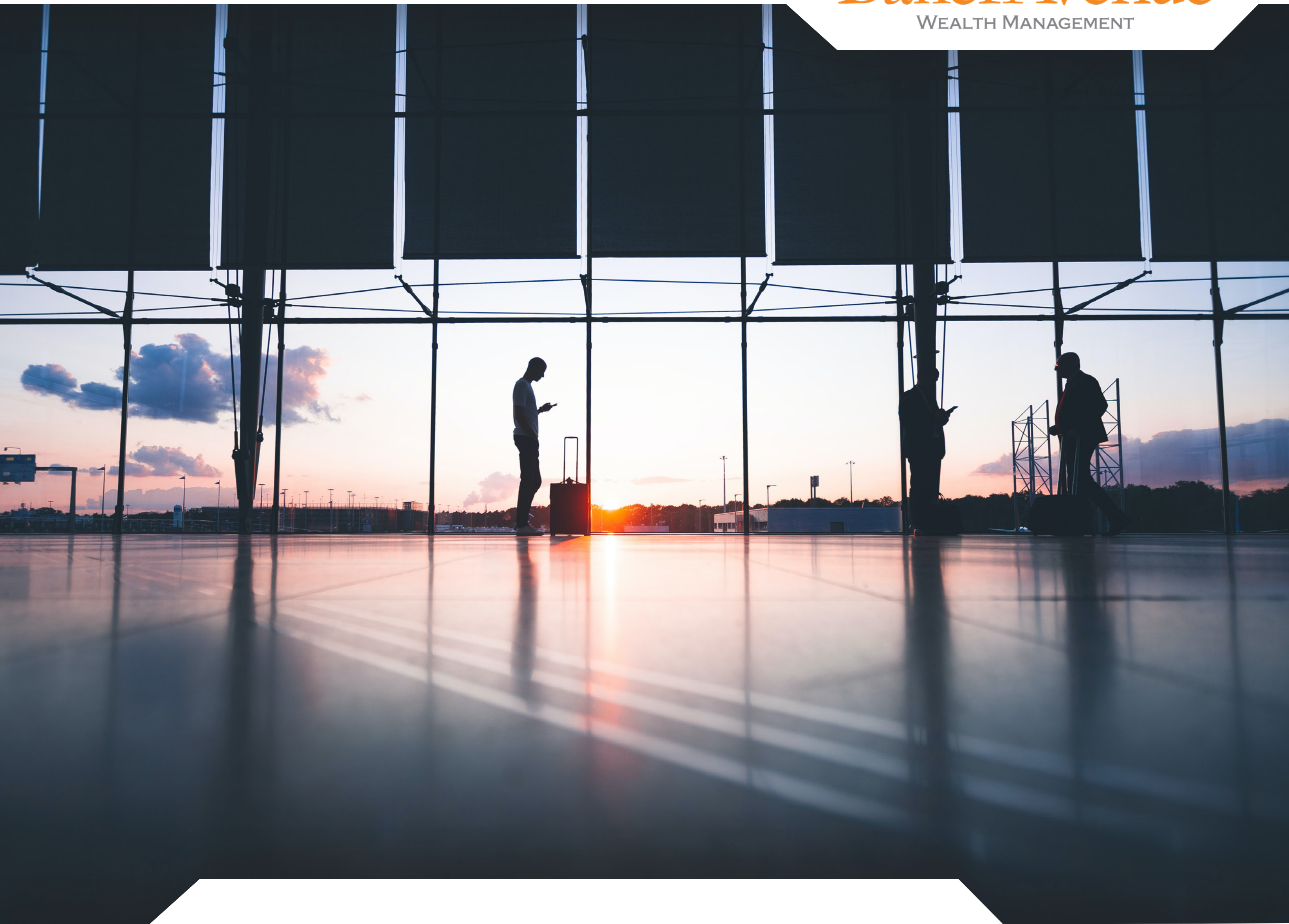

International Tax Planning Overview

For Non / New US Residents and Their Families

by Gerry O'Connell, EA, Tax Planning, Partner

Navigating through the various and ever-changing tax regulations, particularly for non-US citizens, is extremely complex. Here's our comprehensive reference guide to help you sort through the various international tax issues and requirements that should be considered.

