COMMITTEE REPORT:
INTERNATIONAL PRACTICE

By **J. Andrew P. Stone** & **Eric Huang**

Journey to the West

Considerations for inbound foreign professionals regardless of net worth or length of stay

Foreign executives and professionals are routinely deployed to the United States for a variety of reasons, ranging from short-term, limited scope projects to long-term strategic initiatives. Consequently, inbound foreign professionals come from a variety of seniority levels and circumstances. While individuals intending to reside in the United States for a longer or indefinite duration may seek tax advice prior to or shortly after arrival, individuals coming to the United States for a short and limited duration often underestimate the tax implications of a short residency in the United States. Unfortunately, even a brief stint in the United States can result in significant tax liability and onerous reporting obligations. Here are the various tax considerations that a foreign professional coming to the United States for a limited defined duration may encounter and how thinking ahead can help avoid painful pitfalls.

Income Tax Residency

Most foreign professionals coming to the United States for work are fully aware of the need to file a U.S. income tax return and pay taxes on any income earned while working in the United States. Unfortunately, some individuals may not be aware that becoming a U.S resident for income tax purposes causes their worldwide income to be subject to U.S. taxation, similar to U.S. citizens.[1] Consequently, foreign professionals may be surprised and upset to learn that certain foreign income may be subject to U.S. income taxation, especially when such income may be in connection with compensation earned prior to entering the United States. Income tax treaties and totalization agreements between the United States and an individual's home country may provide overriding rules and benefits to reduce the individual's overall tax liability.

Generally, an individual residing in the United States on a nonimmigrant visa, such as an employment visa, becomes a U.S. resident for income tax purposes the first day they were present in the United States during the year they satisfy the "substantial presence test."[2] Under the substantial presence test, an individual will be considered a U.S. resident if the individual is physically present in the United States for *at least*: (1) 183 days the current calendar year, or (2) 31 days during the current calendar year and at least 183 days during a weighted 3-year period.[3] Arriving in the United States in July or later will generally result in nonresident status for the full year in which the foreign professional entered the United States, unless a "first year election" is made.[4]

An individual's residency end date is correspondingly determined by when the individual ceases to meet the substantial presence test. The general rule is that an individual's "residency termination date will be the last day of the calendar year" they fail to satisfy the substantial presence test.[5] However, if an individual can establish that their "tax home was in a foreign country and he or she maintained a closer connection" to that foreign country, the residency termination date is the last day the individual was physically present in the United States.[6] Foreign professionals maintaining a residence and other connections in their home country generally will be able to establish a closer connection.

(From left to right) **J. Andrew P. Stone** is a partner and **Eric Huang** is an associate, both in the Chicago office of Kozusko Harris Duncan

For example, Ashley is a foreign professional who enters the United States on Nov. 1, 2021 on a nonimmigrant visa and spends every month of 2022 in the United States except for December each year. She continues to live in the United States until Oct. 31, 2023. Ashley wouldn't be a U.S. resident in 2021 because she hasn't spent 183 days in the United States in 2021, unless she qualifies for and makes a first year election. Whether Ashley should make this first year election will likely depend on her foreign income during the 2021 partial year period and whether she can benefit from certain credits and deductions only available to U.S. residents.

Ashley then becomes a U.S. resident in 2022 because she meets the substantial presence test by being present in the United States for over 183 days. Her U.S. residency began on Jan. 1 because she was present in the United States on Jan. 1, 2022. She ceases to be a U.S. resident for income tax purposes on Oct. 31, 2023 due to a demonstrable closer connection to her home country.

Timing of Foreign Income

Once a foreign professional has a good grasp of when their U.S. income tax residency begins and ends, they may consider timing the recognition of income to reduce their U.S. tax liability. An individual should consider selling certain stock or exercising stock options before their U.S. residency begins or deferring a sale or exercise until after their residency ends, if possible.

The timing for receiving a bonus or other deferred compensation may also result in undesirable tax consequences. For example, assume Ashley received a grant of 1,000 restricted stock units from her employer on Jan. 1, 2020 that vests over a 5-year period. For any vesting that occurs while Ashley is a U.S. resident, she'll be taxed on the entire amount.[7] For any vesting that occurs while she *isn't* a U.S. resident, a portion of the income recognized on vesting may still be treated as effectively connected income, taking into account the time she spent working for her employer while in the United States.[8] Other forms of equity compensation, such as incentive stock options, non-statutory stock options and employee stock purchase plans are also subject to specific U.S. income taxation rules.

Foreign Spouse and Joint Returns

Once a foreign professional has established residency for U.S. income tax purposes and a new year rolls around, they may have to consider their appropriate filing status. For unmarried professionals and professionals coming to the United States together with their spouse, the appropriate filing status is often readily apparent. For foreign professionals with a nonresident spouse abroad, it may not be as straightforward.

> A foreign professional deployed to the United States for a set duration is extremely unlikely to be a resident for U.S. estate tax purposes.

A foreign professional with a spouse remaining abroad may elect to treat the nonresident spouse as a "resident" for the limited purposes of filing a joint tax return by making an election under Internal Revenue Code Section 6013. Filing a joint return under the married filing jointly status may allow the couple to take advantage of lower tax rates and larger deductions and exemptions. On the other hand, if the couple has a certain amount of foreign income or a certain income distribution, they may get hit with a greater tax liability and/or the "marriage penalty." Individuals with a spouse remaining in their home country should carefully consider the advantages and disadvantages of filing as married filing jointly or married filing separately.

