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Common Tax, Investment, and Immigration Mistakes Among U.S. International Citizens, Permanent Residents, and Foreign Investors in the United States

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AMERICAN CITIZENS AND GREEN CARD HOLDERS

In our more than 75 combined years of practice, we have noticed that many overseas American citizens and Green Card holders (a/k/a permanent residents) put themselves in substantial financial jeopardy as a result of misinformation or a complete blindness to the many nuances contained in U.S. law. In this practical article, we hope to spare some individuals this pain by pointing out the landmines that we often find unfamiliar U.S. taxpayers stepping on.

Mistakenly Believing That the United States Does Not Allow Americans to Also Have Other Citizenships or Residences

Many Americans and Green Card holders mistakenly believe that they have or will lose their prior citizenship when they become naturalized in the United States. Furthermore, many Americans mistakenly assume that they will lose their U.S. citizenship should they acquire another citizenship through naturalization, lineage, or investment. This does not happen without the American clearly articulating (and not later contradicting) that when they acquire the new citizenship, they intend to give up their U.S. citizenship.

It is worth noting that other countries (e.g., Singapore) require an individual to renounce their current citizenship in order to assume the citizenship of their country. However, this is not the case in most countries and certainly not a requirement in order to acquire a foreign residence.

Mistakenly Believing That the Acquisition of a Foreign Residence or Citizenship Results in an Automatic Audit or Is Otherwise “Dodgy”

Tens of millions of Americans have a second or even third citizenship, along with their U.S. citizenship. Most just have two, hence the common term ‘‘dual citizenship.’’ The most accurate term is ‘‘multiple citizenship’’ and occurs where the other countries also allow multiple citizenships. In some countries, such as China and India, multiple citizenships are prohibited.

Multiple citizenships or foreign residence permits are also becoming increasingly popular in the last few years as a result of pandemic travel restrictions. They

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allowed significantly greater mobility along with the traditional benefits of expanding education and work opportunities for family members.

Mistakenly Believing That Other Countries Tax Based Upon Citizenship

Aside from the African state of Eritrea, the United States is the only country which has citizenship-based taxation in addition to the residence-based taxation that virtually all other countries have. Needless to say, Eritrea does not have a tax agency similar to the IRS or international leverage to be able to impose a FATCA-[1] like regime on the international financial world.

As a result, the simple acquisition of acquiring another citizenship through lineage or investment does *not* result in automatic tax liability in that country. Conversely, Americans acquiring a second citizenship without also renouncing their U.S. citizenship, does not reduce their U.S. tax liability but may add to their U.S. reporting burdens. Naturalization may or may not require an individual to be tax resident in the country of naturalization. Proper advice on local naturalization laws is paramount.

Buying Foreign Mutual Funds and Other Registered Foreign Private Equity Funds

Foreign mutual funds and foreign private equity funds may seem attractive to an American taxpayer living abroad. However, the IRS considers these funds to be Passive Foreign Investment Companies (PFICs) and they are a tax nightmare for U.S. filers. If you are a U.S. citizen or permanent resident (Green Card holder) who has been living and working outside the United States and investing your savings through a non-U.S. financial institution, you need to understand PFICs. PFICs are subject to special, highly punitive tax treatment by the I.R.C. Not only will the applicable tax rate be much higher than that of similar or identical U.S. registered investments, but the required accounting/recordkeeping for reporting PFIC investments on IRS Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, each year can be very expensive.

[1] The Foreign Account Tax Compliance Act (FATCA), Pub. L. No. 111-147, generally requires that foreign financial institutions identify U.S. account holders and report them to the IRS or pay a 30% withholding tax.

Avoiding Investments and Staying in Cash

Many American expats find themselves so overwhelmed by the complex rules and many horror stories they have heard about investing while living abroad that they are cowered into not making any investments at all. However, with currently historically low (but now rising) interest rates and soaring inflation, remaining in cash may still result in a loss of capital or buying power and will certainly not provide for a comfortable retirement for yourself or a college education for your kids. Investing efficiently and compliantly while living abroad can be daunting, but it does not have to be overwhelming. A little research can go a long way. Qualified advisors can be found. Do not give up. This is too important.

Ignoring Foreign Exchange Risk

Expat investors often mistake the currency in which their brokerage firm reports the value of their investment with the fundamental currency denomination of those same investments. For example, many foreign public companies list their shares in both their home country and on the New York Stock Exchange (NYSE). The NYSE-listed shares will trade in dollars, but that does not make them fundamentally U.S. dollar investments. Those shares will simply track the performance of shares on their primary (non-U.S.) exchange. Similarly, the performance of a U.S.-listed mutual fund that invests in foreign currency bonds will be determined by the fate of those underlying currencies. It is irrelevant that the fund trades in New York in U.S. dollars. The corollary is that truly multi-currency investment portfolios can be constructed through a U.S. brokerage firm that lists all investment values in dollars. What matters is the currency denomination of the underlying investments, not the ''reference currency'' of the brokerage statement.

