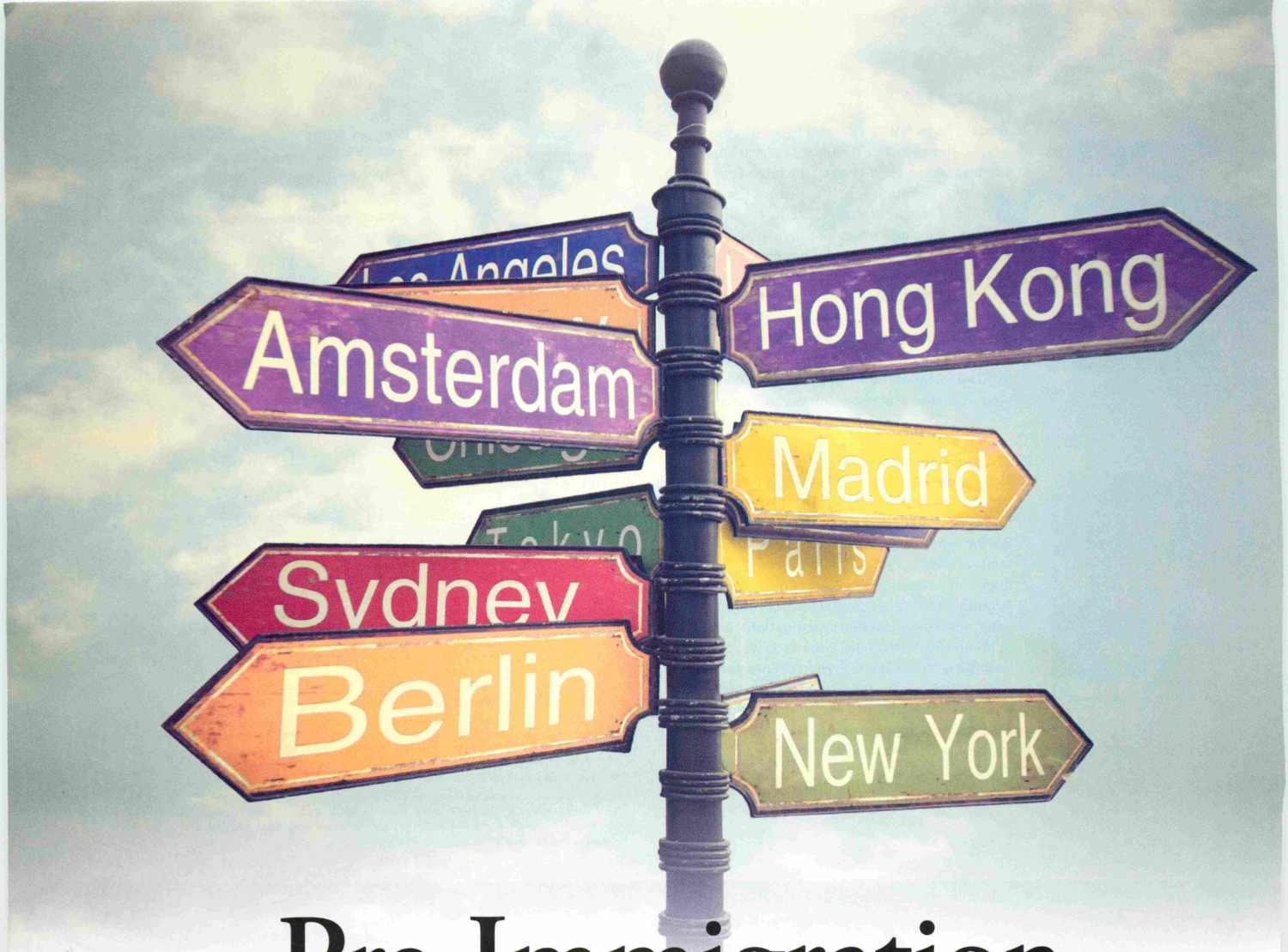

Pre-Immigration TAX PLANNING

by Jacob Stein

The recent decade has seen a significant inflow of wealthy EB-5 immigrants to the United States. The move to the United States exposes these immigrants to the U.S. tax system, which taxes them on worldwide income and imposes an estate tax on their worldwide assets. With proper planning U.S. income and estate taxation of wealthy immigrants can be significantly minimized.

