AN ENGLISHMAN IN NEW YORK – TAX CONSIDERATIONS FOR FOREIGN INDIVIDUALS[1]

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BACKGROUND

The phrases "green card" and "U.S. citizen" have the ability to strike panic and even terror in tax advisors around the world. It is well known that the U.S.'s Internal Revenue Service ("I.R.S.") casts a wide – indeed worldwide – net with regards to the tax obligations of U.S. persons, which include lawful permanent residents (or "green card holders") and U.S. citizens. Less well known, and often misunderstood, are the tax consequences imposed on those with non-immigrant status, those holding ownership of foreign corporations, and on U.S. property.

WHAT IS TAX RESIDENCY IN THIS CONTEXT?

Any foreign individual present in the U.S. on a temporary, non-immigrant basis should determine their U.S. tax residency.

How Does the "Substantial Presence Test" Work in Practice?

Even if a foreign individual does not become a green card holder, a foreign individual can become a U.S. tax resident if they are present in the U.S. for 183 days or more during a rolling three-year period (the Substantial Presence Test), assuming presence in the U.S. for at least 31 days during the tax year in question. The test uses a weighted formula, giving full weight to days present in the current year, one-third of the days in the prior year, and one-sixth of the days in the second prior year. A person may be present in the U.S. on average for roughly 120 days each year without becoming a resident.

What Are the Filing and Reporting Requirements?

U.S. tax residents are subject to filing and reporting requirements including the federal income tax filing (I.R.S. Form 8938, *Statement of Specified Foreign Financial Assets*) and must disclose details of non-U.S. bank accounts and other foreign financial assets on annual F.B.A.R. filings (FinCen Form 114). A comparison of Form 8938 and F.B.A.R. requirements is available on the I.R.S. website.

Are There Any Exemptions?

Certain individuals are exempt from the Substantial Presence Test (*e.g.*, a student temporarily present under an F, J, M, or Q visa as well as a teacher or trainee under a J or Q visa – the individual is required to file I.R.S. Form 8843).

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When Does Residency Begin?

The tax residence of a person who meets the Substantial Presence Test is generally the first day during the calendar year on which the individual is present in the U.S. (the "residency starting date"). A person may be present in the U.S. for up to ten days without triggering the residency starting date if the individual's tax home was in a foreign country and they maintained a closer connection to that foreign country than to the U.S.

What is the Closer Connection Exception?

A person who otherwise meets the Substantial Presence Test may be treated as a non-resident if they can demonstrate a "closer connection" to another foreign country. To come within this exception, the individual must be present in the U.S. for fewer than 183 days in the current year and must maintain a "tax home" in a foreign country during the year. Establishing a closer connection during the year to the foreign country of the tax home takes into account factors such as

- the person's home,
- family,
- personal belongings,
- social clubs,
- banking relationships,
- business,
- driver's license,
- voting status, and
- official forms filed by the person.

Special rules apply to persons who move between foreign jurisdictions.

I.R.S. Form 8840 (*Closer Connection Exception Statement for Aliens*) is used to claim the closer connection exception. An individual who claims this exemption is not required to make F.B.A.R. filings or file Form 8938.

How Do Tax Treaties Affect Matters?

Even though a foreign individual is a resident under U.S. internal law, they may be a non-resident under an income tax treaty for certain U.S. tax purposes. The residence article of an income tax treaty generally contains a tiebreaker provision applicable to an individual classified as a resident of both countries (a "dual resident") – the individual will be treated as resident of only one of the treaty countries for treaty purposes.

A series of tests is applied in a specific order to the particular facts and circumstances of the dual resident to establish residence status. Once the individual's residence is determined under a particular test, there is no need to proceed to another test. In general, exclusive residence is determined by applying the following tests in the following order:

1. The individual is deemed to be a resident of the country in which a permanent home is available.

2. If the individual has a permanent home in both countries or in neither country, they will be deemed to be a resident of the country with which their personal and economic relations are closer – this is known as the center of the individual's vital interests.

3. If the closer economic relations cannot be determined, the individual will be a resident of the country in which he has an habitual abode.

4. If they have a habitual abode in both countries or in neither one, they will be deemed to be a resident of the country of which he is a national.

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If the issue cannot be settled by the application of these tests, the competent authorities of both countries (the I.R.S. and its overseas counterpart) will decide by mutual agreement the country of which the individual will be considered an exclusive resident.

How Do You Claim a Treaty Benefit?

