Navigating international tax and estate planning with your global clients

Part 1: Income taxation of noncitizens

WHITE PAPER

Income taxation of noncitizens

Lance Winston, J.D., LL.M., and Mark Phelps, CLU®, collaborated to bring you valuable international tax information presented in both a technical and a practice implementation format. This can help you gain an understanding of the tax laws as they pertain to your foreign national clients so that you can identify situations that can arise in your cases and plan accordingly.

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When approaching global clients, the complications of cross-border taxation can be daunting for those of you who aren't tax professionals. The goal of this multipart white paper is to equip you with the basic knowledge you will need to point your clients in the right direction to help them navigate their initial conversations with the right advisors.

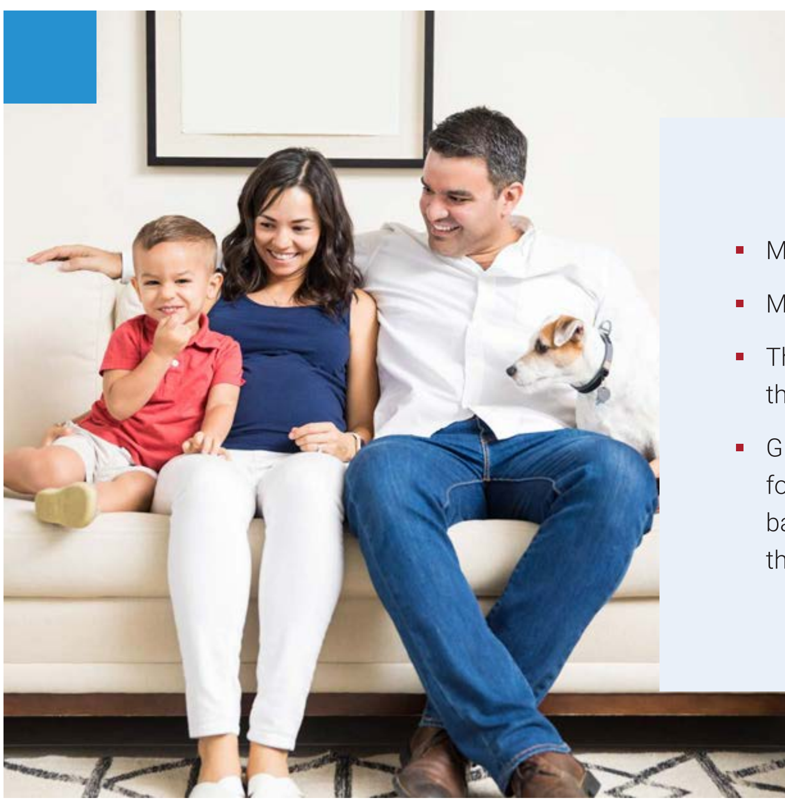
Life insurance can be an important part of financial planning for wealthy global clients. Your value will likely be your knowledge of U.S. life insurance products and process, but we want you to be ready for your seat at the table with the client's other advisors.

Throughout this white paper, you'll find descriptions of various aspects of income tax laws to consider, user-friendly interpretations of how they apply to planning situations, and easily relatable client examples.

Did you know that a non-U.S. citizen, nonresident client:

- **May not owe capital gains tax in the U.S. on the sale of appreciated U.S. stock?**
- **May pay different tax rates for U.S. business activities than for interest or rental income?**
- **Could end up paying tax on his or her worldwide income by spending too much time in the U.S. or by getting a green card?**

Meet Guillermo



- Mexican business owner, age 42
- Married with three children
- The family divides time between the U.S. and Mexico.
- Guillermo runs a successful gourmet foods company with a large client base in Mexico, South America and the United States.

What determines U.S. income tax residency status?

An individual's status as a "resident alien," commonly referred to as a U.S. resident, for federal income tax purposes, determines the extent to which he or she is subject to U.S. federal income tax. A U.S. resident, like a U.S. citizen, will be subject to U.S. federal income tax on their worldwide income at graduated tax rates. Reg. §1.1-1(b). Whereas, a non-U.S. citizen, nonresident alien (NRA), is usually subject to U.S. federal income tax only on U.S. source income. IRC §871; Reg. §1.871-1.

If your client is a U.S. income tax resident, he or she will pay U.S. federal income tax on his or her worldwide income. For this reason, it's important for a foreign client to understand what would cause him or her to become a U.S. income tax resident.

