PRE-IMMIGRATION TAX PLANNING CONSIDERATIONS

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Notoriously aggressive and grossly intricate, U.S. tax law is often a trap for the unwary. Among tax professionals, it is well-known that U.S. citizens or residents are subject to income tax on their worldwide income and gift/estate tax on their worldwide assets. However, this global taxation snare often comes as a shock to a non-U.S. person who might be more familiar with the concept of territoriality, or "source country" taxation, or who comes from a country where gift/estate taxes are nominal (or even nonexistent).

This piece discusses what causes an individual to be characterized as a U.S. person/resident for both U.S. income tax and U.S. gift/estate tax purposes, and mentions certain tax-planning strategies for nonresidents who anticipate moving to the United States and becoming U.S. residents. While the U.S. income and gift/estate tax regimes may both be aggressive relative to other countries, one should not be discouraged from moving to the United States. There are pre-immigration tax strategies that minimize the impact of these regimes, and the transactional costs to implement these strategies pale in comparison to the significant, adverse U.S. tax consequences of failing to act.

TO BE OR NOT TO BE A U.S. RESIDENT

The ability of the United States to tax nonresidents (as opposed to U.S. residents) is limited.

From an income tax perspective, nonresidents are subject to U.S. income tax on:

i. Income (net of certain allowable deductions) from an active business conducted in the United States, including, in most cases, the rental of U.S. real property, at rates up to 37 percent (or 29.6 percent in the case of certain qualifying businesses), and from the sale of such businesses or U.S. real property, mostly at capital gains rates of up to 20 percent; and

ii. Certain U.S.-sourced, passive (nonbusiness) income (such as royalties, dividends, interest and, in some cases, rents) at a 30 percent (or lower, applicable treaty) rate.

From a gift or estate tax perspective, nonresidents are generally subject to tax upon the transfer of their U.S.-situs assets, such as U.S. real estate holdings or tangible personal property located in the United States. In addition, nonresidents are subject to estate (but not gift) tax with respect to U.S.-situs intangibles, such as debt obligations issued by U.S. persons and stock issued by U.S. corporations. The U.S. gift and estate taxes are at rates up to 40 percent of the value of the U.S.-situs assets (with only the first $60,000 of value being exempt from taxation).

In contrast, U.S. residents and U.S. citizens are subject to U.S. income tax on their worldwide income and gift/estate tax on their worldwide assets. Income is generally taxed at rates of up to 37 percent, although certain trade or business income may qualify for the lower 29.6 percent maximum rate. A lower maximum tax rate of 23.8 percent applies to certain gains from assets held for more than one year and certain corporate dividends from U.S. corporations or foreign corporations located in certain treaty countries. The gift/estate tax is on worldwide assets at rates of up to 40 percent of the asset's fair market value (but the first $11 million-plus of value, adjusted annually for inflation, is exempt from taxation).

With the disparity of treatment between a nonresident and a U.S. resident, proper "residency planning" for income and gift/estate tax purposes is crucial.

DETERMINING U.S. RESIDENT CLASSIFICATION

Somewhat counterintuitively, the determination as to whether an individual is a U.S. tax resident does not fall squarely in line with the definition of residency under U.S. immigration laws. Moreover, the tests for determining U.S. tax residency for purposes of the U.S. income tax versus the gift and estate taxes vary significantly. Accordingly, a nonresident may become a U.S. resident for income tax purposes but not necessarily for estate and gift tax purposes.

For U.S. income tax purposes, in order for an individual to be classified as a U.S. resident, he or she must (i) be considered a lawful permanent resident (*i.e.*, apply for a green card or, in some cases, an EB-5 visa), (ii) be deemed to have spent 183 days or more in the United States under the substantial presence test, or (iii) elect such treatment.

The substantial presence test is met if the individual is present in the United States for at least 31 days of the current calendar year and if the sum of the following equals 183 days or more:

1. the individual's actual days in the United States in the current year;
2. one-third of the individual's days in the United States in the immediately preceding year; and
3. one-sixth of the individual's days in the United States two years prior.