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[1] PLANNING POINTS FOR INTERNATIONAL FAMILIES AND THE US TAX SYSTEM

Pre-Immigration Planning

- Divest of highly appreciated assets before becoming a resident. Can be re-acquired to secure high tax basis before residency is obtained. No US tax but consider foreign taxation of the sale – might be at favorable tax rates or allowances for inflation.
- Step-up basis to Fair Market Value of assets held in a foreign company by triggering a liquidating distribution for (only) US tax purposes under the check-the-box regulations. The foreign corpation would become a disregarded entity for US tax purposes but the assets would be stepped up to FMV for US capital gains tax purposes.[1]
- If significant cash is to be sent to the US, avoid gifts of US bank account cash. Rather establish an off-shore bank account solely in the recipient's name. Gifts of cash from US bank accounts are potentially subject to gift tax with low thresholds where the donor is a Non Resident Alien (NRA) – For example, the annual gift tax spousal exemption is currently $157,000, while the non-spousal exemption is only $15,000. Gifts of US bank account cash above these levels will trigger a gift tax liability of 40% [2]– See Gift and Estate Tax Chart after Section 5.
- Where assets and income can be divided between family members, transfer non-US assets to those members not intending to become US residents thus keeping them outside the US tax nexus. This is especially true where the family owns non-US corporations – US residents owning or being officers of foreign corporations is the most burdensome and penalty heavy part of the US tax code. There are also situations where income can be attributed to US resident aliens without any distribution having taken place – Subpart F (passive income) inclusions[3].
- Where significant US situs assets (especially real estate) are owned (or are to be owned) by the family consider having these US assets owned by the intended resident as he/she will be able to avail of very high estate tax and gift tax exemption threshold ($11.58 million). This contrasts with the very low threshold of $60,000 where the US situs assets are owned by a NRA – the death of the NRA[4] while holding US situs assets could immediately expose the estate to a 40% US tax hit on practically the full market value of US situs assets. Similarly gifts of US situs assets by an NRA are also subject to very low thresholds before Gift tax becomes payable. See gift and estate tax chart in Section 5.
- Use Trusts where appropriate. Before becoming a U.S. resident, a taxpayer can make irrevocable gifts to non-U.S. persons in trust where (1) the trust document indicates that it is not permitted to have U.S. beneficiaries, and (2) the trust is not otherwise considered a U.S. grantor trust. By doing so, the taxpayer may avoid U.S. income taxes on future income earned by the gifted assets and may also avoid later U.S. gift and estate taxes on the transfer of those assets, simply because the now-U.S. resident no longer owns the income-producing assets for U.S. tax purposes – However there is a 5 year "look-back" where the donor subsequently becomes a US resident. Thus, a nonresident alien who intends to immigrate to the United States should create and fund the foreign trusts at least five years before becoming a U.S. person, in order to avoid being taxed on trust income.[5]

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1 Treasury Regulations 301.7701-1
2 IRC Sections 2523(i)
3 IRC Section 951(a)
4 IRC Section 2001-2209
5 Treasury Regulations 1.679-5(a)

- Alternatively, a taxpayer can, before immigrating to the United States, transfer a portion of his or her non-US assets to an irrevocable discretionary trust of which the taxpayer and other family members are permissible discretionary beneficiaries. While this will become a grantor trust for U.S. income tax purposes, subjecting its income to U.S. income tax in the hands of the grantor after the grantor becomes a U.S. resident[6], the assets should not be subject to U.S. estate tax on the taxpayer's death[7]. Moreover, life insurance can be used to cut off the accumulation of any undistributed net trust income (thereby minimizing the income tax liability to the grantor) by using trust assets to purchase a life insurance policy.
- Gifts of US Shares. Shares of a U.S. corporation are intangible property and therefore are not considered taxable as U.S. situs property for gift tax purposes[8]. However, shares of a U.S. corporation are considered U.S. situs property for estate tax purposes. Thus, nonresidents who own U.S. shares and intend to immigrate to the United States, and also intend to gift the shares, should consider making gifts of their U.S. shares before becoming a resident. Those gifts may achieve two tax-saving goals - the gifts will be exempt from U.S. gift tax and will also reduce the U.S. estate for estate tax purposes.

