TAX ADVICE

for the Mobile Foreign Executive

PART 1

In our normally mobile world (when not in the midst of a pandemic), US tax practitioners are often asked to advise foreign executives who are considering an extended US-based work assignment about the US tax consequences of becoming a green card holder and a permanent US resident. It is important for practitioners who provide services to these clients to develop expertise in the particular tax laws that affect them. The foreign executive, spouse, and children may ultimately plan to leave the United States and return home upon the foreign executive's retirement, abandoning their green cards. Many foreign executives will be subject to the US expatriation or exit tax upon departure from the United States. Part 1 of this article addresses tax planning for these foreign executives before their move to the United States. Part 2, which will be published in the next issue of Wealth-Counsel Quarterly, will address exit tax and inheritance tax considerations on departure from the United States.

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I. INCOME TAX PLANNING FOR ALIENS WHO ARE MOVING TO THE UNITED STATES TEMPORARILY AND WILL BE GREEN CARD HOLDERS

Income Tax Overview

The executive will be required to file a US resident income tax return (Form 1040, U.S. Individual Income Tax Return) beginning with his US "residency start date." If the executive receives his green card while abroad (outside the United States), then the residency start date is his first day of physical presence in the United States after he receives his green card. If he receives the green card while physically present in the United States, the date of issuance of the green card and the residency start date will be the same date. The executive will also be required to file the Financial Crimes Enforcement Network (FinCEN) Form 114, Report of Foreign Bank & Financial Accounts (also known as the FBAR), if the individual owns foreign accounts that meet certain thresholds. There are numerous other US tax information reporting obligations that may be imposed on green card holders with foreign assets, including Form 8938, Statement of Foreign Financial Assets, Form 5471, Form 8621, and other US tax information reporting forms disclosing foreign assets.

The author believes that too often, affluent executives who move to the United States temporarily for a work assignment of extended duration are not well-advised about the initial alternatives to obtaining a green card, including different types of work visas. Due to potential tax consequences and the difficulty of severing US taxpayer status when the executive decides to depart the United States and again become a nonresident alien (NRA), it may be preferable to avoid or at least delay first obtaining a green card.

Preimmigration Planning to Minimize US Income Tax

Basis Step-Up and Check-the-Box Election

Unlike other countries, the United States does not offer an inbound individual who will obtain a green card and US income tax residency a new or fresh basis in premove assets. Prior to immigrating to the United States, an NRA will want to try to refresh the basis in his or her assets in order to limit capital gains on the later sale of those assets. If the NRA resides in a relatively low- or no-tax jurisdiction, the NRA can refresh basis by selling and repurchasing assets just before obtaining a green card and becoming a US income tax resident. However, it may not be practical to sell and repurchase assets, or doing so may result in significant capital gains tax under the tax law of the NRA's current country of residence. Transferring capital assets to a new, non-US corporation organized in a no-tax jurisdiction (e.g., the British Virgin Islands or the Cayman Islands) may also produce a basis step-up. A check-the-box (CTB) election can be made for the foreign corporation before the inbound individual obtains a green card, assuming such entity is an "eligible entity." By filing a CTB election to treat the foreign corporation as either a disregarded entity or a partnership for US tax purposes, there is a deemed liquidation of the foreign corporation for US tax purposes that will result in a current fair market value basis in the underlying assets. A CTB election may also prevent any foreign companies owned by the immigrant from being a controlled foreign corporation (CFC) or passive foreign investment company (PFIC) after the immigrant arrives in the United States.

The details and timing of a CTB election are vitally important. Following incorporation but before arrival in the United States, the inbound individual (shareholder) should liquidate the foreign corporation. To accomplish this objective, the inbound individual should cause the foreign corporation to file Internal Revenue Services (IRS) Form 8832 (Entity Classification) before the individual's residency start date. A deemed liquidation of the foreign corporation occurs for US tax purposes at the end of the day preceding the effective date of the CTB election. Once the CTB election is effective, the individual would be deemed to be the US tax owner of the portfolio assets that are legally owned by the foreign corporation. With this deemed liquidation, the basis of all of the portfolio assets would be stepped up to their fair market value on the day before the CTB election becomes effective.

On the green card holder's subsequent sale of these portfolio assets, basis for computing taxable capital gain would reference the fair market value of the portfolio assets on the day before the foreign corporation was deemed liquidated. Filing a CTB election on a foreign corporation simply results in a deemed liquidation of such corporation for all US tax purposes; there is no need to actually liquidate the corporation under local law. Additionally, the individual's advisors would want to be sure that there is so-called factual relevance for US tax purposes. Before the individual moves to the United States, the foreign corporation might open a US securities account, purchase a Treasury bill, and then deliver an IRS Form W-8 BEN-E to the US government to create US tax relevance.

