EXPAT TAX HANDBOOK

Non-Citizens and U.S. Tax Residency

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Ephraim Moss, Esq. – 718-887-9933 Ext 101
emoss@expattaxprofessionals.com

Joshua Ashman, CPA – 718-887-9933 Ext 102
jashman@expattaxprofessionals.com

The Expat Tax Handbook – Non-Citizens and U.S. Tax Residency

Straightforward Explanations with Helpful Examples

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1. Residency for U.S. Income Tax Purposes

The Residency Rules

The U.S. income tax obligations of non-U.S. citizens depend on the tax residency status of the individual. It is therefore important to understand the criteria under U.S. tax law for distinguishing between non-citizens who are considered U.S. tax residents (so-called "resident aliens") and non-citizens who are considered not to be U.S. tax residents (so-called "nonresident aliens").

A non-citizen will be considered a resident alien for U.S. income tax purposes if he or she meets one of two objective tests: (1) the "lawful permanent residence" test or (2) the "substantial presence" test. A non-citizen that fails both tests will generally be considered a nonresident alien for U.S. income tax purposes.

Lawful Permanent Residence Test

Under the lawful permanent residence test, a non-citizen is considered a resident alien from the day he or she is admitted to the United States as a lawful permanent resident (i.e., receives a "green card") until the day that this status ends. Therefore, persons in lawful permanent resident status are considered U.S. tax residents even when they are living outside of the U.S.

A U.S. tax treaty, if applicable, may give a green card holder the option to elect non-resident alien ("NRA") status and thereby be released from U.S.-tax-resident status. This type of position is often very tricky and requires a detailed technical analysis by a tax professional.

Substantial Presence Test

Under the substantial presence test, an individual will be considered a U.S. resident for tax purposes if he or she is physically present in the United States on at least: (a) 31 days during the current calendar year; and (b) A total of 183 days during the current year and the 2 preceding years, counting all the days of physical presence in the current year, but only one-third the number of days of presence in the first preceding year, and only one-sixth the number of days in the second preceding year.

You are treated as present in the United States for purposes of the substantial presence test on any day you are physically present in the country, at any time during the day. However, there are exceptions to this rule. Examples of days of presence that are not counted for the substantial presence test include:

- days you are in the United States for less than 24 hours, when you are in transit between two places outside the United States; and
- days you are an exempt individual (which includes certain teachers, students, and professional athletes)

Exceptions

Additional exceptions to the substantial presence test include:

The "closer connection" test – Under U.S. tax law, even if you fail the substantial presence test, you can still be treated as a nonresident alien if you maintain a "tax home" in a foreign country during the year and have a "closer connection" during the year to one foreign country in which you have a tax home than to the United States.

Treaty relief – Under an applicable U.S. tax treaty, an individual may be subject to a less onerous test than the substantial presence test. The "tie-breaker rules" of many income tax treaties with the United States commonly provide that if an individual is a "resident," as that term is defined in the treaty, of both the United States and the treaty partner country, preference is given to the country where the individual has a permanent home available to him, or if one is available in both jurisdictions, then such person is considered to be a resident in the place where his personal and economic relations are closer ("center of vital interests").

Example – Michael, from Vietnam, comes to the U.S. in October 2017 with his wife and 2 small children and intends to stay and work in the U.S. for 2 years. In this case, Michael should generally not be considered an alien resident for U.S. federal tax purposes in 2017, assuming no presence in prior years.

IRS Examples – For further examples of alien residency offered by the IRS in various situations, please see the following link:

https://www.irs.gov/individuals/international-taxpayers/alien-residency-examples

2. U.S. Income Tax Implications of Residency

The following summarizes the key differences between the substantive U.S. federal income tax obligations of resident aliens and nonresident aliens.

A. Resident Aliens

In general, the **tax rate** applicable to your income will depend on your tax filing status and your taxable income amount. Beneficial rates may apply to certain types of income, for example, capital gains and qualifying dividends. The Tax Cuts and Jobs Act of 2017 (the "Trump Tax Reform") generally reduced the federal income tax rates for the 2018 tax year (with the top rate, for example, being reduced from 39.6% to 37%). The IRS publication official announcing the new rates can be found here:

https://www.irs.gov/irb/2018-10_IRB#RR-2018-06

If an individual has income from investments, the individual may be subject to a 3.8 percent Net Investment Income Tax ("NIIT") on the lesser of their net investment income (such as interest, dividends, capital gains, rental and royalty income, among others), or the amount by which their modified adjusted gross income exceeds the statutory threshold amount based on their filing status. The current thresholds are $250,000 (married filing jointly), $125,000 (married filing separately), or $200,000 (single or head of household). In general, nonresident aliens and nonresident alien spouses are not subject to the NIIT.