Misunderstanding or Overlooking ADR Benefits

American Depository Receipts (ADRs) offer U.S. investors a means to gain investment exposure to non-U.S. stocks without the complexity of dealing directly in foreign stock markets. The sponsoring non-U.S. companies file required disclosure statements with the U.S. Securities and Exchange Commission (SEC). Some ADR sponsors that meet all SEC reporting and disclosure rules are permitted to raise capital directly from U.S. investors. Other foreign companies that meet a more limited set of SEC reporting rules are permitted only to ''sponsor'' ADRs that represent shares previously issued in their home markets.

The major risk of ADRs is that the currency in the issuing company's country will drop relative to the

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U.S. dollar. Of course, the risk of political or governmental change and inflation in the issuing country could also destabilize the company and its earnings.

Technically, a U.S. bank issues the ADR certificate; however, the certificate is not considered a U.S. asset in the hands of a non-U.S. investor, because the bank is acting as agent for the investor by holding some shares in a foreign company. Since the certificates (ADRs) are ignored, and U.S. tax law looks to the underlying assets (i.e., the foreign shares), the non-U.S. investor is deemed as owning shares in a foreign corporation. This means that a non-U.S. investor in ADRs is deemed to own shares in a foreign corporation not located in the United States for estate tax purposes. The foreign investor has the best of all worlds: an asset located outside the United States for U.S. estate tax purposes, the ability to buy and sell the stock easily on a major U.S. stock exchange (by using the ADR), no capital gain tax on sale and possible reduced withholding rate if the foreigner is resident in a country that has an income tax treaty with the United States.

Not Diversifying Investment Portfolio Beyond Current Country of Residence

Fortunes have been made in all corners of the earth, and rapid growth and opportunities may seem limitless one day ... and disappear the next. It can be particularly easy to become intoxicated with ''change'' or ''progress'' when you are presently profiting from it and have the ''edge'' of living and breathing in the local market. The laws of diversification are universal, and the penalties of failing to obey those laws are equally universal. Take profits in the local market along the way and re-deploy them into other (i.e., stable, boring) markets just in case your bullish long-term thesis turns out to be ... too darn bullish!

Failing to Properly Report Foreign Financial Assets on U.S. Tax Returns

Monitoring IRS reporting requirements is an important concern for Americans living and investing abroad and for all Green Card holders. Often a specialized U.S. accountant skilled in international tax compliance must be retained to keep an American living abroad current on the voluminous and invasive U.S. international informational reporting requirements. Virtually all foreign financial assets (excluding real estate) that are not being held in a domestic (U.S.) financial institution are subject to numerous U.S. reporting requirements. These reporting requirements include, but are not limited to, timely filing a FinCEN Report 114 (FBAR), IRS Form 8938, *Statement of Specified Foreign Financial Assets*, and IRS Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*.

The cost of accounting compliance with all these U.S. regulations often makes otherwise attractive investments inefficient, if not outright unsuitable, for a U.S. investor. Case in point, foreign mutual funds and foreign private equity funds, as mentioned above. In light of FATCA, the risk of noncompliance should only further steer American taxpayers living abroad away from foreign institutions and towards keeping their financial assets in a U.S. domestic institution, where none of these requirements apply.

Failing to Properly Report for U.S. Tax Purposes a Stake in a Foreign Business Entity

Expat American taxpayers with ownership stakes in foreign entities have complex IRS reporting requirements. Failure to properly report ownership interests in controlled foreign corporations (CFCs), foreign partnerships, and foreign trusts can lead to substantial IRS penalties. For example, failure to file IRS Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, for a CFC typically results in penalties in excess of $10,000 per form and opens the taxpayer's entire return to an audit indefinitely. While in the past it has been difficult for the IRS to discover ownership information on foreign corporations, this is becoming much easier through FATCA and intergovernmental agreements. Since 2018, under the GILTI regime, most of the active income of a foreign corporation controlled by an American is currently taxed regardless of actual repatriation of earnings as dividends.

Enforcement for these violations will only increase in the future. Many American taxpayers who start companies abroad unknowingly dig themselves into a deep tax reporting and compliance hole by not dealing with these issues until many years later. The best way to avoid the U.S. anti-tax deferral regime and its onerous tax reporting is to make an informed compliance plan ***before*** starting a foreign company or acquiring ownership therein. Perhaps it may be possible *before* the foreign business begins operations or before making the investment for the American taxpayer to make a ''check-the-box'' election which results in the foreign entity being treated either as a ''disregarded'' or ''pass-through'' entity solely for U.S. tax purposes. Neither a ''disregarded'' or ''pass-through'' foreign entity qualifies as a CFC or PFIC which can only apply to foreign corporations for U.S. tax purposes. Those who are playing compliance catch-up need to engage expert advice to choose the correct path forward.

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Buying Non-U.S. Tax Compliant Insurance

Non-U.S.-registered insurance products that hold cash value — policies that can be redeemed for some amount of cash immediately — almost never qualify under U.S. tax rules as "life insurance." Hence, they do not provide any of the various tax advantages that can make insurance a good long-term investment — primarily tax deferral and no income tax on receipt of the policy death benefit. Without this favorable U.S. tax treatment that domestic policies get, your foreign "insurance" policy is nothing more than a foreign investment account in the eyes of the IRS. In addition, it is probably a foreign trust and loaded with PFIC investments. Such investments and their tax reporting requirements are absolutely tax toxic for U.S. taxpayers.

