Overview of U.S. Taxation of Cross Border Investments & Operations

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Residence of Individuals

U.S. Federal Income Tax Residency Rules for Individuals

- Green card test
  - U.S. resident as soon as present in the U.S. with a green card
  - U.S. residency does not terminate until green card formally surrendered
- Substantial presence test (“183 day” test)
  - Formula - based on 3 years’ days of presence in the U.S.
  - 31 Day Minimum
  - Foreign closer connection exception
  - Exempt individuals
- First-year residency election
- Spousal residency election

Formula For Substantial Presence Test (121 Day Safe Harbor)

	Days present in the U.S.		
Current year	121	X 1 =	121
1st preceding year	121	X 1/3 =	40
2nd preceding year	121	X 1/6 =	20

Sum total (if 183 or greater, then U.S. resident) 181

Beware Leaving the U.S.

- Individuals:
  - Exit Tax (deemed sale) for U.S. citizens renouncing and for long-term green card holders surrendering green cards or claiming foreign residency under a treaty
    - First $690k of gain exempt
  - **Caution foreign pensions**: Full value is deemed distributed as part of the Exit Tax, but there is no threshold exemption (i.e., fully taxable in U.S. on exit)
- Trusts:
  - Gain generally recognized on conversion of a U.S. trust to a foreign trust
- Corporations:
  - Inverting can result in the foreign parent being treated as a U.S. corporation (*i.e.*, inversion is nullified)

Substantial Presence Test

- Mrs. G., a French Citizen, lives in Morocco and Spain.
- Children live in the U.S. and she wishes to visit often. She plans on spending up to six months per year in the U.S. but never 183 days:

2015 – 157 days x 100%	=	157
2014 – 160 days x 1/3	=	53.33
2013 – 90 Days x 1/6	=	<u>15.00</u>
		225.33 days

- Closest connection test – Center of Vital Interests outside of the United States – Investments, home, social contacts, passport
- Not Resident - Form 8840 attached to 1040NR

Green Card Test

- Russian Oligarch obtains US green card on an E-visa
  - Invests $500,000 in the US
- Wife and family move to the U.S. for school
- Russian claims residence in Russia under the Tie Breaker Test under the U.S. – Russia Income Tax Treaty
- Good plan for 10 years!

U.S. Expatriation

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
U.S.	✓	✓	✓	✓	✓	✓⬇				✓	✓⬇
Foreign	✓⬆					✓	✓	✓	✓	✓⬆	✓

- Dr. X is a Spanish national
- On December 31, 2008, he arrives in the U.S. with a green card
- On May 15, 2013, he relinquishes his green card and returns to Spain
- On November 15, 2017, he returns to the U.S. under a newly issued green card
- On June 30, 2018, Dr. X returns to Spain, retains his green card, but claims Spanish tax residence under treaty rules
- Has an expatriation event taken place

U.S. Expatriation

- U.S. Green Card holder for more than 7 years – Exit tax is due
  - Need to determine net worth ($2,000,000)
  - Need to determine 5 years annual net income tax (2015 - $160,000)
  - Individual fails to certify tax compliance for last 5 years – Form 8854
- U.S. Green Card (35 years) went through Voluntary Disclosure without reporting any foreign assets to avoid the net worth test. Must re-enter the Voluntary Disclosure with a hefty burden to avoid Criminal Prosecution.

Forms of Business Entities

Before Planning Begins

- Ascertain venture characteristics and objectives:
  - Income and cash distribution allocation
  - Decision making and management
  - Liability and debt protection
  - Best structure from a federal, state and local individual income or corporate taxation perspective
    - Qualify for business in a particular state, whether contracts are enforceable
  - Family enterprise and succession plans
- Income tax perspective:
  - Profits (or the investment activity) either minimized or deferred
  - Tax losses (or investment losses) used to offset other income
  - Assets be transferred into and out of the entity
- Business (non-tax) perspective:
  - Liabilities limited to the assets of the business and protect owners personally
  - Efficient management structuring
  - Flexible future transferability of ownership

