Moving to the United States

U.S. Tax Planning for Foreign Individuals

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Table of Contents

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Introduction

Moving to the United States – Making the Right Moves

Non-United States (U.S.) citizens who expect to become subject to U.S. tax as a result of moving to the U.S. or applying for a green card can often take simple steps to limit their U.S. tax exposure. Andersen can help such individuals distinguish between necessary action items from burdensome tasks that are ultimately not required. In addition, Andersen can identify the foreign tax implications of strategies or actions that must be considered in conjunction with U.S. tax implications.

Below is an overview of the U.S. tax system, how tax residency in the U.S. is determined and tax filing requirements. Examples and case studies highlight planning strategies, potential opportunities as well as traps for the unwary.

Examples of Common Tax Strategies Prior to Establishing U.S. Federal Tax Residence

1. Sell appreciated assets that would not generate a U.S. source gain (even if immediately re-acquired).
2. Refinance or pay down debt denominated in foreign currency or dispose of/*wash* foreign currency if currently in *exchange-rate gain* position when compared to the U.S. dollar.
3. Exercise stock options related to the performance of services outside the U.S.
4. For purposes of stock options, consider making elections under Sec. 83(b) within 30 days of the grant of restricted property for the performance of personal services (particularly if zero value at grant or if compensation recognized upon election is related to services performed outside the U.S.).
5. Delay actions that may result in a tax loss or deduction if deferred until the U.S. resident (e.g., sale of investment/business assets at a loss, payment of deductible interest or taxes, contributions to U.S. charities (and certain foreign charities via treaty)), actions resulting in U.S. tax credits, etc.
6. Dispose of non-U.S. accounts or interests that may result in U.S. foreign information filing requirements and/or adverse consequences (e.g., passive foreign investment companies, controlled foreign corporations, foreign pensions, foreign life insurance policies, foreign trusts, etc.).
7. Individuals may take steps to accelerate, delay, or avoid U.S. residency for such purposes as well.
8. Determine if any timely tax elections are necessary that may limit U.S. tax exposure currently or in the future. For example, non-U.S. persons from Canada may make an election under the U.S./Canada treaty to limit double taxation that may otherwise occur because of the Canadian exit tax.

Several of these examples are discussed below.

U.S. Tax System Is Complex: Here Are the Basics

U.S. citizens and non-U.S. citizens who are subject to U.S. tax (tax residents or resident aliens) are subject to income taxes on worldwide income and, typically, transfer taxes on their worldwide assets. Most green card holders are considered U.S. tax residents for income tax purposes, with certain exceptions for those residents in countries that have an income tax treaty who choose to claim treaty benefits. U.S. citizens and tax residents remain subject to U.S. federal income tax wherever they reside in the world and may suffer an exit tax (and other related consequences) if they change such status.

Nonresident aliens, on the other hand, are generally only subject to tax on income that is effectively connected with a U.S. trade or business and on other income from U.S. sources (with certain exceptions). Effectively-connected income (ECI) is typically taxed at graduated rates (up to 37%) to nonresident aliens while non-ECI is typically taxed at a flat rate of 30%. Exceptions apply under domestic law and may be available via treaty depending on circumstances.

U.S. citizens, tax residents, and nonresident aliens may be subject to the alternative minimum tax (AMT).

U.S. citizens, residents, and nonresident aliens are entitled to various deductions and credits (including foreign tax credits) though more limitations, and fewer categories are available to nonresident aliens. Full-year U.S. citizens and residents are entitled to claim either itemized deductions or a standard deduction, whichever is higher, while nonresident aliens and part-year residents are not entitled to the standard deduction (unless available via treaty).

Non-US citizens who are not domiciled in the U.S. are subject to U.S. gift and estate tax only on certain U.S. situs assets, real or tangible.

