

# Basics of U.S. Tax Planning for Non-U.S. Persons With U.S. Income and Assets

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*Dina Kapur Sanna  
Partner, Day Pitney LLP*

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Tax Planning for Non-U.S. Persons and  
Trusts: An Introductory Outline" by  
G. Warren Whitaker, Partner, Day Pitney LLP

## Planning for Non-U.S. Persons

- The U.S. taxing system is one of the few that is based on citizenship, as well as residency and domicile
- A U.S. citizen is subject to income tax on worldwide income and transfer taxes on worldwide assets, regardless of where he lives
- However, a non-resident non-domiciliary who is not a U.S. citizen is only taxed on U.S.-source income and income effectively connected with a U.S. trade or business and subject to transfer taxes on U.S.-situated assets

## Planning for Non-U.S. Persons (*Cont'd*)

- A non-U.S. person who wishes to benefit a U.S. person has a unique opportunity to structure his affairs to avoid U.S. income taxes during his lifetime and U.S. transfer taxes during his lifetime, and the lifetimes of his U.S. beneficiaries
- However, 1996 legislation has curbed the ability to do so but it still exists with careful planning

## Planning for Non-U.S. Persons (*Cont'd*)

- Specifically, 1996 legislation has (i) curbed the ability of non-U.S. persons to create non-U.S. **grantor** trusts (and correspondingly for U.S. persons to create non-U.S. **non-grantor** trusts), (ii) expanded reporting obligations on U.S. persons who receive distributions or gifts from non-U.S. trusts and persons (and correspondingly on U.S. transferors making contributions to non-U.S. trusts) and (iii) made it a relatively simple matter for a trust to default to non-U.S. status for tax purposes (thereby triggering these rules)
- Nonetheless significant planning opportunities still exist (especially on the transfer tax side)!

## U.S. Resident (Income Tax)

- Lawful permanent resident (green card holder)
  - Possession is the only factor that is considered
  - Treaty override exists
  - Special rules on how to terminate green card status effectively for income tax purposes
    - surrender card and comply with rules for doing so
    - card is revoked by immigration authorities
    - judicial determination of abandonment of permanent resident status under immigration laws

## U.S. Resident (Income Tax) (*Cont'd*)

- Substantial presence test (183 days)
  - 31 days in current year plus 1/3 of days in prior year plus 1/6 of days in second prior year
  - Closer connection exception
  - Student, teacher or foreign diplomat exception
  - Medical condition exception
  - Treaty override exists
  - Importance of establishing “residency starting date” and “residency termination date” is key to preimmigration and expatriation tax planning

## U.S. Domiciliary (Estate, Gift and Generation-Skipping Transfer Tax)

- Physical presence plus intention to remain indefinitely
- Income tax residence is not tantamount to estate tax domicile (green card is but one factor)
- An illegal alien can be found to be U.S.-domiciled
- An individual on nonimmigrant visa can be found to have intent to be U.S.-domiciled despite terms of visa

## U.S. Domiciliary (Estate, Gift and Generation-Skipping Transfer Tax) (*Cont'd*)

- Objective factors measure intent, including:
  - length of time spent in U.S. and abroad, visa and income tax filing status
  - location, value and size of real and personal property and, in case of former, whether owned or rented
  - social, business and religious affiliations
  - jurisdiction where registered to vote and that issued driver's license
  - statements of domicile made in legal documents

## Income Tax Rules Applicable To Non-Residents Who Are Not Citizens (“Non-U.S. Persons”)

- Taxed only on U.S. source income and income effectively connected with conduct of a U.S. trade or business
- U.S. source income is taxed on a gross basis by withholding at source at rate of 30% (subject to lower treaty rate)
- Effectively connected income is taxed on a net basis at graduated rates of up to 35%

## Income Tax Rules Applicable To Non-Residents Who Are Not Citizens ("Non-U.S. Persons") (*Cont'd*)

- U.S. source income subject to withholding includes U.S. dividends, interest, rents and salaries
- Broad exceptions exist for U.S. source interest:
  - portfolio interest
  - bank deposit interest
  - short-term debt obligations
- Capital gain on U.S. assets (except U.S. real property) is not subject to income tax unless non-U.S. person is present in U.S. for 183 days and has a tax income in U.S.