Contributing to Non-Qualified Foreign Pension Plans

Expat American taxpayers often participate in foreign pension plans sponsored by their employers. Foreign pension plans generally have beneficial tax treatment under local country of residence law, and employers often make valuable pension contributions. Even so, American expats must remain aware that not all foreign pension plans receive favorable tax treatment under U.S. tax law.

Most foreign pension plans are not qualified under double taxation treaties entered into by the United States, and participation in a non-qualified foreign pension plan can have negative tax consequences. For example, local tax benefits may be nullified by U.S. tax treatment, and double taxation could occur in the worst-case scenario. Failing to report these foreign pension assets further adds complexity and costs in planning a retirement with a foreign pension. American taxpayers living abroad should beware of the tax treatment of both contributions to, and distributions from, these foreign plans in order to avoid headaches in the future.

Relying on Legacy U.S. Estate Plans

U.S. estate plans generally do not travel well. Laws regarding wills, trusts, and who can lawfully inherit your wealth upon death may be different in your new country of residence or where you own some real estate, and, as a result, you may find that your legacy U.S. estate planning strategy either (1) is no longer legally valid, or (2) even worse, triggers taxes that render the strategy completely counterproductive.

If you relocate to a new country, it is critical that you consult with an international U.S. estate planning expert who understands the intersection of U.S. estate planning and overseas investments and can introduce you to top-tier estate planning lawyers in the jurisdiction of your new residence. This may necessitate engaging multiple lawyers, each engaged in a different but relevant jurisdiction. Of critical importance is understanding the relevant local succession laws, inheritance tax systems and the interaction of tax treaties and foreign tax credits on the distribution of the estate.

The trust is clearly the workhorse of the U.S. estate planning system. A U.S. trust is generally the lynchpin to most applicable exclusion, marital deduction and charitable deduction planning for U.S. citizens. Lifetime gift planning including so-called "sales to grantor trusts" obviously depend on the law of trusts. Contrast that with a country such as Germany whose internal laws provide that any transfers to local (German) trusts violate public policy, while transfers to non-German trusts under non-German legal instruments incur German gift and inheritance tax at the highest marginal rates. The bottom line is that the common law of trusts is not fully integrated into the internal laws of many countries in continental Europe.

Under the laws of China, as well as most continental European and virtually all Latin American countries (i.e., "civil" law countries), spouses own property "in community" unless they have expressly adopted another marital property regime (such as separation of property) for property acquired during the marriage. This means that a typical married U.S. citizen may not have as much property to dispose of as originally thought if most of such individual's assets are located outside of the United States. Moreover, a married U.S. citizen from a noncommunity U.S. state (i.e., excluding California, Texas, and Arizona and some mostly Western states) who buys a residence or business in a community property country might effectively be making a gift of one-half of such property to the nonpurchasing spouse at the time of acquisition. This could result in significant U.S. gift and estate tax issues if the nonpurchasing spouse is not a U.S. citizen. Conversely, there may be significant planning opportunities when the purchasing spouse is neither a U.S. citizen or U.S. domiciliary.

Virtually all of these civil law countries also generally provide that spouses and descendants have the legal right to a portion of or interest in their decedent's property, regardless of what the decedent's will may provide. (Most U.S. states permit a free disposition under a decedent's will, subject to certain statutory share rights of surviving spouses.) These mandatory or "forced heirship" rules in most civil law countries can wreak havoc on a U.S. estate plan. Such estate plans, which typically defer U.S. estate taxes until the death of the surviving spouse, would in the most obvious circumstance conflict with a civil law country's

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internal law provision which mandates a non-U.S. citizen spouse or child (regardless of residency) must inherit large portions of property outright on the death of the first spouse to die.

Another potential pitfall which runs counter to U.S. legal principles is that in most civil law countries, heirs assume liability to creditors of their decedent even if those liabilities exceed the value of the inherited property. Often an election is available to limit this liability to the value of the inherited assets, but the time limit on making this election is often very short.

Wrapped around all of these issues is the challenge of knowing with reasonable certainty the local foreign succession law that will apply to a U.S. citizen's estate plan. Prior to 2015, the primary options have been nationality as to all property, residence as to tangible personal property, situs for immovable property (real estate), and domicile for movables (intangible personal property).

However, since 2015, many member countries of the European Union (EU) have adopted Brussels IV,[2] which now makes a decedent's habitual residence the principal criterion of what law governs a succession in those countries. Most important, Brussels IV now allows for a voluntary choice of the law of the nationality of the testator as an alternative to habitual residency. Thus, a U.S. citizen who owns property in these EU countries can now elect in a will that the law of the testator's U.S. home state (i.e., U.S. law) will determine who the beneficiaries are, as well as rights to disinherit a family member, the transfer of ownership of a decedent's assets, who should be liable for any debts, and how assets will be shared among heirs. However, the Brussels IV rules on inheritance do not determine the inheritance tax that heirs may have to pay in the foreign country, the property regime of the marriage, or certain company matters.

