Inbound Tax Planning: What Your Clients Need To Know Before Immigrating

Part 1 – Income Tax Planning

By John R. Strohmeyer, J.D., LL.M.

The digital economy makes it easy for people and money to move across international borders. If the United States is not involved, then generally a nonresident of the United States will have few, if any, interactions with the Internal Revenue Service (IRS). However, as more foreign citizens look to the United States as a place to invest, advisers need to be aware of the tax laws that apply to nonresidents. [1] Why? When a nonresident becomes a "resident" of the United States for tax purposes, the rules change dramatically, and if not anticipated, the consequences can be severe.

Any person who is considering spending more time in the United States should be aware of the two tax systems that affect individuals: the federal income tax and the federal "wealth transfer" taxes – the estate tax, the gift tax and the generation-skipping transfer tax. Addressing either of these tax systems would be enough to fill volumes, so this article will be divided into two parts, and this Part I will only address the income tax aspects of the immigration process. Part II of this article will address the wealth transfer taxes.

Because of the complexity involved in planning for any one of these taxes, both articles only provide a cursory introduction to the concepts involved in immigration tax planning. And beyond the rules outlined in both parts of this article, the United States is a party to over 50 bilateral income tax treaties and several bilateral estate and gift tax treaties, each of which creates a unique taxing regime between the two countries. For these reasons, many concepts have been abbreviated or left out entirely to provide a brief overview.

Decades ago, Congress implemented a worldwide taxation system, meaning that U.S. citizens and residents are subject to U.S. income tax on their worldwide income. This is dramatically different than most countries, which use a territorial system to impose income tax only on the income generated within that country's own borders. To offset potential double taxation, the United States allows taxpayers to use worldwide expenses to reduce worldwide income, and grants a foreign tax credit for foreign income taxes paid on income generated outside of the United States.

Because of the differences between the U.S. worldwide tax system and the territorial taxation system, nonresidents must know how and when they will be treated as residents for U.S. tax purposes. For income tax purposes, non-citizens are divided into two groups: residents and nonresidents. An income tax resident is a person who satisfies one of two tests: the legal permanent resident test and the substantial presence test.

continued on next page

The legal permanent resident test (also known as the "green card test") is satisfied if a person is a lawful permanent resident of the United States (because they have been granted a "green card," and with it, the right to legally reside in the United States) at any point during the tax year.[2]

The substantial presence test, although more complicated, is satisfied if a person is present in the United States for at least 31 days during the calendar year, and for 183 or more total days during the current year and the previous two years (with only a fraction of each day from the prior two tax years being counted). A person who can demonstrate a closer connection to another country may qualify for an exemption to the substantial presence test.[3]

Both tests produce a clear result based on bright-line rules. Once determined to be a resident under either test, residents must file income tax returns to report and pay tax on their worldwide income. Additionally, residents must comply with foreign asset reporting requirements (e.g., the FBAR, Form 5471 and Form 8938).

But if not determined to be a resident, then nonresidents are only subject to income tax on income derived from sources within the United States. And instead of a single set of tax rules applicable to all income, the income derived by a nonresident breaks down into four broad categories of taxation.

Effectively Connected Income (ECI) – Nonresidents are generally taxed in the same manner on effectively connected income as citizens and residents: only the net income (i.e., applicable deductions are allowed) is taxed at graduated rates. The determination of whether income is effectively connected with a U.S. trade or business is a two-prong test. Under the first prong, the taxpayer must be engaged in a U.S. trade or business, while under the second prong, any income must be effectively connected with that U.S. trade or business.

It is possible for a nonresident to have both effectively connected income and non-effectively connected income in the same year. If the nonresident has both, the filing of a return will almost always be required. If the nonresident only had non-effectively connected income and income tax is withheld at the source, no return would likely need to be filed.

A nonresident's income from the conduct of a U.S. trade or business includes income from the performance of personal services within the United States at any time during the tax year. However, if the services are performed for a foreign employer, the aggregate compensation does not exceed $3,000, and the nonresident is present in the United States for 90 days or less during the tax year, the nonresident will not be treated as being engaged in a U.S. trade or business.[4]

A foreign person who trades in stocks, securities or commodities in the United States is not treated as conducting a U.S. trade or business (and is not subject to U.S. income tax on his/her "effectively connected income" from the securities or commodities trading) if the foreign person does not have an office in the United States through which, or under the direction of which, the securities transactions are affected.[5] Safe harbor rules enable a foreign individual to avoid being treated as conducting a U.S. trade or business even if he/she or it has an office in the United States that otherwise would cause that income to be effectively connected income if the transactions are for the taxpayer's own account.[6]

Fixed, Determinable, Annual or Periodical Income (FDAP Income) – FDAP Income is generally passive income realized by nonresidents earned from U.S. sources that is not "effectively connected" with a U.S. trade or business (e.g., dividends, interest, rent and royalties). FDAP Income is taxed at a flat 30 percent rate. A significant drawback to being taxed at a flat rate is that a taxpayer is taxed on the gross amount received, and is not allowed deductions for the expenses of producing such income. The flat 30 percent tax is also imposed on original issue discount on certain debt obligations,[7] net gains from the sale of capital assets of taxpayers who have been present in the United States for 183 days or more during the taxable year[8] and 85 percent of any Social Security benefits.[9]

Sales of U.S. Real Property and the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA Income) – Nonresidents may elect to treat their real property gains as effectively connected income. Before the enactment of the FIRPTA in 1980, a foreign person could invest in U.S. real property without being subject to U.S. income tax on the later sale or disposition of that U.S. real property, providing a great advantage to foreign investors. FIRPTA treats a foreign individual's gain and loss from the disposition of a U.S. real property interest as income or loss effectively connected with a U.S. trade or business. Additionally, while income from real property (e.g., rent and royalties) would be treated as FDAP income (and subject to 30 percent tax), nonresidents may elect to treat that income as effectively connected income so that it is taxed on a net basis at graduated rates.

