**WELCOME PILGRIM**

by

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I.U.S. TAX NEXUS

A. Welcome Resident Alien or Citizen.

* Subject to income taxation on worldwide income.
* Character of income under local law principles has no impact on its character as determined under US tax principles.

B. The Noncitizen.

* Absent citizenship status, taxation of the noncitizen is based upon a mixed bag of principles relating to residency, asset situs, and domicile.
* Income Tax – generally taxation hinges on residency status.[[1]](#footnote-1)
* Gift Tax – generally gift taxation of lifetime transfers depends upon the donor’s domicile, although at times the situs of the transferred asset can be determinative [with some exceptions]
* Estate and GST – also generally dependent upon principles of domicile.

II. INCOME TAX

A. General Rule of Taxation. Nonresidents are subject to a flat withholding tax of 30% on fixed or determinable periodic (“FDAP”) income derived from U.S. sources not connected with a U.S. business.

* **FDAP**. The Code defines FDAP as “interest [other than OID], dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income . . ..” §871(a)(1)(A).[[2]](#footnote-2)
* **Exemptions**. The Code exempts from tax “portfolio interest,” dividends and interest derived from deposits in U.S. banks and S&Ls.
* **Capital Gain Special Rule**. As a general rule, the nonresident is not subject to taxation on U.S. source capital gains. However, the nonresident will be subject to the 30% tax if he/she is present in the U.S. for more than 183 days during the taxable year in which the gain is realized. §871(a)(2).
* **FIRPTA Override**. The Foreign Investment in Real Property Tax Act (“FIRPTA”) overrides the provisions of §871 and taxes nonresidents on realized gain from the disposition of an interest in real property. §897. The gain is taxed as if effectively connected with the conduct of a U.S. trade or business and therefore subject to normal income tax deductions and tax rates.

B. U.S. Tax Residency. Code defines resident individual with respect to any calendar year as (i) lawful permanent resident, or (ii) an alien who satisfies the “substantial presence test.” §7701(b)(1)

* ***Lawful Permanent Resident***: “Green card test” hinges upon immigration status and not time spent in U.S.
* “***Substantial Presence***”: Tested annually. Threshold inquiry is whether the individual is present 31 days in current year. Then, the sum of those days + days in two preceding years = 183. These 3 years are subjected to weighted multiplier formula. §7701(b)(2).
* Current year: 1.0
* Immediate preceding year: 1/3
* Second preceding year: 1/6

 Note. Generally, presence in the U.S. for 122 days/year meets substantial presence test.

 Example #1: Underwood was present in U.S. for 122 days in 2016. He was also here for 122 days in each of 2015 and 2014. He meets the substantial presence test for 2016 and must report his worldwide income (absent a Treaty override). 2016 at 122 days, plus 2015 days of 40 2/3 (122 x 1/3), plus 2014 days of 20 1/3 (122 x 1/6) = 183 days. *Regs. § 301.7701(b)-1(e).*

 Note. Beware the unwary tourist.

 Example #2: In 2015, Oakley vacations in U.S. during Jan. (31 days), Feb. (28 days), Mar. (31 days), July (31 days), Aug. (31 days) and Sept. (30 days). Oakley does not meet substantial presence test in 2015 because present only 182 days. However, if he spent the same period of time in 2016, a leap year, he would meet the test.

* Excluded Days for Substantial Presence

*Foreign Government-Related Individuals* – generally A and G-4 visa holders.

*Teacher or Trainee* – J and Q visa holders + immediate family.

*Student* – F, J, M and Q visa holders + immediate family.

*Certain Professional Athletes* – days of actual competition in charitable sports events.

* ***Residency Commencement Date***: Significant for determining date on which an alien is considered to have received income subject to U.S. tax and avoidance of tax on income received prior to that date. *See generally,* §7701(b)(2)(A)(iii); Regs. §301.7701(b)-4(a).
	+ Green Card. Residency commences on the first day present in U.S. after card issues. If the individual is already present in the U.S., commencement is as of the date of card issuance.
	+ Substantial Presence. Commencement on the first day of the calendar year in which the individual is actually present in U.S. Therefore, the start date is effectively retroactive for the current calendar year.

 Example #3. Same facts as in Example #2 for the year 2016. Oakley’s commencement date is January 1, 2016, and not September 30.