Sticking With an Old U.S. Tax Preparer Even After Moving Abroad

Many competent U.S. tax preparers will mistakenly believe that they can continue to prepare your U.S. tax returns even after you move abroad. But beware. Even a very good domestic tax return preparer may be out of their depth when preparing expat returns. Too often, the tax preparer with little or no expertise in expat tax preparation will fail to do even the most basic research on special reporting requirements, relevant income tax treaties, the application of foreign tax credits, etc.

We're not telling you that your existing tax return preparer is purposefully misleading you, but we are certainly suggesting that while confidently continuing to prepare your returns, if your preparer never considered the requirements of X, Y, and Z, that can be extremely hazardous to your financial health — and that's something you don't want to have to realize years after expatriating.

Not Understanding U.S. Retirement Account Contribution Rules on Foreign Earned Income

Many American taxpayers who move abroad incorrectly assume they can no longer contribute to U.S. retirement accounts such as traditional IRAs, Roth IRAs, and 401(k)s. Eligible American expats who contribute foreign earned income to a U.S.-based account without making a full analysis of the local tax implications often unwittingly set themselves up to be double-taxed because they did not fully understand the complex interaction of their local and their U.S. tax obligations.

Not Understanding the Expatriation Tax Rules and Planning Opportunities

American taxpayers who want to leave the U.S. tax system by renouncing their U.S. citizenship, as well as long-term Green Card holders who want to abandon such U.S. immigration status, will be classified as Covered Expatriates if they satisfy any one of three alterntive tests as of the day before the date of renunciation or abandonmen; (1) their net worth is $2 million or more, (2) they have been paying an average of over $170,000 in U.S. tax over the last five years, or (3) in the five years preceding expatriation they have not been fully U.S. tax compliant with all their U.S. tax filings (including gifts tax returns if applicable).

Even if these American taxpayers have been fully compliant with their prior five years of U.S. tax filings, there is a good chance that they will be designated as ‘‘Covered Expatriates'' and subject to the Expatriation Tax Regime often because they have a personal net worth that meets the threshold. This regime has two key elements, namely the ‘‘Exit Tax'' under §877A[3] and the ‘‘Inheritance Tax'' under §2801. The Exit Tax is a type of income tax that has several different sets of rules for different types and classes of income and assets. Most taxpayers have heard of the ‘‘mark-to-market'' Exit Tax on worldwide appreciated assets in excess of an annual exemption amount. There are other Exit Tax rules applicable to certain

[2] EU Succession Reg. No. 650/2012.

[3] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

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types of retirement assets and beneficial interests in certain types of trusts. The Expatriation Tax Regime rules are very technical and not many U.S. advisors fully understand them. The IRS has been very slow in providing guidance under the Expatriation Tax Regime rules. Many U.S. domestic estate planning lawyers are often unaware of the Inheritance Tax and most U.S. return preparers tend to focus on the Exit Tax as between the two Expatriation Tax Regimes.

For example, many American Green Card holders do not know how to calculate whether or not they are ''long-term'' Green Card holders. Many mistakenly assume that they ceased to be Green Card holders on the date that their alien registration card expired. On the flipside, many Green Card holders residing abroad in a country which has a tax treaty with the United States do not know that they can exclude from the calculation of ''long-term'' resident alien status for Expatriation Tax Regime applicability, any of the first seven years as a Green Card holder. To exclude any of the first seven years from the ''8 of 15'' year count for determining long-term Green Card status, the individual must have a home in a country with which the United States has a tax treaty. The Green Card holder would claim a treaty tie-breaker position for each of those first seven years by filing IRS Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, attaching it to an IRS Form 1040NR. However, if the Form 8833 treaty tie-breaker election is filed any time after the seventh year as a Green Card holder, the mere filing of this tax return is considered an ''act of expatriation'' and will potentially trigger the Expatriation Tax Regimes.

Another common mistake is, in the year in which an American citizen renounces his or her U.S. citizenship or a long-term Green Card holder abandons permanent legal residence in the United States, such individual has no lifetime gift tax exclusion amount for that year. The effect is to prohibit making large gifts in the year of expatriation by which time it is too late to reduce the amount subject to Exit Tax. However, large gifts made in the years before the year of renunciation or abandonment may be permitted to legitimately avoid or minimize the Exit Tax. Minimization is done by properly gifting assets with significant unrealized capital gains in years before the year of expatriation. Whether those gifts are subject to gift tax depends on the size of the gift, whether it is given to a spouse, and whether it is made in the year prior to the expatriation. In a twist, however, for purposes of determining an expatriate's net worth under that prong of the covered expatriate test, gifts made within three years of expatriation in which the individual had a retained interest or right to use property are added back to the net worth of the individual.

While large completed gifts without any strings attached in the years before the year of expatriation are permissible to reduce net worth (and likely require the filing of a Form 709 Gift Tax Return), those same gifts made in the five years prior to expatriation must also be disclosed in a separate statement attached to Form 8854 Expatriation Statement. The instructions to Form 8854 state that if there have been significant changes in an expatriating taxpayer's assets and liabilities during the five-year period prior to expatriation, such taxpayer must attach a statement to Form 8854 explaining such changes.