Let's take a look at Guillermo:

- Doesn't have a green card
- Spends a substantial part of the year in the U.S.
- Has property and income both in Mexico and the U.S., as well as a few other countries

Is Guillermo a U.S. income tax resident?

A non-U.S. citizen will be treated as a resident for U.S. federal income tax purposes if he or she (1) is a lawful permanent resident (green card holder), (2) satisfies the substantial presence test, or (3) makes an election to be treated as a U.S. resident. IRC §7701(b)(1)(A).

There are two tests that determine if your client is a U.S. income tax resident: the "Green Card Test" and the "Substantial Presence Test." If the client qualifies under EITHER test, he or she is a U.S. income tax resident. This often becomes part of a larger discussion about the pros and cons of U.S. residency.

Green card test

An individual is a lawful permanent resident of the U.S. if he or she is afforded the privilege, according the immigration laws, of residing permanently in the U.S. as an immigrant. Reg. §301.7701(b)-1(b)(1). An individual generally has this status if the U.S. Citizenship and Immigration Services (USCIS) (or its predecessor organization) has issued an alien registration card, also known as a "green card." See IRS Publication 519.

If your client has a green card, he or she is U.S. income-taxed like a U.S. citizen. Many international clients take this into consideration before deciding to become U.S. residents or green card holders. Then again, many clients aren't even aware of what would trigger a change in their tax residency status.

Guillermo doesn't have a green card, but he still could be a U.S. income tax resident based on the amount of time he spends in the U.S.

Substantial presence test

The substantial presence test is an objective, mechanical test based on physical presence in the U.S. and numerical day count. An individual will meet the substantial presence test if (1) the individual is physically present in the United States for one hundred eighty-three (183) days or more during the current calendar year, or (2) if the individual is physically present in the U.S. for at least thirty-one (31) days during the current calendar year, and a weighted average of the individual's physical presence in the U.S. for the current calendar year and the two preceding calendar years equals one hundred eighty-three (183) days or more. IRC §7701(b)(3)(A)(ii); Reg. §301.7701(b)-1(c)(1).

In calculating the three-year look back weighted average, each day of physical presence in the U.S. during the current calendar year is counted as a full day. Each day of physical presence in the U.S. in the first preceding calendar year counts as one-third (1/3) of a day, and each day of physical presence in the U.S. during the second preceding calendar year counts as one-sixth (1/6) of a day. IRC §7701(b)(3)(A)(ii); Reg. §301.7701(b)-1(c)(1). In general, if an individual is physically present in the U.S. for one hundred twenty-two (122) days or more, each year, over a three-year period, the individual will satisfy the substantial presence test. Reg. §301.7701(b)-1(e)(1).

An individual physically present in the U.S., even for a portion of the day, is counted as a full day for purposes of the substantial presence test. Reg. §301.7701(b)-1(c)(2). However, the following days are excluded and will not count as days of physical presence in the U.S. for the substantial presence test such as any day an individual (1) is an exempt individual, (2) is prevented from leaving the U.S. because of a medical condition arising while in the U.S., (3) is in transit between two points outside of the U.S., and (4) is a regular commuter residing in Canada or Mexico and commutes to and from employment in the U.S. Reg. §301.7701(b)-3(a). An exempt individual includes individuals associated with foreign governments, teachers or teachers in training, students, and professional athletes participating in a charitable sporting event. Reg. §301.7701(b)-3(b)(1).

If the client spends a lot of time here, he or she could be U.S. income-taxed like a U.S. citizen.

Let's see how much time Guillermo spends in the U.S. We need data from the last 3 years.

- This past year, he spent 121 days in the U.S.
- Last year, he spent 117 days in the U.S.
- The year before that, he spent 114 days in the U.S.

Did he spend 183 or more days in the U.S. last year? No. BUT, did he spend at least 31 days? Yes.

So we need to do some math:

- 100% of the days he spent this past year: 121 x 100% = 121
- 1/3 of the days he spent last year: 117/3 = 39
- 1/6 of the days he spent the year before that: 114 = 19
- The weighted total = 121 + 39 + 19 = 179

179 days is LESS THAN 183 days, so he is NOT a U.S. income tax resident. In fact, it looks like Guillermo is keeping an eye on the number of days he's spending in the U.S.