It is important to note that for certain high-income taxpayers, a so-called alternative minimum tax ("AMT") may apply. This additional tax is calculated separately from a taxpayer's regular tax and is paid in addition to the regular tax if certain criteria are met. AMT is intended to ensure that high-income taxpayers pay a minimum amount of income tax (e.g., in the case where the taxpayer's income is otherwise reduced due to available deductions and credits).

Anti-deferral regimes

Like U.S. citizens, resident aliens are subject to certain anti-deferral regimes that are designed to prevent U.S. taxpayers from deferring payment of U.S. tax through the use of foreign companies.

Following the Trump Tax Reform, the Internal Revenue Code now contains three principal anti-deferral regimes that may impose tax on a U.S. taxpayer on a current basis when its foreign subsidiaries generate income. They are the:

- Controlled Foreign Corporation ("**CFC**") regime;
- Passive Foreign Investment Company ("PFIC") regime; and

- Global Intangible Low-Taxed Income (“GILTI”) regime

(i) CFC Regime

A foreign corporation is a CFC when more than 50 percent of the voting power or value of its shares is owned by “U.S. shareholders.” A “United States shareholder” is generally any U.S. person who owns 10% or more of the total vote or value of shares in the foreign corporation. U.S. shareholders of a CFC are taxed on a current basis on certain types of income (generally referred to as “Subpart F” income) earned by the CFC even though the CFC has not made an actual distribution to the shareholder.

Furthermore, this income is taxed at ordinary income rates even if it would have been treated as capital gain (possibly taxed at lower tax rates) had it been earned directly by the shareholder.

(ii) PFIC Regime

A number of foreign investment products are classified as PFICs for U.S. federal tax purposes. Technically, a PFIC is a foreign corporation that has one of the following attributes: (i) At least 75% of its income is considered "passive" (e.g., interest, dividends, royalties), or (ii) At least 50% of its assets are passive-income producing assets.

Most foreign mutual funds fall within the definition of a PFIC. This can be the case even if such mutual funds are held through a foreign tax-deferred savings account or a non-qualified pension and retirement account. PFIC investment income is generally subject to highly punitive U.S. federal income tax rates. A non-deductible penalty interest charge can also compound regularly while holding an interest in PFIC stock.

Several elections are available to mitigate the more onerous aspects of PFIC taxation (e.g., a so-called “QEF election” or “mark-to-market” election). Special rules apply if such elections are not made by the taxpayer for the first year of PFIC stock ownership.

When a shareholder makes a QEF election, he will be required to include each year in gross income the pro rata share of earnings of the QEF and include as long-term capital gain the pro rata share of net capital gain of the QEF.

Under the mark-to-market election, shareholders must include each year as ordinary income, the excess of the fair market value of the PFIC stock as of the close of the tax year over its adjusted basis in the shareholder´s books. If the stock has declined in value, an ordinary loss deduction is allowed, but it is limited to the amount of gain previously included in income.

(iii) GILTI Regime

Starting with the 2018 tax year, a U.S. shareholder of any CFC will have to include in gross income the CFC's global intangible low-taxed income ("GILTI") in a manner generally similar to inclusions of Subpart F income as described above. In general, GILTI is computed as the income of the CFC (aggregated for all the CFCs owned by the U.S. shareholder) that is in excess of a 10% return on certain tangible property of the CFC. GILTI does not include income effectively connected with a U.S. trade or business, Subpart F income, Subpart F income qualifying for the high-tax exception, or certain related party payments.

A U.S. corporate (non-individual) shareholder is entitled to a 50% deduction to offset GILTI income plus an 80% foreign tax credit for the foreign tax paid at the CFC level (a so-called "indirect" credit). As a result, the corporate shareholder will be taxed at a maximum 10.5% rate (50% x 21% corporate tax rate), and there will be no additional tax if the GILTI was subject to foreign tax of at least 13.125%.

A U.S. individual, on the other hand, will be taxed at the ordinary tax rate on such GILTI income (37% will be the top rate starting with the 2018 tax year) with no 50% deduction and no foreign tax credit for the foreign tax paid at the CFC level. For this reason, an individual U.S. shareholder who holds at least 10% of the CFC should consider making a so-called "962 election" to be taxed as a corporation on the GILTI income (i.e., taxed at the 21% corporate rate with the indirect foreign tax credit, but still with no 50% deduction). Such an election can have complex and varied tax consequences, and a tax advisor should be consulted to fully understand its merits.

