AMERICAN BAR ASSOCIATION

Tax Section

2022 FALL TAX MEETING

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Here Today, Gone Tomorrow

Tax Issues Affecting Temporary Residents

U.S. Activities of Foreigners and Tax Treaties

October 14, 2022

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The Panel

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Objectives

- Aliens may come to the U.S. for a temporary period that may be fixed, flexible or undefined. We refer to such aliens as "temporary residents".
- Although the rules for temporary and permanent residents are largely the same, the way these rules work for temporary residents results in their facing issues which can differ from aliens who are coming to the U.S. for the long-term or permanently.
- This program seeks to identify the most important issues and suggest ways to deal with them, taking into account the differing circumstances of temporary residents.

Key Considerations and Objectives

- Understand the different definitions of residence and the impact on timing of change of residence
- Limit exposure of assets to U.S. estate and gift taxes
- Plan for application of worldwide taxation to foreign and U.S. assets:
  - Basis step-up
  - Loss importation
  - Dealing with controlled foreign corporations and passive foreign investment companies (not just non-U.S. funds)
  - Deal with existing trusts and foundations
  - Trust planning
- Consider home country consequences of changing residence
- Plan for the possibility that temporary may become permanent

Differences

- For the advisor, the starting point is to understand the client's expectations:
  - Why are they coming?
  - How long do they expect to be here?
  - How firm are their plans?
- Differences:
  - Some come for a clearly defined period
  - Some come for an undefined period
  - Some come for an exploratory period
  - These differences can significantly affect planning. We will try to address this during our presentation

Timing – Different Rules

- Bear in mind:
  - Residence is defined differently for purposes of income tax and taxes on gifts and estates.
  - Residence is defined differently for purposes of Federal income tax and state income taxes.
  - There are even a number of situations where the main Federal income tax definition of residence does not apply.
  - Other countries have their own rules and it is possible that an individual may be resident in two or even more than two countries or none, depending on the application of these rules.

Pre-Residence Planning

The key to planning for a prospective resident is to determine exactly when residence will begin and to carry out tax planning best undertaken before that.

- Accurately time when U.S. tax residence begins for income tax and transfer tax purposes.
- Consider carefully appropriate immigration status, given punitive rules applicable to green card holders who later become “covered expatriates” on leaving the United States.

Timing Arrival

- Timing arrival in the United States is critical
- Consider alternative visas and exempt individual rules (e.g., student visas (although duration limited)
- For income tax purposes, arrival in 2nd half of year may make it possible to be in the United States for several months without becoming a resident (except green card holder)
- But residence may begin right away for transfer tax and state tax purposes
- Some countries (e.g., Canada) will not treat an individual as ceasing residence unless new residence established but, in some cases, an individual may cease to be resident in the previous country without becoming a U.S. tax resident until the beginning of the next year

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Lawful Permanent Resident (Green Card) Test

- U.S. resident for any year in which individual holds a green card) for any part of the year. Reg. § 301.7701(b)-1(b)(1)
- Residency Starting Date:
  - First day the person is physically present in the U.S. as a lawful permanent resident. IRC section 7701(b)(2)(A)(ii); Reg. § 301.7701(b)-4(a).
  - Assumes the substantial presence test not already met
  - Also assumes not a resident in the prior year
- Exception:
  - If person is also a resident of a treaty country (i.e., dual-resident taxpayer) and that treaty has a tie-breaker rule. Reg. § 301.7701(b)-7

Substantial Presence Test ("SPT") – 1

- Must be present in the U.S. for at least 31 days in current year <u>and</u> satisfy the 183 weighted average calculation as of last day of physical presence in the current year. IRC section 7701(b)(3)(A); Reg. § 301.7701(b)-1(c)(1).
- Begin Date:
  - Use look-back rule to determine current year.
  - If satisfy test, first day will be the first day of physical presence in U.S. during calendar year in which the test is satisfied. IRC section 7701(b)(2)(A)(iii); Reg. § 301.7701(b)-4(a).
- <u>General "121 Day" Rule</u>: If the individual does not have a green card and is not on a preferred visa classification, then if the individual stays in U.S. for at most 121 days each year then the individual will avoid being considered a U.S. income tax resident under the SPT.

Substantial Presence Test – 2

- De Minimis Rule - Must be present in the U.S. for at least 31 days in current year to satisfy the substantial presence test. IRC section 7701(b)(3)(A)(i); Reg. § 301.7701(b)-1(c)(4).
- Nominal Presence - Up to 10 days of presence disregarded if person can establish a closer connection to a foreign country. IRC section 7701(b)(2)(C); Reg. § 301.7701(b)-4(c)(1).

Substantial Presence Test – 3

- Foreign tax home/closer connection.
- Statutory exception applies if throughout the year, the individual:
  - Has a "tax home" in another country.
  - Has a closer connection to the other country than to the United States.
  - Has less than 183 days of presence in year.
- "Tax home" does not mean tax residence in the other country. It means regular or principal place of business or, if none, regular or principal place of abode.
- Closer connection based on personal ties

Both Tests Satisfied

What If a Person Satisfies Both Tests for the First Time in the Same Year?

The residency starting date is the earlier of (i) the first day the individual is physically present in the U.S. as a lawful permanent resident or (ii) the first day during the year that the individual is present for purposes of the substantial presence test. Reg. § 301.7701(b)-4(a).

