

# **Strangers in Paradise – and what to do about them**

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# Overview

- Taxation Issues for US Persons Dealing With Foreign Persons and Matters
  - Who (and what) is foreign?
  - Estates and trusts
  - A series of income tax opportunities and pitfalls
  - Withholding tax overview
  - Reporting
  - Planning for Departure

**This program is about issue spotting**

# Who (and What) Is Foreign?



# Taxpayer Classification

- Type of person – Individual or legal
- Citizenship – US or foreign
- Residence – US or foreign
- “Foreign person” means a foreign corporation and a nonresident alien. Where relevant, it includes a foreign partnership, trust or estate.
- “US person” means a citizen, a resident alien, a domestic corporation and, where relevant, a domestic partnership, trust or estate

# Who Is a US Citizen?

## ■ Birth in US

- Birth in US (including, in most cases, Puerto Rico, Guam and US Virgin Islands), except to foreign diplomat
- Proof of citizenship: birth certificate

## ■ Birth abroad to TWO US citizens

- Both parents were US citizens when individual was born;
- At least one parent lived in US at some point in their life.
- Proof of citizenship
  - ◆ Record of birth abroad, if registered with US consulate or embassy
  - ◆ Provision of information required by passport application
  - ◆ Certificate of Citizenship – apply using Form N-600

## ■ Birth abroad to ONE US citizen

- One parent was US citizen when individual born
- Before individual born, citizen parent lived in US at least 5 years, at least 2 of which after citizen parent's 14th birthday (10 and 5 years if individual born before November 14, 1986)
- Proof of citizenship: same as for birth abroad to two US citizens

## ■ Naturalized in the US

# Residence

- Residence means different things for different purposes:
  - Immigration
  - General Federal tax residence rules (§ 7701(b))
  - Federal estate and gift tax purposes (domicile)
  - State tax purposes
  - Regulatory and reporting requirements, e.g., FBAR
  - Home country taxation (and other requirements)
- These rules are not uniform and coordination is erratic
- Timing is critical

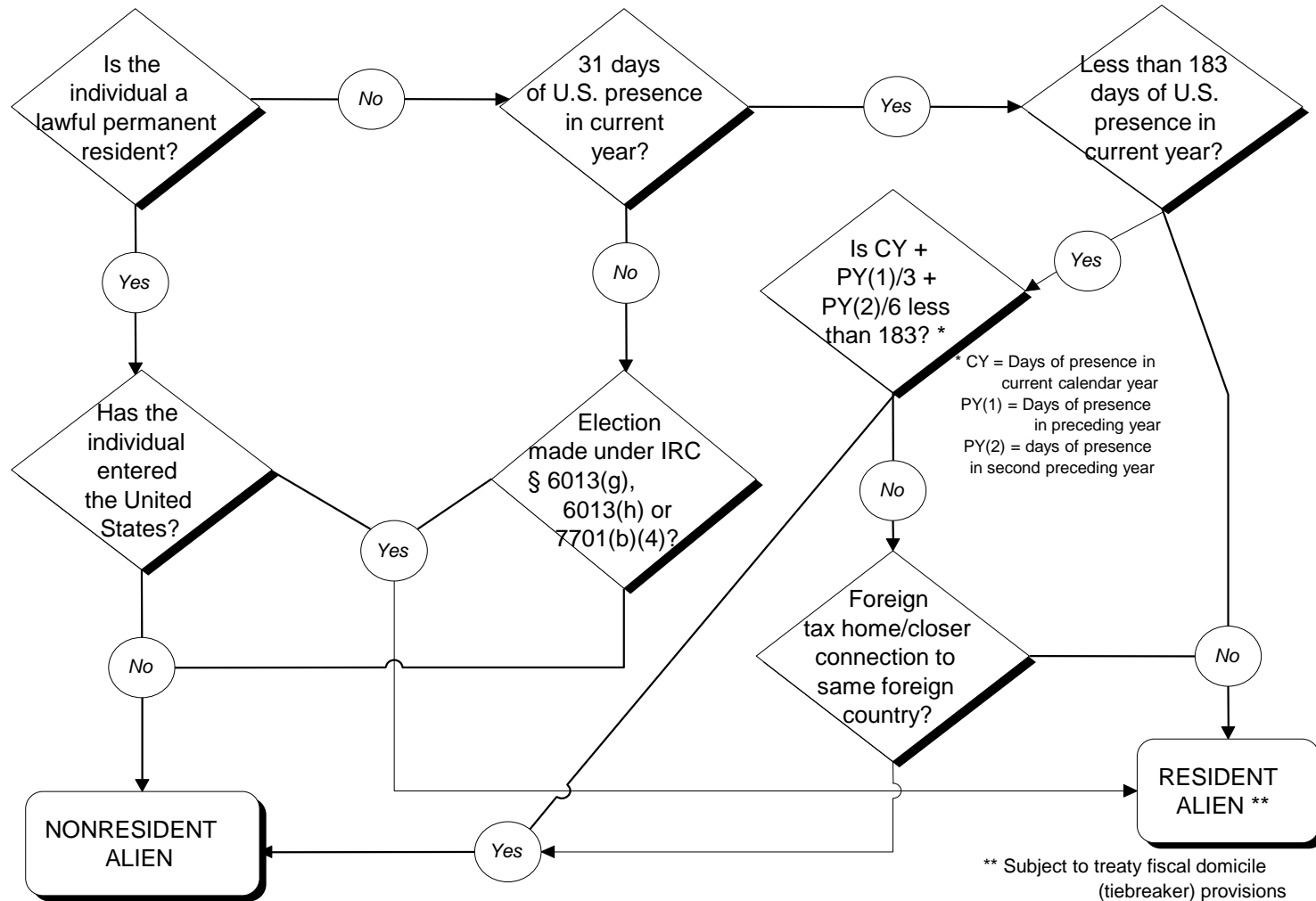
# Who Is Foreign?