Structuring Related to Offshore Investment Entities

Certain entities, referred to as "eligible entities," may elect to be treated as flow-through entities (e.g., a partnership or disregarded entity) for US tax purposes.[1] For foreign eligible entities with limited liability, the default status for US tax purposes is a corporation,[2] which is often unfavorable. As a result, certain US antideferral tax regimes that would apply if the entity were a foreign corporation will be inapplicable if the CTB election can be made prior to the start of an individual's US tax residency.

US antideferral tax regimes may apply to foreign corporations, resulting in phantom income to their owners and other adverse tax and compliance consequences. Without a CTB election to change the classification of a foreign entity from the default status of a foreign corporation to a partnership or disregarded entity, the entity may be treated as a CFC or a PFIC, either of which could subject the green card holder to current phantom income regardless of distributions of earnings to shareholders.

Controlled Foreign Corporations

A CFC is any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of the corporation entitled to vote, or of the total value of the stock of the corporation, is owned (under various indirect and constructive ownership rules beyond the scope of this article) by "United States shareholders" on any day during the taxable year of the foreign corporation.[3] A United States shareholder for this purpose is a US person who owns or is considered to own (applying special (constructive ownership) rules) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.[4]

1 Treas. Reg. § 301.7701-2.
2 Treas. Reg. § 301.7701-3(b)(2).
3 I.R.C. § 957(a).
4 I.R.C. § 951(b).

Generally, CFC status is best avoided, as it can result in substantial phantom income to US individual shareholders on their pro rata share of the business income of foreign corporations, taxable at ordinary individual tax rates.

Passive Foreign Investment Companies

When the US ownership of a foreign corporation by a green card holder is not high enough to trigger CFC status, a foreign corporation holding mostly passive (investment) assets that fail to produce a certain threshold of active income will generally be characterized as a PFIC.[5]

The PFIC rules are complicated and beyond the scope of this article but are disadvantageous to the US holder of PFIC stock, generally resulting in phantom income and distributions taxed at ordinary rates or interest charges. In addition, distributions from PFICs are not eligible for the lower US tax rates applicable to qualified dividends.

If a qualified electing fund (QEF) election is made pursuant to § 1295 in the first year of PFIC status on Form 8621, the US tax resident preserves some ability to benefit from lower rates but is still in a position far less favorable than a pass-through entity. Generally, if a QEF election is available, it is beneficial for tax rate and basis purposes.[6]

Advisors with US residents (and citizens) who regularly invest in foreign start-up businesses should be on alert that until the company turns a profit, the entity might be classified as a PFIC because all of its assets consist of money market funds from an initial round of equity funding. Under the principle of "once a PFIC, always a PFIC," it may not be possible to shed PFIC status once the company begins to turn a profit.

II. PREIMMIGRATION PLANNING TO MINIMIZE ESTATE TAX FOR THE NONDOMICILED GREEN CARD HOLDER

An inbound individual should always consider the extent to which an estate tax treaty may provide protection from US estate tax during a period of temporary residence in the United States. The United States is now a party to fifteen estate tax treaties. Each of these treaties alter in some way the gift and estate tax rules discussed below. For example, the German estate tax treaty provides that real property, business property, and an interest in a partnership that owns such property is subject to US estate and gift tax. All other property of a German citizen and resident, including cash, tangible personal property, and debt obligations situated in the United States and shares of stock in US corporations may be subject to estate and gift tax in Germany.

Overview of Transfer Tax Planning: Domicile

Preimmigration planning to avoid US transfer taxes (gift, estate, and generation-skipping transfer (GST)) may be straightforward. Noncitizen nondomiciliaries (NCNDs) of the United States are subject to US gift tax only on gratuitous transfers of property having a US situs. Until an individual becomes a US person for transfer tax purposes, the individual can make a gift of unlimited amounts of non-US-situs assets. The scope of non-US-situs property includes US intangible property (such as shares in US corporations or mutual funds) as well as all foreign intangible and tangible personal and real property.

The difficulty for transfer tax planning purposes is that there is no bright-line test for determining whether a non-US citizen is domiciled in the United States. Once the individual obtains either a US domicile or US citizenship, gifts made of any property, no matter where located, become subject to US transfer taxes if the transfers cumulatively exceed the applicable lifetime exclusion amount ($11.7 million in 2021). As a result, the period following the decision to emigrate to the United States and preceding the date of immigration to the United States is often the best time for making significant gifts of non-US-situs assets, including shares in US corporations and mutual funds, with no federal gift tax consequences.