* + Double Return Filing. Practically, the individual is required to file two returns for the commencement year. One to report worldwide income for the entire year to the home country, and a second with the U.S. to be taxed on a portion of that worldwide income. Tax credits may be available to avoid double taxation.
	+ Tourist Trap. As indicated, a visitor’s status can change for any given year. Therefore, the substantial presence test can trap the unwary foreign tourist who makes frequent visits to the U.S.
* ***Treaty Override***: When an individual is treated as a U.S. resident for tax purposes and a tax resident of another treaty-based country (perhaps based on the alien’s citizenship), the individual may be able to avoid U.S. resident status. Treaty review a must!

C. Pre-Residency Tax Saving Measures. In counselling alien individuals who are planning to establish U.S. residency status, consideration should be given to proactive actions that may be taken to avoid U.S. income and transfer taxes.

* ***Avoiding Capital Gains (General Rule****):* As indicated above, with the exception of sales of U.S. real property under the FIRPTA rules, nonresidents are not subject to U.S. tax on U.S. source capital gains. *See generally*, §871(a)(1). Therefore, if the noncitizen is coming to the U.S. from a country that does not tax capital gains, or one whose tax rate is lower (or if the noncitizen has capital loss carryforwards), consider selling capital assets before resident status established.

 Example #4: Sell foreign home or vacation property before the residency commencement date. Although the principal residence exclusion of §121 may apply to a sale after residency established, it will not result in a basis step up for any new U.S. principal residence.

* Timing Critical. Again, the resident status commencement start date either under the “green card” or “substantial presence” tests can be critical for avoidance of U.S. tax on potential sales of capital assets.
* ***Basis Step-up****:* As implied by Example #4, above, basis step-up opportunities may exist.
* General Rule. For U.S. tax purposes, assets owned by the nonresident alien have an income tax basis equal to the dollar values as of the purchase date.
* Sell highly appreciated assets before residency commencement date, *e.g.,* Apple stock.
* Use proceeds to repurchase shares in the same company.
	+ The resulting stepped-up basis in the newly-acquired shares enables the alien to reduce the realized gain on a future sale of assets.
	+ In addition, the higher basis presents a valuable gift tax planning opportunity. Caveat the potential U.S. gift tax impact. *See discussion, below.*
* ***Delay Sale of Depreciated Assets****:* consider postponing sale of depreciated assets until after residency established in order to offset losses against expected U.S. gross income.
* ***Acceleration of Installment Sale Income****:* Generally, the Code requires election out of installment sale treatment to be made on the U.S. income tax return filed for the sale year. *See, e.g.,* PLR 9412008 and PLR 8708002. Therefore, if the Alien has elected installment sale treatment on a pre-move sale, consider electing out of installment treatment upon filing of first U.S. resident alien income tax return. Such an election will avoid U.S. taxation of post-residency installment sale collections.
* ***Transfer Tax Planning****:* Alien should also consider means to avoid U.S estate and gift taxes which become applicable upon establishment of domicile. Formation of a “drop-off trust” before moving to U.S. may be a viable alternative. *See,* Bissell, *Some Cautionary Comments on “Drop-Off Trusts” for Incoming Aliens,* 42 Tax Mgmt. Int’l 697 (Nov. 2013); 903 T. M., *Tax Planning for Portfolio Investment Into the United States by Foreign Individuals.*

III. “NONRESIDENT OR RESIDENT” FOR TRANSFER TAX PURPOSES

A. General Principle. Only “citizens” and “residents” are subject to the U.S. transfer tax on their worldwide assets. Nonresidents and noncitizens are subject to transfer tax on U.S. situs assets.

B. Definition. A “nonresident” alien is an individual who is not a U.S. citizen and who is not domiciled in the U.S. at the time of the gift. *See, Regs.* §25.2501-1(b).

* *“Resident”*: as indicated above, the definition for income tax purposes is not the same as for transfer tax purposes.
* “Resident” = “domiciliary”
* “*Domicile”*: Code offers no definition. Regulations attempt to fill void:

A person acquires a domicile in a place by *living there*, “for even a brief period of time, with no definite present intention of moving from that place.” *See*, 2016 Form 709 Instructions, Part 1. Residence without the requisite *intention to remain indefinitely* will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. Regs. §20.0-1(b)(1).