Three Basic Entity Classifications

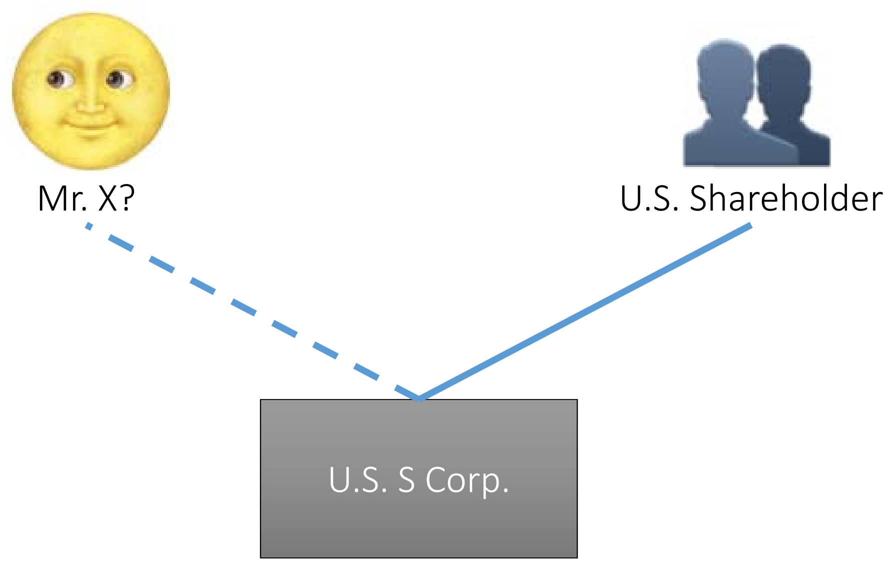
- Corporation: Subject to double tax (corporate tax + tax on dividends)
  - However, corporations having special tax status, such as S Corporations, R.E.I.T.'s and Regulated Investment Companies (mutual funds), may not be subject to corporate tax
- Pass-through: eliminates double taxation of income
  - Partnership:
    - Created through a contract for General Partnership *or* under state law for Limited Partnership
    - Taxable income & loss is allocated among members through "Partnership agreement"
    - To qualify, entity must have 2 or more partners
    - Partnerships tend have legal personality in the U.S. so that they can own property and be sued
  - L.L.C.:
    - Created under state law
    - Taxable income & loss is allocated among members through "Operating agreements"
    - In the absence of an election, domestic L.L.C. is a pass-through for U.S. tax purposes
  - S Corporations:
    - Cannot have more than 100 shareholders
    - Shareholders can only be U.S. individuals, certain trusts and estates
    - Only one class of stock allowed
- Disregarded entity ("D.R.E."): An L.L.C. that has only one member
  - In the absence of an election,, taxable income, gain, loss, and foreign tax credits belong to its sole member for U.S. tax purposes, but not for other purposes
  - Valuable classification for operations abroad in reducing C.F.C. and other tax concerns

Check the Box ("C.T.B.") Rules: Flexibility

- Default Rules for Most Non-U.S. Entities:
  - If no owner is personally liable for debts of the entity, then classified as a Corp
  - If at least one member is liable for debts of the entity, then
    - If 2 or more members—partnership
    - If 1 member—disregarded entity
- Per se corporations:
  - For each foreign country, regulations designate entity that is always classified as a corporation. (e.g. S.A. or Canadian Corporation)
- In comparison to a domestic L.L.C., a foreign L.L.C. defaults to corporate treatment for U.S. tax purposes
- Election to obtain different tax classification – Form 8832:
  - Generally within 75 days of effective date
  - Corrective late filing within an additional 3 years if –
    - Failure is due to reasonable cause,
    - All tax returns filed timely, and
    - All tax returns prepared as if an election were made
  - Changes
    - Can change initial classification on a prospective basis at any time
    - A non-initial classification election cannot be changed for 5 years

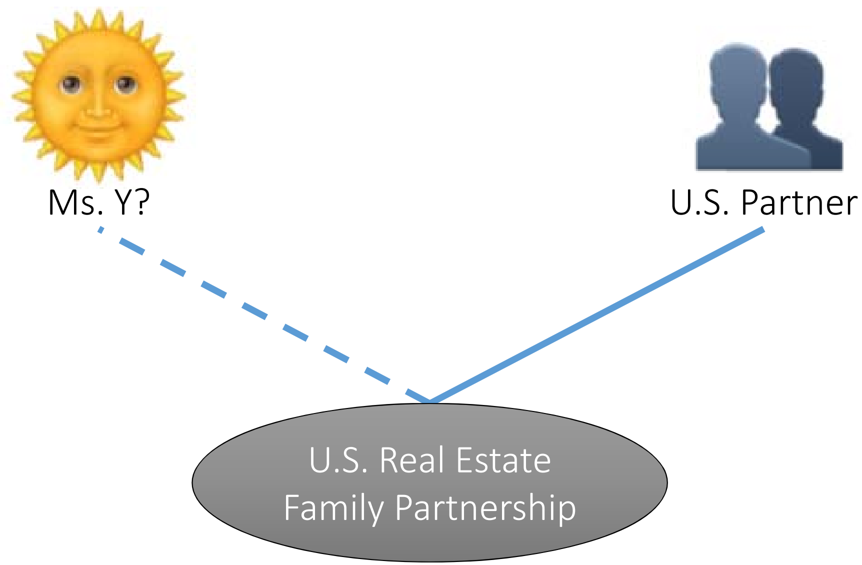
What's Wrong with This Picture? – Ex. 1

- Mr. X, a Hong Kong citizen and resident, wishes to invest in his U.S. friend's corporation, an "S" corporation.



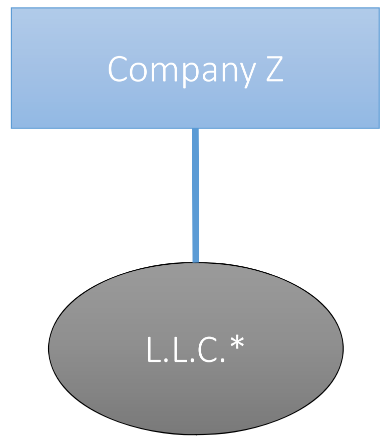
What’s Wrong with This Picture? – Ex. 2

- Ms. Y, a Brazilian citizen and resident, wishes to become a member of an L.L.C. owning commercial U.S. real estate.



What's Wrong with This Picture? – Ex. 3

- Company Z, a Panamanian S.A., creates a New York L.L.C. to operate its U.S. operations.