## (b) Definition of resident alien and nonresident alien.

- (1) In general. For purposes of this title (other than subtitle B)--
- (A) Resident alien. An alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) such individual meets the requirements of clause (i), (ii), or (iii):
- (i) Lawfully admitted for permanent residence. Such individual is a lawful permanent resident of the United States at any time during such calendar year.
- (ii) Substantial presence test. Such individual meets the substantial presence test of paragraph (3).
- (iii) First year election. Such individual makes the election provided in paragraph (4).
- (B) Nonresident alien. An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)).
- (2) Special rules for first and last year of residency.
- (A) First year of residency.
- (i) In general. If an alien individual is a resident of the United States under paragraph (1)(A) with respect to any calendar year, but was not a resident of the United States at any time during the preceding calendar year, such alien individual shall be treated as a resident of the United States only for the portion of such calendar year which begins on the residency starting date.
- (ii) Residency starting date for individuals lawfully admitted for permanent residence. In the case of an individual who is a lawfully permanent resident of the United States at any time during the calendar year, but does not meet the substantial presence test of paragraph (3), the residency starting date shall be the first day in such calendar year on which he was present in the United States while a lawful permanent resident of the United States.
- (iii) Residency starting date for individuals meeting substantial presence test. In the case of an individual who meets the substantial presence test of paragraph (3) with respect to any calendar year, the residency starting date shall be the first day during such calendar year on which the individual is present in the United States.
- (iv) Residency starting date for individuals making first year election. In the case of an individual who makes the election provided by paragraph (4) with respect to any calendar year, the residency starting date shall be the 1st day during such calendar year on which the individual is treated as a resident of the United States under that paragraph.
- (B) Last year of residency. An alien individual shall not be treated as a resident of the United States during a portion of any calendar year if--
- (i) such portion is after the last day in such calendar year on which the individual was present in the United States (or, in the case of an individual described in paragraph (1)(A)(i), the last day on which he was so described),
- (ii) during such portion the individual has a closer connection to a foreign country than to the United States, and
- (iii) the individual is not a resident of the United States at any time during the next calendar year.
- (C) Certain nominal presence disregarded.
- (i) In general. For purposes of subparagraphs (A)(ii) and (B), an individual shall not be treated as present in the United States during any period for which the individual establishes that he has a closer connection to a foreign country than to the United States.
- (ii) Not more than 10 days disregarded. Clause (i) shall not apply to more than 10 days on which the individual is present in the United States.
- (3) Substantial presence test.
- (A) In general. Except as otherwise provided in this paragraph, an individual meets the substantial presence test of this paragraph with respect to any calendar year (hereinafter in this sub§ referred to as the "current year") if--
- (i) such individual was present in the United States on at least 31 days during the calendar year, and
- (ii) the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:
- | In the case of days in   | The applicable multiplier is |
|--------------------------|------------------------------|
| Current year .....       | 1                            |
| 1st preceding year ..... | 1/3                          |
| 2nd preceding year ..... | 1/6                          |
- (B) Exception where individual is present in the United States during less than one-half of current year and closer connection to foreign country is established. An individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year if--
- (i) such individual is present in the United States on fewer than 183 days during the current year, and
- (ii) it is established that for the current year such individual has a tax home (as defined in § 911(d)(3) without regard to the second sentence thereof) in a foreign country and has a closer connection to such foreign country than to the United States.
- (C) Subparagraph (B) not to apply in certain cases. Subparagraph (B) shall not apply to any individual with respect to any current year if at any time during such year--
- (i) such individual had an application for adjustment of status pending, or
- (ii) such individual took other steps to apply for status as a lawful permanent resident of the United States.
- (D) Exception for exempt individuals or for certain medical conditions. An individual shall not be treated as being present in the United States on any day if--
- (i) such individual is an exempt individual for such day, or
- (ii) such individual was unable to leave the United States on such day because of a medical condition which arose while such individual was present in the United States.
- (4) First-year election.
- (A) An alien individual shall be deemed to meet the requirements of this subparagraph if such individual--
- (i) is not a resident of the United States under clause (i) or (ii) of paragraph (1) or paragraph (1)(A) with respect to a calendar year (hereinafter referred to as the "election year"),
- (ii) was not a resident of the United States under paragraph (1)(A) with respect to the calendar year immediately preceding the election year,
- (iii) is a resident of the United States under clause (ii) of paragraph (1)(A) with respect to the calendar year immediately following the election year, and
- (iv) is both--
- (I) present in the United States for a period of at least 31 consecutive days in the election year, and
- (II) present in the United States during the period beginning with the first day of such 31-day period and ending with the last day of the election year (hereinafter referred to as the "testing period") for a number of days equal to or exceeding 75 percent of the number of days in the testing period (provided that an individual shall be treated for purposes of this subclause as present in the United States on a number of days during the testing period not exceeding 5 days in the aggregate, notwithstanding his absence from the United States on such days).
- (B) An alien individual who meets the requirements of subparagraph (A) shall, if he so elects, be treated as a resident of the United States with respect to the election year.
- (C) An alien individual who makes the election provided by subparagraph (B) shall be treated as a resident of the United States for the portion of the election year which begins on the 1st day of the earliest testing period during such year with respect to which the individual meets the requirements of clause (iv) of subparagraph (A).
- (D) The rules of subparagraph (B) shall apply for purposes of determining an individual's presence in the United States under this paragraph.
- (E) An election under subparagraph (B) shall be made on the individual's tax return for the election year, provided that such election may not be made before the individual has met the substantial presence test of paragraph (3) with respect to the calendar year immediately following the election year.
- (F) An election once made under subparagraph (B) remains in effect for the election year, unless revoked with the consent of the Secretary.
- (5) Exempt individual defined. For purposes of this subsection--
- (A) In general. An individual is an exempt individual for any day if, for such day, such individual is--
- (i) a foreign government-related individual,
- (ii) a teacher or trainee,
- (iii) a student, or
- (iv) a professional athlete who is temporarily in the United States to compete in a charitable sports event described in § 274(f)(1)(B).
- (B) Foreign government-related individual. The term "foreign government-related individual" means any individual temporarily present in the United States by reason of--
- (i) diplomatic status, or a visa which the Secretary (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status for purposes of this subsection,
- (ii) being a full-time employee of an international organization, or
- (iii) being a member of the immediate family of an individual described in clause (i) or (ii).
- (C) Teacher or trainee. The term "teacher or trainee" means any individual--
- (i) who is temporarily present in the United States under subparagraph (J), (M), or (O) of § 101(15) of the Immigration and Nationality Act (other than as a student), and
- (ii) who substantially complies with the requirements for being so present.
- (D) Student. The term "student" means any individual--
- (i) who is temporarily present in the United States--
- (I) under subparagraph (F) or (M) of § 101(15) of the Immigration and Nationality Act, or
- (II) as a student under subparagraph (L), (N), or (O) of such § 101(15); and
- (ii) who substantially complies with the requirements for being so present.
- (E) Special rules for teachers, trainees, and students.
- (i) Limitation on teachers and trainees. An individual shall not be treated as an exempt individual by reason of clause (i) of subparagraph (A) for the current year if, for any 2 calendar years during the preceding 6 calendar years, such person was an exempt person under clause (ii) or (iii) of subparagraph (A). In the case of an individual all of whose compensation is described in § 872(b)(3), the preceding sentence shall be applied by substituting "4 calendar years" for "2 calendar years".
- (ii) Limitation on students. For any calendar year after the 5th calendar year for which an individual was an exempt individual under clause (i) or (iii) of subparagraph (A), such individual shall not be treated as an exempt individual by reason of clause (iii) of subparagraph (A), unless such individual establishes to the satisfaction of the Secretary that such individual does not intend to permanently reside in the United States and that such individual meets the requirements of subparagraph (D)(ii).
- (6) Lawful permanent resident. For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if--
- (A) such individual has the status of having been lawfully admitted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and
- (B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).
- (7) Presence in the United States. For purposes of this subsection--
- (A) In general. Except as provided in subparagraph (B), (C), or (D) an individual shall be treated as present in the United States on any day if such individual is physically present in the United States at any time during such day.
- (B) Commuters from Canada or Mexico. If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico, such individual shall not be treated as present in the United States on any day during which he so commutes.
- (C) Transit between 2 foreign points. If an individual, who is in transit between 2 points outside the United States, is physically present in the United States for less than 24 hours, such individual shall not be treated as present in the United States on any day during such transit.
- (D) Crew members of foreign vessels. An individual is temporarily present in the United States on any day as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States shall not be treated as present in the United States on such day unless such individual otherwise engages in any trade or business in the United States on such day.
- (8) Annual statements. The Secretary may prescribe regulations under which an individual who (but for subparagraph (B) or (D) of paragraph (3)) would meet the substantial presence test of paragraph (3) is required to submit an annual statement setting forth the basis on which such individual claims the benefits of subparagraph (B) or (D) of paragraph (3), as the case may be.
- (9) Taxable year.
- (A) In general. For purposes of this title, an alien individual who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.
- (B) Fiscal year taxpayer. If--
- (i) an individual is treated under paragraph (1) as a resident of the United States for any calendar year, and
- (ii) after the application of subparagraph (A), such individual has a taxable year other than a calendar year,
- he shall be treated as a resident of the United States with respect to any portion of a taxable year which is within such calendar year.
- (10) Coordination with § 877. If--
- (A) an alien individual was treated as a resident of the United States during any period which includes at least 3 consecutive calendar years (hereinafter referred to as the "initial residency period"), and
- (B) such individual ceases to be treated as a resident of the United States but subsequently becomes a resident of the United States before the close of the 3rd calendar year beginning after the close of the initial residency period,
- such individual shall be taxable for the period after the close of the initial residency period and before the day on which he subsequently became a resident of the United States in the manner provided in § 877(b). The preceding sentence shall apply only if the tax imposed pursuant to § 877(b) exceeds the tax which, without regard to this paragraph, is imposed pursuant to § 877.
- (11) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

