U.S. TAX PLANNING FOR NONRESIDENT ENTREPRENEURIAL FAMILIES

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A SUMMARY OF THE U.S. TAX SYSTEM

UNDERSTANDING THE U.S. TAX SYSTEM – A HIGH LEVEL SUMMARY

- Type of tax
  - U.S. income tax
  - U.S. gift tax
  - U.S. estate tax
  - U.S. generation skipping transfer tax
- Application
  - Depends on whether an individual is resident in the United States, and the source of the income and assets.
  - Residency is defined differently for income tax purposes and for gift/estate tax purposes.

U.S. INCOME TAX OVERVIEW

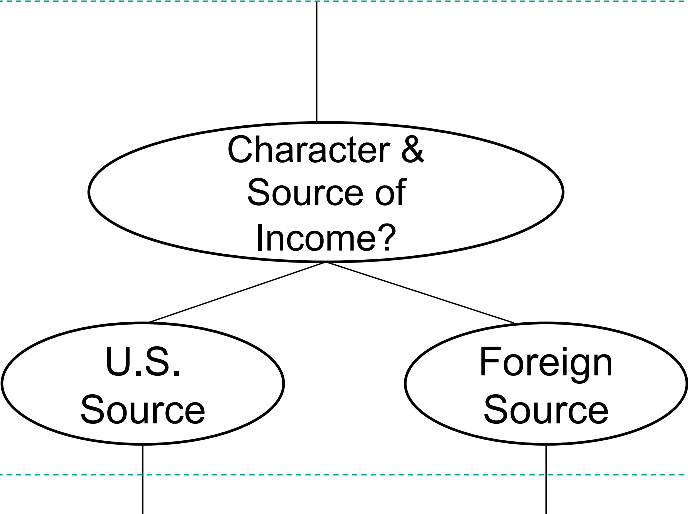
- U.S. income tax residents are subject to U.S. federal income tax on their worldwide income.
  - The highest marginal federal income tax rate for ordinary income is 37%.
  - The federal income tax rate for long-term capital gains and qualified dividends is up to 20%.
  - A 3.8% net investment income tax may apply.
- Non-U.S. income tax residents are generally only subject to U.S. federal income tax on:
  - U.S. source fixed, determinable, annual, periodic income (“FDAPI”).
    - Taxed at source via withholding (generally, 30%) unless an income tax treaty applies to reduce or eliminate withholding.
  - Income effectively connected to a U.S. trade or business.
  - Gain from the sale or exchange of U.S. real property interests.
  - Key benefits for non-U.S. income tax residents:
    - Capital gains generally not subject to U.S. tax (except if attributable to U.S. real estate)
    - Portfolio interest not subject to U.S. tax.

Outbound Taxation

Inbound Taxation

(1) Residency — U.S. Persons — Foreign Persons

(2) Character and Sourcing



(3) US Trade or Business?

Engaged in a US T/B?

No

Yes

Engaged in a US T/B?

Yes

No

(4) Gross or Net Basis Taxation

FDAPI
30% Gross WHT

ECI?
Net Tax Basis

Foreign Sourced
- Dividends, Interest
- Certain Rents, Royalties
- Inventory Sales
- Gains?

No US Tax

No

Yes

No

Yes

(5) Treaty Relief

No US Tax

Does US Bilateral Treaty reduce tax rate?

If US Bilateral Treaty applies, is permanent establishment (PE) definition met?

U.S. GIFT TAX OVERVIEW

- An individual who is a citizen of or “domiciled” in the United States is subject to U.S. tax on taxable gifts of his or her worldwide assets, subject to a lifetime gift tax exemption amount (currently $12.06 million).
- An individual who is neither a citizen of or “domiciled” in the United States is subject to U.S. tax only on taxable gifts of his U.S.-situs real estate and tangible personal property. There is no lifetime exemption amount.
- Currently, the highest marginal federal gift tax rate is 40%.

U.S. ESTATE TAX OVERVIEW

- The estate of an individual who was a citizen of or "domiciled" in the United States at death is subject to U.S. estate tax on the decedent's worldwide assets, subject to an estate tax exemption amount (currently $12.06 million *minus* amount used for lifetime gifts).
- The estate of an individual who is neither a citizen of or "domiciled" in the United States at death is subject to U.S. estate tax only on the decedent's U.S.-situs assets, subject to a small exemption amount (currently $60,000).
- Currently, the highest marginal federal estate tax rate is 40%.