Tax Treaty Residence Provisions

- Most U.S. tax treaties have provisions dealing with individuals who are resident in the United States and in another country
- The treaties typically provide a series of tiebreaker tests so that the individual will be resident in one but not both
- For incoming residents, useful mainly in delaying start of U.S. residence
- Warning: Treaty nonresidents may still be treated as U.S. residents for some (but not all) reporting purposes. Exceptions:
  - Form 8938
  - Form 8621 (PFICs) in certain cases
  - Uncertain: FBARs where U.S. residence results from SPT

Non-Standard Treaties

- China
  - Go directly to competent authority but use UN Model Treaty principles
- Australia
  - Switches habitual abode and center of vital interests
  - Does not have nationality as tie-breaker rule
- Certain older treaties (No Tie-Breaker Rules)
  - Greece (1953)
  - Pakistan (1957)
  - Trinidad and Tobago (1970)
  - Former USSR (1973)
    - Still applicable to Armenia (though Armenia does not recognize), Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan

Immigration Status

- The alien needs to consider what immigration status is most appropriate.
- If an individual considers it likely or possible that he or she will not remain permanently in the United States, consider whether a green card is necessary.
- The covered expatriate rules IRC sections 877A and 2801 apply only to a green card holder who ceases to be resident after being a lawful permanent resident **in** 8 of the preceding 15 years.
- But green card may be necessary (for example, dependent children of non-green card holders cannot remain in the United States as once they become adults) or much more convenient. It can also help persuade the home country that the move away is permanent.

Short-Term Residence – Some Deadlines

- Green card holder becomes a long-term resident potentially exposed to the covered expatriate rules if present in the United States in (not for) 8 years within 15 calendar years – i.e., as little as 6 years and 2 days
- IRC section 7701(b)(10): Alien resident for period including at least 3 consecutive calendar years ceasing to be a resident who subsequently becomes a resident before the close of the 3rd calendar year beginning after residence ended is taxable for the period during the interim period in the manner provided in section 877(b)
- 30 social security totalization agreements are currently in force (https://www.ssa.gov/international/). Under the "detached worker" rule, a person temporarily transferred to work for the same employer in another country (assignments expected to last for five years or less) remains covered only by the country from which he or she has been sent.

Gift and Estate Tax Residence

- Transfer taxes: Residence is based on concept of domicile
- Regulations provide that a person has a U.S. domicile if physically present in the United States with no fixed intention to depart.
  - Immigration status is relevant but not determinative.
  - It is possible (a) to have a green card and not be domiciled in the United States and (b) to have non-immigrant status and yet be treated as domiciled in the United States.
- Temporary residents need to consider whether they can take the position that they have not acquired U.S. domicile, even if they have obtained a green card. On this will depend whether gifts can be made or trust planning can work after income tax residence has begun.
- Alternatively, consider deferring gifts until after departure

Dealing with Non-U.S. Assets

All or Nothing

- No landed basis – basis in assets is computed using U.S. rules
  - No statutory and very little treaty coordination with deemed sales for foreign tax purposes, including foreign exit taxes
- Cash method can result in tax on income earned before residence and received after residence
  - But favorable treatment of payments from pre-residence installment sales - *see* TAM 8708002 and PLR 9412008
- No rule limiting application of anti-avoidance rules for CFCs, PFICs and trusts for temporary residents
- Gifts:
  - Pre-residence (domicile) – taxable only on U.S.-situs property
  - Post-residence – fully taxable

General Pre-Immigration Planning Points

- Given worldwide tax exposure of U.S. resident for income tax purposes (and potentially U.S. transfer tax purposes), most effective tax planning can be achieved prior to a move to the U.S. since the NRA is then neither subject to U.S. income tax nor U.S. transfer (i.e., estate and gift) tax on non-U.S. assets.
- Common strategies include the following:
  - Accelerate income
  - Sell or step up the basis of appreciated assets
  - Keep loss assets and substantiate basis prior to U.S. residency
  - Avoid foreign tax credit mismatches (if possible)
  - Deal with interests in foreign corporations, esp. CFCs and PFICs (see below)
  - Deal with pensions and deferred compensation plan
  - Trust planning – both for income tax and transfer tax purposes (see below)
- All of this must be coordinated with home country advisors

General Pre-Immigration Planning Points

- Inventory assets and income sources
- Planning requires that entities and arrangements (especially foreign ones) be classified as business entities, trusts or contractual rights
  - Corporations (Treas. Reg. section 301.7701-2(b))
  - Partnerships (Treas. Reg. section 301.7701-2(c)(1))
  - Other business entities (Treas. Reg. section 301.7701-2(c)(2))
  - Trusts (Treas. Reg. section 301.7701-4)

General Pre-Immigration Planning Points

- Common strategies include the following (continued):
  - Invest in a variable life insurance policy ("LIP") or in an annuity
    - Useful both for income tax planning and transfer tax planning for assets transferred to LIP or annuity prior to establishing U.S. residency
    - Private Placement Life Insurance Plans ("PPLI(s)") and Private Placement Deferred Annuities ("PPDA(s)") are good tools but are currently subject of scrutiny due to perceived abuse (scrutiny is not just directed at cross-border planning)
      - PPLIs – Better for long term immigration to the U.S.
      - PPDAs – Better for short term residence in the U.S.
    - Note: Practitioners need to consider local law to avoid foreign tax traps especially with insurance policies. Most foreign-issued life insurance policies from insurance carriers unfamiliar with U.S. rules do not meet the definition of a life insurance contract under IRC 7702. Can cause major compliance and tax issues for individual that becomes a U.S. tax resident.

General Pre-Immigration Planning Points

- Common strategies include the following (continued):
  - Consider creating irrevocable discretionary trusts
    - Drop-off trust designed to keep assets out of gross estate
    - Foreign "drop-off" trust if set up or funded within 5 years of U.S. residency will become grantor trust if it has (or may have) a U.S. beneficiary (including beneficiary who later moves to the U.S.) Correctly draft irrevocable trust may still offer value and protection for U.S. transfer tax purposes
    - Conversely, with enough advance notice, consider ability to create nongrantor trusts outside of 5-year window
      - Nongrantor trusts can be foreign or domestic depending on appetite for U.S. tax complexity and permanency.
      - If current year distributions are less than or equal to distributable net income ("DNI"), then the income taxation of U.S. beneficiaries of foreign nongrantor trusts is equivalent to the taxation of a domestic nongrantor trust whose capital gain is included in DNI (see more detailed discussion below).