Most states and the District of Columbia impose separate income taxes, as do certain local jurisdictions. Some states also impose estate, gift, and/or inheritance taxes. Personal and real property taxes are also common at the state and local levels. Social Security and Medicare taxes generally apply to *earned income* at the federal level, with certain exceptions. Each of these is outside the scope of this overivew.

Federal Income Tax Rate Comparison			
	2020	**2021**	**2022**
Maximum Rate	40.8%*	40.8%*	40.8%*
Long-Term Capital Gains (>12 months) and Qualified Dividends	23.8%*	23.8%*	23.8%*

* Includes additional 3.8% Tax on Net Investment Income above an applicable threshold, depending on filing status (but not applicable to nonresident aliens)

Overview of Federal Estate, Gift, Generation-Skipping Transfer (GST) Taxes for Individuals Domiciled in the U.S.			
	2020	**2021**	**2022**
Lifetime Gift and Estate Tax Exclusion*	$11.58 million	$11.70 million	$12.06 million
Lifetime GST Exclusion	$11.58 million	$11.70 million	$12.06 million
Gift Tax Exemption (per year, per donee)	$15,000	$15,000	$16,000**
Maximum Estate/Gift Tax Rate	40%	40%	40%

* For those non-U.S. citizens not domiciled in the U.S., the estate tax exemption is limited to $60,000 and there is no gift tax exemption.
** $164,000 for gifts to spouses who are not U.S. citizens.

It is notable that increases in certain rates and reductions in exclusion amounts have been proposed; however, as of the date of this guide it is expected that these would take effect January 1, 2022 at the earliest.

For federal income tax purposes, individual rate schedules and limitations often vary based on filing status. Individual taxpayers may file as single, married filing jointly, married filing separately, and head of household. Married individuals cannot file as single even if married to a nonresident alien spouse who has no U.S. presence or tax filing requirement. Both spouses must file as full year U.S. citizens or residents to qualify for married filing joint filing status (elections may be available to qualify as full year resident discussed further below).

Residence

Know Your Residency Status (Including How to Delay or Avoid U.S. Tax Residence)

An individual who is not a U.S. citizen is treated as a U.S. tax *resident* (also known as a *resident alien*) during a particular taxable year, and, hence, is subject to U.S. federal income tax on a worldwide basis (unless an applicable treaty provides otherwise), if such individual (i) is a *lawful permanent resident of the U.S* at any time during the calendar year (the *green card test*), (ii) satisfies the *substantial presence test* discussed below, or (iii) via an election to be treated as a U.S. tax *resident*. Once a non-U.S. citizen becomes a U.S. tax *resident*, that individual is generally taxed on worldwide income and gains until and unless such status is terminated.

The *Green Card Test*

In general, an individual is treated as a *lawful permanent resident of the U.S.* at any time if:

- Such individual has the status of having been lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with the immigration laws, and
- Such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

Once an individual has been granted an alien registration receipt card (i.e., a green card) in accordance with the U.S. immigration laws, resident status is deemed to continue (typically until Form I-407, *Record of Abandonment of Lawful Permanent Resident Status,* is filed). Expiration of the green card without Form I-407 is not relevant for purposes of the *green card test*.

The *Substantial Presence Test*

The most common manner of establishing federal tax residence for non-U.S. citizens without green cards is via the *substantial presence test* under Sec. 7701(b)(1)(A)(ii). The *substantial presence test* is typically met for a calendar year if the individual is present in the U.S. for at least 31 days during the year, and the number of days present in the U.S. is at least 183 when counting all days of U.S. presence in the current year, 1/3 of those in the preceding year, and 1/6 of those in the 2nd preceding year. Any portion of a day between midnight and midnight is considered a day for these purposes. Subjective criteria such as domicile, intent, tax home, and close connections are not relevant to the *standard substantial presence test*. While on its face this test is basic, special rules and exceptions apply.