Overview of U.S. Taxation

There are three ways a country can define its tax borders: citizen-based, residence-based and territorial. A citizen-based tax system taxes all income earned by a citizen, regardless of where the citizen lives or where the income is earned. The residence-based model taxes worldwide income of those individuals who are resident in the country. The territorial system taxes only the income earned within that country.

The United States uses both the citizen-based tax system and the residence-based tax system. U.S. citizens and U.S. income tax residents are subject to U.S. taxation on their worldwide income (net of deductions) as well as reporting requirements on certain foreign financial assets. Conversely, nonresident aliens (non-U.S. citizens and non-U.S. tax residents, "NRAs") are subject to U.S. income tax only on their investment income from U.S. sources and income from a U.S. trade or business. Similarly, the United States imposes an estate tax on the worldwide holdings of its citizens and tax residents.

Wealthy immigrants often come from countries that use a residence-based tax system (where income taxation may be avoided or minimized by splitting residence between two countries), that use a territorial tax system (no taxation of income earned abroad), have a low tax rate, or a lax tax collection system. They are often unprepared for the U.S. tax system, which not only will tax their worldwide earnings, but will do so aggressively and in a well-structured manner.

Residence

All tax planning for an immigrant starts with the determination of when the immigrant becomes a U.S. resident alien for tax purposes ("U.S. tax resident"). This is the day on which the immigrant becomes subject to the U.S. tax regime. All pre-immigration tax planning must be in place prior to this date. Determining the residence start date is very different for income tax and for estate tax purposes.

For income tax purposes, an NRA becomes a U.S. tax resident if: (1) he holds a green card at any time during the taxable year, (2) meets the substantial presence test or (3) makes an election to be deemed a U.S. tax resident for a tax year when present in the United States for at least 31 days. Under the substantial presence test, U.S. income tax residence is triggered as follows: (i) presence in the United States for at least 31 days during the calendar year, and (ii) presence in the United States for 183 days or more taking into account: all the days of the calendar year at issue, one-third of the days of the first preceding calendar year, and one-sixth of the days of the second preceding calendar year.

If a non-resident alien becomes a U.S. tax resident under the substantial presence test, then he is deemed to be a U.S. tax resident for U.S. income tax purposes from January 1 of that year. An immigrant who comes to the United States on a "green card" or an EB-5 visa will be deemed a U.S. tax resident on the date when he obtains permanent residence and is physically present in the United States. If an immigrant meets the substantial presence test and obtains an EB-5 visa in the same calendar year, then the residence start date will be determined under the substantial presence test (i.e., January 1).

An NRA may stay in the U.S. for up to 183 days a year without becoming a U.S. tax resident if the NRA has a tax home in a foreign country and a closer connection to that foreign country. This is also mirrored in some income tax treaties. All income tax treaties also use a residence tie-break test if an individual can be deemed a tax resident of both treaty countries. Using the treaty tie-break must be disclosed to the Internal Revenue Service and does not relieve the NRA of certain reporting requirements (like disclosure of foreign bank accounts).

Using the treaty tie-break may be problematic for an immigrant seeking a permanent residence visa in the United States. Claiming a foreign country residence would usually contradict the stated intent of an immigrant visa applicant to reside permanently in the United States.

For estate tax purposes an NRA becomes a U.S. tax resident when the NRA has intent to make the United States his domicile (no intention of leaving). This is a subjective test, and intent is inferred through circumstantial evidence, such as the length of stay in the United States, statements of intent on visa application, frequency of travel, size and cost of U.S. home, location of close family members, social activities, business interests and voting records. For an immigrant seeking an EB-5 visa it would be difficult to argue that his domicile is intended to be outside the United States.

Taxation of NRAs

Having determined the residence start date, the focus shifts to how the United States will tax the NRA's pre-immigration planning transactions.