Controlled Foreign Corporations (CFCs)

- Before 2017, shareholder of a CFC with active foreign business did not pay tax on income from that business until it was distributed
- GILTI changed this, but for C corporation shareholders, the trade-off was bearable – effective permanent rate reduction and in exchange for loss of deferral
- For individuals, no trade-off: Immediate taxation at ordinary rates with no credits for foreign tax (except dividend withholding taxes)
  - Therefore, an individual moving to the U.S. should not simply leave an active business CFC in place and defer taking distributions until after residency ends

Subpart F – The Old

<table>
<tr>
<th>Subpart F income – section 951(a)
(passive income and certain related party business income, unless taxed at 90% of US corporate rate (31.5%);)</th>
<th>Other income</th>
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- Immediate taxation
- Full rates (individuals cannot treat Subpart F inclusion as qualified dividend)
- Actual dividend not taxed (PTI)
- Basis in CFC increased by PTI (and reduced by distribution of PTI)
- Foreign tax credit available:
  - Foreign withholding tax when PTI distributed but timing issue
  - Indirect credit only for C corporations

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- Deferred taxation. Deferral ends:
  - When dividend paid (can qualify as qualified dividends, if CFC in treaty country)
  - CFC invests in US property (section 956) – treated like Subpart F income
  - When shares sold (section1248)
- Foreign tax credit available:
  - Foreign withholding tax
  - Indirect credit only for C corporations

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Subpart F, GILTI and QBAI – The New

Subpart F income

- No change but note high tax kickout income increased due to cut in US rate (i.e., passive and related-party income is not Subpart F income if foreign tax is 90% of 21% (18.9%), down from 90% of 35% (31.5%))

GILTI – section 951A (most business income)

- 10% C corporation shareholders:
  - Immediate taxation at 50% (10.5%)
  - 80% foreign tax credit available
- Individuals
  - Full individual rates
  - No FTC, except on dividends
  - Must consider section 962 election

Qualified business assets income (QBAI) and high taxed FPHC income

- QBAI = 10% return on tangible depreciable assets
- High foreign tax FPHC (threshold now 18.9%)
- 100% dividends received deduction for 10% C corporation shareholders
- Other shareholders
  - Deferral
  - Sections 956 and 1248 not repealed

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Typical Business Profile (Especially Individually–Owned)

Subpart F income

GILTI

Immediate 37% + on distribution 3.8%

QBAI

40.8% on distribu-tion

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Retained Interests in CFCs

- The individual may be unable or not wish to sell interests in a foreign corporation that is already or will (as result of his change of residence) become a CFC
- Consider alternatives to prepare for residency period and model out options:
  - Check-the-box elections to obtain flow-through treatment
  - IRC section 962 election
  - Contribution to a U.S. C corporation.
  - Decontrol: Prevent corporation from even becoming a CFC (but then is it a PFIC?)
- Especially if from a treaty jurisdiction with significant foreign tax on corporate income, may be best for temporary resident to retain CFC interest and make a section 962 election - no deemed sale/gain on U.S. exit and, based on *Smith* case, distributions after residence terminates will not be taxable.
- Contribution to U.S. C corporation least preferred for temporary resident: May be taxable in foreign country; post-residence exit likely to be tax inefficient; U.S. C

Passive Foreign Investment Companies (PFICs)

- PFICs are often undesirable and in some cases actively harmful
- But they may have little or no impact for temporary resident if they make no distributions during the residence period and the temporary resident does not sell them
- Note Prop. Reg. section 1.1291-3(b)(2) (1992) (loss of citizenship or residence is a deemed disposition of PFIC – doubtful if this regulation is valid; there is no such rule in the statute)

PFIC Rules to Watch Out For

- CFC Overlap Rule (Section 1297(d))
  - Effective 1/1/1998 CFC rules trump PFIC rules for “U.S. shareholder”
  - Beware Section 1298(a)(2)(B) attribution rule that turns off CFC Overlap Rule for PFIC attribution of ownership purposes
- Holding Company Exception (Section 1297(c))
  - 25% or greater ownership of stock of another corporation applies a look-through rule to deem activities and assets held by the subsidiary to be performed or held proportionally by the parent
- Always consider impact of indirect attribution rules, which are unclear with respect to beneficiary interests in discretionary trusts. There are no constructive ownership rules for PFIC purposes

Retained Interests in PFICs

- Consider ability/impact of default IRC section 1291 PFIC rules and pattern of distributions expected during residency period
- Consider viability of a Qualified Electing Fund election (requires annual cooperation of PFIC) or availability of mark-to-market election
- Moving foreign funds can be problematic
  - Some funds allow conversion to fund designed for U.S. investors
  - Others will provide required information to enable newly U.S. resident to make QEF election
  - In some cases, funds do not permit U.S. investors (even temporary residents) and must be sold/redeemed; may require giving substantial notice

Foreign Corporations – In General

- Corporate distributions are allocated under usual section 301(c) rules, so new resident can be taxed on distributions from earnings and profits (E&P) from pre-residence years of <u>any</u> foreign corporation
  - Need to compute E&P using U.S. rules even though corporation has never had any dealings with the U.S.
  - If information unavailable, all distributions may be presumed to be dividends
- For non-CFCs, where possible, defer distributions until temporary residence ends. For example, share rights in family-owned company may be adjusted or recapitalized where other shareholders require continuing dividends

Pension and Deferred Compensation Plans

- Foreign plans almost never meet U.S. qualification requirements
- Existing plans raise numerous issues:
  - Deductibility of contributions
  - Taxation of plan income
  - Taxation of lump sum or periodic distributions or withdrawals
    - IRC section 72(w): Payouts treated as annuities (investment in the contract does not include foreign employer contributions that were free of foreign tax)
  - Examples:
    - Timing mismatches if foreign country taxes distributions and U.S. taxes plan income when earned
    - U.S. does not allow rollover into qualified U.S. plans
- Most treaty pension articles are inadequate