Not all Physical Presence Is Counted

1. Days of presence as an *exempt individual* are not counted, typically for those present in the U.S. on certain types of visas. Presence in the U.S. as a **student, teacher, trainee, diplomat, international organization employee**, and accompanying family members of such individuals are often considered *exempt individuals* while in the U.S. if relevant requirements are met. Obtaining one visa type over another can thus have a material impact on how much time an individual can spend in the U.S. without triggering residence under the *substantial presence test*. Type A, F, G, and J visas often carry preferred tax treatment.
2. Those expected to leave the U.S., but who are unable to because of a **medical condition** that arose while present in the U.S., are not counted if requirements are met.
3. Temporary presence in the U.S. for less than 24 hours while in transit between two points outside the U.S. (e.g., **a layover in the U.S.** while traveling between foreign countries) is not counted as U.S. presence.
4. **Commuters from Canada or Mexico**, who reside in either country but work in the U.S. and cross the border regularly for work are not considered present in the U.S. on commuting dates if requirements are met.
5. **Regular crew members of foreign vessels engaged in transportation** are not considered present in the U.S. while temporarily present solely for such purposes.
6. **Disaster or other special relief** may be available. For example, special exceptions were provided for certain days during 2020 because of the COVID-19 pandemic.

Special forms are typically required to document qualification to not count days of presence for purposes of the *substantial presence test* (e.g., Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition*).

Closer Connection Exception

If days of presence counted for purposes of the *substantial presence test* result in the *general* test being met, an individual may nonetheless qualify as a nonresident alien for a tax year under the ***closer connection exception*** if requirements are met. In general, to meet this exception the individual must have less than 183 *counted* days of presence in the current taxable year, and the individual must have a tax home in a foreign country and a closer connection to that country than the U.S. for the entire tax year (a move from one foreign country to another during the year may be permitted). Further, at no time during such year may the individual, (i) have an application for adjustment of status pending, or (ii) take other steps to apply for status as a *lawful permanent resident of the U.S.*

For this purpose, an individual's *tax home* is generally the country in which their regular or principal (if more than one) place of business is located, or, in the absence of such regular or principal place of business, the individual's regular place of abode. If the individual has neither a permanent place of business nor a permanent place of abode, the individual's *tax home* is the country where the individual works.

A foreign individual who wishes to avoid U.S. *resident* status based on the *closer connection exception* must attach a completed IRS Form 8840, *Closer Connection Exception Statement for Aliens*, to the individual's U.S. federal income tax return for the applicable taxable year, or, if no such return is required to be filed, file such form with IRS by the due date for filing IRS Form 1040NR, *U.S. Nonresident Alien Income Tax Return*.

For those filing under the *closer connection exception* via Form 8840, nonresident alien status is respected for foreign information reporting and other requirements (e.g., Report of Foreign Bank and Financial Accounts (FBAR) on FinCEN Form 114; Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations;* Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund;* Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation;* Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships; Form* 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)*; Form 8938, *Statement of Foreign Financial* Assets; etc.)

Treaty Tie-Breaker

Individuals considered resident aliens by reason of the *substantial presence test* or the *green card test* may also qualify to file as a nonresident alien for all or a portion of a tax year if considered a **resident of a treaty country** (as defined under the treaty) for such period and certain other requirements are met. This is typically via certain residency *tie-breaker* provisions, based on a series of tests with each being relevant only if the previous is not determinative. The typical treaty tie-breaker article provides that the individual:

a) Shall be deemed to be a resident of the State in which the individual has a permanent home available to them; if the individual has a permanent home available to them in both States, the individual shall be deemed to be a resident of the State with which the individual's personal and economic relations are closer (center of vital interests);

b) If the State in which the individual has their center of vital interests cannot be determined, or if the individual does not have a permanent home available to them in either State, the individual shall be deemed to be a resident of the State in which the individual has a habitual abode;

c) If the individual has a habitual abode in both States or in neither of them, the individual shall be deemed to be a resident of the State of which the individual is a national; and

d) If the individual is a national of both States or of neither of them, the competent authorities of the contracting States shall settle the question by mutual agreement.