** disregarded entity*

Federal vs. State Tax Issues

Tax Residence in a State

<u>Objective Test</u>

- Seventeen States have a **<u>183 days of presence</u>** rule
- Usually these rules also require an "abode" to be available to the Individual
- New York requires 184 days plus maintaining a "permanent abode" in the state for 11 months
- Other States require 185 days, New Mexico – 200 days, Hawaii and Ohio – and 210 days North Dakota

Tax Residence in a State

Subjective Test

- Twenty eight states have a “domicile” test to define tax residency
  - Domicile is generally the intent to remain in a state indefinitely
  - Domicile is not changed easily. The taxpayer must move to a new state with the intent to remain there indefinitely –
  - New York to Florida where there is no tax
- Facts and circumstances determine if domicile has been changed. Long list of factors are reviewed.

Tax Residence in a State

- Presence in Two States
  - If for a short stay, resident on one state and non resident in the other state.
    1. Resident state taxed on <u>**all**</u> income for the year
    2. Non resident state taxed on income earned <u>**in the**</u> state
    3. Tax credit in the resident state to off set the double tax
- What about resident in two states?
  - Domicile in Massachusetts but more than 183 days in R.I. with apartment available. Complex tax credits in both states based on the state taxes due to each state.

Relinquishing State Domicile – New Jersey

- *Lyon v. Glaser,* a state inheritance tax matter
  - The taxpayer resided in New Jersey for the majority of her life.
  - Once married, she resided there with her husband through the time of his death.
  - Thereafter, she lived in Baltimore with her son and his family, as she was elderly and in need of constant medical care and attention
  - Retention of former residence, left unoccupied for the most part
  - Regular visits to N.J.
  - Retention of safety deposit box in N.J. Bank
- Issue – Where was decedent domiciled at death?

Relinquishing State Domicile – New Jersey

- *Samuelsson v. Director*, income tax matter
  - The taxpayer was a professional hockey player who signed with a team in Florida
  - The family left New Jersey, rented a new home in Florida, moved all of their furniture and belongings to the rental home and put up their New Jersey house for sale, but it never sold and was not rented to others
  - At the end of the year, the taxpayer retired from professional hockey and the family moved back to New Jersey
  - The New Jersey tax authorities determined that the taxpayer remained domiciled in New Jersey, had a New Jersey permanent place of abode, and spent more than the 30-day minimum during the year in New Jersey

Relinquishing State Domicile – New Jersey

- <u>Factors indicating N.J. domicile</u>
  - The failure to actually sell the New Jersey home;
  - The return to New Jersey within one year of departure;
  - The failure to purchase a home in Florida;
  - The limited time the taxpayer worked in Florida; and
  - The retention of a New Jersey voter registration and driver's license by the taxpayer's wife.
- <u>Factors against N.J. domicile</u>
  - The moving of furniture and belongings;
  - Listing the New Jersey property for sale instead of renting it out.
  - House hunting in Florida;
  - Enrolling their children in school in Florida;
  - Saying farewell to their friends;
  - Closing New Jersey bank accounts and opening Florida accounts; and
  - The taxpayer obtained a Florida driver's license and registered his automobile in Florida.

Recommended Action Steps for Clients

- Purchase and own a home in the new state in a residential area and not a vacation area
- If the sale takes time, remove all furniture and arrange for long-term lease to others
- If some presence is maintained, it should be at a resort area
- If a vacation house is maintained, notify the electric, gas and cable companies, and the real estate tax collector to send all bills to the new address
- Physical presence in the new state of domicile should be maximized and physical presence in New Jersey should be limited.
- A final New Jersey income tax return should be filed
- All Federal income tax returns should reflect the new address and be filed with the I.R.S. district in the new location.
- File for a homestead exemption if one exists in the new location to reduce real property tax for state residents
- Register to vote in the new location and actually vote
- Notify the New Jersey motor vehicles office of the move
- Apply for a driver's license in the new state and surrender New Jersey driver's license
- Change the registration on any automobiles from New Jersey

Recommended Action Steps

- Do not keep a vehicle in New Jersey
- Obtain a declaration of domicile if available in the new state
- Maintain an appointment book that notes the duration of all trips to New Jersey.
- All airplane tickets involving visits to New Jersey should be retained
- On the flight from New Jersey to the new location when domicile is changed, purchase a one-way ticket
- Apply for a new passport
- Execute a new will and new estate planning documents that recite the new domicile
- Move as many of personal possessions as possible to the new location, including collections, personal records, mementos, artwork, stock certificates, etc.
- Move bank accounts to a bank in the new location.
- Use a new checking account(s) to pay regular living expenses.
- Rent a safe deposit box at a bank in the new location
- Brokerage accounts should be maintained through a broker in the new location
- Make funeral arrangements with a funeral home in the new location and do not maintain a New Jersey burial plot
- Join social clubs and civic and religious organizations in the new location and resign from memberships in New Jersey clubs and organizations.
- If resignation is not feasible, change the New Jersey memberships to nonresident memberships.