Post-Immigration Tax Planning

- Where one spouse is a US resident and the other is NRA, US resident should elect to file Married Filing Separately in order to keep the NRA's income clear of the US tax nexus.
- Where there are significant US real estate assets consider accelerating tax deductions for depreciation – not only can these eliminate tax liability associated with the real estate business but they can, in certain situations, provide tax shelter against other income such as wages and investment income (subject to income thresholds).
- Other planning techniques available to resident aliens (as well as US citizens) include.
- Tax deductions for contributions to US retirement plans are available to resident aliens as if they were full citizens. These are particularly generous for business owners.
- On-shore estate planning techniques to reduce the impact of estate and/or gift tax are available to resident aliens.
- Accelerated Depreciation on real estate is likewise available to US businesses where business tax returns are filed.
- On-shore charitable giving with attendant tax benefits is similarly available.

Exit Tax

A US citizen or long-term resident, needs to file form 8854, which determines whether you are a "covered expatriate" and subject to the exit tax regime. You are a "covered expatriate" if you meet one or more of the following three conditions: (1) Your worldwide personal net worth is more than $2 million at the date of expatriation. (2) The average annual net income that you are taxed on for the five years before you expatriate is more than $175,000. (3) You fail to certify that you have complied with all the required federal tax obligations for the past five years[3].

In determining the amount of tax to be paid the IRS will base its tax evaluation on the fair market value of your assets. In other words, the IRS taxes you on the capital gains should you sell your assets on the date of expatriation.

6 IRC Section 671-677

7 IRC Section 679

8 IRC Section 2104, 2501 and 2511

[2] INTERNATIONAL TAX ISSUES FOR RESIDENT ALIENS AND NON RESIDENT ALIENS (NRAS).

Non-US citizens can either be resident aliens, or nonresident aliens, for income tax purposes. In this context, being an "alien" simply means being a non-US citizen. Thus, the key driver for non-US citizens is whether they are deemed to be *residents* as well.

The distinction matters, because resident aliens declare and pay taxes on worldwide income (similar to US Citizens), while nonresidents only have to report and pay taxes on income earned or sourced in the US[9].

In other words, resident aliens must pay taxes on any income generated from anywhere in the world, while nonresident aliens (who are still residents in some other country) only pay taxes on their actual US income and US property (e.g., real estate physically located in the US, or investment accounts held in the US). Having resident alien status can therefore have huge tax consequences for a non-US citizen who has income generated abroad (such as non-US business or investment income).

Determining Resident Status

To determine whether non-US citizens will be treated as residents, they must meet either the Green Card Test or the Substantial Presence Test.
A person meets the Green Card Test if he or she is a Lawful Permanent Resident of the United States at any time during the calendar year. He or she is a Lawful Permanent Resident of the United States, at any time, if he or she has an alien registration card, Form I-551, also known as a "green card"[10].

A non-US citizen without a Green Card can still be a resident alien if he or she meets the Substantial Presence Test[11]. This test counts the number of days an individual has been physically present in the US in the current year, and over the past 3 years. To meet the Substantial Presence Test, you must be physically present in the United States (US) on at least:

31 days during the current year, and 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting: (a) + (b) + (c), where (a) All the days you were present in the current year, (b) 1/3 of the days you were present in the first year before current year, and (c) 1/6 of the days you were present in the second year before the current year.

Ultimately then, non-US citizens who have either a Green Card or meet the Substantial Presence Test are treated as resident aliens. If neither the Green Card nor the Substantial Presence Test is met, they are Non Resident Aliens (NRAs).