Income tax rules applicable to NRAs are complex. As a general rule, an NRA pays a flat 30 percent tax on U.S.-source "fixed or determinable, annual or periodical" ("FDAP") income that is not effectively connected to a U.S. trade or business, and which is subject to tax withholding by the payor. The rate of tax may be reduced by an applicable treaty to anywhere between zero and 15 percent. FDAP income includes interest, dividends, royalties, rents annuity payments, and alimony. For example, if an NRA receives interest income from U.S. sources (other than interest on bank deposits), he is subject to a 30 percent tax. Note that the NRA is subject to this tax but does not pay it. The 30 percent FDAP tax is withheld by the payor at the time of payment and remitted to the U.S. Treasury. The NRA receives the remaining 70 percent.

NRAs are generally not taxable on their capital gains from U.S. sources unless (i) the NRA is present in the United States for more than 183 days, (ii) the gains are effectively connected to a U.S. trade or business (this includes gain from sale of U.S. real property), or (iii) gains are from the sale of certain timber, coal or domestic iron ore assets. When these exceptions apply, the NRA is taxed on U.S. source capital gains at the rate of 30 percent.

NRAs may be subject to U.S. transfer taxes (estate and gift) if they have property in the United States. The estate tax is imposed only on the NRA's property that at the time of death is situated in the United States. An NRA is subject to the same 40 percent estate tax rate as a U.S. taxpayer, but only the first $60,000 of property value is exempt. These harsh rules may be ameliorated by an estate tax treaty. The United States does not maintain as many estate tax treaties as income tax treaties, but there are estate tax treaties in place with most Western European countries, Australia and Japan.

The following assets are specifically included in the definition of property situated in the United States: (1) shares of stock of

Continued to page 16

"Non-U.S. income earned by an NRA prior to the residence start date is not taxable by the United States."

Continued from page 15

a U.S. corporation, (2) revocable transfers or transfers within three years of death of U.S. property or transfers with a retained interest, and (3) debt issued by a U.S. person or a governmental entity within the United States (e.g. municipal bonds).

Gift taxes are imposed on the donor. A NRA donor is not subject to U.S. gift taxes on any gifts of non-U.S. situs property gift to any person, including U.S. citizens and residents. U.S. citizens and residents must report gifts from a NRA, in excess of $100,000 on Form 3520.

Gifts of U.S.-situs assets are subject to gift taxes, with the exception of intangibles, which are not taxable. Tangible personal property and real property is sited within the United States if it is physically located in the United States.

Pre-Immigration Planning

There are generally four tax planning objectives that an immigrant may wish to accomplish prior to the resident start date: (1) recognize capital gains and step up basis; (2) accelerate income; (3) defer deductible expenses; and (4) transfer assets to foreign trusts.

Recognize Capital Gains

Following the residence start date the immigrant is taxed identically to every other American taxpayer. On a sale of a capital asset, the United States will tax the difference between the sale price and the tax basis (the acquisition cost, subject to possible adjustments). The burden falls on the immigrant to establish the tax basis, and if the immigrant cannot establish basis, it will be presumed to be zero.

When immigrants sell their foreign assets following the residence start date, many cannot substantiate tax basis, and those that can, often have low basis. Some assets may have been owned for decades or for generations, and the acquisition costs are either negligible or long forgotten. This holds true for all types of foreign assets, including real estate, investment portfolios, interests in closely held businesses, intellectual property and art.

Because basis is defined as the cost of the property, an NRA can increase basis of an existing asset by transferring the ownership of the asset in exchange for its fair market value. This may include the sale of an asset, the exchange of an asset for a similar asset, a contribution of an asset to a foreign corporation or partnership, a liquidation of an existing entity (an actual liquidation or by using the "check-the-box" rules to elect disregarded entity status) or a distribution of an asset from an existing entity.

Immigrants often engage in the above transactions by selling or transferring assets to family members. There is no prohibition from using related parties for these transactions, but these transactions would be ignored if they lacked economic substance, and consequently should be structured at arm's length.