* + Two Essential Elements: **physical presence** + **intent**.
	+ Interpretation: facts and circumstances test and case law covers broad spectrum. *See, e.g.,* *Khan Estate v. Comm’r,* T.C.M. 1998-22 (full unified credit entitlement for Pakistani who spent last 3 years of life in home country but had filed nonresident tax returns for 1986-1990); *Paquette Estate v. Comm’r,* T.C.M. 1983-571 (long stays in Florida during winter months outweighed by other factors and domicile held to be in Canada); *Nienhuys v. Comm’r,* 17 T.C. 1149 (1952) (Dutch citizen in U.S. from 1940-1946 unable to return home because of war found to be a nonresident); *Fokker Estate v Comm’r,* 10 T.C. 1225 (1948); *Cooper v. Reynolds,* 24 F.2d 150 (D. Wyo. 1927) (short presence before accidental death overcome by factors indicating intent to stay).
* Treaty Override? Intended to avoid double taxation. Pre-1956 treaties are *situs-type* and subsequent treaties have been based upon *domicile*.
	+ *Situs Principle*. The physical location of the asset determines the taxing authority.
	+ *Domicile.* Under a domicile-type treaty, the decedent’s country of “domicile” establishes the taxing authority.
* These treaties are also intended to avoid a major complication inherent in situs-type treaties — the need to determine a situs for each asset of the estate. Domicile-type treaties seek to avoid the issue by allocating exclusive taxing jurisdiction to the treaty country of domicile.
* Because treaty countries may differ as to domicile, domicile-type treaties are commonly contain “tie-breaker” rules to settle on a single domicile, known as the fiscal domicile.

IV. GIFT TAX

A. Focus of Discussion*.* On individuals who are neither citizens nor “residents” of the U.S. (the “NRNC”).

B. NRNC Gift Tax Taxability. Gift Tax applies to all transfers made, directly or indirectly, of real or tangible (but not intangible) assets located in the U.S. Therefore, the character and location of the transferred asset is the determining factor. §§2501(a)(1), (2); 2511(a), (b).

* *Real Property and Tangible Personal Property*. If locus is in U.S. then the transfer is subject to taxation.
* *Intangible Property*. Transfers of such assets are not subject to tax, regardless of location.

Examples. Stocks, bonds, debt obligations, and bank deposits. Regs. §25.2511-3(b). Treasury bills. PLR 8210055.

Promissory Notes. Generally excluded. [Query: what if obligor is U.S. person and note relates to real property; mortgage?]

Cash? Some uncertainty. Generally, transfer funds to an offshore account or wire transfer funds to U.S. account?

C. NRA Transferor Return and Tax.

* *Annual Exclusion.* Allowable. §2503(b). 2017 amount = $14,000.
* *Annual exclusion for Spousal Transfers.*
* $100,000, as adjusted for inflation. §2523(i)(2). 2016 amount is $148,000.
* *Medical and Education Exclusion*. Direct payment of same allowable.
* *Charitable Contribution.* Limited allowance. §2522(b).

 *Unified Credit*. No allowance. Credit applies to a “citizen or resident of the United States.” §2505(a).

* *Marital Deduction*. Allowable only if donee spouse is citizen at time of transfer. QDOT unavailable. *See,* §2523(i)(1).
* *Tax Rate*. Same rate schedule as applicable to U.S. citizens or residents.

D. Citizen or Resident Transfers to NRAs. Generally, normal rules apply with the following exceptions.

* *Charitable Contributions*.
* *Marital Deduction.*

E. Transferee Return. Any “U.S. person” (other than a 501I organization) who receives from an NRA gifts or bequests totaling more than $10,000 (adjusted by subsequent IRS Notice) during a taxable year must report the gift to the IRS. §6039F. Note that this filing obligation is imposed upon the donee and not the donor.

* “*U.S. Person*” includes U.S. citizens and residents, domestic corporations and partnerships, and domestic trusts and estates. §7701(30).
* Rule inapplicable to amounts that qualify for exclusion of medical and tuition expenses.
* *Form 3520.* Filed with Ogden office.
* *Threshold Modification.* IRS in Notice 97-34 modified the threshold filing requirements as follows:
	+ Gifts from Nonresident Alien Individuals and Estates. Aggregate amount of gifts during the taxable year from same foreign person exceeds $100,000. Once amount met, each gift in excess of $5,000 must be described but identity of donor required only upon request from IRS.
* Gifts from Foreign Corporations and Partnerships. Reportable whenever aggregate amount from all such entities exceeds $10,000.
* *Penalty.* Donee penalty equal to 5% of gift amount for each month report delinquent, with maximum of 25%. Waiver allowable under standard of reasonable cause and not willful neglect.