No maximum number of U.S. days is prescribed to qualify as a foreign resident under a treaty, the individual may have a U.S. tax home, and less detailed personal information must be disclosed on the required Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, versus that required on Form 8840 (though qualification for each is clearly different).

First and Last Year of Residence

Non-U.S. citizens may be U.S. tax residents for all or a portion of a tax year. An individual who meets the *substantial presence test* for a tax year (and does not claim the *closer connection exception*), and who does not have a green card, typically starts U.S. residence on the first day of presence counted for purposes of the *substantial presence test*. De minimis presence during trips to the U.S. that do not exceed (in aggregate) 10 days can, but are not required to, be disregarded if the individual has a foreign tax home and a closer connection to a foreign country than the U.S. during such trips. Individuals who qualify for a residency start date under the *substantial presence test* may delay taxation as a residence further via treaty tie-breaker (if requirements are met).

Note that those individuals who qualify as a U.S. resident for any portion of the current year, who were U.S. residents for any portion of the previous tax year, are subject to a *no-lapse* rule whereby residence continues during the intervening period that may otherwise qualify for nonresident alien status under U.S. domestic law. Those residents in treaty countries during such period may, however, qualify to *tie-break* out of U.S. residence triggered via the no lapse rule.

Additionally, non-U.S. citizens who were U.S. residents in any part of at least three consecutive years who cease U.S. residence but re-establish resident status before the close of the third calendar year beginning after the close of the initial residence period are subject to an alternative tax regime during the intervening period as a nonresident alien.

Non-U.S. citizens who are residents under the *substantial presence test* and/or via a green card, typically have a *default* residency termination date of December 31st of the last year of residence if they do not meet either test the following year. An early residency termination date may be available based on criteria similar to that for establishment of residence. For example, the last day of presence (notwithstanding trips that do not exceed 10 days in aggregate) may be established as the residency termination date for those meeting the *substantial presence test*, and the last day with a green card (i.e., the date Form I-407 is filed) may be established as the residency termination date if, for the remainder of the tax year, the individual has a tax home in a foreign country and a closer connection to that country than the U.S. for the remainder of the year. Treaty tie-breaker may also be utilized to terminate tax residency during such period based on alternate criteria and procedures.

Elections Into U.S. Residence

A non-U.S. citizen is not entitled to file Form 1040, *U.S. Individual Income Tax Return*, as a resident alien unless the individual qualifies as a resident via 1) a green card, 2) the *substantial presence test*, or 3) by reason of certain elections. U.S. residence status may be preferred for certain taxpayers, for example as a result of available losses, deductions, credits, graduated versus flat tax rates on income not effectively connected with a U.S. trade or business, and joint filing status not otherwise available to nonresident aliens. Non-U.S. citizens not qualifying as U.S. residents under one of the specified three methods are not technically entitled to file Form 1040 as U.S. residents.

Two Primary Types of Elections Into U.S. Residence are Available

One is the ***first-year election*** for an individual who does not meet the *substantial presence test* or hold a green card during the current year but who does meet the *substantial presence test* for the following year. An individual in this category may elect to establish U.S. residence during the current year if present in the U.S. (considering only days that count toward the *substantial presence test*) for at least 31 consecutive days for the current year and if present in the U.S. for at least 75% of the *testing period*, beginning with the first day of the 31 consecutive day period and ending with the last day of the election year. Specific election and other rules apply as specified under Sec. 7701(b)(4).