Recommended Action Steps

- Contribute to charities located in the new location and reduce or eliminate contributions to New Jersey charities
- Notify relatives and friends of the new address by sending out printed announcements
- Inform the U.S. post office of the change in address and have all mail forwarded
- File change of address forms with the Internal Revenue Service and the Social Security administration
- Change the address for all credit card companies, utility bills, landscaping, garbage collection, pensions, magazine subscriptions, stock dividends, partnerships and directories.
- Have all bills for insurance premiums (homeowner's, renters, automobile, health) sent to the new location
- Use the new location address in all legal documents and when registering in a hotel, renting a car, etc.
- Subscribe to a local newspaper in the new location.
- Declare yourself to be a resident of the new location resident on any census being conducted.
- Establish relationships with a doctor and dentist in the new location.
- Notify all New Jersey doctors and dentists to have all medical records transferred to a new doctor or dentist in the new location.
- Give up charge accounts with stores in New Jersey, and open new accounts with stores in the new location.
- Purchases of expensive items should be made in the new location.
- If you change your mind, you should not return to live in New Jersey until three or more calendar years have elapsed.

Withholding Tax & Anti-Conduit Rules

U.S. 30% Withholding Tax

- Payments of U.S. source investment-type income to non-U.S. persons are subject to a 30% U.S. withholding tax. *E.g.*:
  - Dividends
  - Interest
  - Royalties
  - Rents
  - Services performed in the U.S.
- The 30% tax is often reduced or eliminated by income tax treaties

U.S. 30% Withholding Tax Continued

- For treaty benefits, recipient of the payment must generally:
  - Be liable to tax on its worldwide income in its home country, and
  - Meet the LOB provisions of the respective income tax treaty
- U.S. <u>payor</u> is required to withhold 30% unless the <u>recipient</u> certifies on Form W-8BEN/W-8BEN-E that it qualifies for treaty benefits
- No longer need foreign recipient to obtain U.S. taxpayer identification number – instead now can use foreign country taxpayer identification number

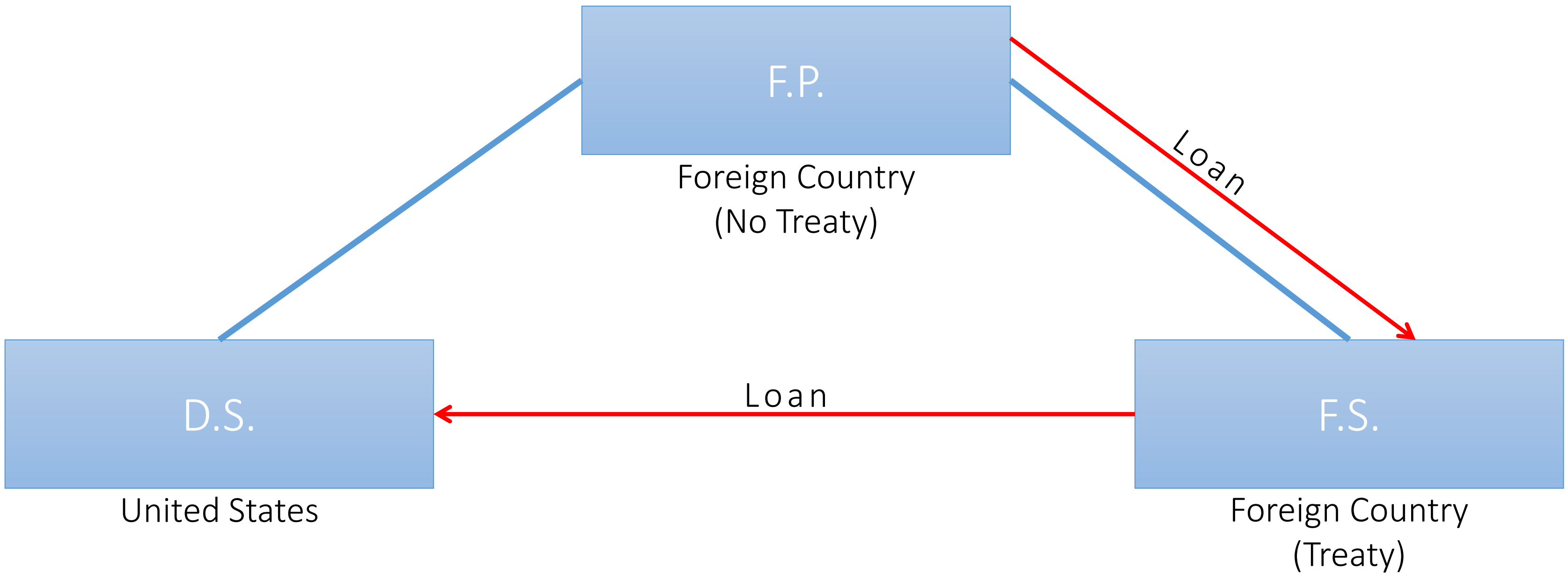
Anti-Conduit Rules

- No reduction in the withholding tax rate if certain intermediate entities are used
- I.R.S. may disregard intermediate entities in a "financing arrangement"
  - Generally applies even if meet L.O.B. provisions in treaties
- Financing arrangement:
  - One person (<u>financing entity</u>) advances money or other property, or grants rights to use property
  - Another person (<u>financed entity</u>) receives money or other property, or rights to use property
  - Through <u>intermediate entity</u>(ies)
  - <u>Linkage</u>: Financing transactions (*e.g.*, loans, licenses, leases, etc.) link the entities

