U.S. Tax Issues Facing Foreign Nationals On U.S. Assignment

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Foreign nationals transferred to the U.S. by their employer are often confronted with a variety of issues upon establishing themselves in the U.S. Among the most important of these considerations is exposure to U.S. taxation, including income tax, estate and gift tax. As a foreign national integrates into the community and develops more substantial ties to the U.S., his or her tax liability may increase. However, there are steps that can be taken to reduce a foreign national's U.S. tax liability. As discussed below, significant savings can be achieved through proper tax planning. Of equal importance is the avoidance of tax pitfalls where inadequate planning is undertaken.

U.S. Transfer Tax Planning

U.S. domiciliaries are subject to U.S. gift and estate tax on their worldwide assets while non-domiciliaries are subject to the U.S. transfer tax system only to the extent of their U.S. property. Domicile is a grey area of law, based on facts and circumstances, but in general a foreign national will be considered domiciled in the U.S. if he or she is currently in the U.S. with no present intention of later leaving.

Even a non-domiciliary is subject to estate tax on U.S. securities and U.S. real estate, so tax planning is often necessary before a person even moves to the U.S.

1. Since domicile is a facts and circumstances test, a foreign national can show that he or she intends to return to the home country, thus reducing estate tax exposure on foreign property while residing in the U.S. by maintaining strong ties to the country of origin. For example, maintaining a personal residence, financial, religious and social affiliations in the home country, as well as voting and maintaining a foreign driving license will imply a foreign national does not intend to remain indefinitely in the U.S. Applying for a green card and buying U.S. real estate as a personal residence, however, both suggest an intention to remain in the U.S. and could lead to the Internal Revenue Service (IRS) assessing gift and estate tax on worldwide assets.

2. An outright gift of foreign property will not be subject to U.S. gift tax provided the donor is not domiciled in the U.S. Foreign nationals should consider outright gifts, or transfers to certain "drop-off" trusts, in order to keep foreign property outside the scope of estate tax if he or she later becomes domiciled. A "drop off" trust could also acquire U.S. property and shelter such property from U.S. gift and estate tax.

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3. Stock of a U.S. company is *not* subject to gift tax, so shares in U.S. companies can be transferred without a U.S. gift tax cost. In contrast, if a foreign national passes away owning the U.S. stock, it is subject to estate tax at rates that quickly reach 45 percent, irrespective of domicile status.

4. Cash in a U.S. bank account is not generally subject to estate tax for a non-domiciliary. However, if that person is resident in the U.S. for income tax purposes, the account will be subject to estate tax, even if he or she is not domiciled in the U.S. A foreign national residing temporarily in the U.S. should therefore consider maintaining large cash deposits in overseas accounts.

5. A foreign national working in the U.S. should also consider having a U.S. will. A U.S. will can be an essential estate planning tool in that it can allow the foreign national to dispose of his or her assets in the most globally tax efficient manner. A U.S. will can also determine the guardianship of children. Without a U.S. will, both the disposition of assets and the guardianship of children could be determined by a U.S. court.

6. A foreign national residing in the U.S. should be cautious when making substantial gifts. Gifts of tangible property located in the U.S. could trigger a gift tax. Annual exclusions are available for up to $12,000 ($13,000 in 2009) per donee, and a special annual exclusion of $128,000 ($133,000 in 2009) is available for gifts to a non-U.S. citizen spouse.

Income Tax Planning

A foreign national's exposure to U.S. income tax depends on residency status. To be a U.S. resident for income tax purposes, an individual must be physically present in the U.S. for at least 183 days of a three-year period, calculated by adding all the U.S. days of the current year, 1/3 of the U.S. days of the preceding year, and 1/6 of the U.S. days in the second preceding year. Foreign nationals who meet this test are subject to U.S. income tax on their worldwide income, while those who do not establish U.S. residency are subject to income tax only on their U.S. source income.

There are several steps foreign nationals can take prior to entering the U.S. to limit U.S. income tax exposure.