9 IRC Section 7701(a)(30)
10 IRC Section 7701(a)(30)
11 IRC Section 7701(b)(1)(A)
12 IRC Section 7701(b)(3)(A)

Taxation of Non Resident Aliens (NRAs)

As described above, nonresident aliens are taxed on US-sourced income only, but the exact tax treatment depends on the type and source of income[12].

Nonresident aliens are subject to two different tax rates, one for effectively connected income (ECI), and one for fixed or determinable, annual, or periodic (FDAP) income. ECI is earned in the US through personal service (e.g., wages, self-employment), or from the operation of a business in the US, and is taxed for a nonresident at the same progressive ordinary income tax brackets as for a US citizen. FDAP income is passive income, such as interest, dividends, rents or royalties, and is taxed at a flat 30% rate.

Citizens of China are subject to only a 10% withholding rate on dividends and interest instead of the standard 30% rate. (May require filing IRS Form 8233 to support the tax treaty exemption for the lower withholding amount).

When it comes to capital gains tax, nonresident aliens are generally not subject to capital gains tax in the US unless the gain is from US real property.

Nonresident aliens married to a US citizen or resident alien can choose to be treated as US residents and file joint returns. However, a resident spouse may file as "married filing separately" in order to keep the NRA spouse's income from being subjected to US taxation.

[3] FOREIGN ASSET REPORTING REQUIREMENTS FOR RESIDENT ALIENS

Anyone who is a resident alien and has any foreign (i.e., non-US-based) bank accounts (including joint accounts) exceeding $10,000 during the year has to file FinCEN Form 114, also known as the Report on Foreign Bank and Financial Accounts (FBAR). Information contained in FBARs can be used to identify or trace funds used for illicit purposes or to identify unreported income maintained or generated abroad. Notably, FBAR reporting applies to US citizens themselves with foreign accounts, in addition to non-US citizens who are resident aliens with foreign accounts[13].

In addition to FBAR reporting, when a resident alien's (or a US citizen's) foreign assets are more than $50,000, complying with the Foreign Account Tax Compliance Act (FATCA) becomes mandatory as well. The resident alien needs to attach Form 8938 to his or her annual tax return. Like FBAR, the Foreign Account Tax Compliance Act (FATCA) is an effort to combat tax evasion by US persons holding accounts and other financial assets offshore[14].

For most individuals that simply have an overseas account for legitimate reasons, including convenience and access, the FBAR and FATCA reporting requirements are burdensome but do not, in themselves, raise any red flags for the IRS. However, not filing FBAR/FATCA returns when required to do so, or willfully not reporting assets on a return, attracts some of the heaviest penalties in the tax code, including forfeiture of up to half the relevant account balance and even jail time where the non-compliance is deemed willful and prolonged.

12 IRS Publication 519
13 Form 114 IRS Instructions
14 Form 8938 IRS Instructions

Form 5471 for Resident Aliens16

The Form 5471 is filed on an annual basis by a U.S. shareholder (which includes Resident Aliens) that owns at least 10% of the vote or value of a Controlled Foreign Corporation (CFC). The Form 5471 is also required to be filed in a year when a U.S. shareholder (including a Resident Alien) acquires or disposes of a 10% ownership interest in a foreign corporation, even if the corporation is not a CFC.

Additionally, a nonresident alien must file a Form 5471 in a year when the individual becomes a U.S. tax resident while owning at least 10% of a foreign corporation. A U.S. resident (including a resident alien) who is an officer or director of the foreign corporation must file the Form 5471 in a year when any U.S. resident acquires at least a 10% ownership of a foreign corporation. A U.S. resident that controls (>50% by vote or value) a foreign corporation must file the Form 5471 every year. There are different attribution of ownership rules that may apply in determining control for the Form 5471 reporting and whether a foreign corporation is a CFC.

To be considered a CFC in the U.S., more than 50% of the vote or value must be owned by U.S. resident shareholders, who must also own at least 10% of the company. U.S. resident shareholders of CFCs are subject to specific anti-deferral rules under

Form 5472 Foreign owned US Companies[15]

LLCs and C corps with at least 25% foreign shareholders (i.e. NRAs) or partners must file the information return Form 5472 for every year with reportable transactions. The corporation, not the individual owner or shareholder, files this form. Any penalties would be assessed to the US corporation.