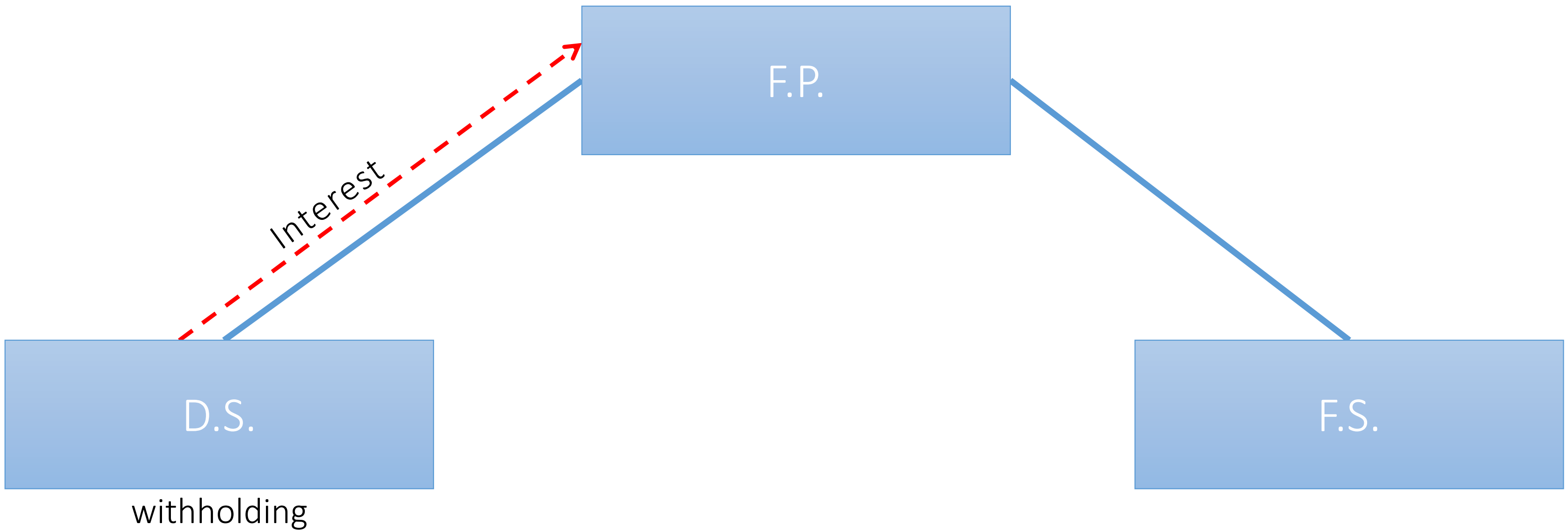
Anti-Conduit Rules

- Intermediate entity is a conduit entity if:
  - Transactions would reduce U.S. withholding tax;
  - There is a tax avoidance plan; and
  - The intermediate entity is related <u>or</u> would not have participated but for the financing transactions.