Not Being Aware of the Punitive U.S. Inheritance Tax Imposed on U.S. Heirs of Covered Expatriates

Classification as a Covered Expatriate generally remains with the individual for life and attaches to their assets indefinitely after death. A Covered Expatriate who leaves a gift or bequest to U.S. heirs forces very significant U.S. Inheritance Tax liability and recordkeeping burdens on these individuals. The U.S. Inheritance Tax rate is currently 40% of the assets received by such U.S. heirs, without benefit of a lifetime exclusion amount available to such recipients. This means that if a modestly wealthy former U.S. citizen or long-term Green Card holder at the time of expatriation is classified as a Covered Expatriate, and then subsequently inherits significant wealth or self-creates material wealth after leaving the United States, the U.S. Inheritance Tax will be imposed on all such after-acquired wealth to the extent it is distributed to U.S. persons. As noted, the burden of proof is on the U.S. heir to satisfy the IRS that the person they inherited from was not a Covered Expatriate even if that person has been dead for years.

Not Being Aware That Noncompliance With Any U.S. Tax Obligation During the Five-Year Period Prior to Expatriation Can Be Highly Problematic

For expatriates who were lax about any aspect of their U.S. tax reporting for the five-year period prior to expatriation, now is the time to come clean with the assistance of a tax professional. Otherwise, they will be unable to certify on their IRS Form 8854, *Expatriation Statement*, filed for the year of departure from the United States that they have been fully compliant with all of their U.S. tax obligations for the five years preceding expatriation. Regardless of net worth, the inability to certify to this U.S. tax compliance may classify the individual as a Covered Expatriate who might become subject to Exit Tax and whose U.S. heirs might be subject forever to U.S. Inheritance Tax

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on gifts or bequests received from such Covered Expatriate. While coming clean and remediating can be time-consuming and expensive, it is far preferable for U.S. heirs whose future inheritance otherwise could be imperiled by an open-ended Inheritance Tax on cash or property inherited from a Covered Expatriate, years after such Covered Expatriate has died.

Mistakenly Believing That Spouses Need to Renounce Citizenship or Relinquish Green Card Status Simultaneously

Rarely if ever do couples both expatriate at the same time. When they do, it is usually a client preference as opposed to required for tax planning. The goal is to protect the family wealth, not to make a political statement about the United States. In fact, having a spouse who is a U.S. citizen or Green Card holder provides the mental comfort of knowing that they could always sponsor the expatriate for Green Card status in the future. Interestingly, in the decades that both of the authors have assisted American taxpayers to leave the U.S. tax system, not once have we ever actually had a client return to live in the United States on a permanent or semi-permanent basis.

For a variety of reasons, American citizens and Green Card holders are looking beyond the United States for temporary and even permanent relocation. However, many ignore — to their great dismay — certain key issues involved in moving out of the United States and moving into another jurisdiction. Timely expert advice often makes the difference between a successful relocation and disaster. It is a wide world full of opportunity and promise, but taking full advantage requires careful and thoughtful planning.

FOREIGNERS INTERACTING WITH THE UNITED STATES

Failure to understand the basic rules of U.S. tax compliance and immigration rules when it comes to cross-border investing can jeopardize an international family's ability to successfully build wealth through effective investing and financial planning. At worst, it can expose taxpayers to costly and punitive tax penalties. Here are some of the common tax, investment, and immigration misconceptions for foreigners seeking to make investments in the United States or to move to the United States.

Assuming That All Family Members Should Acquire Green Card Status

Ever since the EB5 program became widely marketed after the 2007 market collapse, the authors have talked countless wealthy foreigners out of blindly securing this status. This is because the successful applicant for an EB5 Visa becomes a Resident Alien and starts on the march to potential Covered Expatriate status if the Green Card is not abandoned in the first seven years. This means the individual will be subject to full worldwide U.S. tax liability and possible future Exit Tax and Inheritance Tax.

We often find that members of their family want to move permanently to the United States for educational or career opportunities. These family members will become U.S. taxpayers as a result of their excessive physical presence by first triggering the Substantial Presence Test and then later by disqualifying themselves of a treaty election. Other family members may only want access to the United States for business, pleasure or to visit U.S-based family and friends. We often can get these clients preferred access with a nonimmigrant Visa such as an L-1 intracorporate transfer Visa. While they have easy access to the United States, they can avoid exposing the family wealth to U.S. taxation by avoiding excessive physical presence in the United States. Moreover, a Substantial Presence Test taxpayer can never become subject to Exit Tax or Inheritance Tax no matter how many years they remain subject to U.S. income tax.

Failing to Report Investment Income From Assets Held Outside the United States

Foreign nationals who also possess resident alien status or who spend too much time in the United States (with some exceptions) are subject to U.S. taxation on their worldwide income, just like U.S. citizens. Nevertheless, foreigners in America routinely fail to report foreign financial assets (usually acquired before coming to America). Waiting years or decades to fully report foreign assets is likely to result in large tax penalties and require them to spend large amounts for legal redress to become compliant.