A single-member foreign-owned LLC is a Disregarded Entity for tax purposes, meaning that all income flows through to the owner. For the purpose of Form 5472 however, the LLC must file Form 5472 together with a pro-forma Form 1120 (usually used for corporations) by the due date.

The 2017 TCJA substantially increased the 5472 penalties for not filing or filing a Form deemed substantially incomplete, from $10,000 to $25,000 per year per form. The penalty also applies for failure to maintain the required records.

The foreign-owned company must list all reportable transactions on form 5472. The IRS defines a “Reportable Transaction” very broadly. Basically, it includes any type of activity between a NRA foreign owner and the US corporation, with no limit in value. For example: the exchange of money or property, including payments, rental income, sales transactions, remuneration, commission payments, capital contributions and capital reduction as well as loans and/or interest payments between the corporation and a foreign own. If you are a NRA and you receive money from a US LLC into your personal account, contribute money to the LLC (capital contributions), pay for an expense on behalf of the LLC (such as the franchise tax or registered agent fees) or have any transactions involving the LLC, you need to file 5472. Furthermore, for this form you need to calculate the asset value at the end of the year. An LLC owned by a NRA must first obtain a US Employer Identification Number (EIN) to complete Form 5472. Unfortunately, you cannot e-file Form 5472. You must submit it by pape

15 Form 5471 IRS Instructions

Dividends received by Resident Aliens from foreign corporations

All dividends received by a resident alien are subject to US taxation in the normal way (same as any US resident) with a credit available for any withholding taxes suffered. Because dividends are paid out of post-tax corporate profits there is no mechanism available in the US to off-set expenses against this income because they would properly have been charged in the corporate profit and loss account. Furthermore there are reporting requirements where a resident alien acquires or disposes of a 10% shareholding in a foreign company (Form 5471).

[4] REAL ESTATE INTERNATIONAL TAX ISSUES

Non-US residents (NRA) have to pay U.S. tax on rental income generated by their U.S. real estate[16]. NRA investors in U.S. real estate have two options when it comes to paying taxes on income from rental properties:

1. The investor elects to have 30% withholding taken from each gross rental payment they receive. A withholding agent – usually the property manager – collects the tax and then forwards it directly to the IRS. If an income tax treaty exists between the U.S. and the investor's country of residence the 30% withholding rate may be reduced.
2. The investor agrees to prepare a U.S. tax return to report the rental income earned each year. (Just like a U.S. investor would need to do). To do so, the investor needs to apply for an Individual Taxpayer Identification Number (ITIN) using Form W-7 and submits it, usually when filing the tax return. A Form W-8ECI will also need to be filled out (called a "NET election") and sent to the withholding agent, which is usually the property manager.

The second option requires more work. It does however allow you to deduct all ordinary and necessary expenses incurred while operating the rental property. Common deductible expenses include mortgage interest, real estate taxes, advertising, cleaning and maintenance expenses, and property management fees and depreciation. Accelerated depreciation can maximize these deductions often resulting in a dramatically reduced US tax liability.

Any rental income left after deducting all qualifying expenses will then be subject to ordinary income tax rates, which may be far less than the standard 30% withholding rate of the first option.

Sales of US Real Estate By Foreign Owners

The Foreign Investment Real Property Tax Act (FIRPTA) imposes taxes on nonresident aliens and foreign corporations when they have Effectively Connected Income (ECI). ECI is income that an individual or entity makes when engaged in a trade or business within the U.S. The gain from selling a U.S. property qualifies as such income. The tax applies not only to individuals who are non-U.S. citizens or residents but also to foreign companies. It also includes the stock held in a US holding corporation that owns real estate[17].