1. If the tax rates are lower in their home country, a foreign national should consider selling appreciated investment assets and then buying them back prior to beginning their U.S. assignment. This results in a step-up in tax basis, thus preventing the U.S. from taxing gains that accrued prior to entry into the U.S.

2. Foreign nationals should also be aware that the exercise of stock options in the U.S. may result in U.S. income tax (including state tax) on the entire amount of profit. If tax rates on option income are more favorable in the home country than in the U.S., a foreign national should consider exercising stock options before beginning the assignment in the U.S. Where the options are in a U.S. company, this will also allow the foreign national to transfer the stock to a trust, for example, to minimize estate tax exposure.

3. Due to a potential tax liability on foreign currency conversion, it could be advisable for foreign nationals to open a U.S. dollar bank account prior to commencing their U.S. assignment and convert foreign currency investments to dollars prior to meeting U.S. residency status.

4. Foreign nationals who are considering selling a primary residence can lower their U.S. income tax liability by selling it either before of after their period of U.S. residency. The U.S. allows an exclusion of $250,000 ($500,000 for married taxpayers filing jointly) if the home was the primary residence for at least two years. If the foreign national doesn't intend to keep the property indefinitely and fails to meet the two-year test, or has an unrealized gain in excess of the U.S. exclusion amount, it could be beneficial to sell the home prior to becoming a U.S. resident.

5. Foreign nationals on assignment in the U.S. should consider shifting their philanthropic activities to U.S. charities so that they may benefit from the U.S. charitable deduction. The U.S. generally does not allow an income tax deduction for gifts to non-U.S. charities.

Non-U.S. Mutual Funds

Many foreign nationals who move to the United States have interests in non-U.S. mutual funds, which are considered passive foreign investment companies (PFICs). The U.S. tax on PFICs can be severe; the U.S. imposes a tax on PFIC distributions and capital gains from the disposition of an interest in a PFIC at ordinary income rates (currently 35 percent), plus an interest charge. Compare this to the 15 percent rate that currently applies to many distributions and gains from U.S. mutual funds. The additional interest charge assessed on gain from disposing of a PFIC interest is based on the period the investment has been owned, and can lead to an effective tax rate of over 100 percent in extreme cases.

A well-advised foreign national would review his or her portfolio to identify PFICs and consider some of the following planning ideas:

1. The easiest solution to avoid the PFIC rules is to sell the investment prior to moving to the U.S. Home country tax consequences should be considered.

2. A foreign national already residing in the U.S. can make a qualified electing fund ("QEF") election. This essentially converts the PFIC to a partnership for tax purposes and allows the taxpayer to retain the favorable long-term capital gains rates and avoid the interest charge on dispositions and distributions.

3. The foreign national may be able to elect to mark-to-market the PFIC interest, claiming as income or loss each year the fluctuations in its fair market value.

4. A foreign national can also consider making an election to treat the PFIC as a pass-through entity by making a "check the box" election. The election eliminates the application of the PFIC rules, but must be made at the fund level, so this option is generally available only for interests in closely held PFICs.

Information Reporting

In all likelihood, foreign nationals residing in the U.S. will hold interests in a variety of foreign accounts and foreign entities. It is important that these interests are accurately reported to the IRS, given the recent increase in enforcement of international reporting requirements and the steep penalties imposed for non-compliance. The following information reports are commonly filed by a foreign national in the U.S.:

1. Form 8858, "Information Return of U.S. Persons With Respect To Foreign Disregarded Entities."

2. Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships."

3. Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations."

4. Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund."

5. Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."

6. Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts."

7. Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner."

8. Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts."

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Conclusion

There are significant tax planning opportunities for foreign nationals moving to, or already residing in, the U.S. For the unwary, there are also potential traps that could result in punitive and unexpected tax exposure. Due to the additional complexities, foreign nationals should seek advice from a qualified advisor with expertise in this area to develop a tax efficient strategy.

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