Certain foreign nationals who have a Green Card but live abroad in a country which has a tax treaty with the United States, often overlook the fact that they are able to make a special *annual* elections (on Form 8833) to limit their U.S. tax for the year to only employment income earned in the United States or other portfolio or trade or business income from U.S. sources and to reduce their foreign financial reporting to the United States.[4]

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[4] Making these *annual* treaty tie-breaker elections may prevent certain Green Card holders from becoming subject to the U.S. Exit Tax and Inheritance Tax regimes when they abandon their

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Failing to Understand the Implications of FATCA

Long gone are the days of undeclared foreign bank and brokerage accounts. For over a decade now, the United States has been implementing FATCA, a system of mandatory reporting by foreign banks and governments around the world on all U.S. taxable persons (including foreigners resident in the United States). Before FATCA, failure to disclose non-U.S. assets and income was very rarely uncovered by the IRS. Now, however, FATCA provides tax transparency where previously there was none. Real-time disclosure of foreign financial assets to the IRS is a given, and those who choose to ignore FATCA will dig themselves a deep hole with potentially severe financial repercussions.

Allowing Tax Complexity to Deter Investing and Retirement Planning

Many foreigners who come to America find themselves overwhelmed by the complexity of U.S. taxation. The frequent result is that they do not invest at all. This outcome preempts savers from benefiting from the very consistent long-term growth that a well-diversified and efficiently managed investment portfolio would provide. Every foreigner immigrating to the United States deserves the opportunity to have their money work as hard as they do. They may need help figuring out the basics of investing and retirement planning. Sometimes foreigners are put off by the tax and investment transparency culture in the United States which Americans often take for granted.

Failing to Restructure U.S. Tax Toxic Investments Before Arriving in America

When legacy foreign assets — such as pensions, mutual funds, business or investment interests, trusts or cash-value insurance policies, or a potentially large inheritance — are owned by foreigners about to move to the United States, severe complications often arise because of punitive tax rates and complex reporting rules that the I.R.C. imposes on these foreign assets. U.S. tax deferral on the income or gain from these foreign assets is not possible for U.S. tax residents. Ideally, new residents of the United States should develop a plan to deal with these tax issues *before arrival* in the United States.

If an individual becomes a U.S. tax resident or citizen, certain controlled foreign corporations (CFCs) owned (controlled) by the individual (and other Americans) may become subject to ''double tax'' on their earnings. That is, the CFCs will be subject to corporate tax in their home country on their earnings, and possibly to withholding tax when they pay a dividend to a U.S. person as a shareholder. Moreover, since 2018 under the GILTI rules the U.S. CFC regime will cause the U.S. person to be taxed on a significant portion of the company's ''active'' business earnings even if they are not distributed to him as a dividend.

Through proper planning (known as a ''check-the-box'' election) *before arrival* in the United States, involving converting the CFCs to either ''disregarded'' or ''pass-through entities'' for U.S. tax purposes, the U.S. person may avoid the pernicious CFC regime altogether. The U.S. person may also be able to claim a U.S. foreign tax credit on their personal U.S. income tax return for some or all of the home country corporate income tax against his or her IRS tax liability, thereby mitigating double taxation.

Further, it can be highly inefficient from a U.S. tax standpoint for a U.S. tax resident or citizen to own ''passive'' investment assets through a foreign corporation including as a holding company. Such existing investment arrangement can cause loss of favorable *long-term capital gain income* and *qualified dividend income* (normally taxed at a preferable top 20% rate in the United States) to be taxed significantly higher as ''ordinary income'' at tax rates of up to 37% for U.S. individual taxpayers.

The dreaded PFIC regime can significantly increase the rate of U.S. income tax payable from certain ''passive'' foreign assets, including foreign mutual funds, hedge funds, and private equity funds. If the foreign company cannot be liquidated before arrival in the United States, it may be possible to restructure the entity's tax treatment (solely for U.S. tax purposes) through proper pre-arrival planning (''check-the-box'' election).

Finally, if an inbound individual becomes a U.S. tax resident or U.S. citizen and then sells long-held appreciated portfolio investments, they will be subject to U.S. income tax on the entire gain — even the gain that had built up while the individual was a nonresident of the United States. By establishing a foreign corporation in a no-tax jurisdiction such as the British Virgin Islands or the Cayman Islands, and then immediately filing a ''check-the-box'' election on such new foreign corporation *before arrival* in the United States, the inbound individual may be able avoid the U.S. income tax on most pre-arrival appreciation before becoming a U.S. resident. However, once the individual becomes a U.S. resident it is often too late to obtain this benefit.

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permanent legal residence in the United States.