To claim a treaty benefit, the individual must prepare an income tax return as a non-resident alien on Form 1040NR and file Form 8833 (*Treaty-Based Return Disclosure Under §§6114 or 7701(b)*). This should include

- a statement that the taxpayer is claiming a treaty benefit as a non-resident of the U.S.,
- the facts relied upon to support the position taken,
- the nature and approximate amount of income that is exempted, and
- the specific treaty provision for which the taxpayer is claiming a treaty benefit.

An individual who claims this exemption is required to make F.B.A.R. filings (FinCEN Form 114) reporting certain foreign financial assets, but not I.R.S. Form 8938 (*Statement of Specified Foreign Financial Assets*) under a recent policy change.

Recommendation: Foreign individuals should carefully plan for and be aware of the residency start date if completing pre-immigration tax planning actions (such as a sale of property or assets) after that date has adverse U.S. tax consequences.

WHAT IS THE POSITION AROUND THE OWNERSHIP OF SHARES OF FOREIGN CORPORATIONS?

Assuming that the foreign individual is a U.S. tax resident and has investments in foreign corporations, the potential application of the rules applicable to controlled foreign corporations ("C.F.C.'s") and passive foreign investment companies ("P.F.I.C.'s") must be analyzed.

What is a C.F.C.?

A foreign corporation will be treated as a C.F.C. if "U.S. Shareholders" (defined to mean U.S. persons holding 10% or more of the stock by voting power) own more than 50% of the stock (by voting power) after application of attribution and constructive ownership rules. Stock owned by a non-resident alien is generally not attributed to a U.S. taxpayer under these rules.

What is a P.F.I.C.?

A P.F.I.C. is defined as a foreign corporation where 75% or more of the corporation's income is considered 'passive' or 50% or more of the company's assets are investments that produce or are held for the production of passive income. A special look-through rule applies to 25% or greater subsidiaries owned by the foreign corporation.

The C.F.C. rules (which generally pre-empt the P.F.I.C. rules, discussed below) subject certain types of income allocable to a U.S. shareholder to immediate U.S. taxation, whether or not distributed, and characterize certain gains upon disposition of the stock as ordinary income. Unless certain exceptions apply, the P.F.I.C. rules are designed to penalize U.S. taxpayers on 'excess distributions' from a P.F.I.C. or upon a disposition of P.F.I.C. stock, imposing the highest ordinary income rates and an interest charge.

Recommendation: Foreign individuals should consider whether the C.F.C. rules can be avoided by restructuring the ownership of the potential C.F.C. by sale or gift of shares of in the corporation before the residency starting date. Foreign individuals should consider selling P.F.I.C. shares unless it is fairly certain that there will be no sale of or excess distributions from the P.F.I.C. during the period of the tax residency.

Note that the rules applicable to C.F.C.'s and P.F.I.C.'s can also apply if such interests are owned by a trust in which the individual has an interest or is treated as the granter. It is common for a foreign trust to own a holding company for investments in stocks and securities, which will be characterized as a P.F.I.C. It is often recommended that a special U.S. "check the box election" be made to treat the P.F.I.C. as a disregarded entity for U.S. tax purposes (assuming no other adverse U.S. income or estate tax consequences).

WHAT IS THE POSITION IN RESPECT OF TRUSTS?

Foreign persons who have settled foreign trusts or are (or will be) foreign trust beneficiaries must be cognizant of several special rules.[2] A trust will be considered to be a foreign trust unless

- a U.S. court can exercise primary supervision over trust administration (the "Court Test"), and

[2] See Code §§643, 672, 677, 679 and 684.

- U.S. persons control all substantial trust decisions (the “Control Test”).

How Are Grantor Trusts Approached?

The grantor of a “grantor trust” is generally treated as the owner of the assets, and all income and gains of the trust are taxed currently to the grantor. The grantor trust rules for U.S. tax persons differ from that with respect to foreign persons who are non-resident aliens. A trust established by a non-resident alien will be treated as a grantor trust only if the trust is revocable or can benefit the grantor and spouse exclusively. If the foreign individual becomes a U.S. taxpayer, a trust that was a foreign non-grantor trust when established may become a grantor trust if other rights are present that would otherwise make the trust a grantor trust (*e.g.*, where income may be paid to the grantor or spouse in addition to others).

The foreign individual may therefore be taxable on the income and gains of the trust. It should also be noted that when the foreign individual leaves the U.S. and is no longer a U.S. tax resident, that trust may revert to foreign non-grantor status. In that case, there may be a deemed sale or exchange of the trust’s assets, taxable to the foreign individual, under a special rule applicable to transfers of property by U.S. persons to a foreign trust or estate.