Domicile is defined for US estate and gift tax purposes as living within a country with no definite present intent of leaving. Determining domicile for estate and gift tax purposes is fact-specific. Once a non-US citizen establishes the United States as his or her domicile, the non-US citizen remains a US domiciliary until a new domicile is established. If there is doubt as to the location of domicile, there is a rebuttable presumption that the decedent was domiciled within the country where the decedent last resided.[7]

Common considerations used by US courts to determine domicile include (but are not limited to) the location of the taxpayer's residences and the time spent at such residences; the domicile of an individual's family and friends; the location of social, professional, and religious affiliations; the location of investments and business interests; and whether the individual holds a green card. (There is a rebuttable presumption that a green card holder is a US domiciliary because a green card

5 *See* I.R.C. § 1297.

6 For example, if a US decedent dies holding shares of a QEF, the decedent's heirs will receive a basis step-up, whereas if there are shares of a § 1291 fund, the heirs would inherit a carryover basis. *See* I.R.C. § 1291(e).

7 Treas. Reg. § 20.0.1(b)(1).

holder must be a permanent legal resident of the United States to hold such immigration status.)

Use of a Foreign Holding Company

Historically, NRAs (foreign investors) have made their direct investments in the United States principally through foreign (non-US) corporations sometimes referred to as a foreign holding company. The overriding reason to do so is the NRA investor's primary objective of avoiding US estate and gift taxes on those assets. Where the NRA investor is investing in US real estate or an active business, the US income tax considerations might suggest the use of an irrevocable trust as the ownership vehicle. Sometimes the use of a two-tier partnership (an upper tier foreign partnership and a lower tier US partnership) is appropriate as the best structure to invest in US rental real estate. A thorough analysis of this topic is beyond the scope of this article. The bottom line is that the US income and estate tax consequences of a particular investment made by NRAs (foreign investors) must be analyzed and weighed together by a US tax adviser.

If the nondomiciled alien owner of the foreign holding company becomes a US person, there can be adverse subpart F CFC or PFIC antideferral regimes. As an example, to the extent the foreign holding company realizes long-term capital gains from investments in US equities, that gain will be taxed to the US shareholder at ordinary income rates. To the extent the foreign holding company invests in dividend-paying US equities, unless limited by tax treaty, it is likely that 30 percent withholding tax will be imposed on the dividends. Since most foreign holding companies are established in no-tax jurisdictions (i.e., the British Virgin Islands or the Cayman Islands) with which there are no US tax treaties, if the underlying income is earned in a high tax jurisdiction, any foreign tax credit benefits may be lost unless the holding company makes a CTB election to be treated as a pass-through.[8]

Preimmigration Gifts

An individual thinking of becoming a green card holder should consider transferring assets to a NCND spouse who is not immigrating. If both spouses are immigrating to the United States as green card holders, once they establish their US domicile, gifts to a non-US citizen spouse will be subject to US gift tax to the extent they exceed an annual spousal gift exclusion amount ($159,000 in 2021, adjusted annually for inflation). Due to this constraint, if a substantial number of assets are to be transferred from one NCND spouse to another, these transfers should occur for US gift tax purposes before the NCND spouses establish domicile in the United States.

III. TRUST TAX CONSIDERATIONS

Classifying the Trust for US Tax Purposes

Before discussing the various available tax strategies for trusts, some preliminary rules must be understood.

Domestic versus Foreign Trust

A trust is a US trust if **both** the court test and the control test are satisfied:

- The court test requires that a court within the United States is able to exercise primary supervision over the administration of the trust.
- The control test requires that one or more US persons have authority to control **all** substantial decisions of the trust.[9]

A non-US trust is any trust that is not a US trust. A trust that fails the court test or the control test is a foreign trust.[10] The takeaway is that it is relatively easy to establish a foreign trust by granting a foreign person the power to make at least one substantial decision regarding the trust, perhaps retaining merely the power to veto a trust decision, even for a trust established in a US state with a modern trust law.

US Grantor Trust Status of Foreign Trust

In general, a US person who transfers property to a foreign trust that has a US beneficiary remains the federal income tax owner of that property.[11] A trust is assumed to have a US beneficiary unless (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the tax year to or for the benefit of a US person and (2) if the trust were terminated at any time during the tax year, no part of the income or corpus of the trust could be paid to or for the benefit of a US person.[12]

Foreign Grantor Trust Status of Foreign Trust

In general, the grantor trust rules only apply if they result in a US person being treated as the income tax owner of the trust.[13] However, the Internal Revenue Code (Code) provides that a

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8 Among other forms, IRS reporting requirements include Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, and Form 8938, Statement of Specified Foreign Financial Assets.