The other types of residence elections are available for **individuals married to U.S. citizens or residents as of the last day of the tax year** (typically December 31) but either spouse is not otherwise considered a U.S. resident for the entire tax year. These elections result in both spouses qualifying as U.S. citizens or residents for the entire tax year. Section 6013(g) provides an election where one spouse qualifies as a nonresident alien as of the last day of the tax year, whereby Sec. 6013(h) provides an election where at least one spouse is otherwise a part-year resident alien (as long as a resident on the last day of the year). The Sec. 6013(g) election remains in effect for both spouses until and unless revoked (though is suspended for years both spouses are considered nonresident aliens the entire tax year) and can be made only once by either spouse. It is extremely important for individuals who have made the election to file a revocation statement with the U.S. tax return for the first year (or portion of year) if nonresident alien status is available and desired (assuming the electing spouse is not also a nonresident alien for the entire tax year). Treaty tie-breaker rules cannot override residence as a result of this election. A Sec. 6013(h) election can be made only once by either spouse and applies only for the year of the election.

Individuals who are U.S. resident aliens only by reason of election may not be considered U.S. residents under the provisions of an income tax treaty.

Case Study #1 – Residency Under the Substantial Presence Test: Single Individual

- Assume A relocates to the U.S. from Germany on July 15, 2021, and A remains in the U.S. beyond 2021.
- A was in the U.S. for 45 days in 2020 and 60 days in 2019.
- A spent seven days in the U.S. in March 2020.
- A is not considered an *exempt individual* for any day.
- German income tax residence was terminated July 15, 2021.
- A is not married.

Under the *substantial presence test*:

  - A has 177 days in 2021 (seven days in March plus July 15 – December 31).
  - A has 15 days in 2020 (1/3 of 45).
  - A has 10 days in 2019 (1/6 of 60).
  - Total of 202 days = ***Resident.***

U.S. residency start date: July 15, 2021. The trip in March 2020 can be disregarded for purposes of the residency start date as it is less than 10 days, assuming A had a tax home in Germany and a closer connection to Germany throughout the trip (if desired).

Case Study #2 – Residency Under the Substantial Presence Test – Married Couple

- B and B's spouse have never applied for green cards, have never held U.S. citizenship, and have never made elections to be treated as U.S. residents. They are not legally separated.
- Assume B is present in the U.S. 160 days in 2021, 60 days in 2020, and 60 days in 2019, and that no days qualify as *exempt days* for purposes of the *substantial presence test*.
- B's first trip to the U.S. during 2021 was a two-week trip starting February 28th.
- Under the *substantial presence test*:
  - B has 160 days in 2021 (100% of 160).

- B has 20 days in 2020 (1/3 of 60).
- B has 10 days in 2019 (1/6 of 60).
- Total of 190 days = ***Resident***.

- Also assume that B remained a tax resident of Austria for all of 2021 (within the meaning of Article 4, Residence, of the U.S./Austrian Income Tax Treaty), was present in Austria all non-U.S. days, and maintained a primary residence in Austria and closer connections to Austria than the U.S. throughout 2021. B resided with B's spouse while in Austria.
- B's spouse remained in Austria the entire 2021 calendar year.

U.S. residency start date: Several alternatives are possible in this case, including:

1. February 28, 2021. This is the residency start date under general rules if no elections are made. Since B's first trip to the U.S. during 2021 exceeded 10 days, no de minimis presence exception is available. B would file a dual-status return using married filing separate filing status.
2. January 1, 2021. An election with B's spouse under Sec. 6013(g) would result in both B and B's spouse being considered full-year residents for 2021. B may file jointly with B's spouse or as married filing separately.
3. Full-year nonresident alien. This may be possible under either the *closer connection exception* (by filing Form 8840) or via treaty tie-breaker based on Austrian residence under Article 4 of the U.S./Austria Income Tax Treaty (Form 8833 required). B may prefer one over the other, e.g., considering information required on Form 8840 versus Form 8833, and impact on foreign information filing requirements (e.g., FBAR; Form 926, *Return by a U.S. Transferor of Property to a Foreign* Corporation; Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign* Gifts; Form 5471; 8621; 8858; 8865; 8938).
4. Any other day during 2021 after February 28th. Because B qualifies to file as a nonresident alien via treaty for the entire 2021 calendar year, B can choose any day during 2021 that B would be considered a U.S. resident under domestic law to claim nonresident alien status via treaty. Technically this may be starting and ending on any day that B qualifies.