Pension and Deferred Compensation Plans

- Planning requires analysis of the plan to understand how it is likely to be taxed once the individual is a U.S. resident
  - Differentiate between ownership interest in plan assets and mere contractual right to future benefits from unsegregated assets
  - Check application of section 409A and exceptions (especially exception for plans fully funded before residence and regulatory exemption for foreign “broad-based” unfunded retirement plans)
  - Consider terminating or suspending plan or participation in plan (where possible under foreign law)
  - Review reporting requirements – plan is a foreign financial account for purposes of FBAR and Form 8938; see Rev. Proc. 2020-17 limiting application of foreign trust reporting requirements

Passive Foreign Investment Companies (PFICs)

- A foreign entity is a Passive Foreign Investment Company ("PFIC") under Section 1297(a) if it is a foreign corporation and:
  - 75% or more of its gross income is passive,
  - Average percentage of assets producing or held for production of passive income is 50% or more, or
  - The foreign corporation previously qualified as a PFIC and such status was not 'purged' ("Once a PFIC always a PFIC" rule)

Once a U.S. Person, Prepare for Large Scale Reporting of Foreign Assets – 1

Forms to Consider:

- Form 56, *Notice Concerning Fiduciary Relationship*
- Schedule B (Form 1040) Part III, *Foreign Accounts and Trusts*
- Form 1040NR, *U.S. Nonresident Alien Income Tax Return (Foreign Non-Grantor Trusts)*
- Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*
- Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*
- Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*
- Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*
- Form 5472*, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

Once a U.S. Person, Prepare for Large Scale Reporting of Foreign Assets – 2

- Form 8938, *Statement of Specified Foreign Financial Assets*
- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*
- Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*
- Form 8233, *Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*
- Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding and Reporting (Individuals)*
- Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting*
- Form W-8BEN-E, *Certificate of Status of Beneficial Owner for U.S. Tax Withholding and Reporting (Entities)*
- Form 8833, *Treaty Based Return Position Disclosure under Section 6114 or 7701(b)*
- Form 8832, *Entity Classification Election*

Trusts and Foundations

Existing Foreign Trust/Foundation Structures

- Question 1:
  - Is the existing foreign entity/arrangement a “trust” for U.S. tax purposes?
- Question 2:
  - Was trust a grantor trust when settled by the non-U.S. settlor?
- Question 3:
  - If trust was a non-grantor trust upon settlement, does it become a grantor trust when the settlor becomes a U.S. person and what are the U.S. tax implications?
  - Should trust remain a nongrantor trust? If yes, what should be done?
  - Should the trust be domesticated?
- Question 4:
  - If trust was a grantor trust upon settlement, does it remain a grantor trust and what are the U.S. tax implications?

1 – Definition of Trust

- Trust is defined in Reg. section 301.7701-4:
- "An arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts"
- The word foreign does not appear in the regulation
- Nevertheless, a foreign arrangement or entity can be classified as a trust even though the word trust never appears (conversely, some arrangements are not trusts even though they use the words "trust" or "fiduciary")

1 – Definition of Trust

- Foreign entities/arrangements taxed as trusts under U.S. law
  - Estate of Swan v. Commissioner, 24 T.C. 829 (1955)
  - PLR 2002260012
  - PLR 200302005
  - PLR 200901023
  - Chief Counsel Advice AM-2009-12 (2009)
  - ROST v. U.S., 130 AFTR 2d 2022-5462
  - Other miscellaneous cases and rulings
- Takeaways
  - Local law designations are not determinative.
  - A foreign entity/arrangement's key attributes need to be analyzed in their totality for determining whether, substantively, it is more aligned with those of a trust under U.S. law or those of a business entity under U.S. law - *a facts and circumstances test.* Key issues:
    - Was foreign entity/arrangement established to protect and conserve family property (a trust under U.S. law) or to carry on trade or business (corporation or partnership under U.S. law).
    - Is the holder of the assets of the foreign entity/arrangement acting in a fiduciary capacity?

2. Classification of Trust – Grantor or Non-Grantor

- Income tax concept: Who is the taxpayer: the settlor (grantor trust) or the trust and/or its beneficiaries (non-grantor trust)?
- Grantor Trust (settlor as taxpayer)
  - If settlor is a **U.S. person** (generally Code Sections 672 – 678)
    - Reversionary interests; powers over beneficial enjoyment; administrative powers; revocation powers; income for benefit of grantor or grantor's spouse; etc. Limited exception for independent
  - If settlor is a **non-U.S. person** (Code Section 672(f)(2)(A))
    - When the settlor is a non-U.S. Person, the trust is a grantor trust only if either:
      - **Revocable**: "the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor," OR
      - **Only beneficiaries settlor and/or spouse**: "the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor".
  - If settlor is a **"new" U.S. person** – special rules under Code Section 679
    - If, within 5 years of becoming a U.S. person, settlor directly or indirectly transfers property to a foreign trust, and if trust can have a U.S. beneficiary, then trust becomes a grantor trust when the settlor becomes a U.S. person.
    - Defined terms: "transfer", "U.S. beneficiary" etc.
    - Limited exceptions
- Nongrantor Trust (trust as taxpayer) -- a trust that is not a grantor trust

2. Classification of Trust – Foreign or Domestic

- Domestic (i.e., U.S.) Trust (section 7701(a)(30)(E))
  - "court test" – "a court within the United States is able to exercise primary supervision over the administration of the trust."
  - "control test" – "one of more United States persons have the authority to control all substantial decisions of the trust."
- Foreign Trust:
  - Any trust that is not a U.S. trust.
- Relevance of distinction:
  - Foreign trust may be grantor trust under section 679
  - Domestic trust taxed on worldwide income; foreign non-grantor trust taxed like a nonresident alien
  - Throwback rules apply to distributions by foreign non-grantor trust (sections 665-668)
  - Deemed sale or exchange of assets when trust becomes foreign (section 684)
  - If (under foregoing rules) trust is grantor trust, it makes no difference if it is domestic or foreign