State and Local Tax Considerations

In additional to U.S. federal taxes, resident aliens can be subject to income taxation as residents of a particular U.S. state.

Residency rules vary by U.S. state and are not necessarily the same as the federal income tax rules described above. Careful consideration should be taken to determine one's residency for state and local tax purposes for someone immigrating to the U.S.

Some U.S. states do not have an income tax, although the majority of states do. The highest personal income tax rate of any state currently is California at the rate of 13.3%.

B. Nonresident Aliens

While the U.S. government taxes its citizens and tax residents on worldwide income and subjects them to certain anti-deferral regimes, it taxes nonresident aliens in a more limited manner.

First, foreign persons are generally subject to tax on U.S.-source "FDAP" (fixed, determinable, annual, or periodic) income, which includes passive-type items, such as interest, rent, royalties, and dividends. This income is taxed on a gross basis (i.e., with no offsetting deductions) at the rate of 30% by way of withholding at source by the U.S. payer, who has primary responsibility as the "withholding agent" to collect, deposit, and report the tax to the IRS. Failure to do so can expose the U.S. payer and foreign person to significant penalties and interest.

Second, foreign persons who are considered to earn income "effectively connected" with a trade or business in the U.S. (in contrast to the passive-natured FDAP income) are subject to tax at graduated rates on a net basis (i.e., reduced by available deductions). U.S. payers generally do not need to withhold tax on such effectively connected income ("ECI").

Example – Michael, from Vietnam, comes to the U.S. in October 2017 with his wife and 2 small children and becomes a resident for U.S. federal income tax purposes. Michael owns stock in a foreign corporation. If Michael were to receive dividends from the corporation or sell his stock interest prior to becoming tax resident in the U.S., his income would not be subject to U.S. federal income taxation. If Michael were to receive dividends from the corporation or sell his stock interest after becoming tax resident in the U.S., the income would be subject to U.S. federal income taxation and possibly subject to the anti-deferral regimes as well.

3. U.S. Tax Compliance Implications of Residency

Once an individual becomes a resident alien for tax purposes, in addition to being subject to U.S. income tax on worldwide income, he will have to file IRS forms that disclose his worldwide assets due to extensive U.S. reporting requirements of U.S. taxpayers with foreign assets. It is important that such individual understand the scope of this web of reporting before becoming subject to it.

U.S. taxpayers, including resident aliens, who hold accounts or assets overseas are subject to a number of specific filing requirements in the form of informational forms. Some of these forms are submitted to the IRS as attachments to the personal income tax return, while others are submitted to other governmental departments. The failure to file any of the below forms can result in severe civil penalties, such as a $10,000 penalty per form per year. Additionally, in certain extreme cases, criminal penalties, including fines and incarceration, may apply if the reporting delinquency is shown to be willful.

International Tax Forms

Example of common international tax forms include:

Foreign Bank and Financial Account Report (FBAR)

The Foreign Bank and Financial Account Report ("FBAR") is not a tax form and it is not filed with the IRS. Instead, it is an informational report that is submitted with the Treasury Department.

Any U.S. account holder (person or entity), including resident aliens, with a financial interest in or signature authority over one or more foreign financial accounts, with more than $10,000 in aggregate value in a calendar year, must file the FBAR annually with the Treasury Department.

Example – Alan, a U.S. resident alien, has a checking account at a foreign bank. During 2017, he opens a savings account at a separate foreign bank. He first funded the checking account with $5,000 and then funded the savings account with $6,000, the balance of which was reduced to $4,000 by year-end. Although Alan did not have any single account with $10,000 in value and although the aggregate account value of his two accounts did not exceed $10,000 at year-end, Alan would be required to file a 2017 FBAR, because during the 2017 year, the aggregate maximum account value of Alan's two accounts was more than $10,000 (i.e., $11,000).

Form 8938 (FATCA Reporting), Statement of Specified Foreign Financial Assets:

If you have a bank account or investment account in a foreign financial institution, you are generally required to include Form 8938 with your U.S. federal income tax return if you meet the following thresholds:

- You are filing a return other than a joint return and the total value of your specified foreign assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the year; or
- You are filing a joint return and the value of your specified foreign asset is more than $400,000 on the last day of the tax year or more than $600,000 at any time during the year.

Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations:

Certain U.S. taxpayers, including resident aliens, who own more than 10% of stock in a foreign corporation must include this form with their federal tax return. It is important to keep in mind that entities that are not considered corporations under foreign law may be considered corporations for U.S. tax purposes and thus may fall within the U.S. tax rules related to foreign corporations.