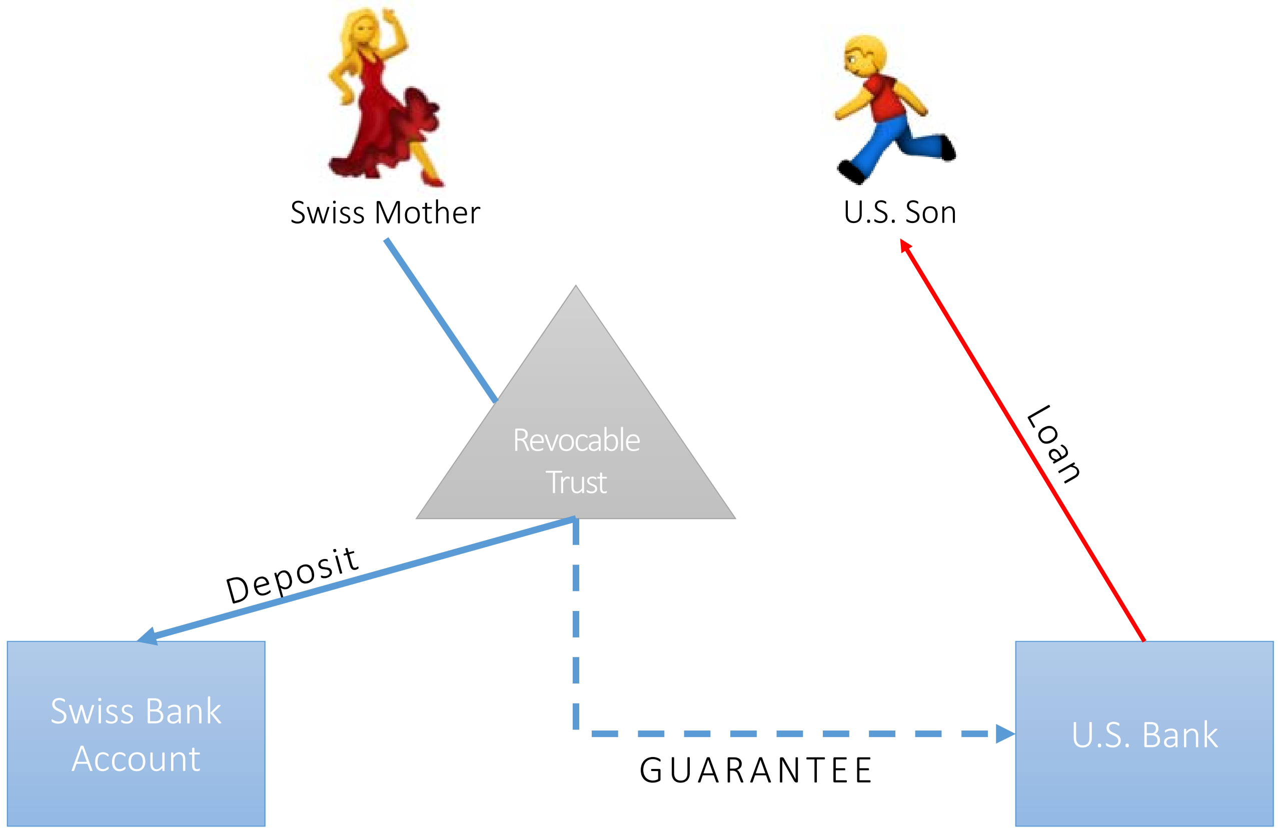
Anti-Conduit Rules



Ignore F.S. and Treat as Loan from F.P. to D.S. – Withholding Required



Anti-Conduit Rules



Ken Vacovec

Limitation on Benefits

Income Tax Treaties

- In General
  - Treaties reduce or eliminate withholding tax on items of dividends, interest, royalties and gains
  - Not all treaties provide similar benefits and the actual text of a treaty and an accompanying protocol or memorandum of understanding must be consulted in each case

Limitation on Benefits

- Intended to prevent inappropriate claims of treaty tax benefits
- The policy of the U.S. Treasury Department is that a treaty's benefits should be limited to qualified investors
- The policy ensures that a reduction in U.S. withholding tax should be used only as a means of avoiding actual double taxation and to ensure that only foreign entities with a strong connection to a treaty partner should benefit from U.S. treaty benefits
- This is followed in Action 6 of the B.E.P.S. Project – Prevent Treaty Abuse

Limitation on Benefits

- Broad themes for qualification under the limitation on benefits provision in a treaty
  - Publicly traded companies qualify
  - Subsidiaries of publicly traded companies qualify.
  - Companies that are primarily owned either by resident individuals of a treaty country or owned by U.S. residents or citizens qualify when base erosion is absent
  - In treaties with European countries, a company owned by a defined class of third country persons (E.U. or N.A.F.T.A.) qualify if treaty exists with resident country of owners and benefits are identical in both treaties

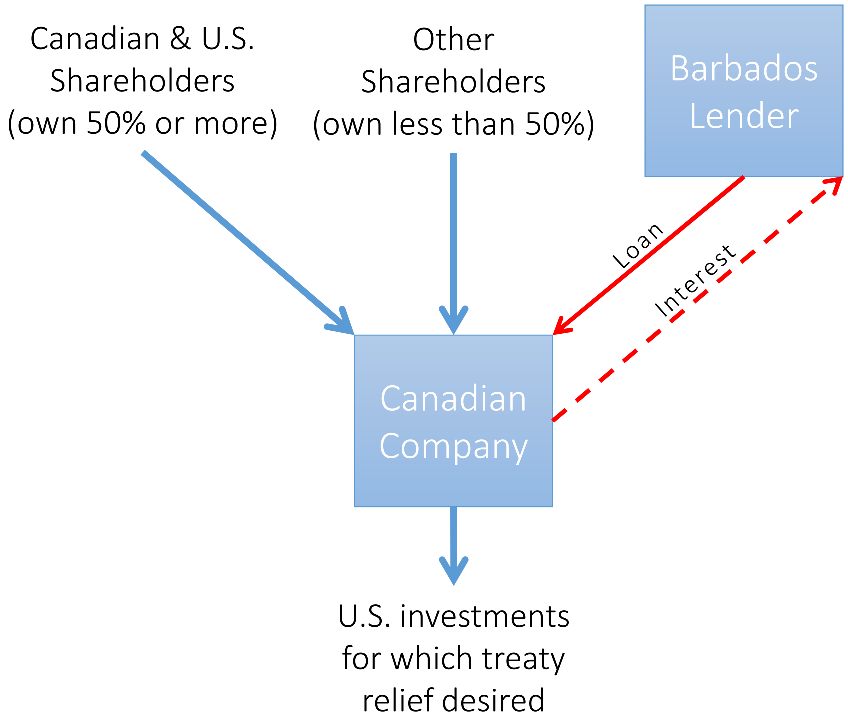
Limitation on Treaty Benefits

- If a company does not qualify for general treaty benefits, it may, nonetheless qualify with regard to specific streams of income related to an active trade or business carried on in the country of residence that is viewed to be substantial in relation to the U.S.
  - The business may be carried on by a party related to the treaty resident
- In some circumstances, the competent authority of the U.S. will rule that treaty benefits are allowed based on facts and circumstances even if none of the tests are met