9 I.R.C. § 7701(a)(30)(E).

10 I.R.C. § 7701(a)(31)(B).

11 I.R.C. § 679(a)(1).

12 I.R.C. § 679(c).

13 I.R.C. § 672(f).

foreign grantor (settlor) can be treated as the US income tax owner of all or a portion of a grantor trust only if

- the power to vest title to trust property in the grantor is "exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor"; or
- "the only amounts distributable from the trust, whether income or corpus, during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor."[14]

The US tax advisor quickly realizes that the definition of a foreign grantor trust (FGT) is much narrower than that of a US domestic trust.

Overview of Foreign Nongrantor Trust Throwback Tax

Adverse US income tax consequences can arise from an accumulation distribution from a foreign nongrantor trust (FNGT) to a US person. This could occur if discretionary trust distributions exceed distributable net income. There are two important exceptions to this definition that may apply to distributions from FNGTs.

An amount that the trust instrument requires to be paid to a beneficiary as a gift of a specific sum of money or of specific property and that is actually paid to the beneficiary all at once or in no more than three installments is not treated as a distribution and therefore is not included in the gross income of the US beneficiary.[15]

The terms "income" and "trust accounting income" are generally used to describe under local law the amount required or permitted to be distributed to current trust beneficiaries. The items that are included in these terms vary by jurisdiction. They generally include items such as dividends, interest, and rent. They generally exclude gains from the disposition of property. Under the Code,[16] distributions that do not exceed trust accounting income in the year in which they are made are not accumulation distributions.

Undistributed net income (UNI) limits the amount of an accumulation distribution that will be subject to tax. If an FNGT has no UNI, no tax will be imposed on its accumulation distribution. UNI for a particular year is equal to the amount by which its DNI for such year exceeds the sum of (a) the amount of trust accounting income required to be distributed in such year, (b) the amount of any other amount properly paid or credited or required to be distributed for such year, and (c) the amount of any taxes imposed on the FNGT that are attributable to its DNI for the year.[17]

There are a number of proven solutions for managing UNI of an FNGT with US beneficiaries. The use of offshore private placement variable life insurance (PPLI) is one solution. Sometimes the current distribution of all of the DNI of the FNGT is appropriate, perhaps with all such DNI distributed to a mirror image US irrevocable trust for the FNGT's US beneficiaries. Sometimes the UNI can be distributed to a new foreign trust solely for foreign beneficiaries, and the trust with the remaining cleansed trust assets can be domesticated to the United States. Sometimes it might be appropriate to use the default method of calculating accumulation distributions. In large, multigenerational FNGTs, perhaps capping distributions to US beneficiaries to the amount of DNI of each year may still provide sufficient annual distributions to US beneficiaries.

Trust Planning for the Immigrating Individual

There are various trust strategies that may benefit an NCND for transfer tax purposes, depending on whether the NCND is immigrating to the United States as a green card holder, has children who are moving to the United States, or simply wishes to have investments in the United States on a US tax-efficient platform.

Foreign Trust Solely For Non-US Beneficiaries

When the incoming NCND has no US beneficiaries, the NCND might establish an irrevocable, discretionary foreign trust solely for non-US family members before the NCND becomes a US domiciliary. Completed gifts that occur before the NCND establishes US domicile will avoid US federal gift, estate, and GST tax exposure. The trust can be established in a modern trust state in the United States or in a foreign jurisdiction, so long as at least one major power over the trust is controlled by a non-US trustee, which will make the trust a foreign trust and avoid US income tax on non-US source income. As discussed below, however, if the trust is a foreign trust, it will be a grantor trust if property is transferred to the foreign trust within

14 *Id.*
15 I.R.C. § 663(a)(1).
16 I.R.C. § 665(b).
17 I.R.C. § 665(a).

five years of the NCND obtaining a green card (or residency start date under the substantial presence test) and the trust has any possibility of benefiting a US person.

Self-Settled Trust

An inbound NCND might wish to establish an irrevocable self-settled trust to protect assets from US estate tax, even for descendants. The trust would require an independent trustee who resides in the United States and perhaps a distribution advisor who determines whether to instruct the independent trustee to make trust distributions. The inbound NCND would retain no power over trust distributions. The inbound NCND should be able to serve as investment advisor to the trust and to remove and replace the independent trustee and distribution advisor with another person who is not related or subordinate to the NCND settlor of the trust.