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Parents Failing to Restructure U.S. Person's Inheritance of Foreign Assets

Pernicious outcomes may be mitigated if the assets are structured properly from the beginning. U.S. estate planning considerations for legacy foreign assets is critical. Without it an individual who becomes a U.S. resident and eventually citizen will be subject to onerous U.S. estate tax upon death. If a U.S. person inherits outright ownership of legacy foreign assets from his or her parents, those assets will be subject to U.S. estate tax at the death of such U.S. person. With a properly structured family trust created any time before the foreign resident parent dies, the parent's legacy foreign assets may legitimately be kept out of the U.S. person's taxable estate. Often some type of family trust that becomes a U.S. domestic trust after the foreign parent's death works best.

Disregarding U.S. Foreign Trust Reporting Rules

Foreign trusts are particularly common tax time bombs that lurk undetected in the old country investment portfolios of many new arrivals to the United States. Many structures (including pension funds and family businesses) often meet the IRS definition of a foreign trust even though they are not commonly thought of as trusts by a layperson. Unfortunately, many new Americans and new Green Card holders go years without properly reporting interests in foreign trusts, only to find out that cleaning up the problem is costly and time intensive.

Where a U.S. taxable person is a current beneficiary of certain irrevocable foreign family trusts, the trustee must provide a detailed annual accounting of its activities to the IRS, and the U.S. beneficiary will be subject to punitive tax rates on accumulated distributions received from such foreign trust. Several legitimate strategies and workarounds have been developed to limit or prevent accumulated distributions to be made to U.S. beneficiaries.

Ignoring Estate Tax Implications of Assets Retained in America After Returning Home

Foreigners who acquire U.S. assets such as U.S. securities or real estate in America and then leave the United States and continue to own those assets need to be aware of U.S. estate tax rules. The United States imposes estate tax on non-residents (at rates rising to 40%) on U.S. assets (called ''U.S. situs assets'') above a low $60,000 exemption threshold when those assets are owned at death by so called ''non-resident aliens.'' The most common U.S. situs assets subject to estate tax if owned by a non-resident at death are U.S. real estate and U.S. stocks (securities). In some cases, the $60,000 exemption is overridden by estate tax treaties the United States maintains with some countries around the world. Where no applicable treaty exists, however, large potential estate tax burdens face non-resident aliens who own U.S. situs assets at death.

We are aware of U.S. brokerage houses managing U.S. securities accounts for foreigners who have left the United States, and advising such clients to rely on a U.S. estate tax treaty with the foreign country to avoid U.S. estate tax on such U.S. securities account at the death of the foreign account owner. To claim such treaty relief, the foreign executor must file a IRS Form 706-NA, *Estate Tax Return of a Non-Resident Alien Decedent*, and file a Form 8833 claiming a treaty reporting position. Our general view here is that this recommendation from the brokerage house forces the foreign executor to go to the expense of filing a Form 706-NA within 15 months of death and then waiting during Covid-19 perhaps another two or more years before the IRS eventually issues a Tax Certificate to be delivered to the U.S. brokerage house to retitle the account is a bridge too far. Our alternative advice is for the client moving abroad to transfer the U.S. securities to a Cayman corporation that is properly maintained through the death of its shareholder(s). The Cayman corporation is an effective U.S. estate tax blocker and avoids a lengthy possible three year delay before the executor can retitle assets in the U.S. account into the name of the successor in interest to the deceased person.

Cashing Out of Retirement Account When Leaving the United States

Many foreigners build up substantial U.S. retirement account (401(k)s, IRAs, etc.) balances during their working years in America. Deciding what to do with these accounts when they leave the United States can be a daunting task. Generally, high taxes and early withdrawal penalties will apply if the accounts are cashed in before retirement age (59½). Furthermore, U.S. retirement account investment options are often much better than investment options available back home. On the other hand, a U.S. retirement account is considered a U.S. situs asset, which means it will be subject to potentially substantial U.S. estate tax if the non-resident alien holder dies still owning the assets (see above). A strategic distribution plan should be adopted that optimizes both the income tax and estate tax.

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Overlooking the Narrow Window of Time to Continue U.S. Tax Deferral on Certain U.S. Retirement Accounts (Such as 401(k) Accounts) After Expatriation and Before Retirement Age

If you expatriate, how your 401(k) plan is taxed will depend on whether it is an "eligible" deferred compensation item or an "ineligible" deferred compensation item. An "eligible" deferred compensation item is one where the U.S. government can easily collect tax. As a result, if you own an "eligible" deferred compensation item, the tax rules that apply to you are (relatively) benign: you pay tax as you get distributions often beginning with reaching retirement age.

Conversely, if it is very hard for the IRS to collect tax once you have left the United States, the deferred compensation item is "ineligible." The tax rules are simple for "ineligible" deferred compensation: pay all your tax immediately when you expatriate without any opportunity for continued U.S. tax deferral.

Three things must be true for your 401(k) plan to be an "eligible" deferred compensation item:

1. The 401(k) plan administrator who makes the payment to you is in the United States or is a foreigner who elects to be a U.S. person for limited tax purposes;

2. You notify the 401(k) plan administrator that you are a Covered Expatriate; and

3. You waive the benefits of any U.S. income tax treaty that would reduce your U.S. income tax rate below the default 30% withholding rate.

If you violate one or more of these three requirements, your 401(k) plan account becomes an "ineligible" deferred compensation item. If you are a Covered Expatriate, you pay a giant lump-sum tax when you expatriate.