Effect of tax treaties

U.S. income tax residency rules do not override income tax treaty definitions of residency. Under certain circumstances, an individual could be classified as a dual-resident taxpayer of both the U.S. and another country under each country's income tax residency internal laws. If the two countries have a bilateral income tax treaty, generally, the treaty will contain a tiebreaker provision that provides for the resolution of conflicting claims of residency. If the individual determines under the tiebreaker rule that he or she is a resident of the other country, then he or she will be treated as a nonresident alien only for computing his or her U.S. income tax liability. For other purposes, the individual will be treated as a U.S. resident. Reg. §301.7701(b)-7(a). The U.S. is a party to 58 bilateral income tax treaties with other countries. However, the treaty with the Commonwealth of Independent States (CIS), formerly known as the Union of Soviet Socialist Republics (USSR), includes countries such as Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan. Each income tax treaty is unique and must be consulted if applicable.

Always have the client check with his or her tax advisor to see how any tax treaties may affect his or her tax situation.

Is there an income tax treaty between the U.S. and Mexico? Yes! Find a complete list of treaties on the IRS website.

What does the treaty say? Guillermo should consult his tax advisor. In fact, Guillermo will also want to tell his tax advisor about the assets he has outside of the U.S. and Mexico since the situs of that property may also affect its taxation.

U.S. income taxation of NRAs

An NRA is usually subject to U.S. federal income tax only on U.S. source income. U.S. source income is generally divided into two broad categories: (1) effectively connected income (ECI) with a U.S. trade or business, and (2) income not effectively connected with a U.S. trade or business. IRC §871; Reg. §1.871-1.

Clients who are NOT U.S. income tax residents will only pay U.S. income tax on their U.S. source income. Many international clients take this into consideration before deciding to become U.S. residents or green card holders. Have the client check with his or her tax advisor to see what would trigger a change in their tax residency status.

Guillermo is a nonresident alien for the purposes of U.S. income tax. So, he needs to know that his U.S. source income would be subject to income tax in the U.S.

Effectively connected income

ECI is computed on a net basis that takes into account deductions attributable to the ECI, and is subject to U.S. federal income tax at the same graduated rates applicable to U.S. citizens and residents. IRC §871(b), IRC §873. The term "trade or business in the U.S." includes the performance of personal services in the U.S. IRC §864(b); Reg. §1.864-2(a). In general, wages, salaries, fees, and compensation received by an NRA for performing services in the U.S. that constitute a U.S. trade or business is ECI and subject to U.S. federal income tax at graduated rates under IRC §871(b) and income tax withholding under IRC §3402(a), rather than on a 30% gross amount withholding basis where fixed or determinable annual or periodic (FDAP) income is paid to an NRA. Reg. §31.3401(a)(6)-1; Rev. Rul. 92-106.

If your client works for a U.S. company or does business with a U.S. company, that income is likely U.S. income taxable. But your client will want to check with his or her tax advisor for his or her complete income tax picture. There are graduated tax rates for this type of income.

Guillermo owns a business in Mexico and has a large number of clients in the U.S. The money he earns from those clients could be subject to U.S. income tax. He should talk to his tax advisor.

U.S. real property interest

An NRA must treat the sale of a U.S. real property interest as if the NRA was engaged in a U.S. trade or business and the gain or loss was effectively connected to that U.S. trade or business. IRC §897(a)(1). Gains are taxed under the provisions of the Foreign Investment Real Property Tax Act of 1980 (FIRPTA), on a net basis, and generally, subject to tax at the same rates that apply to U.S. citizens and residents. To ensure and enforce that an NRA will pay taxes on the gain from the sale of a U.S. real property interest, income tax withholding is imposed at its source by the transferee/purchaser. IRC §1445(a); Reg. §1.1445-1(b)(1).

The transferee/purchaser has a withholding obligation, and is required to deduct and withhold a tax that is, generally, 15% of the total amount realized (sales price), and must report and pay to the IRS the amount within 20 days after the transfer. IRC §1445(a); Reg. §1.1445-1(b)(1); Reg. §1.1445-1(c)(1). However, the transferee/purchaser is only required to deduct and withhold a tax that is, generally, 10% of the total amount realized if the property is acquired by the transferee/purchaser, for the transferee/purchaser's residence, and the sales price exceeds $300,000 but does not exceed $1,000,000. IRC §1445(c)(4); Reg. §1.1445-1(b)(2).