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A foreign trust established by a U.S. tax resident will be treated as a grantor trust. Furthermore, even if a previously-established trust would not otherwise be treated as a grantor trust, if the foreign individual transferred property to the foreign trust within five years of the residency start date, the trust will be treated as a grantor trust (as to the foreign individual) unless the terms of the trust prohibit any U.S. person from receiving any income (whether current or accumulated) or any corpus, either during the life of the trust or upon its termination.

If the foreign individual is the beneficiary (but not the grantor) of a foreign trust, the individual may be treated as the owner of the trust to the extent of any property (and cash) transferred by the foreign individual to the grantor of the trust. This prevents a foreign person intending to move to the U.S. from gifting assets to another foreign person, who then establishes a trust for the benefit of the person moving to the U.S.

Is the Position Different Around Non-Grantor Trusts?

If a foreign trust is not treated as a grantor trust, a U.S. tax resident will generally be taxed on distributions of “distributable net income” (or “D.N.I.”) which, in the case of a foreign non-grantor trust, will include capital gain income realized by the foreign trust. In addition, a distribution of undistributed net income (“U.N.I.”) from a foreign non-grantor trust may be subject to onerous throwback taxes on accumulated income. A loan from a foreign trust or the uncompensated use of trust property to or by the U.S. tax resident can be treated as a distribution from the trust, with certain exceptions, potentially taxable to the individual.

Recommendation: Planning in advance of the residency start date may mitigate some unintended and potentially harsh results. For example, distributions of D.N.I. and U.N.I. should be made prior to the residency start date. Consideration should be given to excluding any U.S. persons as beneficiaries of foreign trusts if the trust would otherwise become a U.S. grantor trust after the residency start date. Any

foreign trust to be established by the U.S. tax resident to benefit non-U.S. persons should be created and funded prior to the residency start date.

WHAT ARE THE KEY CONSIDERATIONS WHEN REPORTING ON I.R.S. FORM 3520?

The U.S. requires U.S. taxpayers to report gifts and bequests from foreign persons and distributions from foreign trusts on I.R.S. Form 3520. A gratuitous transfer from a foreign corporation or partnership must also be reported and, under Treasury regulations, may be subject to income tax. In addition, U.S. tax rules will treat a distribution through an intermediary (other than the grantor of the trust) as made directly to the U.S. person. For example, a distribution to a foreign sibling of the U.S. tax resident from a discretionary foreign trust established by a foreign parent will generally be treated as a distribution directly from the foreign trust to the U.S. tax resident, if the sibling makes a gift of that distribution to the U.S. tax resident.

Recommendation: It is generally desirable to receive gifts prior to the residency start date. Trust beneficiaries should request that the appropriate trust beneficiary statement be prepared for purposes of completing I.R.S. Form 3520.

HOW DOES THE U.S. ESTATE TAX OPERATE?

U.S. estate tax is imposed on a non-resident alien decedent's U.S. situs property, as specially defined to include, among other things, shares of stock of U.S. corporations, and U.S. real and tangible property. Portfolio debt obligations, bank accounts, and life insurance proceeds on the life of a non-resident alien are not treated as U.S. situs assets. U.S. gift tax is imposed on gifts of U.S. real and tangible personal property – gifts of intangible assets (*e.g.*, shares of stock) are excluded. The estate tax exemption amount, however, is limited to $60,000 – far less than the $5.43 million lifetime exemption available to U.S. citizens and residents who are taxed on the worldwide estate.

For U.S. estate and gift tax purposes, a foreign person is treated as a resident if he or she is domiciled in the U.S. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of leaving. A person who is temporarily present in the U.S. would not ordinarily be treated as a U.S. domiciliary, particularly if the person continues to have significant contacts with his or her original jurisdiction of domicile, but the particular facts and circumstances should be carefully reviewed. Estate and gift tax treaties to which the U.S. is a party, or, in the case of Canada, the income tax treaty with the U.S., may modify these rules. Newer treaties generally reserve taxation to the jurisdiction of the domicile, with notable exceptions for real property and business property.

Recommendation: The potential application of an estate and gift tax treaty is particularly critical and should not be overlooked. Nevertheless, foreign individuals temporarily present in the U.S. should exercise caution in purchasing a U.S. residence, moving valuable tangible property to the U.S. and acquiring other U.S. situs assets.