FIRPTA withholding rates may vary depending on the ownership and the nature of the real property interest disposition. When a foreign person, partnership, trust or estate disposes of U.S. real property, the withholding will be 15% of the fair market value (sales price). However, the 15% automatic withholding for FIRPTA is not supposed to exceed the actual tax liability. The investor can apply for reduced withholding through form 8288-B requesting a withholding certificate. Foreign corporation - A foreign corporation that disposes of real property

16 Taxation of Foreign Nationals by the US – Deloitte 2019

17 IRS Publication 515 and Form 8288 Instructions

and distributes to the foreign shareholder will withhold 21% of the gain from the sale.

U.S. partnership - If a domestic U.S. partnership disposes of real property there is no 15% withholding. However the partnership must pay 35% of the gain that is allocable to the foreign partner.

U.S. corporation - Domestic U.S. corporations with foreign shareholders will not have any FIRPTA taxes imposed on the disposition of real property. Rather, it will pay corporate tax rates on the gain at the rate of 21%.

The mandatory FIRPTA tax withholding is usually coordinated with the sellers and the escrow company. The escrow agent will withhold the prescribed amount and forward it to the IRS on the seller's behalf. To achieve this, foreign sellers must obtain tax identification numbers. Entities need to submit a Form SS-4 application to request an Employer Identification Number (EIN). For individuals the process is a bit more complicated and involves applying for an Individual Taxpayer Identification Number (ITIN) using Form W-7.

Planning Point**:** If the foreign investors acquire and own the property through a U.S. C-corporation, they pay the corporate tax rate of 21% upon selling the property. After that they can dissolve the corporation without US capital gains tax.

Foreign Real Estate owned by Resident Alien

Same as for US residents – Gross rentals fully taxable with deduction for any expenses associated with the rental activity.

If the real estate is owned by a foreign corporation/partnership and the Resident Alien receives dividends/profit share from that corporation/partnership, then these are fully taxable in the US as normal dividends/profit share with a credit for any withholding taxes deducted by the foreign country. Where the US resident shareholder is a more than 10% shareholder in the foreign corporation/partnership then there may be further reporting requirements – See Section 3 Reporting of Foreign Assets.

[5] GIFT AND ESTATE TAX

The federal Estate Tax and the Gift Tax in the US are always paid by the donor (i.e., the person making the bequest or gift), not the recipient. But the exact tax impact of estate and gift tax transfers also depends on whether the donor and donee are US Citizens, Resident Aliens or Non Resident Aliens – it also matters greatly whether the assets transferred are US situs assets or non-US assets. The full matrix of possibilities for both estate and gift tax is reproduced in the accompanying table at the end of this article[18]. Note that where a NRA donor or decedent makes bequests or gift of US situs property to a non US citizen (including resident aliens), the thresholds before gift or estate tax become payable can be as low as $60,000 (estate tax), $157,000 (annual spousal gift) and $15,000 (annual non-spousal gift) - so great care needs to be taken when US situs assets are the subject of transfer from a NRA to a non-US citizen. This can be contrasted with the treatment of a NRA transferring non-US situs assets – in this situation no estate tax or

18 IRC Section 2001-2209 Estate Tax and IRC Section 2501-2524 Gift Tax

gift tax liability arises in any situation.

In terms of what constitutes US situs assets, US real estate will be regarded as having a US situs. Cash in domestic US bank accounts is generally regarded as a having a US situs for Gift Tax purposes (but not for estate tax purposes) – therefore care should be taken with gifts of US bank cash. Where a NRA needs to make gifts of cash in excess of $15,000 per recipient and $157,000 (spousal recipient) the cash gift should not take place from a US bank account, but be made at the up-stream level (i.e. at off-shore bank level).

Form 3520

It should be noted that there are reporting requirements (even where no tax is due) when NRAs, foreign trusts or foreign companies make gifts to US residents. If you are a U.S. person, including a resident alien, who received foreign gifts of money or other property, you may need to report these gifts on Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts[19]. Form 3520 is an information return, not a tax return, because foreign gifts are not subject to income tax. However, there are significant penalties for failure to file Form 3520 when it is required.