V. ESTATE TAX

A. Citizens and Residents. U.S. citizens are subject to estate and GST taxes on their **worldwide** assets. §2031(a). Dual citizens are potentially subject to double tax.

* The Code states that “a tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.” §2001(a).
* *“Resident”*: as indicated above, the definition for income tax purposes is not the same as for transfer tax purposes and domicile principles apply.

B. Nonresident Non-Citizens (“NRNCs”). Estate tax applies to gross estate of (i) tangible and intangible assets situate in U.S., and (ii) U.S. situs properties in which decedent had an interest, deemed to have an interest, or had certain rights or powers over the property within the meaning of §§ 2033 – 2046. *See, §§ 2103, 2104(b).*

 NRNC’s Gross Estate.

* *Real Estate and Tangible Personal Property.* If asset physically located in U.S., then part of gross estate.
	+ *Works of Art* *Exception*. Public exhibition; on loan to public nonprofit gallery or museum; or, on exhibition or en route to an exhibition.
* *Stock*. Actual physical location is may not be determinative.
	+ U.S. Issued Shares. Located in U.S. and part of gross estate.
	+ Foreign Issued Shares. Located outside U.S.. Often used planning technique is for the NRNC to organize a foreign corporation to hold U.S. situs assets.
* *Life Insurance*. All policies, regardless of issuer’s situs, treated as a non-US asset.
* *Portfolio Debt*. Debt obligations of banks, savings and loans and similar organizations excludible if interest exempt from U.S. income tax under §871(h)(1). Caveat contingent interest that may be considered situate in the U.S. §2105(b)(3).
* *Deposits.* Specified deposits are treated outside the U.S. if not connected with a U.S. trade or business.
	+ U.S. bank.
	+ Savings and loan associations supervised by state or federal law.
	+ Amounts held by U.S. insurance companies under an agreement to pay interest.
	+ Foreign branch of a U.S. bank.
* *Non-portfolio Debt Obligations*. Debt obligations of U.S. persons are treated as a U.S. situs asset subject to the estate tax, *e.g.,* the promissory note of a U.S. citizen for a loan made by a noncitizen is part of the noncitizen’s U.S. gross estate.

Example #5*.* The Aspen condo and its furnishings, the RV in the driveway, the Kandinsky over the fireplace, the loan to a U.S. friend to buy a condo, and the Microsoft shares are U.S. situs assets of the NRNC’s U.S. gross estate. Upon death they are all subject to tax to the extent their combined value exceeds $60,000.

 Tax Calculation.

* *Deductions.*
	+ Expenses . Generally prorated relative to proportion of U.S. assets over worldwide assets. §2106(a).
* Marital. Allowable only if spouse is U.S. citizen or if transfer is to a qualified domestic trust (“QDOT”). §§2106(a)(3), 2056(d).
* Charitable. Allowable if to a U.S. entity or for use in the U.S.

* Treaty Override. Applicable treaty may increase credit by a fraction the numerator of which is the value of U.S.-situs assets and the denominator of which is worldwide gross estate.
* *Computation.*
	+ Gift ”Gross Up.” Pre-death taxable gifts for property located in U.S are added back to determine taxable estate.
	+ Rate Schedule. Same rate schedule as applicable to U.S. citizens and residents. §2101(b)(1).
	+ Credit. $13,000. Equivalent to $60,000 of asset values.
* *Form.*
* 706-NA.
* Filing Date. 9 months after date of death, subject to extension.
* Where. Cincinnati.

C. Cross Border Marital Planning. Estate planning for a cross-border couple, *i.e.,* a U.S. citizen married to a NRNC, poses complex challenges.