## Estate, Gift and Generation-Skipping Transfer Tax Rules

- *Applicable To Non-Domiciliaries Who Are Not U.S. Citizens (“Non-U.S. Persons”)*
  - Taxed only on U.S.-sitused assets
  - Broad exceptions exist for intangible assets (such as U.S. stocks) for gift tax purposes

## Estate, Gift and Generation-Skipping Transfer Tax Rules (*Cont'd*)

- *Applicable To Non-Domiciliaries Who Are Not U.S. Citizens (“Non-U.S. Persons”)* (*Cont'd*)
  - For estate tax purposes, U.S.-situated assets include U.S. stocks, and partnerships that either conduct business in U.S. or own U.S.-situated assets, U.S. tangible and U.S. real property
    - most U.S. bonds are excepted, as are U.S. bank deposits
  - Holding U.S.-situated assets through a non-U.S. corporation provides a cover against estate tax

## Estate, Gift and Generation-Skipping Transfer Tax Rules (*Cont'd*)

- *Applicable To Non-Domiciliaries Who Are Not U.S. Citizens (“Non-U.S. Persons”)* (*Cont'd*)
  - Situs of assets transferred subject to retained provisions needs to be reviewed at time of transfer and death under a special claw-back rule
  - Avoid corporate veil being pierced or having corporation otherwise treated as “nominee”
  - Weigh income tax effects of interposing a corporation in structure against potential estate tax savings (e.g., with U.S. real property, an irrevocable trust holding a U.S. partnership may be better)

## Estate, Gift and Generation-Skipping Transfer Tax Rules (*Cont'd*)

- *Applicable To Non-Domiciliaries Who Are Not U.S. Citizens (“Non-U.S. Persons”)* (*Cont'd*)
  - Non-U.S. persons are subject to estate, gift and generation-skipping transfer tax at rates of up to 45%
  - The offsetting estate tax exemption equivalent is fixed at \$60,000 (absent treaty relief)
  - There is no gift tax exemption equivalent but annual exclusion of \$13,000 is available for gifts of U.S.-situated assets (and non-U.S. person may make unlimited gifts of assets that are not U.S.-situated)

## Estate, Gift and Generation-Skipping Transfer Tax Rules (*Cont'd*)

- *Applicable To Non-Domiciliaries Who Are Not U.S. Citizens (“Non-U.S. Persons”)* (*Cont'd*)
  - Deductions are available for worldwide administrative expenses, indebtedness and taxes on a pro-rated basis
  - Charitable deduction is limited to transfers to U.S. charities – case law suggests that to obtain full benefit will or trust should direct bequest be paid from U.S.-situated assets
  - Tax treaties may alter the result

## Estate, Gift and Generation-Skipping Transfer Tax Issues

- *Where Donee Spouse Is Not A U.S. Citizen*
  - Estate and gift tax marital deduction is available for bequests to U.S. citizen – case law suggests to obtain full benefit will or trust should direct bequest be paid from U.S.-situated assets
  - Tax treaties may alter result
  - Bequest to noncitizen spouse must be in QDOT

## Estate, Gift and Generation-Skipping Transfer Tax Issues (*Cont'd*)

- *Where Donee Spouse Is Not A U.S. Citizen (Cont'd)*
  - Broad requirements of a QDOT:
    - U.S. trustee (and in some cases U.S. corporate trustee) is required
    - U.S. trustee must have right to withhold estate taxes on principal distributions
    - trust must contain provisions set out in Treasury regulations to insure compliance
    - executor must make irrevocable election on estate tax return

## Estate, Gift and Generation-Skipping Transfer Tax Issues (*Cont'd*)

- *Where Donee Spouse Is Not A U.S. Citizen (Cont'd)*
  - No gift tax marital deduction is available for transfers to noncitizens
  - As compensation for complete loss, increased annual exclusion of \$133,000 exists for intraspousal transfers where donee is a noncitizen

