INTERNATIONAL PLANNING

Bridging Borders: Tax Implications of Inbound Wealth

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As the world becomes increasingly mobile, the tax implications associated with crossing borders gain significance. Determining exactly whose income, gains, and assets are subject to the U.S. Federal tax system is a complex inquiry that requires a comprehensive approach with the guidance of knowledgeable advisors. For international individuals thinking about investing in the U.S. or coming to the U.S. to study, work, or establish a new residence, understanding the broad scope of potential tax implications is an important first step toward avoiding any costly, unintended results.

First, because there are anticipatory planning opportunities, it is important to understand how a U.S. person is taxed for Federal income tax purposes versus citizens not resident in the U.S. Next, consideration should be given to the estate and gift tax rules applicable to non-U.S. persons, including married couples either of whom is not a U.S. citizen. Once the foundation is laid, consideration to planning opportunities is possible.

U.S. INCOME TAX CONSIDERATIONS

A U.S. citizen or resident ("U.S. person") is generally subject to tax on worldwide income. However, individuals who are neither citizens nor residents of the U.S. are potentially subject to U.S. income tax on U.S. source income. So-called non-resident aliens ("NRAs") are taxed on fewer categories of income than a U.S. person. From a policy perspective, this is to encourage foreign investment in the U.S.

Once a non-U.S. citizen or non-U.S. resident individual moves to the U.S., the tax implications may change—including the potential loss of favorable U.S. income tax treatment. Therefore, understanding the general income tax implications of various decisions and conducting pre-investment or pre-immigration planning are particularly important.

NRA's are generally subject to income tax on U.S. source income as follows:

Type of U.S. Source Income	General U.S. Income Tax Treatment for a Non-Resident Alien
Capital Gains (except U.S. real property gains)	Generally excluded from U.S. tax. If the NRA was in the U.S. for 183 days or more during the tax year, the net gain from sales or exchanges of capital assets is taxed at 30%. Capital gains are taxed also if they are effectively connected with a trade or business in the U.S. during the tax year.
Dividends	Generally included as U.S. source taxable income subject to 30% withholding.
Interest from Bank Accounts	Excluded from U.S. income tax.
Interest from Bonds or Other Debt Obligations	Taxable and subject to 30% withholding unless the portfolio interest exemption or an income tax treaty applies.*

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Type of U.S. Source Income	General U.S. Income Tax Treatment for a Non-Resident Alien
Portfolio Interest Exemption	Excludes interest paid to non-U.S. persons on bonds and other debt obligations held for investment if: (i) The obligation identifies the payer (i.e., is in registered form); (ii) The payee is a foreign individual or entity and is the beneficial owner of the income; and (iii) The foreign individual or entity provides a Form W-8 to the payer. See Forms W-8BEN, 1042 and 1042-S. Other portfolio exemptions apply. See IRS Publication 515. *This exception does not apply if the foreign investor owns 10% or more of the U.S. corporation or partnership that issued the obligation or if the obligation arises in the course of a bank's extension of credit. The exemption also generally does not apply to interest tied to the issuer's receipts, sales, cash flow, income, etc. Nor does this exception apply to registered debt convertible to bearer form.
Capital Gains from the Sale of Real Estate	Under FIRPTA, such capital gains are treated as effectively connected income, and proceeds taxed on a net basis. However, 10% withholding is on gross sale price, unless seller applies for reduced certification. See Form 8288 and 8288-A.
Rental Income	Income generated by the use of U.S. real estate is subject to 30% withholding. However, a special election may be made to treat U.S. real property interests as Effectively Connected Income so tax may be paid on only the net income (income less deductions attributable to rental income). Timely U.S. tax returns must be filed to receive the benefit of this election.
Mutual Funds (the mutual fund will designate in writing which dividends are interest-related dividends or short-term capital gain dividends)	Certain interest-related dividends and short term capital gain dividends from U.S. issuer were excluded from U.S. tax, but these exclusions expired December 31, 2013. The exclusions could be extended by Congress; the status is not known at this time. Long-term capital gain distributions are excluded from U.S. tax.

U.S. ESTATE AND GIFT TAX CONSIDERATIONS

Income tax planning is only one piece of the puzzle and, for U.S. estate and gift tax purposes, the U.S. is similarly aggressive. The focus of the income tax is on the facts of "residence," while the focus of the estate and gift tax is on the intention of "domicile." Even individuals who are neither citizens of nor domiciled in the U.S. ("NRNCs") may be subject to transfer taxes on what are considered U.S. situs assets. There are both familiar similarities and important differences in the U.S. transfer taxation of U.S. citizens or U.S. domiciled individuals and NRNCs. Knowing the general differences is essential for tax sensitive planning.