Accelerate Income

Non-U.S. income earned by an NRA prior to the residence start date is not taxable by the United States. It is therefore beneficial for NRAs to recognize income, to the extent possible, prior to the residence start date. This may include factoring (selling) accounts receivable to increase tax basis or transferring the incidence of taxation to another foreign person or entity, receiving early distributions from foreign pension plans, accelerating stock options, paying out dividends, prepaying salaries, bonuses, commissions, interest, rents, royalties and license fees.

Another important component of accelerating income is to trigger existing accumulated earnings and profits of foreign corporations. For many immigrants their foreign corporations will be classified as controlled foreign corporations following the residence start date, and the immigrants will be taxed on their share of the "Subpart F" income of the foreign corporation. Taxation of Subpart F income is limited to the extent the foreign corporation has accumulated earnings and profits. Earnings and profits can be stripped out of the corporation through a dividend distribution, by liquidating the existing corporation and incorporating a new entity or by using the check-the-box rules to elect disregarded entity status.

Continued to page 18

Continued from page 16

Defer Losses and Deductible Expenses

Some NRAs may have assets that have significantly declined in value from the time they were acquired. Selling or exchanging these assets prior to residence start date will adjust the tax basis downward, to current fair market value. If the acquisition basis can be substantiated, then it is best to preserve the built-in losses of these assets and trigger them only following the residence start date. These losses can then be used by the now U.S. tax residents to offset ordinary income and capital gains.

If an NRA has an extensive investment portfolio with significant values, it would be beneficial to selectively pick stocks that will be sold and repurchased prior to U.S. tax residence (to increase tax basis), and stocks that will not be sold prior to residence start date (to preserve high basis).

Similar logic is applied to deferring the payment of those expenses that would be deductible for U.S. income tax purposes, including both business and personal expenses.

Foreign Trusts

A trust classified as a "foreign trust" is treated for U.S. tax purposes as an NRA. As discussed above, the United States taxes NRAs only on U.S.-source income and imposes an estate tax only on U.S.-sited assets. For these reasons, funding a foreign trust prior to the residence start date is a significant pre-immigration tax planning tool.

Funding U.S. assets into a foreign trust removes them from the U.S. estate tax base, and funding non-U.S. assets into a foreign trust not only removes them from the U.S. estate tax base, but may also eliminate U.S. income taxation.

As discussed above, NRAs are not subject to U.S. gift taxes on gifts of non-U.S. assets and on gifts of all intangible assets (even if in the United States). This allows NRAs to remove an unlimited amount of wealth from their possible U.S. estate prior to the residence start date.

There are four notable points on the U.S. income tax treatment of a pre-immigration foreign trust. First, if the foreign trust ever makes a distribution to a U.S. beneficiary, the distribution will be subject to a throwback regime and an interest charge. Second, capital gains earned by the trust and not currently distributed are taxed under the ordinary income tax rules. Third, trusts funded within five years of the U.S. residence start date are taxed as grantor trusts. Fourth, U.S. beneficiaries must report distributions received from a foreign trust.

The income tax advantages of foreign trusts may be limited when they have U.S.-source income, U.S. beneficiaries or are established within five years of U.S. residence. In certain situations the practitioner may intentionally seek to have the foreign trust classified as a grantor trust. This avoids the application of the throwback regime, reporting requirements for beneficiaries and taxes the grantor on trust income, allowing the grantor to further reduce his assets otherwise subject to the U.S. estate tax.

Conclusion

Advance pre-immigration tax planning can significantly reduce U.S. income and estate taxes of EB-5 investors. This is commonly accomplished by transferring ownership of assets into newly created legal entities or distributing assets from existing entities to obtain a basis step-up, reincorporating entities to obtain basis step up and strip out accumulated earnings and profits, deferring deductible expenses, accelerating income, and funding foreign trusts.

The planning must also account for the tax laws of the immigrant's home country. It would make little sense to reduce U.S. taxes if home country taxes are increased by the same or nearly the same amount. As a matter of practice the author always coordinates U.S. pre-immigration tax planning with foreign tax counsel. ★

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