If the sale price does not exceed $300,000 and the transferee/purchaser, or member of his or her family expects to reside at the property at least 50% of the days it is used by the transferee/purchaser or family member during each of the first two 12-month periods following the date of transfer, no withholding is required. IRC §1445(b)(5); Reg. §1.1445-2(d)(1). If the sales price exceeds $1,000,000, the withholding rate is 15%. IRC §1445(a).

Even though it may not seem obvious, income (or losses) from the sale of U.S. real property would fall under the category of "Effectively Connected Income."

Guillermo has U.S. property. He needs to know how a sale of that property could affect his taxable U.S. income.

Other income not effectively connected

For any U.S. source income that is not effectively connected to a U.S. trade or business, an NRA is subject to a flat 30% tax, unless reduced or eliminated by an applicable U.S. income treaty. IRC §871(a); Reg. §1.871-12. The 30% tax is imposed on the gross amount (no deductions allowed) paid, but only to the extent the amount constitutes gross income. Reg. §1.871-7(a). The 30% tax, withheld at the source (U.S. payor), is referred to as a "withholding tax", and generally applies to U.S. fixed or determinable, annual or periodical (FDAP) income and includes passive investment income, such as dividends, interest, rents, royalties, or other similar types of income. IRC §1441; Reg. §1.871-7(b).

There are U.S. statutory exemptions to the 30% withholding tax on U.S. source FDAP interest and dividend income. The interest income exemption includes (1) interest on deposit with banks, savings and loan associations, and insurance companies, (2) interest on certain short-term obligations, and (3) portfolio interest. IRC §871(i), IRC §871(g)(1)(B), IRC §871(h)(2). The dividend income exemption includes interest-related dividends and short-term capital gain dividends from a mutual fund or other regulated investment company. IRC §871(k)(1); IRC §871(k)(2).

However, the exemption for short-term capital gain dividends is not applicable, under IRC §871(a)(2), to an NRA physically present in the U.S. for 183 days or more during the tax year. IRC §871(k)(2)(B). The 30% tax is imposed on short-term capital gain dividends even if the NRA is an "exempt Individual" (foreign student, foreign scholar, or an employee of foreign government or international organization) for purposes of counting days he or she is physically present in the U.S. under the substantial presence test for determining U.S. income tax residency status. The 183-day rule of IRC §871(a)(2) bears no relation to the 183-day rule under the substantial presence test of IRC §7701(b)(3).

Income from other U.S. sources — especially U.S. investments or things like rents or royalties — would be considered "FDAP" income and would usually be taxed at a flat 30%. There are exceptions to that tax rate, so your client should check with his or her tax advisor.

Guillermo does have U.S. investments. He also rents one of his U.S. properties. Income from these sources could be subject to a 30% flat rate.

Capital gains

U.S. source capital gains realized by an NRA, from the sale of a capital asset (U.S. personal property) that is not effectively connected to a U.S. trade or business, does not constitute U.S. FDAP income, is considered foreign source income, and is generally exempt from U.S. income taxation. IRC §865(a)(2); Reg. §1.871-7(d)(2)(ii). However, this exemption does not apply to the sale of a U.S. real property interest and the gain must be treated as ECI and taxed as if the NRA was engaged in a U.S. trade or business. IRC §871(b)(1); IRC §897(a).

If the NRA is physically present in the U.S. for 183 days or more during the tax year, net capital gains from the sale of U.S. personal property are subject to U.S. income tax on the same basis as U.S. FDAP income and are taxed at a flat 30% (or lower U.S. income tax treaty) withholding rate. IRC §871(a)(2); Reg. §1.871-7(d)(2)(i). This rule applies even if any of the transactions occurred while the NRA was not in the U.S. Reg. §1.871-7(d)(2)(i). The 30% tax is imposed even if the NRA is an "exempt Individual" (foreign student, foreign scholar, or an employee of foreign government or international organization) for purposes of counting days he or she is physically present in the U.S. under the substantial presence test for determining U.S. income tax residency status. The 183-day rule of IRC §871(a)(2) bears no relation to the 183-day rule under the substantial presence test of IRC §7701(b)(3).

Nonresident aliens do not generally pay capitals gains tax in the U.S. But a U.S. tax resident, generally, would up to a maximum rate of 20%. This is another thing that international clients may want to consider before becoming a U.S. income tax resident.