A 401(k) plan by its nature is an "eligible" deferred compensation item. However, there is one thing that you must do in order not to accidentally and irrevocably convert your 401(k) plan from an "eligible" deferred compensation item into an "ineligible" deferred compensation item.

That one thing is to file IRS Form W-8CE, *Notice of Expatriation and Waiver of Treaty Benefits*, with your pension plan administrator within 30 days of your expatriation date. You must notify the administrator that you are a Covered Expatriate. The administrator needs to know that 30% tax should be withheld from future distributions to you, so requiring you to notify makes sense.

What does not make sense is the time frame a Covered Expatriate must satisfy to continue U.S. tax deferral following expatriation. Again, the Form W-8CE *must be filed within the 30 days following your expatriation date.* Filing the Form W-8CE on the due date of your final U.S. income tax return with a Form 8854 Expatriation Statement is too late! There is nothing in the law or the current IRS procedures that cuts a Covered Expatriate any slack. If you miss the deadline, you must pay the lump-sum tax on departure.

Many, many times we've heard stories from U.S. accountants about Covered Expatriates asking for assistance with their expatriation tax reporting months after they relinquish citizenship or abandon their Green Cards. By then it is too late to cure this notification requirement entitling a Covered Expatriate to continued U.S. tax deferral on their 401(k) plan account.

Failing to Make Proper Treaty Claims

Many foreigners who are subject to U.S. or foreign tax on investments held across borders can reduce or eliminate the tax and withholding by making timely tax treaty claims. Such claims are based, as applicable, on one of the many income tax treaties and the roughly 15 estate tax treaties that the United States maintains with other countries. Unfortunately, taxes are often withheld because a timely election was not made and a tax paid was not recovered because the taxpayer and/or their tax adviser was not aware of the tax treaty provisions available.

Failing to Recognize the Benefits of Leaving Assets in U.S. Investment Accounts Even When Leaving

In many cases, leaving financial assets in the United States may be a surprisingly advantageous option for non-Americans. Financial assets held by foreigners are not subject to U.S. capital gains tax. This principle incentivizes foreigners to invest in U.S. portfolio assets. Dividends and interest will be subject to a withholding tax at a rate of up to 30% (usually reduced to 10% or 15% by treaty). This withholding tax, however, can usually be recovered as a tax credit in the country of residence. The net effect, therefore, is that investors, even after returning to their home country or to a third country can continue to benefit from the generally superior investment environment available in the United States. These investment advantages are substantial and include low fund and brokerage fees, greater range of investment options, and greater market liquidity. However, where avoiding U.S. estate tax exposure at the death of the foreign investor is paramount given the low $60,000 exemption amount, we generally advise that the U. S. portfolio assets be held by a Cayman corporation that serves as an effective estate tax blocker.

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Failing to Recognize the Unique Tax Penalty Imposed on Foreigners Investing in U.S. Real Estate

Direct ownership of real estate subjects the foreign, non-resident investor to annual U.S. income tax and potentially state income tax filings. Furthermore, real estate holdings subject the foreign, non-resident to a more complicated tax regime — the Foreign Investment in Real Property Tax Act (FIRPTA), which creates complicated withholding requirements on the gross proceeds when a foreign, non-resident, a foreign trust, or even a foreign partnership sells U.S. real estate. Furthermore, foreign direct ownership of U.S. real estate will subject the non-resident's estate to U.S. estate tax because real estate is a U.S. situs asset.

Often a foreign person will acquire U.S. real estate through a foreign corporation, which serves as an effective estate tax blocker. This is often the primary U.S. tax concern for foreign investors in U.S. real estate. If U.S. rental property is owned directly, the foreign investor may be able to make a special election to shelter significant rental income with a generous depreciation deduction.

However, if the U.S. real estate produces rental income and such property is owned by a foreign corporation, a stealth second level of U.S. tax (known as the branch profits tax) may make it difficult to regularly repatriate the annual operating profits. In such cases, the investor may have to wait until the property is sold to repatriate any profits without a second level of U.S. tax. Sometimes, a complicated multi-tier partnership structure provides favorable pass-through income tax treatment and tolerable estate tax risk. Other times, a diversified portfolio of liquid securities not only provides superior investment outcomes, but also generally creates far fewer compliance, tax, and probate issues.

As with Americans moving abroad, foreigners looking to the United States for investment, education, business, and retirement need to have a timely expert examination of their current situation and their future intentions. They can then plan accordingly to fulfill their personal goals while minimizing all unnecessary additional U.S. taxation.

The United States is an attractive destination, but it is complex and must be approached only with proper advice and clear intentions.

CONCLUSION

Americans are exploring the greater world for investment or living and non-Americans are dealing with the United States for the same reasons. They are doing so to seek opportunities for their family wealth and well-being. However, the complexity and interplay of tax, immigration, and citizenship laws often makes potential pitfalls difficult to identify and navigate. Putting together a team of expert experienced advisors working in concert will maximise the opportunities while minimizing the financial burden. . . .and avoid expensive mistakes.

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