Limitation on Benefits

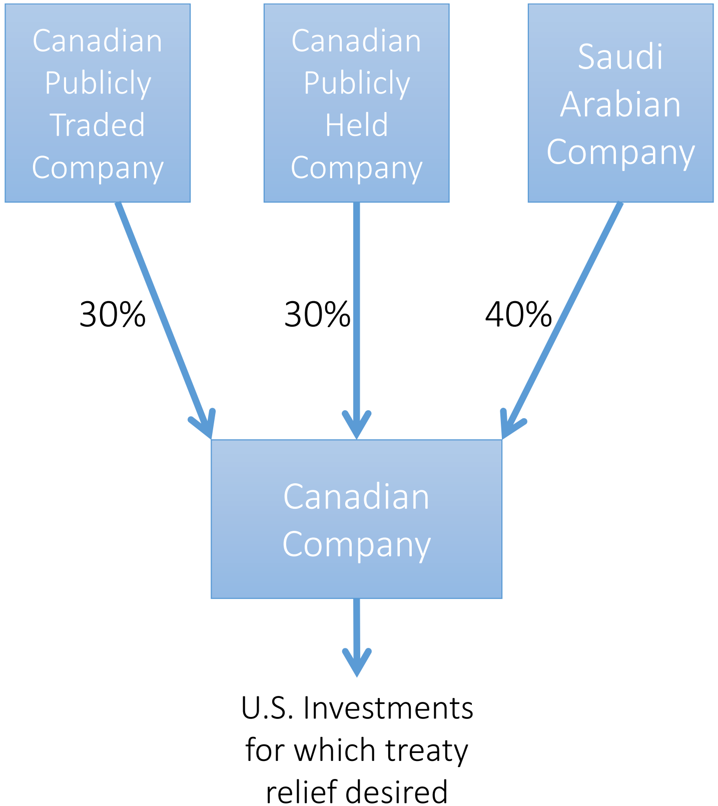
- New I.R.S. Model Tax Treaty Provision
  - Beneficial income tax treatment for interest, royalties, and other income is denied if the recipient benefits from a “special tax regime”
  - The term “special tax regime” means any legislation, regulation, or administrative practice that provides a preferential effective rate of taxation in respect to interest, royalties or other income, including through reductions in the tax rate or tax base
  - In the case of interest, the term includes any practice that provides notional deductions with respect to equity
- The new provision confirms that the U.S. has no special tax regimes in place at this time

Company Primarily Owned by U.S./Canadians



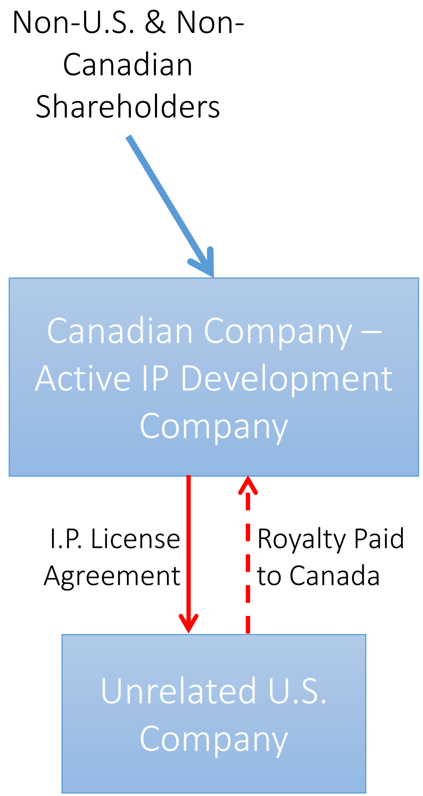
- Non-LOB Compliant Entity:
  - Joint ownership and shareholder test met since 50% or more U.S. or Canadian shareholders
  - <u>But</u>, base erosion exists because economic diversion of profit to foreign lender (more than 50% gross income paid as interest)

Publicly Held Company



- Do not have to look to see who owns the Canadian shareholders
- Why? 2 publicly traded Canadian companies own more than half the stock
- So, L.O.B. compliant

Active Business



- Does not meet general L.O.B. requirements
- <u>But</u>, engaged in active I.P. development business in Canada and U.S. source royalty is income "derived from … or incidental" to that Canadian business
- Because U.S. payor is unrelated, Canadian activity is deemed substantial
- <u>So</u>, royalty gets treaty relief

U.S. Estate & Gift Tax

Gift Tax

- Nonresident alien is taxed on gifts of tangible (but not intangible) property located in the United States.
  - Gift of U.S. real property is subject to gift tax
  - Gift of stock (whether domestic or foreign corporation) is ***not*** subject to tax
  - Gift of partnership interest probably ***not*** subject to tax
  - Points to note:
    - No step-up basis on *inter vivos* gift
    - No unified credit
    - Substance over form risk. For example:
      - Donee or trust is funded with cash and purchases real property from grantor – *e.g.*, *Davies v. Commissioner,* 40 T.C. 525 (1963)
      - Foreign owner contributes property to partnership and then makes gift of partnership interest

Estate Tax

- Estate of nonresident alien is subject to estate tax on property located in the United States. Includes:
  - U.S. real property and tangible property located on it
  - Stock in U.S. corporation (publicly traded or not)
  - But not stock in foreign corporation
  - Top rate (2013) 40%; unified credit equivalent to $60,000 exemption (unchanged for decades)
- Uncertain treatment of partnership interests
  - I.R.S. position: Interest is located in the U.S. if partnership is engaged in U.S. trade or business. What if:
    - Partnership not ETB but decedent elected under §871(d)?
    - Partnership owns only residence for N.R.A.'s personal use?
  - Other theories: Place of organization or partner domicile
  - Estate tax treaties

Gift & Estate Tax in the U.S.