3. Foreign Nongrantor Trust with U.S. Beneficiaries

- Trust taxed like an individual (if U.S., worldwide income; if foreign, limited categories of U.S. income)
- U.S. taxation of the U.S. beneficiaries
  - Beneficiaries taxed on distributions if trust has current income (DNI) or accumulated income (UNI); trust receives deduction for distribution of DNI
  - Throwback tax regime is applicable to "accumulation distributions" received by U.S. beneficiaries from foreign nongrantor trust. (Section 665(b))
  - Throwback tax regime has three major components:
    - <u>Throwback tax</u> – Income tax on U.S. beneficiary who receives accumulation distribution from foreign nongrantor trust. Approximates U.S. tax that would have been paid if trust had distributed income to beneficiary as it arose in prior years. (Sections 666 and 667)
    - <u>Recharacterization of income</u> – Distribution taxed at ordinary income tax rates, even if accumulation derived from trust capital gains. (Sections 666 and 667)
    - <u>Interest charge</u> – Interest charge, compounded daily, applies to throwback tax attributable to UNI. When combined with the tax, can completely consume trust distributions that U.S. beneficiaries receive. (Code Section 668)

3. Foreign Nongrantor Trust with U.S. Beneficiaries

- If U.S. beneficiary is treated as indirect owner of trust shares in CFC or PFIC, income derived by beneficiary from CFC or PFIC is taxed directly to beneficiary and is not DNI and cannot become UNI
- Instead, U.S. beneficiary is the taxpayer
- Treasury and IRS have for years failed to produce guidance on how this is supposed to work where the trust is discretionary, especially one with no or limited history of distributions and/or both U.S. and foreign beneficiaries. Latest guidance, in preamble to T.D. 9936 (January 15, 2021):

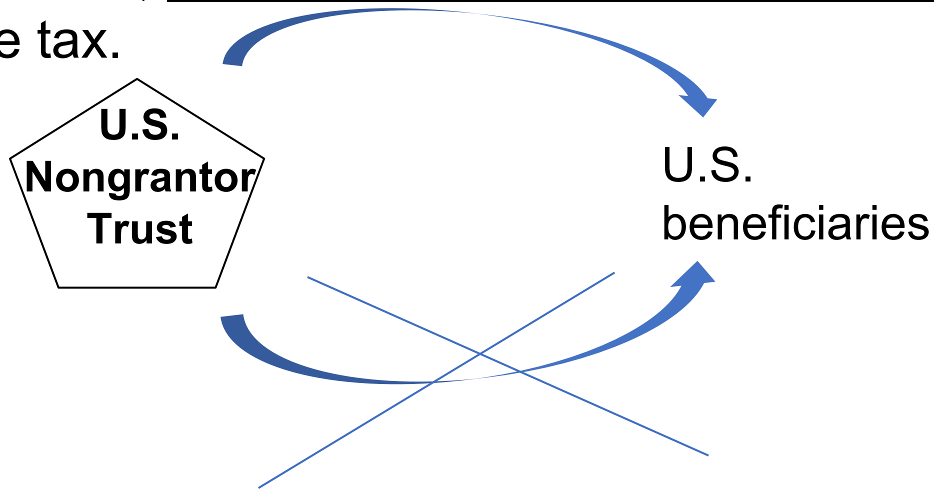
  "The Treasury Department and the IRS believe that further guidance with respect to the identification of indirect shareholders in such circumstances requires coordination of the PFIC rules with the rules of subchapter J, which is beyond the scope of this regulation project. Pending the issuance of further guidance, taxpayers should continue to apply these rules in a reasonable manner as expressed in the preamble to the 2013 temporary and final regulations."

Existing Foreign Trust/Foundation Structures

Ground Rules

When a nongrantor trust (U.S. v. foreign) has income in a particular year ……

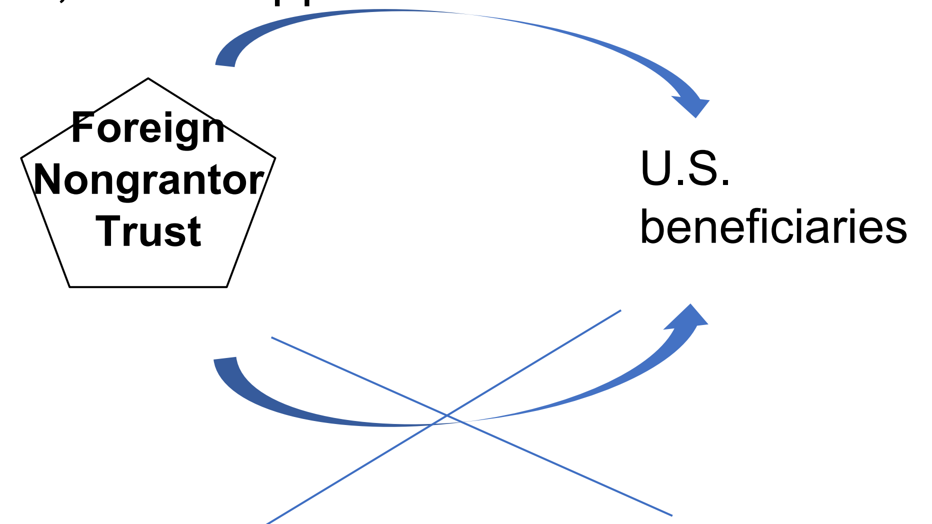
If distributed, **<u>U.S. beneficiaries OR U.S. trust</u>** pay the tax.



If **<u>not</u>** distributed, **<u>U.S. trust</u>** pays the tax.