Generally, the purchaser of a foreign person's real property must withhold 15 percent of the purchase price (not the gain on the sale), and remit that amount to the IRS.[10] The withholding rate is 10 percent if the purchase price is less than $1,000,000 and the property is acquired for use as a residence.[11] This withholding may not be the actual amount of tax due on the disposition, and is only an advance payment toward the final income tax due. So, the foreign investor will need to file the appropriate income tax return (e.g., Form 1040NR and Form 1120F) to report the sale. Any tax withheld on the sale will be credited against the amount of tax due on the return.[12]

There are several exceptions to this withholding. For example, if the purchaser acquires the property to use as a residence and the amount realized does not exceed $300,000, then no withholding is required.[13] Additionally, no withholding is required if the seller provides the purchaser with an affidavit stating, under penalty of perjury, the seller's United States taxpayer identification number and that the seller is not a foreign person.[14]

Income Not Subject to Income Tax – A few types of income, such as interest generated by assets held in a bank account, escape income tax entirely. For example, a foreign taxpayer is not subject to U.S. tax on U.S. source capital gain not effectively connected with a U.S. trade or business. Interest on bank deposits with U.S. banks paid to nonresidents or foreign corporations is not taxed in the United States if the interest is not effectively connected with the foreign person's U.S. trade or business.[15]

Conclusion: Many Traps for the Unwary

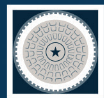
Even this brief introduction to the U.S. income tax shows the varied rules, exceptions, requirements and exemptions that apply to both U.S. residents and nonresidents. These rules are complicated and present many traps for the unwary. But the increased amount of investment in the U.S. by foreign citizens looking for a safe haven for their investments presents opportunities for these tax traps to be sprung. The tax planning needed to avoid these tax traps will take on a greater importance in the coming years as it becomes easier to transfer money and property into the United States.

In Part II, concepts involved in planning for the wealth transfer taxes are addressed because that planning is an integral part of the planning process when a person considers immigrating to the United States.

Footnotes

1. See Jesse Drucker, *The World's Favorite New Tax Haven Is the United States* (available at http://www.bloomberg.com/news/articles/2016-01-27/the-world-s-favorite-new-tax-haven-is-the-united-states).
2. Code § 7701(b)(1)(A)(i).
3. Code § 7701(b)(1)(A)(ii), (b)(3). An individual may also elect under Code § 7701(b)(4) to be treated as a resident alien in the year before satisfying the substantial presence test.
4. Code § 861(a)(3).
5. Code § 864(b)(2).
6. Code §§ 864(b)(2)(A)(ii), (B)(ii).
7. Code § 871(a)(1)(C). Original issue discount accrues over the life of the debt instrument under rules in Code § 1273. Nonresidents are taxed on accrued OID when payments are made on the instrument or when an OID obligation is sold or exchanged.
8. Code § 871(a)(2). Note that in most cases, a person who is present in the United States for more than 183 days during a taxable year is treated as a resident for U.S. federal income tax purposes and would be subject to tax at graduated rates on his/her worldwide income. Thus, the scope of the rule under Code § 871(a)(2) is narrow. But certain persons, including students and foreign government officials, may avoid U.S. resident status even if present in the United States for more than 183 days in a year and can be subject to the Code § 871(a)(2) regime.
9. Code § 871(a)(3).
10. Code § 1445(a); Treas. Reg. § 1.1445-1(c)(1).
11. Code § 1445(c)(4), Treas. Reg. § 1.1445-1(b).
12. Treas. Reg. § 1.1445-1(f)(1).
13. Code § 1445(b)(5).
14. Code § 1445(b)(2).
15. Code §§ 871(i)(2)(A), 881(d).

John R. Strohmeyer is an associate at Crady, Jewett & McCulley LLP in Houston. His practice focuses on estate planning and estate administrations for high-net-worth individuals, including a developing international focus. He is also the co-chair of the International Tax Committee of the tax section of the State Bar of Texas.
He may be contacted at jstrohmeyer@cjmlaw.com.



Goodman Financial
MONEY MANAGER • FINANCIAL ADVISOR • PHILANTHROPY
SERVING CLIENTS FOR OVER 25 YEARS

AN INDEPENDENT FEE-ONLY FIRM SINCE 1988
5177 Richmond Ave., Suite 700
Houston, Texas 77056
713.599.1777
WWW.GOODMANFINANCIAL.COM

TRUST OUR TEAM
MEETING INVESTMENT MANAGEMENT NEEDS ACROSS TEXAS AND BEYOND