Residency Status and Estate and Gift Taxes

Unlike the income tax residency rules, residence status for non-U.S. citizens for gift and estate tax purposes is determined based purely on domicile. Depending on circumstances, it may be beneficial to be a U.S. citizen or domiciliary versus a nonresident alien for transfer tax purposes. As domicile is often subjective because it is based on the intent of the taxpayer along with other factors, IRS may challenge a position of U.S. or foreign domicile whereby the taxpayer will bear the burden of proof for the position. For example, a move to the U.S. along with actions that imply an intention to remain in the U.S. indefinitely such as discontinuing ties with the home country. In addition, applying for U.S. citizenship or a green card could be considered evidence of U.S. domicile for U.S. estate and gift taxes.

U.S. citizens and domiciliaries are entitled to a combined estate and gift tax exemption of up to $12.06 million in 2022; however, for those non-U.S. citizens not domiciled in the U.S. this is limited to $60,000, applies for purposes of the estate tax only, and only on the transfer of U.S. situs assets. Certain special rules and exceptions apply.

Individuals may also pass assets to their spouse via gift or bequest at death. However, this is only possible if the recipient spouse is a U.S. citizen. A transfer to a spouse who is not a U.S. citizen is eligible for an annual exemption amount of $164,000 (2022 threshold). The annual exemption for transfers to non-spouses is $16,000 in 2022.

Pre-Residency Income Tax Planning

Consider Accelerating or Deferring Income

Nonresident alien individuals moving from a jurisdiction with a lower tax rate than the U.S. may consider accelerating the recognition of income — such as dividends paid by closely held foreign corporations or deferred compensation for services performed outside the U.S. — prior to becoming a *resident*. In this way, the individual may avoid being taxed at higher U.S. rates. Conversely, if moving from a jurisdiction with a higher tax rate, individuals may consider deferring recognition of the income until after they move to the U.S. (the effect of deferring the income in the current country should also be considered).

Realize Gains or Defer Losses

While timing of many types of income recognition is often limited (e.g., those who have control over timing of payments, those with vested stock options eligible for exercise, those where elections may be made), the timing of when to realize capital gains or losses can usually be more flexible.

The same objective applies when deciding whether to accelerate the gain or loss; however, it is important to note that, absent a specific treaty article, capital gains realized once you are a U.S. tax *resident* typically carry the original cost basis determined in U.S. dollars using exchange rates at the date of acquisition. For example, someone who bought XYZ stock several years ago for $2 (denominated in U.S. dollars) and established U.S. residence before selling it for $50 will pay U.S. capital gains tax on the entire $48 gain, not just the portion that occurred after U.S. residency was established. Further, an individual who bought UK stock several years ago for £50 when the dollar-to-pound exchange rate was 1:1.9 but sells for £55 as a U.S. resident when the dollar-to-pound exchange rate is 1: 1.4 would realize a U.S. capital loss of $18 (even though a £5 gain). [(50*1.9)-(55*1.4)=18]. The same U.S. tax result would apply if the taxpayer were a U.S. resident at both acquisition and sale of the UK stock.

Case Study #3 – Realizing Capital Gain Before Becoming a U.S. Resident

- H is a nonresident alien living abroad. In 2022, H will obtain a green card and move to the U.S. H has $5 million of unrealized gain in appreciated securities that H is considering selling.
- <u>Potential planning</u>: Depending on how H's home country determines and taxes gains from the sale of securities, it may be beneficial to sell the stock in 2021 prior to becoming a U.S. *resident* in order to avoid subjecting the unrealized appreciation to U.S. income tax.