Include on Form 3520 gifts or bequests valued at more than $100,000 from a nonresident alien individual or foreign estate (including foreign persons related to that nonresident alien individual or foreign estate) as well as gifts valued at more than $16,076 for 2018 (adjusted annually for inflation) from foreign corporations or foreign partnerships (including foreign persons related to the foreign corporations or foreign partnerships).

You must aggregate gifts received from related parties when calculating the $100,000 threshold. A gift to a U.S. person does not include amounts paid for qualified tuition or medical payments made on behalf of the U.S. person.

International tax planning is extremely difficult to navigate so you may want to reach out to our tax experts to avoid any pitfalls or costly mistakes. Contact us for additional tax questions you may have as you and your family go through personal and professional transitions.

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19 Form 3520 – IRS Instructions

GIFT AND ESTATE TAX CHART

United States Gift Tax	To: US Citizen	To: US Resident (Green Card Holder)	To: Non Resident Alien
From: US Citizen	Spouse: Unlimited Marital Deduction Others: Annual Exclusion: $15,000 Applicable Exclusion Amount: $11,580,000	Spouse: Annual Exclusion: $157,000 Applicable Exclusion Amount: $11,580,000 Others: Annual Exclusion: $15,000 Applicable Exclusion Amount: $11,580,000	Spouse: Annual Exclusion: $157,000 Applicable Exclusion Amount: $11,580,000 Others: Annual Exclusion: $15,000 Applicable Exclusion Amount: $11,580,000
From: US Resident (Green Card Holder)	Spouse: Unlimited Marital Deduction Others: Annual Exclusion: $15,000 Applicable Exclusion Amount: $11,580,000	Spouse: Annual Exclusion: $157,000 Applicable Exclusion Amount: $11,580,000 Others: Annual Exclusion: $15,000 Applicable Exclusion Amount: $11,580,000	Spouse: Annual Exclusion: $157,000 Applicable Exclusion Amount: $11,580,000 Others: Annual Exclusion: $15,000 Applicable Exclusion Amount: $11,580,000
From: Non-Resident Alien (US Situs Property)	Spouse: Unlimited Marital Deduction Others: Annual Exclusion: $15,000 No Applicable Exclusion Amount	Spouse: Annual Exclusion: $157,000 No Applicable Exclusion Amount Others: Annual Exclusion: $15,000 No Applicable Exclusion Amount	Spouse: Annual Exclusion: $157,000 No Applicable Exclusion Amount Others: Annual Exclusion: $15,000 No Applicable Exclusion Amount
From: Non-Resident Alien (Non-US Situs Property)	No US Gift Tax Applied	No US Gift Tax Applied	No US Gift Tax Applied

United States Estate Tax	To: US Citizen	To: US Resident (Green Card Holder)	To: Non Resident Alien
From: US Citizen	Spouse: Unlimited Marital Deduction Others: Applicable Exclusion Amount: $11,580,000	Spouse: Applicable Exclusion Amount: $11,580,000 Others: Applicable Exclusion Amount: $11,580,000	Spouse: Applicable Exclusion Amount: $11,580,000 Others: Applicable Exclusion Amount: $11,580,000
From: US Resident (Green Card Holder)	Spouse: Unlimited Marital Deduction Others: Applicable Exclusion Amount: $11,580,000	Spouse: Applicable Exclusion Amount: $11,580,000 Others: Applicable Exclusion Amount: $11,580,000	Spouse: Applicable Exclusion Amount: $11,580,000 Others: Applicable Exclusion Amount: $11,580,000
From: Non-Resident Alien (US Situs property)	Spouse: Unlimited Marital Deduction Others: Applicable Exclusion Amount: $60,000	Spouse: Applicable Exclusion: Amount: $60,000 Others: Applicable Exclusion Amount: $60,000	Spouse: Applicable Exclusion Amount: $60,000 Others: Applicable Exclusion Amount: $60,000
From: Non-Resident Alien (Non-US Situs Property)	No US Estate Tax Applied	No US Estate Tax Applied	No US Estate Tax Applied

Disclosures

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