U.S. GIFT AND ESTATE TAX – A SUMMARY

GIFT TAX	ESTATE TAX
Lifetime “taxable” transfers subject to 40% federal gift tax	Transfers at death subject to 40% federal estate tax
No gift tax on “annual exclusion” gifts ($16,000 per year per donee) or on transfers for tuition and medical expenses	N/A
$12.06 million lifetime exemption for U.S. citizens/residents	$12.06 million exemption for estates of U.S. citizens/residents (reduced by lifetime taxable gifts)
Non-citizens/non-residents only subject to tax on gifts of U.S. situs real estate and tangible personal property	Estates of non-citizens/non-residents only subject to tax on U.S. situs property (including intangibles) transferred at death
No exemption for non-citizens/non-residents	$60,000 exemption for estates of non-citizens/non-residents

BECOMING DOMICILED IN THE UNITED STATES

- Being a U.S. resident for U.S. gift tax and estate tax purposes means being "domiciled" in the United States.
- An individual acquires domicile in a place by living there for even a brief period of time with no definite present intention of leaving.
- This is a facts and circumstances test; there is no bright-line rule.
- Common considerations include:
  - Location of residences and time spent at such residences
  - Domicile of individual's family and friends
  - Location of social, professional, and religious affiliations
  - Location of investments and business interests
  - Holding a U.S. green card

CASE STUDY #1:
NON-RESIDENT ENTREPRENEUR WITH PORTFOLIO OF INVESTMENTS AND BUSINESS INTERESTS

PRIMARY INVESTMENT CONSIDERATIONS

Tax Efficiency

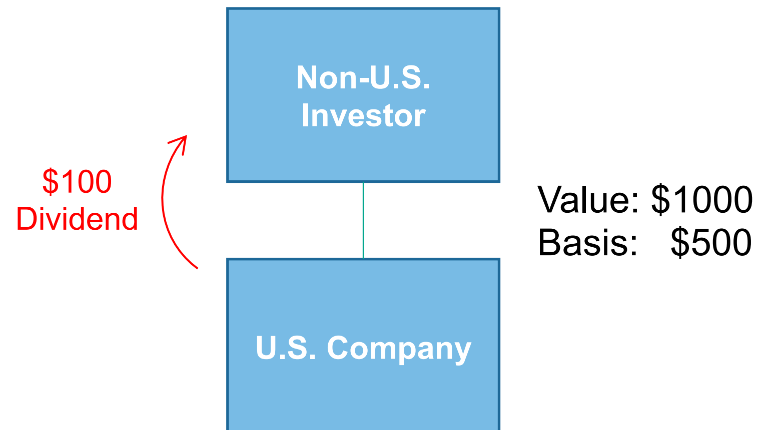
Flexibility

Simplicity

INVESTMENT OPTIONS

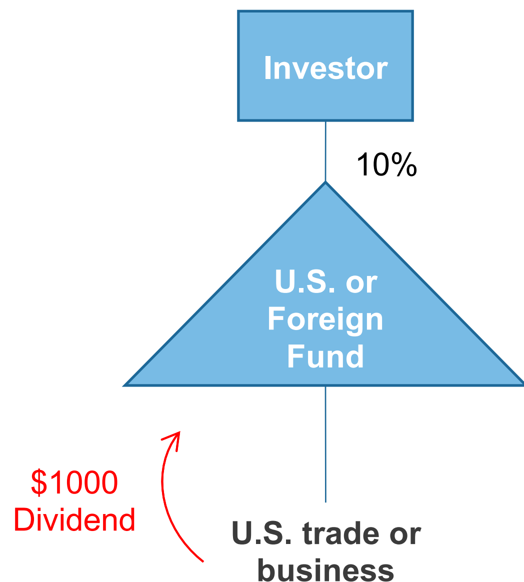
- ☑ U.S. Stocks or Bonds → but withholding tax applies on U.S. dividends, and possibly interest
- ☑ Non-U.S. Stocks
- ⚠ U.S. Private Equity Funds or Hedge Funds
  → *additional consideration is required*
- ⚠ Non-U.S. Funds (mutual funds, private equity funds or hedge funds)
  → *additional consideration is required*
- STOP U.S. Mutual Funds → generally do not allow non-U.S. investors

INVESTMENT IN U.S. STOCK



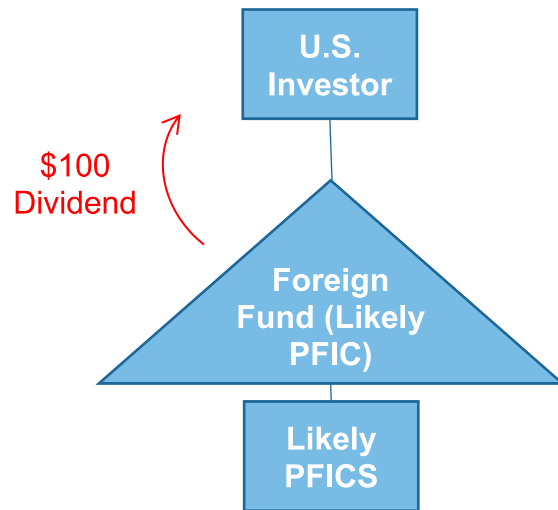
- Generally, non-U.S. investor is subject to a 30% withholding tax on a U.S. dividend. Under an income tax treaty, the withholding tax rate may be reduced (e.g., to 10% or 15%)
  - If the U.S. company pays a $100 dividend, applying a 15% withholding tax rate, non-U.S. investor retains $85 of the $100 received
- Non-U.S. investor generally is not subject to U.S. income tax on a sale of his stock
  - As a result, if non-U.S. investor sells his stock for $1000, realizing $500 of built-in-gain, he will retain all of the proceeds