IRC § 7701(b) – . . . and then there are the regulations

# Perhaps a Diagram Would Help





# OK, So Who Is Foreign?

- Substantive rules vary
  - Federal taxes (except estate and gift taxes)
  - Federal estate and gift taxes
  - State taxes
  - Foreign taxes
  - Immigration and nationality law

# Citizens

- US citizens (*Treas. Reg. § 1.1-1(c)*)
  - Born or naturalized in the US and subject to its laws (*US Constitution*)
  - Born outside US to one or two US citizen parents (*8 USCA § 1401*)
  - Special rules apply to loss (or repudiation) of US citizenship (*IRC §§ 877A and 2801*)
- Everyone else is an alien
- A US citizen may be a dual citizen by birth or marriage – but the US will disregard foreign citizenship of US citizen
- Little leniency for US citizens who did not realize their status or who have never lived in US

# Resident Aliens

- Resident aliens (§ 7701(b))
  - **Green card (lawful permanent resident) test** (§ 7701(b)(6))
    - ◆ Lawful permanent resident immigrant status
    - ◆ Status not judicially or administratively determined to be abandoned
  - **Substantial presence test** (§ 7701(b)(3))
    - ◆ Either 183 days of presence in current calendar year *or*
    - ◆  $CY \geq 31$  days *and*  $CY + (PY_1 / 3) + (PY_2 / 6) = 183$ , where  $CY$  = days of presence in current calendar year,  $PY$  = days of presence in two preceding years, *unless* taxpayer shows closer connection to a foreign tax home in current year
    - ◆ If  $CY < 31$ , not resident under this test
    - ◆ Exceptions for students, teachers, diplomats, employees of international organizations, some professional athletes, certain cases of illness preventing departure

# Resident Aliens (cont'd.)

More on the substantial presence test:

- Tested on calendar year basis
- Days of presence
  - Arrival and departure both count
  - Days in transit between two foreign points will be excluded if stay is less than 24 hours
  - Special rules for commuters from Canada and Mexico
- Foreign tax home/closer connection
  - Tax home defined as regular/principal place of business
  - Closer connection focuses on personal connections (location of home, family, belongings, social organizations, bank accounts, driver's license, etc.)

# Nonresident Aliens

- Nonresident aliens (“NRAs”) (§ 7701(b)(1)(B))
  - Any individual who is not a US citizen or US resident
  - NRA may elect to be treated as a resident alien under certain circumstances (§§ 7701(b)(4), 6013(g), 6013(h))
  - Residence may be affected by treaty residence (“tiebreaker”) provision (*US Model Treaty, Art. 4(2)*)
  - Laws applicable to former citizens who expatriate to avoid US taxes (§§ 877A and 2801) now apply to aliens who give up their green card after at least 8 years of residence within a 15-year period (§ 877(e))
    - these were significantly revised effective 6/17/2008

***No special provision for new or temporary residents***

# Foreign Corporations and Partnerships

- Place of organization is determinative (§ 7701(a)(4))
  - Domestic if formed or organized within the US
  - Foreign if not domestic
- United States = 50 states plus District of Columbia (does not include possessions)
- Special rules:
  - Dual incorporation
  - Dual consolidated loss rules
  - Stapled stock (§ 269B)
  - Contiguous country corporations includible in consolidated group (§ 1504(d))

# Foreign Trusts

- 1996 law (§ 7701(a)(30)) provides two-part test:
  - Court test – US court can exercise primary supervision over trust
  - Control test – US persons must control all substantial (non-ministerial) trust decisions, including
    - ◆ Distributions, allocations between principal and income and other decisions affecting beneficial interest
    - ◆ Lawsuits
    - ◆ Change of trustee
    - ◆ Investments
- A trust is foreign if it does not meet *both* tests, subject to safe harbor and some grandfathering rules (Notice 96-65)
- Estates still governed by old facts and circumstances test - see *B. W. Jones Trust*, 46 BTA 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943); Rev. Rul. 60-181; Rev. Rul. 81-112

# Taxpayer Classification - Recap

Key factors in determining citizenship, residence, and foreign/domestic status

- Individuals
  - ◆ Citizenship: Birthplace or naturalization in US
  - ◆ Residence: Physical presence test or immigration status
- Corporations and partnerships
  - ◆ Place of creation or organization
- Partnerships
  - ◆ Place in which engaged in trade or business (residence only)
- Trusts
  - ◆ Court supervision and US fiduciary control tests
- Estates
  - ◆ Facts and circumstances