Therefore, as an example, if an individual spent fewer than 122 days in the United States in each of years 2017, 2018 and 2019, he or she will be just under the threshold for 2019 and not classified as a U.S. resident for U.S. income tax purposes:

2019: **121 days**

2018: **40.33 (one-third of 121 days)**

2017: **20.2 (one-sixth of 121 days)**

Total: **181.53 days (Total is under the 183-day threshold)**

In comparison, for estate tax purposes, the residency test is more subjective and regulated by the individual's "domicile." The determination of an individual's domicile is based primarily on two elements:

1. **Physical presence**, which requires not just physical presence but also a showing of domestic habitation; *and*
2. **Intent**, which requires that the individual have no present intent to make his or her home elsewhere.

The controversy in this area typically arises from the subjective "intent" of the domiciliary. Intent can be shown through numerous objective indicators, such as whether or not the individual holds or has applied for a green card, where the individual has residential properties and the relative sizes of the properties, where the individual maintains businesses and professional relationships and where the individual's family members are located.

REDUCING TAXABLE INCOME

While U.S. residents are subject to U.S. tax on their worldwide income and gains, nonresidents are not subject to U.S. tax on foreign source income or most gains. So, before moving to the United States, a nonresident should consider accelerating the recognition of foreign income and nontaxable gains before becoming a U.S. tax resident. Similarly, if he or she expects to dispose of foreign assets that have appreciated in value, he or she should do so before establishing U.S. tax residency (assuming that the foreign tax with respect thereto is lower than the U.S. tax thereon). In many instances, the cost basis of those highly appreciated assets can be "stepped up" to fair market value in a pre-immigration transaction that has no tax consequences in his or her country of origin, thereby eliminating any U.S. tax on appreciation that occurred prior to the date of the move.

Consideration should also be given to delaying the recognition of losses until U.S. residence is established to potentially offset future U.S. taxable income. For example, one strategy would be to retain assets that have depreciated and sell those assets after becoming a U.S. resident. If acquired in a foreign currency, such assets may produce losses when the value of the foreign currency decreases. The cost basis of the assets for U.S. income tax purposes is translated into U.S. dollars using the rate on the date of purchase of the assets; whereas, the gain or loss is translated into U.S. dollars at the current rate.

If a nonresident who is moving to the U.S. has one or more businesses outside the United States, he or she may also need to restructure those businesses so that he or she can either:

i. defer future U.S. taxation of the earnings therein (at least until such earnings are remitted to the U.S.); or

ii. maximize the extent that the source country taxes can be credited against U.S. taxes on the same earnings.

Again, such restructuring can frequently be accomplished through transactions that have no tax consequences in the country where the business is located.

REDUCING TAXABLE ESTATE

The nonresident, before becoming a U.S. resident, should complete all nontaxable gift transfers (outright or in trust) and thereby exclude those assets from his or her U.S. taxable estate and potentially from the U.S. taxable estates of his or her descendants. For nonresidents, the gift tax generally only applies to real property and tangible personal property located in the United States. Accordingly, the nonresident, before moving to the United States, should complete gift transfers (outright or in trust) of property located outside the United States and intangible property located within the United States.

In some instances, and provided that certain conditions are met, nonresidents may be able to transform a tangible asset into an intangible asset by transferring the tangible asset into an entity, and gifting the corporate stock or membership interest (an intangible asset).

A trust is a very common vehicle used to achieve various tax and nontax goals. For example, if a nonresident grantor forms a "grantor trust" (revocable trust or irrevocable trust that benefits only the nonresident grantor and/or the grantor's spouse during the grantor's lifetime), the income generated therein, even though accumulated for the future benefit of U.S. beneficiaries, is allocable to the nonresident grantor. The U.S. beneficiaries are not taxed thereon even upon ultimate distribution of the accumulated income to them. Alternatively, if a nonresident, before moving to the United States, creates and transfers assets to an irrevocable trust, he or she may be able to avoid U.S. estate taxes, sometimes for successive generations.

Trusts also provide privacy and the assets therein are protected against a beneficiary's creditors or divorce.

MOVING TO THE UNITED STATES?

Tax planning makes a huge difference in preserving family wealth. With the help of a U.S. tax adviser, you can try to familiarize yourself with your future U.S. tax obligations. From there, you can better determine what pre-immigration tax strategies to pursue to minimize those obligations.

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