* *No Marital Deduction*. *Inter vivos* transfers from US citizen to non-citizen spouse are fully subject to gift tax (less annual exclusion) and transfers at death are fully subject to estate tax.
* *Limited Exemptions*. *Inter vivos* transfers from non-citizen do not qualify for the lifetime exemption - §2505(a) limits unified credit to gifts to US citizens and residents). Estate tax exemption is limited to $60,000. §2102(b).
* *Planning Opportunities*. The potential exclusion of the non-citizen spouse’s foreign assets from gift and estate taxation affords a valuable planning opportunity.
	+ NRNC Trusts. The NRNC may convey foreign assets for the benefit of the U.S. spouse, their children, and other family members free of any U.S. gift tax, and forever allow these assets to be outside the reach of the U.S. gift and estate tax regime. By contrast, as a domiciliary any assets (regardless of situs or status) will be subject to U.S. transfer taxes.
* *Basic Principle*. Strive to have U.S. situs assets owned or controlled by the U.S. citizen, and the foreign situs assets should be owned by the NRNC.
* *Transfers by NRNC to U.S. Citizen*.
	+ Marital Deduction*.* Any U.S. situs assets owned by the NRNC should be transferred either directly to the U.S. spouse or an irrevocable trust for the spouse’s benefit. The lifetime transfer to the U.S. citizen qualifies for the marital deduction. Therefore, the Aspen condo should be the subject of a gift from the NNRC to the U.S. spouse.
	+ Transfers of Intangibles. In addition to asset transfers that qualify for the marital deduction, the NRNC should make gifts of U.S. intangible assets to the U.S. spouse (or children). Such assets are exempt from gift tax. Retention of these assets will subject them to estate tax.
		- Therefore, assets such as shares of U.S.-organized corporations and non-portfolio debt obligations of U.S. persons may be transferred to an irrevocable trust for the benefit of the U.S. spouse without reliance on the marital deduction and still not be subject to gift tax. In effect, this trust is in all respects akin to a credit shelter or bypass trust utilized in an estate tax plan.
* *Transfers by U.S. Citizen to NRNC.* Lesser opportunity for avoidance of transfer taxes.
	+ Marital Deduction. Unavailable! Cannot even use a QDOT. However, increased annual exclusion of $148,000 is available for *inter vivos* transfers.

VI. GST TAX

A. Application to NRNCs. A transfer is subject to GST only if a gift or estate tax is applicable to the transfer. Therefore, only transfers of U.S. situs properties are subjected to GST.

B. Trust Distributions or Terminations. Situs of asset at time of initial transfer to the trust determines application of tax. *See, Regs. §26.2663-2(b)(2).*

VII. MISCELLANEOUS FILING REQUIREMENTS

A. General Principle. US taxpayers are annually required to report interests in foreign assets and financial transactions with foreign persons. Failure to do so can result in impositions of confiscatory civil penalties and potential criminal charges.

B. Foreign Bank Account Reports (FBAR). Annual report required of “US person” who has “financial interest” in or signature authority over foreign “financial account” and aggregate value greater than $10,000 at any time during a given calendar year.

* *“Foreign Financial Account”:* any account located outside US.
* *“United States Person”:* US citizen; US tax resident; US entity: trusts or estates formed under US laws. Children also required to file.
* “*FinCen Form 114*”: used to report a financial interest or signature authority over a foreign financial account. Filed electronically. Due Date – April 15 with automatic extension to October 15. “*FinCen”* refers to Financial Crimes Enforcement Network administered by U.S. Treasury.

B. Statement of Foreign Financial Assets. US citizens and US tax residents required to file annual report.

* *Specified Foreign Financial Account.* Generally all foreign accounts except those maintained by US payer or branch thereof.
* *Foreign Financial “Asset”:* foreign issues securities or stock; foreign entity interests; financial instruments or contracts with a foreign issuer.
* *Dollar Threshold.* Generally $50,000, but higher thresholds apply for filing status, e.g., single, married, married filing separately.
* *Exceptions.*
	+ Taxpayer not required to file return for the year.
	+ Taxpayers who have reported foreign financial assets on another return, *e.g.,* Forms 3520, 3520-A, 5471, 8621, 8865, or 8891.
* *Form 8938.* Filed with Form 1040 or other applicable annual return.

C. Form 3520. Somewhat of a “catchall” return on which foreign gifts and foreign trust transactions are to be reported.

* *Transactions with Foreign Trust and Receipt of Foreign Gifts.* §§671 – 679.
* *Notice of Large Gifts Received from Foreign Persons.* §6039F.
* *Information with Respect To Certain Trusts.* §6048.
	+ *Due Date.* For above returns, same as income tax return.
	+ *Filing Center.* Ogden.

D. Form 3520-A.

* *Annual Information Return of Foreign Trust with a U.S. Owner.* §6048(b).
	+ *Due Date.* Same as for trust’s tax return.
	+ *Filing Center.* Ogden.

RMK

1. Section 7701(a)(30) defines who is a “United States person,” so a foreign person is any person who does not come within the definition of a United States person. [↑](#footnote-ref-1)
2. Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations issued thereunder. [↑](#footnote-ref-2)