# So How Can You Tell?

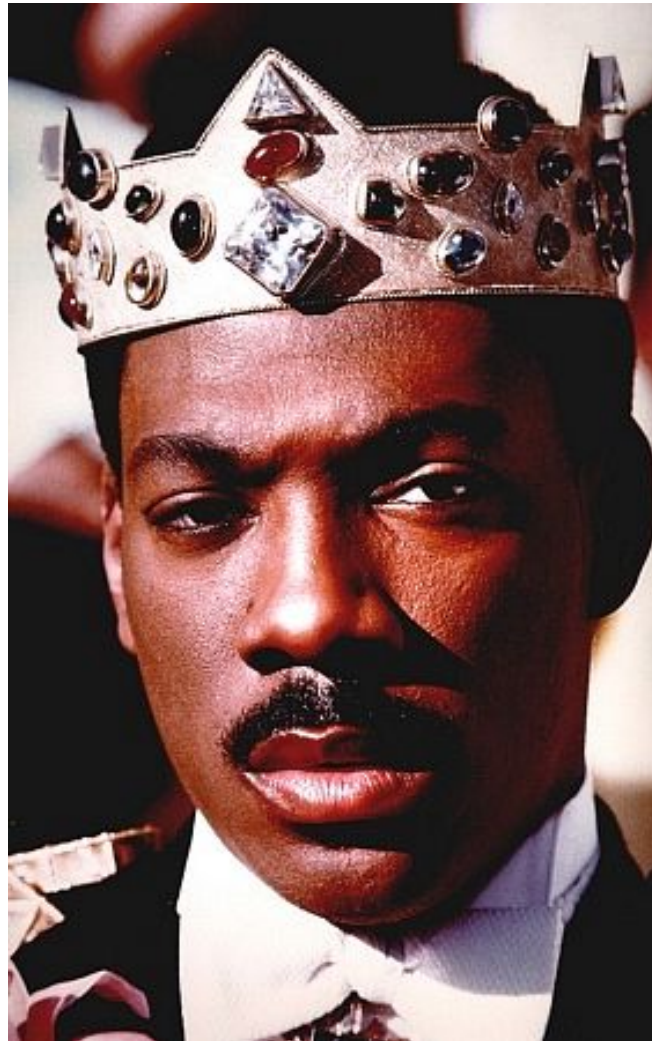
- Sometimes you need to be able to tell whether a person is foreign or domestic
- You cannot reasonably be expected to apply complex substantive rules to facts which you may not know
- You could try looking at them . . .

# American Idol



Actually, the model is from Iceland

# A Typical Foreigner



No Title of Nobility  
shall be granted by  
the United States

US Constitution, Article I,  
Sec. 9, Clause 8

# Another Typical Alien



The heck with  
your leader.  
Take me to  
Catherine  
Zeta-Jones.

- Laura Karlin

# OK, OK! Here She Is!



Catherine Zeta-Jones is an alien from Wales and resides in California with her husband, Michael Douglas

# Since Visual Inspection Is Unreliable

## ■ Forms and Certifications

- IRS Form W-8BEN and Form W-9
- Certification of Nonforeign Status (FIRPTA)
- Employment - Form I-9

## ■ Presumptions

- Often assume foreign in absence of documentation
- Certification of foreign-ness may be precondition to tax exemptions, e.g., bank interest and portfolio interest
- Certification of US citizenship or residence may be precondition to exemption from withholding

*How to determine status depends on why status is relevant*

# Estates and Trusts

# Trust Income Tax Concepts

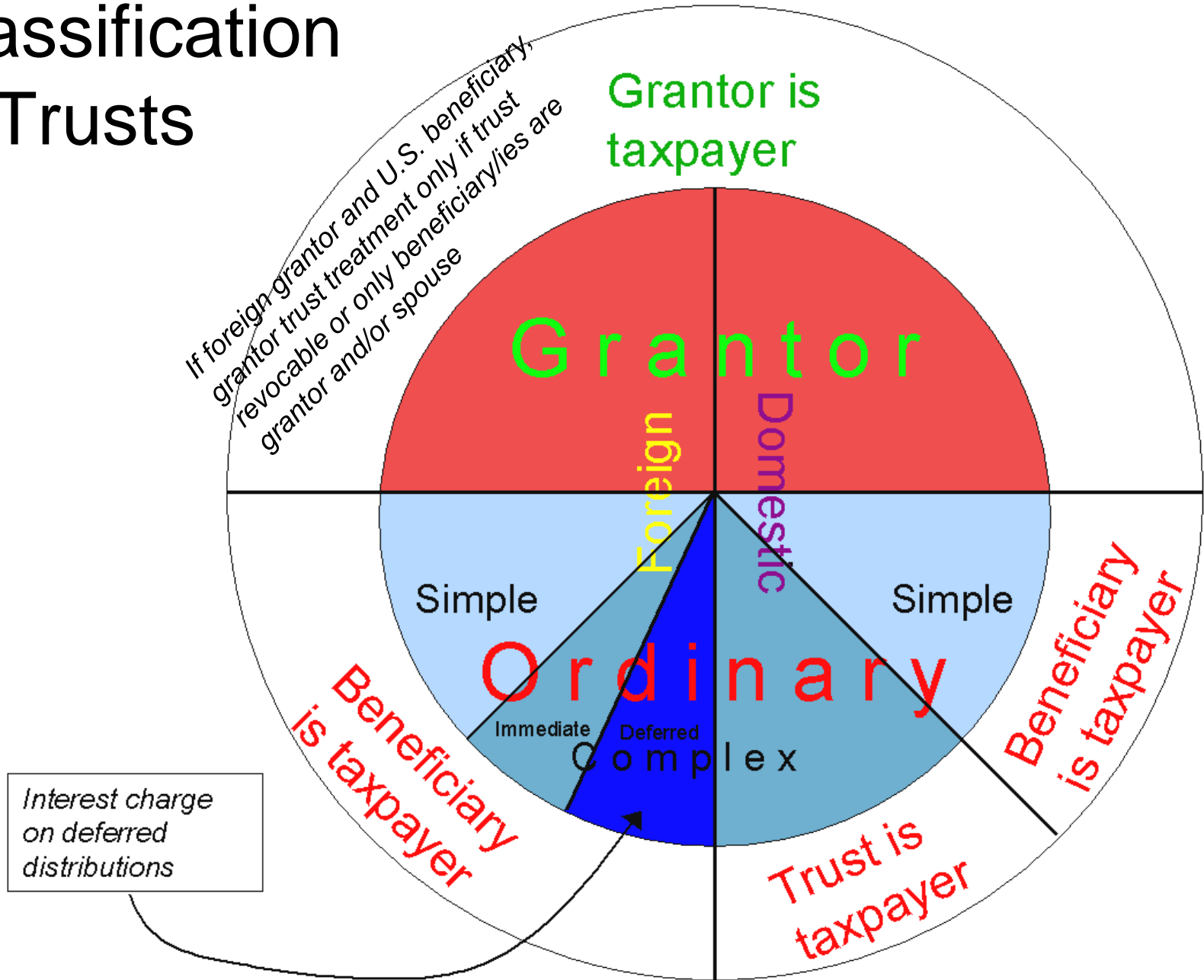
- Trust is either “**domestic**” or “**foreign**”
  - Foreign if governed by non-U.S. law (court test) or U.S. person does not control all substantial decisions (control test) – § 7701(a)(30) and Treas. Reg. § 301.7701-7
- A trust may be a “**grantor trust**”
  - Only the *grantor* is subject to U.S. tax on trust income
  - Grantor is essentially the person who funded the trust
- Alternatively, trust may be an “**ordinary trust**” – *trust* and *beneficiaries* are the taxpayers
  - Trust is taxed like an individual
  - Therefore, foreign trust is treated as an NRA, taxable on:
    - ◆ U.S. source investment income (but not capital gains, except real estate) at flat rate of 30%
    - ◆ Income effectively connected with a U.S. trade or business at regular U.S. rates up to 35%