Before establishing a US domicile, the NCND would make a completed gift of non-US-situs property to the US domestic trust to avoid federal gift tax. The trust should be established in a US jurisdiction to avoid the throwback tax when distributions are made to the settlor at a later date when the settlor is a US person. If the settlor's creditors can access the trust assets, the assets will be included in the settlor's US taxable estate as a retained interest. For this reason, it is important that the trust be settled in a jurisdiction that permits, by statute, self-settled asset protection trusts, such as Nevada, South Dakota, or Delaware. The US advisor must check local law to make sure there is no creditor look-back period that might create an incomplete gift. In most state jurisdictions, in order for the look-back period to apply, the creditor claim must have arisen before the trust was settled, or for future claims, the creditor must be able to prove that the transfer to the trust was made with an intent to defraud creditors.

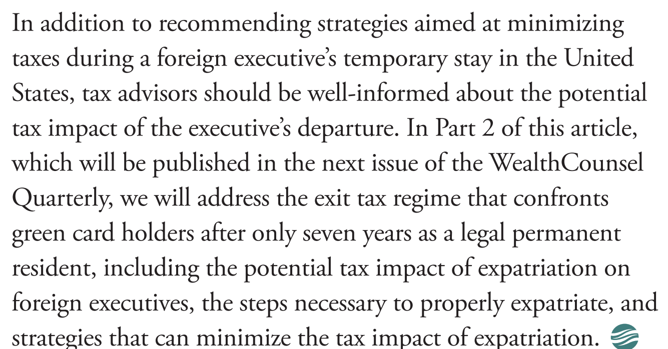
Existing Foreign Trust for Immigrating Foreign Person and Family: Trust Becomes Accidental US Grantor Trust

If there is already an irrevocable foreign trust in place for the current benefit of the immigrating foreign person and his or her family, such trust is an FNGT. One possible strategy is to accelerate all current and accumulated income in the foreign trust before coming to the United States.

The Code provides that if an NRA individual becomes a US income tax resident within five years of transferring property to a foreign trust, the individual is treated for income tax (but not estate tax) purposes as the owner of the trust property if the trust has one or more beneficiaries.[18] One result of a green card holder's use of an FNGT is that while the individual is a US income tax resident, there is additional US. tax reporting (Form 3520 for the person treated as the US tax owner and Form 3520-A for the foreign trust). In a few situations, it may be possible for the inbound individual to wait five years before obtaining a green card, in which case the foreign trust will not be deemed a US grantor trust while the individual is a US income tax resident. For many taxpayers, however, they will have made a transfer of property to the foreign trust within the five-year look-back period. Their best strategy to blunt current US income tax on the trust assets would be to consider having the trustee purchase a foreign private placement policy and wrap the trust assets inside the policy before the individual acquires a green card. If certain special US life insurance rules are satisfied (no investor control, sufficient diversification of assets), there would be no US income tax on the inside build-up in the policy. If the policy is funded over at least four years, it may be possible for the trustee to withdraw from basis in the policy or borrow up to 90 percent of the policy cash value on a tax-free basis.

The tax policy rationale behind these rules is to prevent perceived income tax abuse of so-called drop-off trusts used for estate tax planning—foreign trusts in which someone who planned to become a US income tax resident parks assets in the trust and avoids US income tax. In the absence of I.R.C. § 679(a)(4), the trust would be an FNGT that would be subject to US income tax only on its US-source income. With proper timing, US beneficiaries might receive nontaxable distributions. This special rule treats the now US settlor as the owner (i.e., grantor) of the trust assets for income tax purposes.

When the settlor departs the United States and the US grantor trust rules no longer apply, the settlor reacquiring NRA status faces the prospect that the historical appreciation in trust assets (including appreciation prior to becoming a US income tax resident) will be taxed on departure from the United States with no other US beneficiaries or on the death of the individual.[19]



CONCLUSION

In addition to recommending strategies aimed at minimizing taxes during a foreign executive's temporary stay in the United States, tax advisors should be well-informed about the potential tax impact of the executive's departure. In Part 2 of this article, which will be published in the next issue of the WealthCounsel Quarterly, we will address the exit tax regime that confronts green card holders after only seven years as a legal permanent resident, including the potential tax impact of expatriation on foreign executives, the steps necessary to properly expatriate, and strategies that can minimize the tax impact of expatriation.

18 I.R.C. § 679(a)(4).
19 I.R.C. § 684.