Case Study #4 – Delaying Recognition of Losses Until After Becoming U.S. Resident

- Assume the same fact pattern as Case Study 3, except that H instead has a $5 million unrealized loss in depreciated securities.
- <u>Potential planning</u>: H should consider the U.S. tax benefits of delaying recognition of the losses from the sale of the securities until after H becomes a U.S. *resident* in 2022 (or otherwise accelerating H's U.S. residency start date). This is particularly true if H would not be entitled to a tax benefit in H's home country related to the loss.

Case Study # 5 – Timing Sale of Residence to Avoid Taxable Gain

- C, a nonresident alien individual, resided in London prior to moving to the U.S. and establishing U.S. tax residence. C had owned and resided in a UK principal residence for many years and placed it on the market for sale prior to moving to the U.S.
- The residence had been purchased for £2 million, with a £1.8 million mortgage that required interest-only payments (no payments to principal). At the date of purchase, the pound-to-dollar exchange rate was 1:1.9.
- The property was listed, and ultimately sold, for £2.2 million; however, the home did not sell, and C did not pay off the mortgage until after C had established U.S. tax residence. At the date of sale (and for two months prior to C's move), the pound-to-dollar exchange rate was 1:1.4.
- The loss on the sale of the home for U.S. tax purposes was $720,000 [(2.2 million*1.4) - (2.0 million*1.9) = $720,000), which was nondeductible as personal in nature.
- C recognized a gain for U.S. tax purposes of $900,000 (mortgage in U.S. dollars when obtained was $3.42 million (1.8 million*1.9), but at sale/payoff C was only required to pay $2.52 million (1.8 million*1.4). As a personal gain recognized as a U.S. tax resident, the $900,000 was taxable.
- With proper planning, C could have avoided the $900,000 taxable gain by 1) refinancing the property prior to C's U.S. move, 2) paying off the mortgage prior to the move, or 3) delaying the move or otherwise taking steps to delay U.S. tax residence or tax home establishment until after the home sold and mortgage was paid. *None of these would have changed C's UK tax consequences.*

Review Foreign Holdings

The U.S. tax rules that address foreign investments are complex and geared towards limiting the ability of U.S. citizens and *residents* to defer income taxes or to *hide* income offshore. This is achieved principally by maintaining full transparency through onerous reporting requirements with steep penalties for noncompliance.

It is crucial that individuals understand how foreign holdings will be taxed and reported, ideally prior to becoming a U.S. person (i.e., U.S. citizen or resident). For example, it is not uncommon for wealthy individuals outside of the U.S. to hold their investments through offshore companies. For nonresident aliens who hold such an interest in a foreign company, becoming a U.S. tax *resident* will likely have adverse tax consequences. The income may be taxed each year at the highest rates, even if no income is distributed. The same is true of many foreign pensions and life insurance policies.

Careful consideration should be given as to whether it makes sense to liquidate a foreign company or investment prior to becoming a U.S. *resident*, although that is often not practical and may carry a foreign tax. The same considerations may apply to foreign accounts and financial interests, even if no income is generated (e.g., non-interest-bearing foreign bank accounts), due to reporting requirements alone.

Subject to certain conditions, it may be possible to force a deemed liquidation by electing to treat the company as a pass-through entity such as a partnership for U.S. tax purposes. This has the same tax effect as if the company sold its assets thereby potentially getting a step up in the tax cost basis prior to becoming a U.S. resident while still maintaining the entity's legal form. In this way, the income is taxed each year but many of the complex reporting requirements associated with a foreign holding company may be avoided. One bonus: These rules only apply for U.S. tax purposes, a foreign country will typically not view this as a taxable event.

Case Study #6 – Entity Planning

- P is a nonresident alien and is planning to become a U.S. *resident alien* in the near future. P owns a foreign corporation, which holds several highly appreciated non-U.S. situs assets.
- Potential planning: P may benefit from a *check-the-box* election to treat the foreign corporation as a disregarded entity or partnership for U.S. tax purposes. If the election is made while P is a nonresident alien, the basis of the entity's assets may be stepped up to fair market value as of the date of the election without any U.S. or foreign income tax impact.