# Simple and Complex Trusts

- If an ordinary trust requires current distributions of income, it is a “**simple trust**”.
  - Trust is entitled to deduct amounts to be distributed
  - Beneficiaries pay tax on trust income on current basis
  - Character of income and other tax attributes are the same in the hands of beneficiary
- If the trust does not require current distributions, it is a “**complex trust**”
  - Beneficiaries taxable only when they receive distributions
  - If trust is foreign, accumulation distributions are not entitled to capital gains treatment and tax subject to interest charge
  - Character of income is the same

# Classification of Trusts



# Grantor Trust – Before and After Grantor's Death

Time	Before Grantor's Death	After Grantor's Death
Income earned	<p>All trust income is treated as grantor's – but foreign and favored U.S. income not taxed</p>	<p>All trust income is treated as trustee's – but foreign and favored U.S. income not taxed</p>
Income actually (or required to be) distributed to U.S. beneficiary in year earned	<p>Distribution treated as gift by grantor to beneficiaries</p> <ul style="list-style-type: none"> <li>• No U.S. income tax</li> <li>• No U.S. gift tax if made outside United States</li> </ul>	<ul style="list-style-type: none"> <li>• Taxable to beneficiary when distributed</li> <li>• Capital gains treatment available</li> </ul>
Income accumulated and distributed to U.S. beneficiary in later year		<ul style="list-style-type: none"> <li>• Taxable to beneficiary when distributed</li> <li>• Capital gains taxed as ordinary income</li> <li>• Interest on deferred tax</li> <li>• FTC and U.S. tax credits</li> </ul>



# Taxation of Ordinary Trust Distributions

- **Beneficiaries** taxed on trust distributions made out of DNI (“distributable net income”). Distributions treated as made:
  - First, from DNI of current year (taxable)
  - Then, from the earliest year for which there remains DNI (taxable - plus interest charge)
  - Finally, from trust corpus (nontaxable)
- Current distributions can be ordinary income or capital gain
- Accumulation distributions from foreign trust
  - Ordinary income - even if paid out of capital gains
  - Subject to interest on deferred tax at late payment rate
  - Carry credits for U.S. and foreign taxes paid by the trust
- Good recordkeeping is vital – Forms 3520, 3520A

# Tax Attributes of Distributions

- If Trust only distributes a percentage of DNI of particular year, tax attributes associated with income (capital gain or ordinary, foreign source or U.S. source) and associated credits for foreign or U.S. taxes paid by the Trust are divided proportionately
- Similarly, if DNI is distributed to more than one beneficiary, tax attributes divided proportionately to total distributions to beneficiary within the year – may be some room to maneuver here using concept of “separate shares”.
- Example:
  - Trust has current year DNI 100 (60 capital gain, 40 ordinary income)
  - Trust distributes 80.
  - Result,  $60\% \times 80 = \$48$  capital gain;  $40\% \times 80 = \$32$  ordinary income; undistributed \$20 will all become part of UNI

# Foreign Trusts

- The advisor must determine if impending RA is the settlor, grantor, beneficiary and/or trustee of any foreign trust
- Determine if trust is or will become grantor trust
  - § 672(f) (not a grantor trust if foreign grantor, with exceptions for revocable and grantor/spouse only beneficiary of trust)
  - § 679(a)(4) (NRA grantor of foreign trust becomes RA within 5 years)
  - Regular grantor trust rules
- For trust that will continue as non-grantor trust:
  - Determine distributable net income and undistributed net income (even if accumulated pre-residence)
  - Set up U.S. trust accounting
  - Consider distribution policies
  - Consider “decanting” or other plan to move trust to US

# Estate and Gift Taxes

- NRA pays gift and estate tax on US situs assets
- \$60,000 exemption equivalent amount (except for some treaty NRAs)
- Situs of assets (*§§ 2104 and 2105*)
  - Stock of domestic corporation has U.S. situs
  - Obligations of U.S. obligor has U.S. situs but exceptions for bank accounts and corporate bonds
  - Tangible property: Where physically located (don't bring lots of jewelry to US and then die!)
  - Gift tax: Only tangible assets can have US situs
- Cash = tangible property; don't make cash gifts in US
- US estate and gift tax treaties (c. 20) can limit tax

# Estate and Gift Taxes (cont'd.)

- Retained interest rules (§§ 2036, 2038, 2041) can apply to foreign trusts and their grantors
- GST applies to U.S. situs assets but not gifts or bequests by NRAs of foreign assets
- Limitations on step-up on death
- Non-citizen spouses and QDOTs
- § 2801 – tax on U.S. recipients of gifts from “covered expatriates” (post 6/18/2008)
- Who files estate and gift tax returns
  - Donee or heir may be responsible for tax returns
    - ◆ Especially decedent in civil law country where there is no “estate”
  - Transferee liability for US donees and heirs



# Income Tax Planning

# Opportunities and Pitfalls

- Planning Foreign Activities
  - Avoiding double taxation
  - Deferral and anti-deferral
  - Qualified dividends
  - Taxation through information reporting penalties
- Entity Classification
- Subchapter S
- Issues for Prospective and Actual Immigrants
- Issues for Nonprofits
- Estate and Gift Taxes
  - Situs of assets
  - Non-citizen spouses and QDOTs
  - Limitations on step-up on death
  - Who files estate and gift tax returns

# Avoiding Double Taxation

- US persons doing business abroad may pay tax to foreign country and to US
- Two primary ways to avoid double taxation
  - Plan to reduce foreign taxes
  - Maximize US foreign tax credits (FTC)
- FTC is dollar-for-dollar credit of foreign income tax against US tax on foreign source income
- Limitations on use of credit
  - Compute credit by category of income (the “baskets”)
  - Artificial source rules for income and deductions
  - All major corporations engage in sophisticated planning to maximize credits

# Deferral and Anti-Deferral

- Foreign corporation is taxed only on US business and investment income; no tax until profits repatriated to US – this is called “deferral”
- Many US rules counteract deferral, especially if
  - Income is passive
  - Related party transactions involved
- Main rules are:
  - Controlled foreign corporations (anti-deferral)
  - Passive foreign investment companies (interest charge)
- Deferral primarily available to foreign corporation involved in active business outside United States

# Controlled Foreign Corporations

- 1–5 “US shareholders” control foreign corporation
  - US shareholder means US person with 10%+ of stock
  - Attribution rules and indirect ownership rules apply
  - US beneficiaries may be treated as shareholders
- Consequences:
  - Subpart F income deemed distributed at end of year
  - No further tax when actually distributed
  - Non-subpart F income deemed distributed if:
    - ◆ CFC shares sold (§ 1248)
    - ◆ CFC invests assets in US, with some exceptions (§ 956)