There are also several other similar categories of filers that must file this form. Special attribution rules (which include attribution between spouses) may apply to expand the scope of taxpayers that fall within these categories. It is important for shareholders to determine if they fall into any of such categories.

Form 8621, Information Return by a Shareholder of a PFIC or QEF

Aside from the high taxation rates associated with PFICs, there are specific reporting rules that apply as well. There is a specific form, Form 8621, for reporting your PFIC ownership interests. A separate Form 8621 must generally be filed for each PFIC in which stock is held directly or indirectly.

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts:

Form 3520 involves perhaps the most complex information reporting of all the information returns. In brief, owners of foreign trusts must report whether or not there are specific transaction during the tax year. Certain transactions between a foreign trust and a U.S. person, including a resident alien, need to be reported on Form 3520, and the trust itself may be required to file Form 3520A.

Also required to be reported on Form 3520 is the receipt of certain large gifts or bequests (more than $100,000) from a nonresident alien or foreign estate to a U.S. person. The threshold amount is significantly lower for a gift from a foreign corporation or a foreign partnership (more than $15,797).

4. U.S. Estate and Gift Tax Considerations

The United States taxes U.S. persons, including citizens and resident aliens, on gifts made during their lifetimes and on their property, regardless of where located, when they pass away. The current maximum rate of the estate tax is 40%.

Residency as "Domicile"

The residency test for federal estate tax purposes does not conform to the one for federal income tax. Under the estate tax regulations, a resident decedent is a decedent who, at the time of his death, had his "domicile" in the United States. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later leaving that place. A person's residence will not qualify as a domicile unless the person has the requisite intent to remain in such residence indefinitely. A nonresident alien, for purposes of the estate tax, is an individual who, at the time of his death, had his domicile, as defined above, outside of the United States.

Because the determination of a person's "domicile" relies upon the intent of an individual, a bright-line test to determine if an individual is a resident for federal estate and gift tax purposes is not available. Therefore, the courts consider the following factors in making such a determination: visas, work permits, location of business and property interests, family immigration history, residential property, individual testimony, motivation, duration of stays in the United States, and community group affiliations.

Tax Implications

There are a number of other significant differences in how the estate and gift tax laws are applied to U.S. persons, including citizens and resident aliens, and nonresident aliens. In general, the estate and gift tax applies to all property owned by a U.S. resident but only to U.S. property owned by a nonresident alien.

However, in 2018, a U.S. person could shield up to $11.18 million of property from the estate tax (this amount doubled under the Trump Tax Reform), while a nonresident alien can only shield $60,000 of U.S. property. In terms of the gift tax, a U.S. person can gift an unlimited amount of property to a U.S. spouse without triggering the gift tax, while a gift to a non-U.S. spouse is subject to an annual exclusion limitation amount ($152,000 in 2018).

5. Pre-Immigration Tax Planning

There are a number of different tax planning methods available to U.S. immigrants in order to help minimize the impact of transitioning to the U.S. system of worldwide taxation. Below is a very brief description of some of the more common methods:

- *Acceleration of Income*

This involves the realization of income, to the extent possible, prior to immigration, so that such income will not be subject to U.S. federal income taxation. Generally, this involves collecting outstanding amounts that may be due for personal or other services. Also, if the individual owns a profitable company, he could have the company distribute its accumulated earnings prior to the immigration year.

- *"Basis Step Up" For Appreciated Assets*

This involves reducing or eliminating the difference between the individual's tax basis and fair market value in each of his assets prior to immigration, so that, among other things, the sale of such assets will not result in a taxable gain for U.S. tax purposes. Methods used to accomplish this include the sale and repurchase of foreign property and the actual or deemed liquidation of foreign companies.

- *Gifts to family members*

Similar to a sale, another method of minimizing the effects of the U.S. system of worldwide taxation would be to gift any non-U.S. assets to other people prior to moving to the United States. The form of consideration could be either a cash or a note.

- *CFC/PFIC/GILTI planning*

Individuals should consider reducing or otherwise restructuring their interests in foreign corporations so as not to run afoul of the CFC or GILTI anti-avoidance provisions. They should also consider selling their interests in PFICs, unless certain U.S. tax elections are available, to avoid the onerous default PFIC rules.

Please keep in mind that the above list does not nearly include all of the different options available when it comes to pre-immigration tax planning. If you are interested in immigrating to the United States and would like to manage your tax planning, please contact Expat Tax Professionals and we will be happy to assist you and review your situation.