- Mr. G wishes to purchase and gift real estate in U.S. to his son, a resident of the U.S.

Alternatives

1. Wire transfer from non-U.S. bank by Mr. G to sons' bank account (U.S. or foreign). Son buys real estate
2. Mr. G purchases U.S. real estate and gifts the real estate to son
3. Mr. G establishes discretionary U.S. or foreign trust and contributes cash to trust; trust purchases real estate

Gift & Estate Tax in the U.S.

4. Mr. G establishes a non-U.S. corporation to purchase real estate and gifts shares of the corporation to the son upon his death
5. Mr. G forms a U.S. limited liability company, purchases real estate and gifts the L.L.C. interests to the son

Taxation of U.S. Beneficiaries of Foreign Trusts

Residence of Trusts

- A trust is treated as a U.S. domestic trust if:
  - <u>Meet the "court test"</u>: A court within the U.S. is able to exercise primary supervision over the administration of the trust; <u>and</u>
  - <u>Meet the "control test"</u>: One or more U.S. persons have the authority to control all substantial trust decisions
- Does not matter where the trust was formed
- Easy to be treated as a foreign trust – a trustee residing outside the U.S. could cause a U.S.-formed trust to be a foreign trust

Residence of a Trust

- Refer to the “Court Test” and “Control Test”

1. Trust drafted and established under Massachusetts law.

2. Settlor – not US person, US bank is the trustee

   OR

   Non US person is the trustee with the US bank as the investor

- Where is the Trust resident?
- Graduated rates versus withholding rates and capital gains tax

U.S. Beneficiaries of Foreign Trusts

- U.S. Settlor of a Foreign Trust with U.S. Beneficiaries is treated as a Grantor Trust – Code §679
  - Settlor is treated as owner of trust assets – estate tax
  - Settlor is treated as recipient of all income in the trust – income tax
  - Beneficiaries can obtain the income of the trust tax free
  - Beneficiaries can obtain the principal of the trust subject to gift tax to the Settlor

U.S. Beneficiaries of Foreign Trusts

- Non-U.S. Settlor of a Foreign Trust with U.S. Beneficiaries or non-U.S. Beneficiaries who become U.S. Residents
  - Beneficiaries taxed to extent of Distributable Net Income ("D.N.I.") distributed from the trust each year.
  - To the extent Undistributed Net Income ("U.N.I.") is distributed, the Throw Back Rules apply.

Throw Back Rules

- General Rule – Form 3520 and 4970 actual calculations
  - U.N.I. allocated to year earned
  - Five past years taxable income used to compute tax
  - Highest and lowest taxable income distributed
  - Three remaining taxable incomes determine the tax rate to use
  - Tax computed on U.N.I. distributed and average of the three years is the tax
  - Interest rate to year U.N.I. is earned is charged

Throw Back Rules

- Alternative Rule – Form 3520 Default Calculation
  - Determine current year distributions
  - Determine mumber of years the trust was in existence
  - Total distribution in prior three years
  - Multiply by 1.25% and divide by three
  - Smaller of current year distribution or the result of the computation is ordinary income in the current year
  - Excess is considered U.N.I.
  - Go to I.R.S. tables to compute tax and interest changes

Example

- Foreign complex trust established in 1985
- No distributions to date
- Client wants to make distribution to U.S. beneficiary starting in 2014

Scenario 1: $500,000 distribution

- The entire distribution would all be treated as an accumulation distribution
- 35% annual tax bracket for the three previous tax years (2013, 2012, 2011)
- Tax due of $399,345
- This results in an 80% tax

Scenario 2: Variable Distributions: 8 Year Pay Out

Default Calculation – Estimated 35% Tax Bracket

- **Year 1:** $50,000.00 distribution per beneficiary
- **Year 2:** $62,500.00 distribution per beneficiary
- **Year 3:** $78,125.00 distribution per beneficiary
- **Year 4:** $79,427.08 distribution per beneficiary
- **Year 5:** $91,688.37 distribution per beneficiary
- **Year 6:** $103,850.19 distribution per beneficiary
- **Year 7:** $114,569.02 distribution per beneficiary
- **Year 8:** $129,211.49 distribution per beneficiary

- **Total withdrawn by each beneficiary:** $709,371.14
- **Total tax paid:** $306,672.95
- **Overall tax rate:** 43.23%
- **Total distributions from Trust:** $1,418,742.29

Scenario 3: Variable Distributions: 5 Year Pay Out

Default Calculation – Estimated 35% Tax Bracket

- **Year 1:** $130,000.00 distribution per beneficiary
- **Year 2:** $140,000.00 distribution per beneficiary
- **Year 3:** $140,000.00 distribution per beneficiary
- **Year 4:** $170,833.33 distribution per beneficiary
- **Year 5:** $187,847.22 distribution per beneficiary

- **Total withdrawn by each beneficiary:** $768,680.56
- **Total tax paid:** $382,732.64
- **Overall tax rate:** 49.79%
- **Total distributions from Trust:** $1,537,361.11