# Controlled Foreign Corporations (cont'd.)

- Subpart F income defined:
  - FPHC income (basically, passive investment income)
    - ◆ Rents and royalties – exceptions for active businesses
    - ◆ Interest and dividends – exceptions for same country intra-group payments
  - Base company income
    - ◆ Sales income – buy from related, sell to unrelated OR buy from unrelated, sell to unrelated except for same country use
    - ◆ Services income – material participation by related company in generating services income
  - Shipping income
  - Oil and gas income

# Passive Foreign Investment Company

- Rule enacted in 1986 to level playing field between offshore and domestic mutual funds
- PFIC defined as a foreign corporation where:
  - 75% of gross income for taxable year is passive
  - Average percentage of assets which produce or are held for production of passive income is at least 5%.
- Tax on “excess distributions”, including all gains, at top rate plus interest charge
- PFIC shareholder can make “qualified electing fund” or “mark-to-market” election
- If corporation both a CFC and a PFIC, then it’s a CFC only for 10% US shareholders

# Deferral and Anti-Deferral

- A full explanation of these rules would take several days . . .



# Are You All Comfortable?



- We probably need to defer the explanation . . .

# Qualified Foreign Dividends

- Under legislation enacted in 2003 and now extended to the end of 2012, dividends from domestic C corporations taxed to individuals at capital gains rates
- Politically likely to be extended again past 2012
- Also applies to qualified foreign dividends from foreign corporations located in treaty countries
  - But does not apply to Subpart F inclusions
- The qualified foreign dividend rules offer opportunities to defer tax and to reduce overall tax burden on foreign business income

# Entity Classification

- All entities are either trusts or business entities
- All business entities are corporations, partnerships or disregarded entities
- Taxpayer may elect status – “check-the-box” election, except for
  - Domestic corporation
  - Foreign corporation on regulatory list of 85 countries (one type of entity per country)
    - ◆ E.g. UK PLC, French or Swiss SA, Dutch NV, Japanese KK
  - These entities are known as *per se* corporations and are automatically treated as corporations

# Entity Classification (cont'd.)

- Absent an election, default treatment is provided
- Default treatment for domestic entity:
  - One member: Disregarded entity
  - 2+ members: Partnership
- Default treatment for foreign entity:
  - No member has unlimited liability – corporation
  - At least one member has unlimited liability:
    - ◆ One member: Disregarded entity
    - ◆ 2+ members: Partnership
- IRS Form 8832 is a must if default classification is undesirable – not sufficient to report desired classification on SS-4 (application for EIN)

*See Transparency Table below*

# Entity Classification – Traps for Practitioners

- Most foreign entities are by default corporations, including entities called “limited liability companies” – we see this a lot with LLCs in Nevis and the Cayman Islands
- Regulatory relief is available if entity always treated as partnership by taxpayer, but have to show reasonable cause. Rev. Proc. 2009-41  
2009-39 I.R.B. 1
- Some foreign entities (e.g., Liechtenstein Stiftung) can be classified as trusts, in which case the check-the-box rules don't apply

# Transparency Table

Type of Entity (domestic = formed under U.S.; foreign = formed outside United States)	Type of Owner	Minimum Number of Owners	U.S. Tax Classification (Corporation = not transparent; partnership or disregarded entity = transparent)		Typical Classification under Foreign Tax Law
			By Default	By Election (known as a “check the box” election)	
Domestic corporation	Stockholder (also called a shareholder)	1	Corporation (also referred to as a C corporation)	Cannot make check-the-box election; certain domestic corporations may make “S election” to be treated as transparent; all shareholders must be U.S. citizens or resident individuals (or certain trusts). 100% domestic subsidiary of S corporation can elect to be treated as a disregarded entity. Other restrictions apply.	Corporation (separate taxpayer)
Foreign corporation on IRS list	Usually called a shareholder	Depends on local law	Corporation	Cannot make election	Corporation
Domestic limited liability company (LLC)	Member	1	Disregarded	May elect to be treated as a corporation	Corporation
		2 or more	Partnership	May elect to be treated as a corporation	
Foreign limited liability company	Usually called a member or owner	1	Corporation	May elect to be treated as disregarded	Corporation
		2 or more	Corporation	May elect to be treated as a partnership	
Domestic or foreign limited partnership	Limited partner and at least one general partner	2	Partnership	May elect to be treated as a corporation	Partnership
Domestic or foreign general partnership	General partners	2	Partnership	May elect to be treated as a corporation	Partnership

# Subchapter S

- Only domestic corporation may elect S status or QSub status
  - But foreign corporation may be able to “check the box”
- NRA ineligible as S corporation shareholder
  - US person who becomes foreign causes termination
  - Relief if shareholder promptly disposes of stock

# Issues for Prospective and Actual Immigrants

- Plan timing of beginning of residence
- Before residence begins:
  - Make gifts and establish trusts for foreign children
  - Realize capital gains and defer realizing losses
  - Distribute undistributed earnings of foreign corporations
  - Review foreign pension plans
  - Get rid of PFICs (passive foreign investment companies)
- Consider not getting a green card if any doubt about how long residence will last – 877A and 2801 are major obstacles to leaving
- Have a plan for compliance – once US resident, an alien is subject to full weight of US taxation of worldwide income and extensive reporting
- Cross-border executive transfers



# Issues for Nonprofits

- Foreign entity can qualify for 501(c)(3) exemption
- But charitable contribution available only for contributions to domestic 501(c)(3) organizations
- “Friends of” entities may be used for deductible gifts to foreign charities
- US foundations can make grants to foreign charities, subject to numerous conditions
- And one more . . . US donor can be taxed on charitable gift of PFIC stock

# Departure

# Tax Consequences of Departure

- No departure tax for alien who was income tax resident under substantial presence test or who is not a “covered expatriate”
- § 121 can apply to later sale of principal residence, notwithstanding FIRPTA
- Earnings attributable to U.S. services or pre-departure installment sale taxed to NRA.  
§ 864(c)(6)
- Gain on sale of business property used in U.S. business and sold by NRA within 10 years after being removed from U.S. business treated as ECI. § 864(c)(7)

# Expatriation Rules

- Inbound aliens must be counseled on expatriation rules of § 877A and § 2801
- Affects whether they choose to apply for green card, since rules only apply to “expatriates”
- “Expatriate”:
  - U.S. citizen relinquishes citizenship
  - Alien who was lawful permanent resident in (meaning as little as a day) 8 of preceding 15 years and
    - ◆ ceases to be lawful permanent resident; or
    - ◆ claims to be NRA under income tax treaty

# Definition of “Covered Expatriate”

## ■ “Covered Expatriate”

- Average annual net income tax of > \$147,000 (for 2011) for the five tax years preceding expatriation. Rev. Proc. 2010-40; 2010-46 I.R.B. 1
- Net worth \$2 million or more at date of expatriation (not indexed for inflation)
- Expatriate who fails to certify 5-years of tax compliance