- Current taxation on a worldwide basis.
- Trust income's characters are preserved in the hands of the U.S. beneficiaries.
- No double taxation between trust and beneficiaries.

If distributed, what happens to U.S. beneficiaries???



If **<u>not</u>** distributed, **<u>foreign trust pays no U.S. tax</u>** except on U.S. business income or other taxable income.

- Foreign trust is taxed as a foreign individual.
- No U.S. tax on non-U.S. source income.
- No U.S. tax on U.S.-source capital gains or certain interest income.

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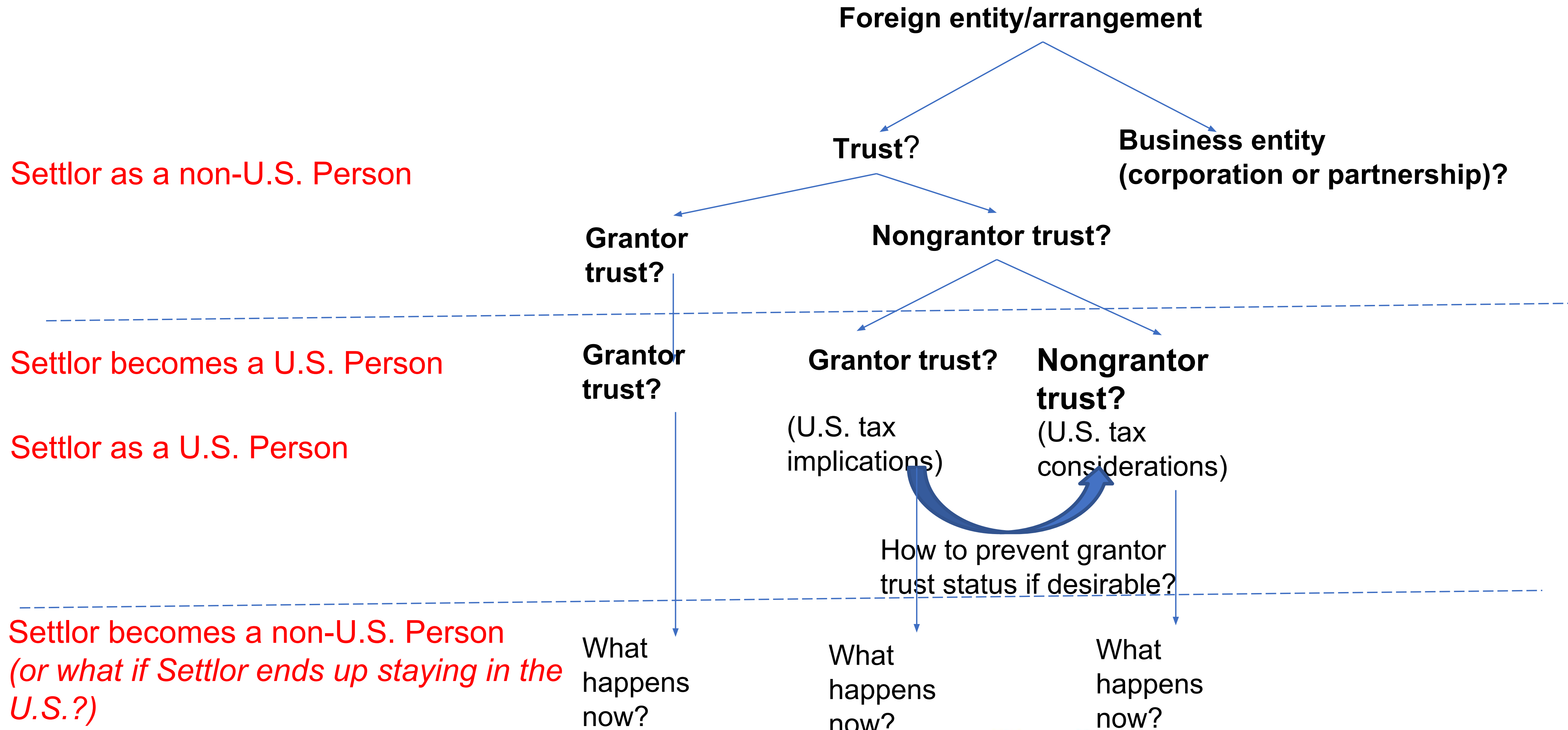
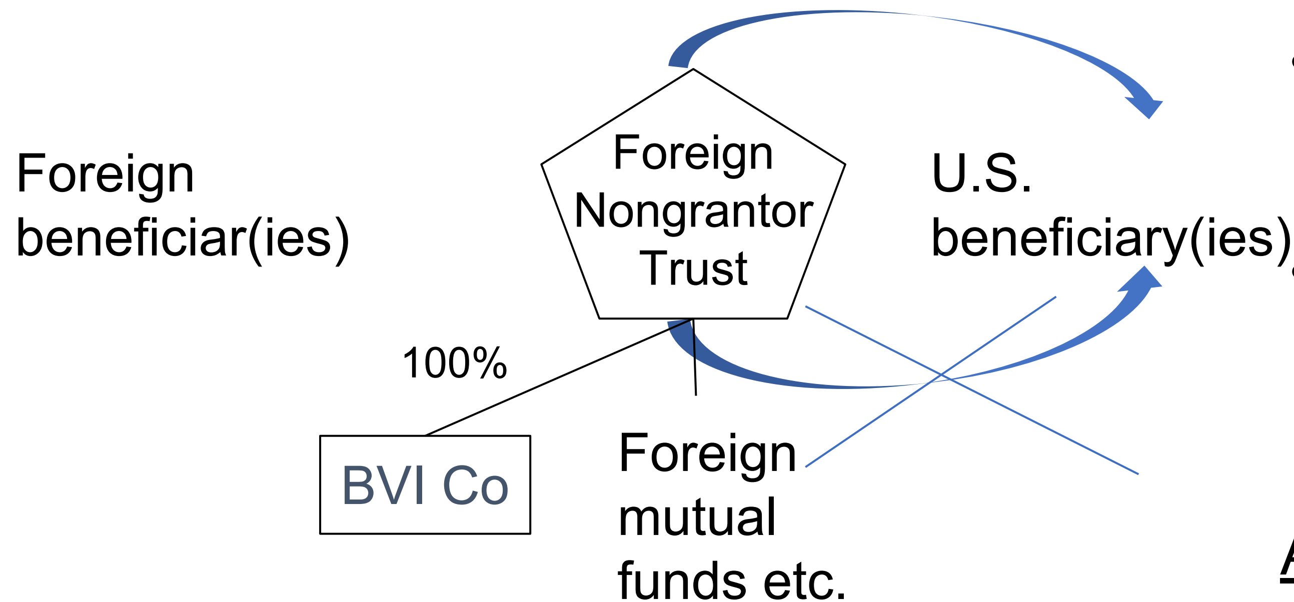
Existing Foreign Trust/Foundation Structures