## Estate, Gift and Generation-Skipping Transfer Tax Issues (*Cont'd*)

- *Where Donee Spouse Is Not A U.S. Citizen (Cont'd)*
  - Jointly-held assets present issues where one joint tenant is a noncitizen spouse because creation of joint tenancy in personal property could result, in some cases, in a gift to noncitizen spouse for which no gift tax marital deduction is available
  - At death of joint tenant if survivor is noncitizen, a tracing rule applies to determine portion of jointly-held asset included in deceased's estate (presumption is that whole is included)

## Use Of Non-U.S. Trusts By Non-U.S. Persons With U.S. Beneficiaries

- Non-U.S. trusts are generally taxed as non-U.S. persons (i.e., withholding on U.S. source income at 30% and tax on effectively connected income)
  - a non-U.S. trust is not considered “present” in U.S. for capital gains tax purposes
- Since 1996, to be a non-U.S. trust, a trust must, flunk one of the two tests required to be a U.S. trust

## Use Of Non-U.S. Trusts By Non-U.S. Persons With U.S. Beneficiaries (*Cont'd*)

1. Control Test – one or more U.S. persons must have ability to control *all* substantial decisions of trust with no non-U.S. person having a veto
2. Court Test – a U.S. court must have *primary* supervision over the administration of the trust (even if a non-U.S. court has jurisdiction over a trustee, beneficiary or trust property)

Note: If either the Control Test or Court Test is not met, the trust defaults to a non-U.S. trust with attendant tax and reporting consequences

## Use Of Non-U.S. Trusts By Non-U.S. Persons With U.S. Beneficiaries (*Cont'd*)

- If a non-U.S. trust is established and funded by a non-U.S. person and qualifies as a “grantor trust” for income tax purposes, it is disregarded as a taxable entity and grantor is taxed on income of trust as its owner
- Correspondingly, if income of trust is not U.S.-source income or effectively connected income, grantor is not subject to income tax
- Distributions to U.S. beneficiary are treated as gifts from non-U.S. grantor and not taxed (although reportable since 1996)

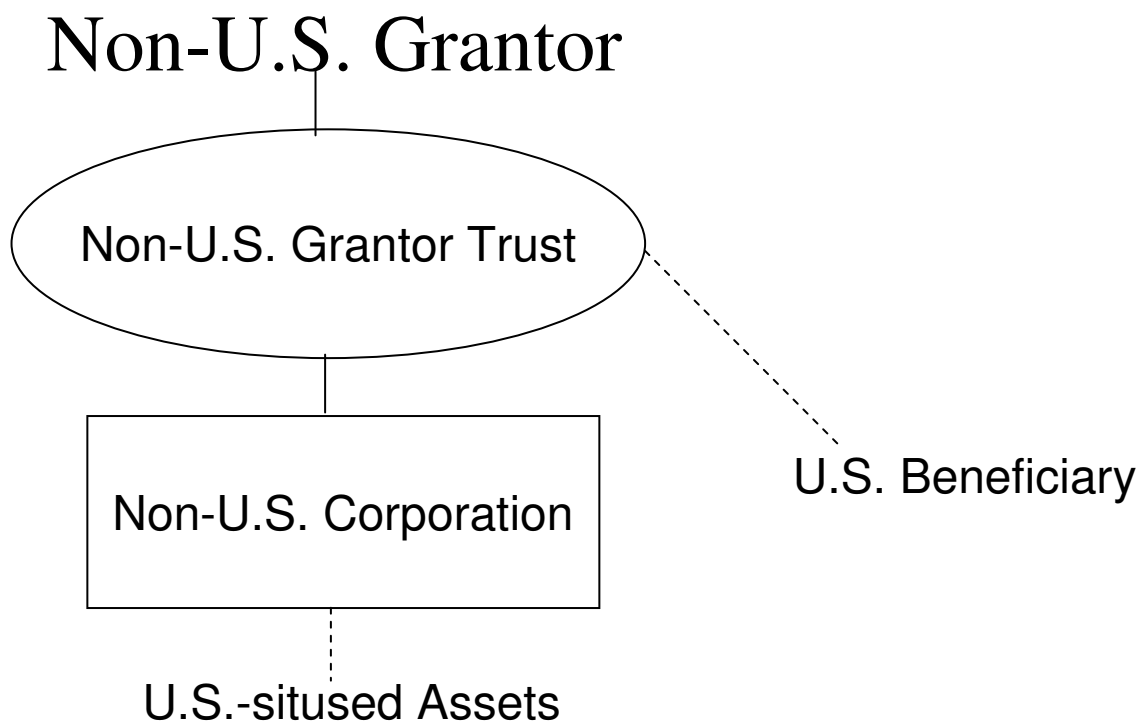
## Use Of Non-U.S. Trusts By Non-U.S. Persons With U.S. Beneficiaries (*Cont'd*)