## ■ Exceptions

- Dual citizen at birth who did not meet “substantial presence” test for more than 10 years before relinquishment
- Person under 18½ relinquishes U.S. citizenship and did not meet “substantial presence” test for more than 10 years before relinquishment (no parallel rule for green card holders)

# Mark-to-Market Rules – § 877A

## ■ Exit Tax

- Applicable to expatriations occurring on or after June 17, 2008
- Under § 877A, mark-to-market regime replaces prior 10-year “alternative tax” on U.S. source income under § 877
- A “covered expatriate” is deemed to sell all worldwide property for FMV on day before expatriation date and is taxed on gains >\$600,000 (indexed; 2010 = \$627,000; 2011 = \$636,000)
- § 877A does not address character. Unclear how \$600,000 exclusion to be allocated among different classes of assets, gain on which may be subject to varying tax rates (e.g., capital gain vs. collectibles gain)
  - ◆ Presumably, allocation will be pro rata across income classes

# Exceptions to Mark-to-Market Regime

## ■ “Deferred compensation items”

- Interests in qualified and non-qualified U.S. and foreign retirement and deferred compensation plans, other deferred compensation, and interests in property for performance of services to extent not previously included under § 83
- Exception for deferred compensation for non-U.S. services while covered expatriate not U.S. citizen or RA
- Tax on “eligible deferred compensation” deferred until includible in gross income under U.S. rules; collected by means of 30% withholding tax
  - ◆ Deferred compensation is “eligible” if paid by U.S. payor or foreign payor electing, under terms acceptable to IRS, to be treated as U.S. payor
  - ◆ Covered expatriate must waive applicable tax treaty benefits and notify payor of status
  - ◆ Risk of double taxation, although tax credits may be available

# Exceptions to Mark-to-Market Regime (cont'd)

- Non-eligible deferred compensation present valued and treated as received day before expatriation
  - “Restricted property” under § 83 treated as transferable and no longer subject to substantial risk of forfeiture
  - Double taxation risk – likely no tax credit in foreign country
- “Specified tax deferred account” treated as received day before expatriation
  - Includes, e.g., IRAs, qualified tuition plan, Coverdell education savings account, health savings account and Archer MSA plans; doesn't include SEPs and simplified retirement accounts (treated as deferred compensation and not specified tax deferred accounts)
- Adjustments made on subsequent distributions; no early distribution penalties



# More Guidance on § 877A

- Notice 2009-85, 2009-45 I.R.B. 1
  - Background regarding general application of § 877A
  - Determining whether an individual is subject to § 877A
  - Operation of the mark-to-market regime
  - Interaction of § 877A and § 877 as well as §§ 367, 684, 897; termination of deferrals (§§ 1031, 1033; time to pay tax)
  - Deferred compensation items and specified tax deferred accounts
  - Rules for interests in nongrantor trusts
  - Filing and reporting requirements of expatriates who are covered by § 877A
  - No guidance yet on § 2801
- Form 8854 (Expatriation Information Statement)
- New Form W-8CE (Notice of Expatriation and Waiver of Treaty Benefits)

# Section 2801: New Succession Tax

- U.S. persons receiving gift or bequest from covered expatriate taxed at highest gift or estate tax rate
  - Exception for annual exclusion gifts (currently \$13,000) or entitled to charitable or marital deduction (QDOT needed?)
  - Exception for property shown on timely gift tax return of covered expatriate or included in gross estate of covered expatriate and shown on timely estate tax return
  - Credit for foreign gift or estate/inheritance taxes
- Transfers in trust:
  - If domestic trust (or foreign trust electing to be treated as domestic), tax paid by trust
  - If foreign trust, U.S. recipient pays tax on distribution portion attributable to covered expatriate's prior transfer in trust; in computing income tax on distribution, can deduct § 2801 tax attributable to income (gee, thanks!)

# More on § 2801

## ■ Scope

- Applies to gifts of wealth created long after expatriation
- Applies to gifts to recipients who may have become U.S. persons long after death of covered expatriate and who may not even have been born at time of expatriation

## ■ Compliance

- U.S. recipient may be unaware of covered expatriation
- Indirect covered gifts

## ■ Treaty interactions – “new” and even “old” treaties may override § 2801

## ■ Guidance is on the IRS Priority Guidance Plan – see <http://www.irs.gov/foia/article/0,,id=181687,00.html>

# Post-Departure Compliance

- Replace any Form W-9 with Form W-8BEN
- Where applicable, provide Form W-8ECI to avoid withholding on business income
- Wage withholding will continue
- 30% withholding on independent services, subject to treaty relief
- File split-year return in year of departure (Form 1040NR, with Form 1040 as schedule)
- Stop using TurboTax!

# Withholding and Reporting

# Withholding

- Required on many payments to foreign persons
- What do US persons have to know?
  - What are major types of withholding?
  - Who must withhold?
  - What is the nature of the payment?
  - What is the source of the payment?
  - Based on type of payment, how is status determined?
  - What is the amount of the payment?
  - What is the rate of withholding?
  - How is eligibility for applicable exemption determined?

# What Are Major Types of Withholding?

- Withholding on “fixed or determinable annual or periodic income” from US sources (§ 1441):
  - Interest and dividends
  - Rents and royalties
  - Services income
- FIRPTA withholding (§ 1445)
  - “Amount received” on “disposition” of “US real property interest”
  - Various corporate and partnership transactions
- Withholding on foreign partner’s allocable share of “effectively connected taxable income” (§ 1446)

# FDAP Withholding – Investment Income

- Applies to US source income
- Generally does not apply to income effectively connected with US trade or business
  - Foreign person may provide W-8ECI to avoid withholding on business income, e.g. real estate rentals where real estate is a trade or business
- Domestic partnership withholds
  - On distributions of FDAP income to foreign partner
  - On undistributed FDAP income when return due
- Amounts withheld must be paid over under Federal tax deposit system



# FDAP Withholding – Services Income

- Most income from performing services in US is US source
- Performance of services is a trade or business
- However, US source service income is still subject to withholding (subject to treaty claim on Form 8233)
  - If individual independent personal services, under FDAP rules
  - If wages, under wage withholding rules
  - Non-individual can avoid withholding on services income by providing Form W-8ECI

# FIRPTA Withholding

- US real property interest defined
  - Interest in real estate
  - Interest other than as creditor in real estate
  - Interest other than as creditor in *domestic* corporation that is (or was in previous 5 years) a US real property holding corporation
    - ◆ US real property holding corporation means corporation where value of USRPIs exceeds value of business assets and foreign real property interests
    - ◆ But note purging rule where *all* USRPIs previously sold in full gain recognition transactions

# Partnership Withholding

- Rate is highest rate of tax in § 1 or 11 – no lower rate for long-term capital gains of NRAs
- Overwithholding very likely because tax base is partnership taxable income. So, no reduction on account of partner-level items:
  - Loss carryovers and suspended losses
  - Cancellation of debt exclusions
  - State, local and foreign taxes or foreign tax credits
  - Charitable contributions
- Withholding treated as distribution of cash
  - May result in capital gain to foreigner
  - Overwithheld tax refunded to partner not partnership

# Who Must Withhold?

- Definition of withholding agent: Person having “control, receipt, custody, disposal or payment” of income
- Where withholding agent is a legal entity
  - “Responsible person” concept applies
  - In case of partnership, general partner or, if no general partner, manager or other responsible person
- There can be >1 withholding agent with respect to same income; withholding by one satisfies obligations of all
- IRS looks primarily to withholding agents rather than foreign taxpayer for collection of tax
- Remember: Withholding agent is just a stakeholder

# What is the Nature of the Payment?

- Withholding agent must determine nature of payment
- Example 1: Is property a US real property interest?
  - Easy enough if property is real estate
  - But what about domestic corporate stock or debt?
  - What if property is installment obligation?
  - What if property is interest in a business entity? Is the entity a corporation or a partnership?
- Example 2: Is payment interest or dividend?
- Example 3: Is there a conduit?