Prospective U.S. Person as Settlor



Existing Foreign Trust/Foundation Structures

Prospective U.S. Person as Beneficiary



In case of trust distributions:

- Distributions not exceeding current year trust income.
- Distributions exceeding current year trust income (accumulation distribution?).
- Alternative distribution strategies in anticipation of the beneficiary's substantial financial needs during his temporary stay in the U.S.

Absent trust distributions:

- CFC attribution and Subpart F/GILTI income concerns.
- PFIC attribution; special management opportunity for temporary residents.

3. Should a Foreign Trust Be Domesticated?

- Domestication often the preferred alternative to deal with foreign non-grantor trust if non-settlor beneficiary becomes a U.S. person
- But it may not make sense where beneficiary's residence is expected to be temporary
  - If trust is discretionary, avoid distributions during temporary stay
  - Track DNI and UNI (including from pre-residence years)
  - Avoid/minimize steps causing temporary resident to be owner of stock in CFC or PFIC or cause corporation to become a CFC
- If domestication is desirable (e.g., if trust owns assets that will be used by temporary resident):
  - Various methods should be considered (e.g., partial domestication, decanting, distribution to original grantor and re-settling)

3. Should a Foreign Trust Be Domesticated?

- If temporary resident was settlor of trust that is a non-grantor trust before residence begins:
  - If trust remains foreign, may become grantor trust (section 679) or because of retained interests (sections 673-677) that were trumped by section 672(f) when grantor was foreign
  - Continued grantor trust status may be acceptable, but consider whether trust does or can be amended to keep trust corpus out of temporary resident’s estate under retained interest rules (esp. section 2036). Domestication does not directly affect this planning.
  - Whatever is decided, consider domestication to avoid burdensome and dangerous Form 3520 and 3520-A requirements.

4. Should a Grantor Trust Remain a Grantor Trust?

- If the foreign grantor remains foreign, the trust can stay in place
  - But consider preparations for the possibility that the foreign grantor might die during the period of temporary residence
- If the grantor is the impending temporary resident:
  - As noted, continued grantor trust status may be acceptable
    - Also, it avoids application of section 684 when residence ends
    - But what made the trust a grantor trust when it was foreign may cause estate tax exposure under section 2036 retained interest rule
    - If section 2036 is to be avoided, better to distribute assets to grantor pre-residence and start over (otherwise three-year section 2035 risk), possibly with a domestic non-grantor trust

Ending Residence

How to Relinquish U.S. Person Status (Voluntarily)

- Alien with non-immigrant status
  - Just leave the U.S. and avoid triggering U.S. SPT rules (mentioned earlier)
  - Try and abide by 120-day rule plan each year or explore closer connection exception planning (if in U.S. <183 days each year), or treaty tie-breaker option (if more in U.S. >=183 days but maintain treaty country tax residency)
  - Remember: In departure year, residence terminates on last day of presence only if alien has a closer connection to another country until end of year
- U.S. green card holder
  - File Form I-407 (generally via certified mail (or foreign equivalent)), some airports/ports of entry allow relinquishment upon entry into the U.S.
  - Claim nonresidence under a treaty
  - RESIDENCE DOES NOT END JUST BY ALLOWING GREEN CARD TO EXPIRE
- U.S. Citizen
  - Expatriation – Renunciation before consular officer or relinquishment via an expatriating act

How to Relinquish U.S. Person Status

- Green Card Holder Strategies
  - HOLD – Request re-entry permits to preserve green card status while residing abroad. Must be periodically present in the U.S. to qualify and must not file federal income tax return as a treaty non-resident
  - FOLD – Sign I-407 and plan ahead for U.S. visa/work authorization as needed. Ideally leave U.S. and surrender green card before first day of eighth year holding green card
  - DOWNGRADE – Downgrade green card to non-immigrant work visa. Strategy is allowed. Can apply for non-immigrant visa immediately upon surrender; visa generally can permit U.S. work authorization. However, no status change while in U.S. (visa must be applied for abroad). Approval not guaranteed
  - UPGRADE – Only makes sense if intend to reside in U.S. indefinitely and concerned about re-entry. Can have positive tax treaty benefits in countries with preferential U.S. citizen terms (e.g., France with deemed paid credit rules)

General Pre-Expatriation Tax Considerations

- Ending U.S. residency can have significant tax considerations for the U.S. person and their assets including foreign entity and trust interests
  - Generally, no deemed sale rule on loss of U.S. person status under the CFC rules
  - As previously mentioned, 1992 Proposed Regulations, treat ending U.S. residency as taxable disposition of a 1291 PFIC fund
    - However, this rules is only under the Proposed Regulations and not under the statute.
  - If the U.S. person is a long-term green card holder (held it in 8 of the last 15 tax years) or U.S. citizen, terminating green card or U.S. citizenship could trigger the U.S. exit tax rules if they are considered a “Covered Expatriate”
  - Where U.S. person is the grantor of, or has a substantial power with respect to a trust, the trust could inadvertently become a foreign trust with consequences under IRC section 684 (deemed disposal of trust assets)
- We touch on the last two potential consequences in the next set of slides