- Since 1996, a non-U.S. person is not treated as owner of trust under grantor trust rules generally, unless trust meets either “Revocable Trust Exception” or “Trusts that Distribute only to Grantor and/or Grantor’s Spouse Exception”
- However, limited grandfathering exists for pre-1996 trusts with respect to contributions made to them on or before 9/19/95

## Use Of Non-U.S. Trusts By Non-U.S. Persons With U.S. Beneficiaries (*Cont'd*)

- Revocable Trust Exception: Non-U.S. grantor can revoke trust and revest property in himself, either alone or with consent of related or subsequent party
- Trusts that Distribute only to Grantor and/or Grantor's Spouse Exception: Trust beneficiaries are limited during grantor's lifetime to him and/or his spouse and no other person can benefit, whether from income or principal

# Optimal Structure For Non-U.S. Grantor With U.S. Beneficiaries



## Optimal Structure For Non-U.S. Grantor With U.S. Beneficiaries (*Cont'd*)

- Benefits:
  1. No income tax (except U.S. withholding on U.S. source income) paid by trust, non-U.S. grantor or U.S. beneficiary
  2. No estate tax on death of non-U.S. grantor (because U.S.-situated assets held through non-U.S. corporation) or on death of U.S. beneficiary (if assets stay in trust)
  3. No generation-skipping transfer tax if trust continues in perpetuity

## Death Of Non-U.S. Grantor

- Trust becomes a non-grantor trust and distributions to U.S. beneficiary are taxable (and reportable since 1996)
- Further, accumulation distributions subject to “throwback rules”:
  - accumulated capital gains taxed as ordinary income
  - accumulation distribution thrown back to prior years in which trust had accumulated income and taxed at beneficiary’s tax rate over deferral years
  - interest charged on tax

## Death Of Non-U.S. Grantor (*Cont'd*)

- No tracing rule applies
- Distributions carry out pro-rata share of current income and gains and accumulated income and gains
- Broad intermediary rules exist to capture distributions made through non-U.S. intermediaries to U.S. persons
- Techniques still exist, however, for managing throwback rules

## Death Of Non-U.S. Grantor (*Cont'd*)

- Also, non-U.S. corporation can be classified as a Controlled Foreign Corporation (“CFC”) or Passive Foreign Investment Company (“PFIC”) if interests therein can be attributed from non-U.S. non-grantor trust to U.S. beneficiary under a “facts and circumstances” test, with emphasis being on distribution history (i.e., who is entitled or eligible to receive net income of trust)

## Death Of Non-U.S. Grantor (*Cont'd*)

- CFC is defined as a non-U.S. corporation, more than 50% owned by 10% U.S. shareholders
- PFIC is defined as a non-U.S. corporation that has more than 75% passive income or at least 50% passive assets (but only U.S. shareholders impacted)
- Both rules have separate means which eliminate any benefit of deferral of tax on earned income of non-U.S. corporation

## Death Of Non-U.S. Grantor (*Cont'd*)

- One solution is to liquidate non-U.S. corporation immediately after death of non-U.S. grantor and migrate trust to U.S. so it becomes a U.S. trust, or pay over its assets to a U.S. trust in same tax year
- Alternatively after liquidation, trust can remain a non-U.S. trust and one or more investment and distribution strategies can be employed to manage throwback rules
- Which is better depends on U.S. beneficiary's individual facts and circumstances, nature, type and value of assets in trust

## Optimal Structure After Death Of Non-U.S. Grantor

- Trust should be a dynasty trust
- Trust should not give U.S. beneficiary powers that would cause property to be included in his estate but:
  - he can have power to replace trustee with independent trustee
  - he can have limited power to withdraw up to 5% of principal each year
  - he can have limited power to appoint the assets (other than to himself) at death