U.S. income tax resident

- Taxed on worldwide income
- Use tax brackets that apply to U.S. citizens

Nonresident for U.S. federal income tax purposes

- Only taxed on U.S. source income.
- ECI: Effectively connected income to a U.S. trade or business. Graduated tax rates apply.
- FDAP: Income that is fixed, determinable, annual or periodical. Flat 30% or rate determined by treaty.
- Capital gains tax, generally, exempt from U.S. income taxation. Pay attention to exception for U.S. real estate.

Even though Guillermo might pay a tax on the dividends earned on his U.S. stocks, he would not have to pay U.S. capital gains tax on any gains associated with the sale of that stock. Just as he may want to sell some of his real estate down the road, he may want to sell some of his stock at a later date, too. But, as you can see, the taxation of those two sales are completely different. Being informed helps him make educated decisions and plan the timing of his sales.

U.S. possessions

A bona fide resident of a U.S. possession (American Samoa, Commonwealth Northern Mariana Islands, Guam, Puerto Rico or U.S. Virgin Islands) who is not a U.S. citizen or U.S. national is treated as an NRA for purposes of the U.S. withholding rules and statutory exemptions described above. See IRS Publication 515.

How is U.S. life insurance income taxed?

First, let's look at the cash values. A life insurance policy owned by a noncitizen will enjoy the same U.S. income tax advantages that a U.S. citizen would enjoy.

- U.S. income tax deferred growth on the inside build up
- First in, first out (FIFO) tax treatment of withdrawals
- No tax penalties for early withdrawals
- Policy loans are not includable in U.S. taxable income

However, if your client is a nonresident, and surrenders his or her policy or otherwise takes a distribution (modified endowment contract), to the extent there is taxable income (cash value exceeds net premiums), it would be considered FDAP income and would be subject to a flat 30% tax rate, UNLESS, reduced or eliminated by an applicable U.S. income tax treaty. U.S. carriers like Lincoln must withhold 30% unless the client has a valid Form W-8 on file, which would allow the client to take advantage of the treaty rate. An updated list of income tax treaties can be found on the IRS website.

Lastly, a taxable event (whether or not there is any withholding required) will trigger reporting to the IRS. Lincoln would use Forms 1042 and 1042-S.

Guillermo paid premiums of $200,000 into his U.S. life insurance policy. He now has $350,000 of cash value in the policy. He decides to surrender his coverage. How much would the U.S. carrier need to withhold?

The reportable portion of the cash surrender value is $150,000. Generally, a U.S. carrier would withhold 30% of that — or $45,000, leaving the client with $305,000 of the cash value. BUT, there is an income tax treaty between the U.S. and Mexico. Guillermo has a valid W-8BEN on file, which allows him to take advantage of the treaty rate of 0%. So, Guillermo walks away with all $350,000 of the cash value.

What about the death benefit of a U.S. life insurance policy?

The death benefit is received U.S. income tax-free by the beneficiary. If Lincoln pays interest on the death benefit proceeds, a 30% withholding tax will apply to that portion of the payment that is deemed interest, unless a treaty (along with completed and updated tax documentation on file) reduces the rate.

It is also NOT U.S. estate taxable to the NRA insured. So, that means, an Irrevocable Life Insurance Trust (ILIT) is not needed in order to remove the death benefit from the NRA's taxable U.S. estate.

U.S. taxation of a U.S. life insurance policy is at least as advantageous for a non-U.S. citizen or nonresident as it is for a U.S. citizen or resident. But, this has nothing to do with possible taxation in the client's (or beneficiary's) home country. The client should seek local counsel as well.

Lastly, many U.S. carriers ask for copies of a W-8BEN during the life insurance underwriting process. Clients should discuss the version, completion and purpose of the form with his or her tax advisor. Many times, carriers are not checking this form for accuracy until a taxable event occurs.

Now that you have the basics about how U.S. federal income taxes may affect foreign national clients, you can follow the tips we've provided to help you plan.

For more information see Part 2 — Transfer taxation of noncitizen clients — Basic Concepts.

Contact your Lincoln representative or email us at ForeignNationals@LFG.com.

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This white paper focuses on U.S. taxation. It is for educational purposes only and cannot be used as a tool to assist your client with his or her tax questions. You must direct your client to his or her own tax advisor for questions that are specific to his or her tax situation. Your client may also have questions about how his or her assets, including life insurance will be taxed in other jurisdictions. You must direct your client to discuss those questions with his or her tax advisor.

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