U.S. Exit Tax Rules

- Definition of “Covered Expatriate”
- The individual must be an “expatriate”
  - U.S. citizens who surrender their citizenship
  - Residents who surrender green cards if held in 8 of the last 15 years.
- The current section 877A rules apply to expatriates that are “Covered Expatriates” with an expatriation date on or after June 17, 2008
- For an expatriate to be a “Covered Expatriate” and be subject to the U.S. exit tax, the expatriate must flunk one of three tests:
  - (1) Have an average annual net income tax liability for the last five years before the expatriation tax year of at least $178,000 (in 2022);
  - (2) Have a net worth of at least $2 million; or
  - (3) Fail to certify five years of U.S. tax compliance for the five years before the year of their expatriation

U.S. Exit Tax Rules

- Exit Tax – IRC Section 877A Income Tax Rules
- All of the covered expatriate's property is treated as sold for fair market value as of the day before the expatriation date
- Any gain or loss realized is required to be recognized. An exclusion of $767,000 (in 2022) is permitted
  - Pre-residence gain is excluded if date of residence basis can be established
- An election to defer recognized gain until sale of property is permitted, subject to requirement for adequate security
- The exit tax provides for aggressive taxation of deferred compensation, including items that are not yet vested and are subject to a substantial risk of forfeiture
- The exit tax also requires 30% withholding on the taxable portion of distributions from nongrantor trusts (with the definition of nongrantor trusts defined under the exit tax rules). However, special rules apply and interpretation of such tax as a withholding tax and not as a substantive tax can lead to interesting results

U.S. Exit Tax Rules

- Section 2801 Inheritance Tax (Not In Force Until 2015 Proposed Regulations Finalized)
  - This is actually a tax on the U.S. recipient of covered gifts and bequests from a Covered Expatriate and is not a tax on the Covered Expatriate. Hence, its operation as an inheritance tax.
  - Any U.S. person who receives a gift or bequest from a covered expatriate is liable for the tax, computed at the highest transfer tax rate in effect upon receipt (currently 40%).
  - Also applies to gifts or bequests to domestic trusts and to distributions from foreign trusts, except distribution that is subject to income tax). Foreign trusts can elect to be treated as domestic trusts for this purpose.
  - Marital and charitable deductions are permitted, as is the annual exclusion.

U.S. Exit Tax – Planning (1)

- If the residence is temporary, or at least not necessarily permanent:
  - Try to avoid classification as "covered expatriate"
  - Delay getting a green card as long as possible
    - Use other forms of non-immigrant status, e.g., E-1 treaty trader and E-2 treaty investor
      - Note: Dependents can only acquire green cards before age 23; can time out due to processing delays.
    - While still U.S. citizen or domiciliary, lower net worth using gifts to citizen spouse and gifts using unified credit
    - For pre-expatriation years, file separate returns to avoid meeting income tax test (tax on joint return deemed paid by both spouses)
  - Mitigate tax on capital gains
    - Maximize valuation of assets as of first year of residence (under either residence test)
    - Reduce value of assets subject to mark-to-market tax using valuation discounts through traditional estate planning techniques. Gift tax valuation rules apply for net worth test purposes; estate tax valuation rules apply for exit tax calculation purposes. *See* Notices 2009-85 and 97-19

U.S. Exit Tax – Planning (2)

- Create “pre-expatriation trust” to use any remaining unified credit and generation skipping transfer tax exemption exemption before expatriating
- Traditional annual exclusion gifting
- Traditional estate freeze techniques
- Potential dynastic trust planning post-expatriation and change in domicile due to mismatched “Covered Expatriate” definition in Section 2801(f) if resumes U.S. income tax residence

Outbound Trust Migrations

- A transfer from a U.S. person to a foreign trust is a deemed sale of that property triggering gain, but not loss. IRC 684(a).
- A transfer from a U.S. person to a foreign grantor trust does not trigger gain so long as the trust remains a grantor trust with respect to that transferor. IRC 684(b).
  - Note the interaction between IRC 679 and the definition of foreign trust under IRC 7701(a)(31)(B).
  - If a foreign person has control (or veto) over a substantial decision and the trust becomes a foreign trust, it will likely be treated as a grantor trust under IRC 679 if there is a U.S. grantor.
- Similarly, if a trust switches from being a domestic trust to being a foreign trust, gain, but not loss, will be triggered. IRC 684(c).

Outbound Trust Migrations

- As an exception to the general rule of outbound migrations of domestic trusts, the regulations provide that a trust may avoid the application of the gain recognition rule in the event of an inadvertent migration.
- In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change (e.g., an inadvertent change from a U.S. substantial power holder to a foreign person), the trust is allowed 12 months to make necessary changes to avoid a change in the trust's residency (e.g., the replacement of the foreign person with a U.S. person), with retroactive effect. Treas. Reg. 301.7701-7(d)(2).
- As part of pre-expatriation planning, all trusts should be examined to identify potential IRC 684 outcomes. Trusts that were grantor trusts prior to U.S. residency that stay grantor trust post-expatriation should not have any IRC 684 tax consequences.

Conclusion

- No one has a crystal ball and clients often cannot predict whether they will become U.S. residents, for how long, or what their U.S. nexus will be long term. However, with proactive planning with flexibility in mind many obstacles can be tackled effectively with proactive planning and competent advice.
- There are many strategies and potential solutions that are workable, but all avenues have their benefits and detriments. The goal is to allow clients to make an informed decision and to try and facilitate their immigration and lifestyle goals but cognizant of the tax costs that come with establishing a U.S. nexus – whether that is temporary or long term.

For more information

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Questions?