## U.S. Reporting For Gifts Received By Foreign Persons and Distributions From Foreign Trusts on Form 3520

- Since 1996, U.S. reporting exists with respect to aggregate gifts which exceed \$100,000 in a calendar year from a non-U.S. donor:
  - aggregation of gifts is required if donors are “related” within meaning of tax rules
  - identify of donor is not disclosed
  - failure to report results is a penalty equal to 5% of gift

## U.S. Reporting For Gifts Received By Foreign Persons and Distributions From Foreign Trusts on Form 3520 (*Cont'd*)

- Since 1996, U.S. reporting exists with respect to distribution from non-U.S. trusts:
  - no minimum threshold amount
  - a “Beneficiary Statement” from the non-U.S. trustee must be obtained to avoid default treatment as accumulation distribution that is subject to throwback rules
  - appointment of U.S. agent may preclude adverse tax treatment to U.S. beneficiary and disclosures by non-U.S. trust
  - failure to report results in a penalty equal to 35% of distribution

## Non-U.S. Person Moving To United States (Estate and Gift Tax Planning)

- Make irrevocable gifts of non-U.S.-situated assets prior to becoming U.S. domiciled
  - outright to non-U.S. persons
  - in irrevocable trust for U.S. persons
- Make irrevocable gifts to U.S. defective grantor trust of which grantor can be a permissible beneficiary and fully fund it prior to becoming U.S. domiciled
- Make irrevocable gifts to spouse to equalize estates

## Non-U.S. Person Moving To United States (*Cont'd*) (Income Tax Planning)

- Step up basis of assets, accelerate income and postpone loss recognition prior to becoming a U.S. resident
- Review and restructure non-U.S. trusts of which non-U.S. person is grantor and/or a beneficiary
- Review and restructure closely-held non-U.S. corporations in which non-U.S. person is a shareholder which may become CFCs, and avoid PFIC investments in the future

## Use of Non-U.S. Trust by U.S. Persons

- A non-U.S. trust is automatically treated as a grantor trust with respect to a U.S. transferor if there is a U.S. beneficiary or if the transferor has retained one or more enumerated “grantor trust powers”
  - very difficult to avoid grantor trust classification since 1996 rules now broaden concept of when a trust is treated as having a U.S. beneficiary
  - also, to avoid classification under “grantor trust rules” U.S. grantor has to give up all control and neither he nor his spouse can benefit

## Use of Non-U.S. Trust by U.S. Persons (*Cont'd*)

- U.S. grantor taxable on income of non-U.S. trust
- Post 1995 transfers are reportable on Form 3520 and failure to report results in a 35% penalty
- Annual reporting exists on Form 3520 and 3520-A (by trustee)
- If U.S. grantor dies, expatriates or otherwise ceases to be treated as grantor of non-U.S. trust, he is subject to tax on unrealized gains of trust
- Nonetheless, may afford asset protection and reduce appreciation in taxable estate (if completed gift)

## U.S. Citizen or Long-Term Resident (green card holder for 8/15 years) Who Expatriates

- If satisfy net worth test or income tax liability test or fail to make required income tax certification, automatically treated as a “covered expatriate”
- New Section 877A, as amended by the Heroes Earnings Assistance and Relief Tax Act of 2008 (“HEART”) imposes a mark-to-market tax on worldwide property of a covered expatriate as if it had been sold on the date of expatriation and he is required to recognize net gains in excess of \$626,000

## U.S. Citizen or Long-Term Resident (green card holder for 8/15 years) Who Expatriates (*Cont'd*)

- Deferred compensation items, tax deferred accounts (IRAs and the like) and interests in non-grantor trusts, are excluded from the ambit of the gain recognition rule
- Instead there is a 30% withholding tax on distributions from non-grantor trusts
- The mark-to-market tax is in lieu of the 10-year regime under prior law that applied to U.S. source income producing assets and U.S.-situated assets

U.S. Citizen or Long-Term Resident  
(green card holder for 8/15 years)  
Who Expatriates (*Cont'd*)

- There is now a succession tax applicable to U.S. recipients with respect to gifts or bequests acquired directly or indirectly from an individual who, immediately before such gift or his death, was a covered expatriate
- The HEART provisions are effective for individuals who expatriate on or after June 17, 2008