INVESTMENT IN FUND PRODUCING INCOME EFFECTIVELY CONNECTED WITH US TRADE OR BUSINESS (“ECI”)



- Investor must file U.S. income tax return
- Investor subject to U.S. income tax on his share of ECI at normal U.S. tax rates
  - If U.S. business pays a $1,000 dividend to fund, investor would be subject to U.S. income tax on his $100 share, resulting in approx. $20 of U.S. income tax (or higher if not a qualified dividend)
- Capital gains from investment is potentially subject to U.S. income and withholding taxes
- There could be second layer of tax if invested through a U.S. or foreign corporation

INVESTMENT IN NON-US FUND



- Most foreign investment funds are "passive foreign investment companies" or could invest in "passive foreign investment companies" (PFICs)
- Investment by a U.S. person in a PFIC could have very adverse U.S. income tax consequences. This is a problem if entrepreneur becomes a U.S. resident in the future.
  - If PFIC pays a $100 dividend to investor, investor would be subject to U.S. income tax at ordinary income tax rates, plus possible interest based on investor's holding period. The effective tax rate could be very punitive

Possible Frameworks:

- Avoid any PFIC investments (this may significantly limit the available investments)
- Consider each investment and its expected ROI, and perform a cost-benefit analysis in event PFIC taxable event took place while entrepreneur was a U.S. resident
- Consider each investment and the availability of and timing an exit strategy if entrepreneur becomes a U.S. income tax resident
- Invest in PFICs without concern for U.S. income tax consequences if entrepreneur becomes a U.S. income tax resident

AVOID BECOMING A U.S. INCOME TAX RESIDENT

- Consider day count each year and application of substantial presence test.
- Exceptions to substantial presence test:
  - Closer connection
  - Treaty tie-breaker
- If avoid U.S. federal tax residency, entrepreneur could be considered a tax resident in a U.S. *state* that imposes income tax.
- Nonresidents spending 183 days or more in the United States could be subject to 30% withholding tax on U.S. sourced capital gains.

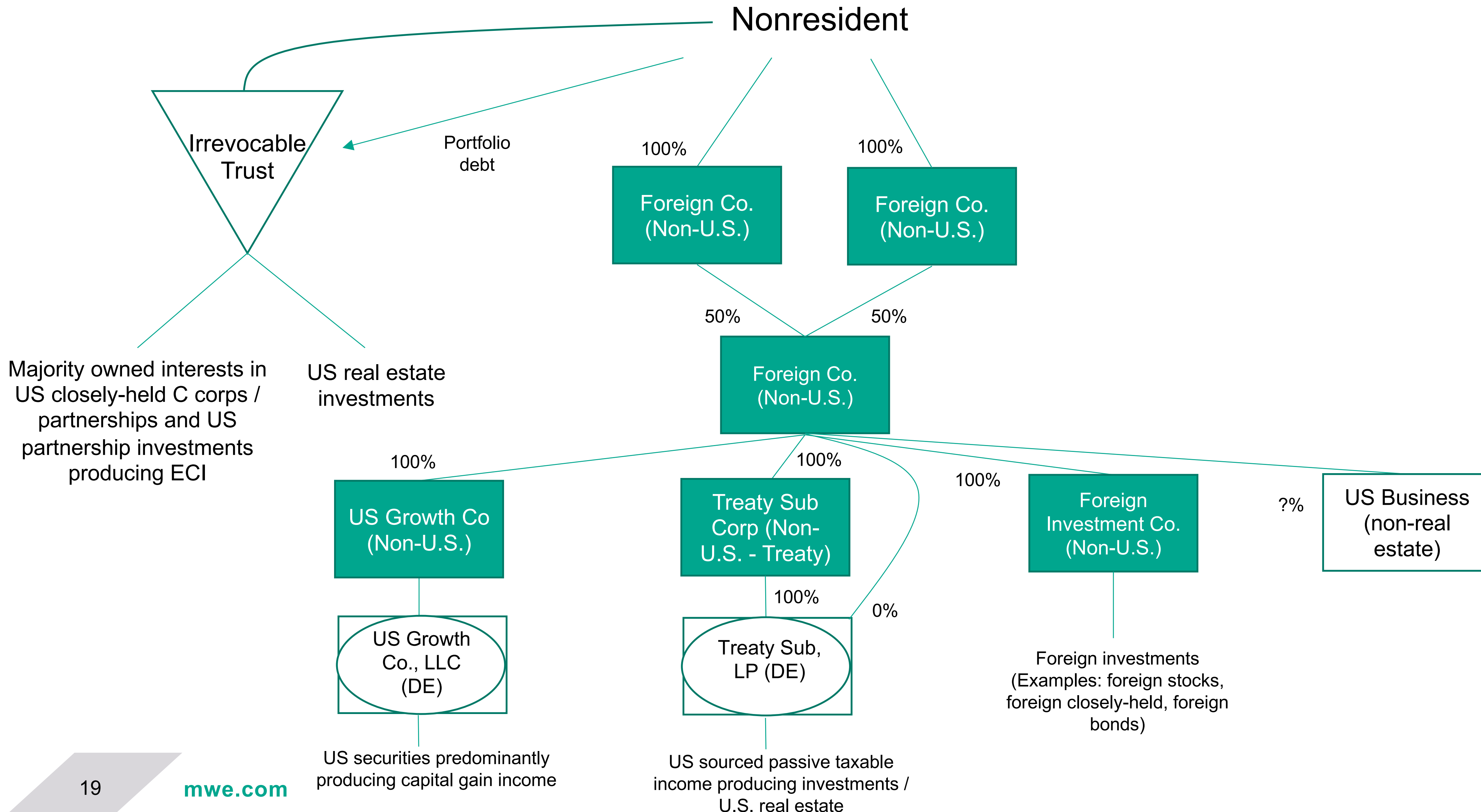
ESTATE TAX PLANNING IF INVEST IN U.S. ASSETS