While certain assets are deemed U.S.-situate assets for U.S. estate tax purposes, these same assets may not be deemed U.S.-situate assets for U.S. gift tax purposes. For the U.S. gift tax to apply to U.S.-situate assets, such assets must also be characterized as U.S. *tangible* assets. This additional criterion opens up an array of strategies for U.S. transfer tax planning. For example, once an asset is characterized as a U.S.-situate asset, the asset will be includible in the non-U.S. person's taxable estate and subject to U.S. estate tax at the decedent's death. However, if the asset

is properly characterized as an *intangible* asset, the non-U.S. person can gift the asset out of his or her U.S. estate, without incurring gift tax.

No unlimited gift or estate tax marital deduction is available for a transfer to a spouse who is not a U.S. citizen. An annual exclusion of $145,000 in 2014 is available for lifetime gifts. Transfers to a trust for a non-U.S. citizen spouse, known as a qualified domestic trust ("QDOT"), will qualify for the unlimited estate tax marital deduction.

Category:	**Non-Resident Non-Citizen:**	**Citizen/Resident:**
U.S. Estate Tax	Taxed on U.S. situs assets (real, tangible, intangible)	Taxed on worldwide assets
Applicable Exclusion Amount	$60,000, subject to treaty modified pro rata rules, only available for estate tax purposes, not available for lifetime gifts	$5,340,000 in 2014, available for estate, gift and generation-skipping transfer tax purposes
U.S. Gift Tax	Taxed on gratuitous transfers of U.S. situs tangible assets (real, personal)	Taxed on all gratuitous transfers
Annual Gift Tax Exclusion	• $14,000 in 2014 • Gift splitting *not* allowed	• $14,000 in 2014 • Gift splitting with U.S. citizen spouse allowed
Transfers to a Spouse	• No unlimited marital deduction for transfers to non-U.S. citizen spouse • Lifetime gift to non-U.S. citizen spouse, annual exclusion $145,000 in 2014 • Estate tax marital deduction for transfers to QDOT for non-U.S. citizen spouse • Contribution rule for joint tenancy with non-U.S. citizen spouse; deferred gift treatment of joint tenancy in real property	

PRE-IMMIGRATION PLANNING

Understanding the general tax implications is an important dimension not only when considering how to structure business and investment activities, but also when analyzing the implications associated with moving to the U.S. Planning should be coordinated with home country advisors as well as U.S. advisors and applicable treaty implications should be taken into account.

Some planning opportunities to consider:

- Accelerating (realize and recognize) income earned by the immigrating NRA prior to becoming a U.S. tax resident. Possible income to accelerate includes compensation, pension plans, stock options, prepaid rents, royalties, dividends, interest, and annuity products.

- Accelerating gain in appreciated assets belonging to the immigrating NRA prior to becoming a U.S. tax resident.
- Deferring losses until after the immigrating NRA becomes a U.S. tax resident. These losses may be taken against gains in assets after the immigrating NRA becomes a U.S. tax resident.
- Exploring tax strategies that will step-up the tax basis of assets to their fair market value so that only appreciation after becoming a U.S. tax resident will be taxable in the U.S. Unlike many jurisdictions, such as Canada, the U.S. does not allow an immigrating NRA to adjust the tax basis of his or her property to reflect its fair market value at the time the NRA becomes a U.S. tax resident.

PARENTS PLANNING FOR CHILDREN

For the NRA/NRNC who is not immigrating, but who has immigrating children, planning opportunities also exist. Often, parents wish to help support their children when the children move to the U.S. Or, the parents want to have a structure that allows for the tax efficient succession of wealth to U.S.-based children. In appropriate circumstances, parents may use a foreign grantor trust to accomplish these tax objectives. The foreign grantor trust structure provides U.S. income tax efficiency during the NRA/NRNC parent's lifetime and provides a shield from U.S. transfer tax after the parent-grantor's death.

- *U.S. Income Tax* – The NRA parents remain the owners of the underlying trust assets for U.S. income tax purposes. This means that foreign sourced income and gains are not taxed in the U.S. As such, while the NRA parents are alive, the foreign income and gains of the foreign grantor trust should not be subject to U.S. income tax. There is no U.S. income tax drag.
- *U.S. Estate Tax* – When the NRNC parents pass away, the trust, designed as an ongoing dynasty trust, remains available for the benefit of the U.S.-based children and grandchildren; yet, these assets may escape the U.S. estate and generation-skipping transfer tax net. At this point subsequent planning may be required for U.S. income tax purposes.

PLANNING AHEAD

These are only some of the planning opportunities which exist; they highlight the benefits of planning ahead and working with advisors on both sides of the border to be crossed. Thoughtful planning will help mitigate taxes and allow individuals to take advantage of any relevant treaty benefits.

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