# How Is Status Determined?

## ■ Payment of FDAP Income

- Withholding agent relies on IRS Form W-8BEN (foreign beneficial owner), W-8IMY (intermediary for foreign owner) or W-9 (US person)
- Absent documentation:
  - ◆ Must first try to determine status as individual, partnership, corporation etc. using reliable indications or, if none, reg. 1.6049-4 guidance
  - ◆ General rule: Presume US person unless paid to person exempt from backup withholding
  - ◆ Numerous special rules cover scholarships, pensions and annuities, payments to offshore accounts, foreign intermediaries, joint payees
  - ◆ If reason to know otherwise, withhold at higher applicable rate

# How Is Status Determined? (cont'd)

- Transferee of US Real Property Interest (§ 1445)
  - US transferor *must* provide certification of nonforeign status
  - Otherwise – transferee must treat transferor as foreign
- Foreign partners (§ 1446)
  - Current: Partnership can rely on certification of nonforeign status or any other means
  - 2008 regulations would require valid Form W8-BEN, W8-IMY or W-9 – if no form or partnership has reason to know form is unreliable:
    - ◆ Presume partner is *foreign*
    - ◆ *Unless* partnership relies on some other means and partnership determination is in fact correct

# What Is the Amount of the Payment?

- Cash or fair market value of property
- Foreign currency is property
- Withholding tax must be paid in US dollars
  - If necessary, withholding agent must dispose of property or not make payment until cash available
- Can there be withholding without cash? Yes!
  - Constructive payments
  - Transfer pricing allocation
  - Foreclosure and cancellation of debt
  - Triangulated payments (A owes B but pays B's creditor C)



# Do Any Exemptions or Reductions Apply and How Is Eligibility Determined?

## ■ Treaties

- Income tax treaties may reduce rate or provide complete exemption on FDAP income or ECI
- Claim treaty benefits using Form W-8BEN, 8233 or W-8IMY
- FIRPTA, partnership withholding not reduced by treaty

## ■ FIRPTA withholding (Form 8288-B)

- IRS certificate to reduce excessive withholding
- Must apply for certificate no later than day of transfer
  - ◆ Pending certificate, transferee withholds but does not remit
  - ◆ Post-transfer, can use procedure to apply for “quickie” refund

## ■ Partnership withholding – *no* reliefs available

## ■ Foreigner can apply to IRS for refund

# Reporting and Penalties

## ■ Withholding taxes

- Forms 1042 and 1042S – FDAP income
- Forms 8804 and 8805 – partnership withholding
- Forms 8288 and 8288A – FIRPTA withholding

## ■ Statute of limitations on underreported withholding taxes does not run if no report filed

## ■ Penalties

- 100% - represents underwithheld tax
- 25% - failure to withhold or to report
- Interest at underpayment rate
- Payment of tax by foreign person does not excuse interest and penalties (§ 1463)

# Reports on Foreign Affiliates

- US persons with Interests in foreign entities
  - Form 5471 (5 categories of interests in foreign corporations, including ownership and directorships)
    - ◆ Principal use is for reporting of transactions between US shareholder and controlled foreign corporation
  - Form 8865 (US person with interest in foreign partnership)
  - Form 8858 (US person owns disregarded entity)
  - Form 3520 (several categories of interest in foreign trust, including as grantor or beneficiary)
  - Form 8621 (PFICs)
  - Form 926 (Transfers of assets to foreign corporation)
- US corporation with foreign 25% shareholder
  - Form 5472

# Financial Transaction Reporting

- Foreign financial accounts of US persons (FBARs) (not a tax form)
  - Form TD 90-22.1
  - Question on Schedule B of Form 1040
  - Bank accounts and securities accounts
- Customs reporting - import/export of cash and bearer instruments \$10,000 or more
- Bank reporting – inbound/outbound transfers of \$10,000 or more
- Foreign trusts and gifts (Forms 3520 and 3520A)
  - Gratuitous transfers by US persons to foreign trusts
  - Foreign gifts
  - Distributions from foreign trusts

# New Reporting Requirements

- Foreign funds (PFICs) (§ 1298(f))
  - PFIC holder is taxable only on receipt of a distribution and, if so, Form 8621 must be filed
  - Under HIRE Act of 2010, P.L. 111-147, Form 8621 is required annually, even if there is no income (per Notice 2010-34, this applies for tax years beginning on or after March 18, 2010, i.e., 2011 for most taxpayers)
- Foreign financial assets (§ 6038D)
  - Any individual who, during any taxable year, holds any interest in a “specified foreign financial asset” must file annual information return with respect to each asset if the aggregate value exceeds \$50,000
  - Applies to tax years beginning after March 18, 2010

# Multiple Overlapping Reporting

- Yes, similar but not necessarily the same information may be required on:
  - FBAR (foreign bank and financial accounts)
  - Form 8621 (interest in PFIC)
  - New foreign financial account rules (no form yet)
  - Form 5471 (interest in foreign corporation)
  - Form 3520 (foreign trusts and gifts)
- All of these rules carry very large penalties and they are cumulative
- Perhaps not intended as a trade barrier but certainly feels behaves like one

# Other Government Agencies

- Bureau of Economic Analysis (US Department of Commerce)
  - Survey of Foreign Direct Investment – statistical
  - Annual for large foreign investor
  - Every five years or so for all foreign investors
    - ◆ But exemption for small investments
  - Report of acquisition of 200 acres or business >\$3 m
  - Individual ultimate owners identified by country only
  - Penalties rarely imposed except for recalcitrant filers
- Agricultural Foreign Investment Disclosure Act
  - Big penalties for non-filing
  - Filed information is public
  - Disclosure limited to three tiers of ownership

# The Feds Attack Offshore Avoidance

- LGT and UBS scandals
- Offshore Voluntary Disclosure Initiatives
  - 2003
  - 2009
  - 2011
- Characteristics
  - Big penalties in exchange for no prosecution and less than maximum civil penalties
  - No differentiation between deliberate evaders and the misinformed and the ignorant – one size fits all
  - No deal for illegal income or if the IRS already had information about the taxpayer
  - The message: Come in now . . . or else! Or else what?



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