- Avoid investments in U.S. assets or sell before death.
- Gift U.S. assets to trusts for benefit of family members.
  - Consider application of U.S. gift tax.
  - Settlor loses benefit of and control over assets. Consider terms of trusts.
- Hold U.S. assets through foreign corporate blockers.
  - Consider formation of structure. Application of anti-inversion rules or Code section 2104(b)?
  - Consider possible U.S. income tax inefficiencies.

PASSING WEALTH TO U.S. FAMILY MEMBERS

- Similar considerations to pre-immigration planning (see Case Study #2).
- Create trusts for current or ultimate benefit of U.S. family members.
  - Grantor trust status during life of non-U.S. entrepreneur.
  - Plan for death of non-U.S. entrepreneur:
    - Minimize application of throwback tax rules.
    - Eliminate PFICs and CFCs in structure.

A POSSIBLE STRUCTURE



POTENTIAL TRAPS

- Use of domestic LLCs for non-U.S. tax reasons (e.g., banking convenience) may create problems
- Liquidation-reincorporation doctrine (e.g., disguised dividends, no-step up)
- Closely held intercompany stock sales or redemptions may result in taxable U.S. sourced dividend income, as opposed to tax-free capital gain income
- Inversion rules may negate U.S. estate tax planning
- Interest payments from foreign entities may be considered U.S. sourced and taxable
- General limitations on interest expense deductibility
- CFC attribution issues that impact portfolio debt
- Beware of PFICs if potential for relocation
- Foreign owned MFOs
- US tax returns obligations may exist, notwithstanding receipt of income
- Treaties do not apply for purposes of State taxation

CASE STUDY #2:
ENTREPRENEUR
MOVING TEMPORARILY TO
THE UNITED STATES

CONSIDER PRE-IMMIGRATION PLANNING IN ADVANCE OF MOVE

- Obtain new basis in assets
- Eliminate CFCs, PFICs, cause distribution of offshore earnings
- Consider application of throwback tax on trust distributions
- Gifting to trusts
- QSBS stacking
- Accelerate income, defer deductions
- Maximize ability to claim foreign tax credits

CONSIDERATIONS FOLLOWING MOVE TO U.S.

- Structuring for investments: focus on flexibility, not locking into a structure
- Reporting of non-U.S. assets
- Consider U.S. domicile for purposes of U.S. gift tax
- Consider application of “exit tax” if stay too long
  - Take treaty position to be treated as giving up green card before long-term residence status kicks in?
- Other considerations
  - Application of “boomerang rule” (see next slide)
  - Potential PFIC exit tax
  - Termination of a trust after leaving U.S.
  - Liquidation-reincorporation doctrine
  - Deferring dividend payments from non-U.S. entities

SALES OF COMPANIES

- U.S. income tax residents other than U.S. citizens or long-term residents (as defined in sec. 877(e)) may relocate abroad before a potential exit to prevent U.S. taxation.
- Consider application of boomerang rules (e.g., must remain a nonresident for at least 3 consecutive years).
- Carefully plan to prevent local country taxation.

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