Pre-Domicile Transfer Tax Planning

Consider Gifting Assets Before Moving

Foreign nationals currently domiciled outside the U.S. who plan to be in the U.S. indefinitely or plan to obtain a green card and face particular exposure to estate and gift taxes on worldwide transfers may consider making an irrevocable gift of non-U.S. assets to a non-U.S. relative or a discretionary trust prior to moving.

Completed gifts should no longer be included in the giftor's U.S. taxable estate. This can be attractive for wealthy individuals whose estates will be in excess of the current $12.06 million lifetime exclusion (2022) from transfer tax for U.S. citizens and domiciliaries (and possibly lower threshold in later years). A gift of assets to a discretionary trust prior to moving will generally not use up any part of this lifetime exclusion. That said, income earned in the trust will probably remain taxable to the transferor unless the trust had been set up and funded more than five years prior to moving to the U.S.

Case Study #7 – Transferring Wealth Via a Revocable Foreign Grantor Trust

- A is a nonresident alien for U.S. transfer tax purposes with no intention of becoming a U.S. resident. A has substantial wealth held in foreign corporations, including operating companies, and A intends to leave their fortune to their child and grandchild who are both U.S. citizens.
- Potential planning: Instead of making outright gifts to the child or grandchild, which would bring the assets into the U.S. income tax net and likely subject the assets to inclusion in their respective U.S. taxable estates upon their death, A could consider transferring their shares in the foreign corporations to a revocable foreign grantor trust. The trust could continue for the life of the grandfather. During A's lifetime he would be treated as owner of the trust assets for U.S. tax purposes. Distributions to the child or grandchild during A's life would be treated in the same manner as gifts from a foreign person and not subject to U.S. gift tax as long as the transfer itself does not take place in the U.S. Those distributions would need to be reported by the recipient on a Form 3520. Additional planning should be considered in anticipation of A's death to optimize the tax treatment to preserve future estate tax deferral and/or transfer assets with a tax basis based on fair market value.

Non-Citizen Spouses May Consider Using a Trust

Individuals with spouses who are not U.S. citizens should consider the fact that the *unlimited marital deduction* for estate and gift tax purposes does *not apply unless the recipient spouse is a U.S. citizen* (a green card and/or U.S. domicile status is not sufficient). Individuals with non-U.S. citizen spouses may wish to consider the use of a Qualified Domestic Trust (QDOT) which effectively allows for a marital deduction upon death of the transferring spouse provided certain terms are met. Ultimately estate tax may still be due on the death of the recipient spouse but this mechanism can allow for a deferral of the U.S. transfer tax until that time.

State and Local Tax

In addition to the federal tax issues discussed above, individuals contemplating coming to the U.S. should be aware that the majority of U.S. states also administer taxes at the state and/or local levels. State residence rules are based on alternate criteria from federal; the *substantial presence test*, *green card test.* Federal residence elections are not directly relevant for state purposes. Most states determine residence based on physical presence and/or domicile and many contain exceptions. Some states, however, limit state income to that taxable at the federal level, whereby nonresident alien status at the federal level may limit state tax.

The rules for determining when an individual is a resident in a specific state and how residents and nonresidents are taxed vary greatly so anyone considering a move to, or to extend presence in, the U.S. should seek further guidance in these areas. The same is true of investments in real estate in such locations.

Final Thoughts

It is important for non-U.S. citizens considering extended presence in the U.S. or a green card to weigh any tax planning ideas against personal and business objectives. In addition, careful consideration regarding U.S. tax treaties and income, transfer, and property tax and laws in other countries is imperative. An Andersen advisor can help you weigh the various factors and develop an effective strategy.

For more information, visit *Individual & Families with International Wealth* on andersen.com or contact the authors, Clarissa Cole, David Roberts or Len Schneidman.