Estate Planning for U.S. Assets

A foreign professional deployed to the United States for a set duration is extremely unlikely to be a resident for U.S. estate tax purposes. To qualify, a foreign national must be "domiciled" here, which means residing in the United States with "no definite present intention of later removing therefrom."[9] Consequently, a foreign professional with a clear end

date to their stay is unlikely to be deemed domiciled in the United States and will therefore have little need to engage in more robust estate planning, such as setting up a revocable trust with qualified domestic trust provisions.

For these foreign professionals, a reasonable estate plan will typically be only a will and powers of attorney for property and health care. Practitioners should think twice about recommending a trust-centric estate plan. Certain countries view trusts unfavorably or simply refuse to recognize them at all. The use of a trust for U.S. estate planning may therefore result in unintended consequences in the individual's home country.

Nonetheless, a foreign professional should, at minimum, engage in some simple estate planning to avoid U.S. estate tax liability and ease estate administration in the unfortunate event that they pass while present in the United States. While U.S. citizens and domiciliaries are subject to U.S. estate tax on their assets worldwide, a "nonresident not a citizen of the United States" is only subject to the U.S. transfer tax regime on U.S.-situs assets, generally tangible property or real property situated in the United States but also including stock in U.S. corporations.[10]

Fortunately, U.S. bank deposits aren't U.S.-situs assets subject to potential taxation. Cash deposited in a brokerage account, however, is a U.S.-situs asset. The United States has entered into estate tax treaties with certain countries that may contain provisions overriding these general rules. However, even if a bank account isn't a U.S.-situs asset, financial institutions will require a transfer certificate issued by the Internal Revenue Service before transferring the assets of a nonresident decedent unless the individual's total assets were less than $60,000. A financial institution requires a transfer certificate to avoid incurring potential liability in connection with a nonresident decedent's unpaid estate taxes.[11]

Consequently, any foreign professional residing temporarily in the United States should aim to keep the total value of their assets and deposits in U.S. financial institutions, including checking, savings, brokerage and money market accounts, to under $60,000. This is advisable even if the deposits are all simply cash at a U.S. bank. Keeping total assets in the United States under $60,000 will minimize U.S. estate tax liability and administrative burden in the event a foreign professional passes during the temporary residency in the United States. Depending on applicable state law, however, probate may still be required.

Reporting Foreign Bank Accounts

As newly minted U.S. income tax residents, foreign professionals living in the United States are also subject to various foreign reporting obligations. The most commonly overlooked interests subject to reporting are foreign bank accounts. U.S. income tax residents are required to file a Financial Crimes Enforcement Network (commonly known as "FinCEN") Form 114 foreign bank account report (FBAR) reporting bank or other financial accounts at a foreign financial institution if the total value of the accounts exceeds $10,000 in aggregate at any time during the year. A foreign spouse who made an IRC Section 6013(g) or 6013(h) election isn't subject to the FBAR filing requirement, but the U.S. resident spouse must still report the full amount for any jointly owned account. Further, a Form 8938, "Statement of Specified Foreign Financial Assets," may also be required depending on the type and total value of the account(s).

Reporting Foreign Mutual Funds

Another commonly overlooked financial asset that has significant and onerous tax consequences are foreign registered mutual funds. This is because foreign mutual funds are typically foreign corporations with a majority of their assets being "passive assets." Consequently, a foreign registered mutual fund, even if it invests solely in U.S. equities, is often considered a passive foreign investment company (PFIC). Ownership of a PFIC triggers exposure to U.S. taxation on "excess distributions."[12] Alternatively, an owner may opt into the "mark-to-market"[13] or "qualified electing fund"[14] regimes. Owners of PFIC interests may be required to report such interests on Form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund."

Foreign professionals should review their investment portfolio and sell any PFICs before

becoming a U.S. income tax resident to avoid any potentially onerous reporting requirement or tax liability. Further, foreign professionals with direct interests in foreign corporations or partnerships, such as a family business of any size, should seek tax advice for their specific situation.

Foreign Gifts and Inheritances

Foreign professionals receiving gifts and inheritances from abroad are required to report such gifts if their total value exceeds $100,000 or more in a calendar year.[15] No tax liability is associated with the receipt of such gifts or inheritances, but the penalty for a late or incomplete Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," may be as high as 25% of the value of the gifts or inheritances received.[16]

Birthright Citizenship

Foreign professionals should also engage in family planning in connection with any temporary residence in the United States. The 14th Amendment provides that "all persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States." As a result, any child born in the United States is a U.S. citizen, even if neither parent is a U.S. citizen and they leave the United States as an infant. According to CNN, the concept of birthright citizenship, or "jus soli," is more common in the Americas.[17] Consequently, foreign professionals from Europe or Asia may be surprised to learn that giving birth to a child in the United States may cause their child to become an "Accidental American."

While U.S. citizenship offers certain advantages, a U.S. citizen is subject to the extensive tax regime already discussed. Often, an Accidental American remains unaware of their U.S. citizenship until they encounter problems applying for entry into the United States, such as for education or employment. They may also experience complications with bank services in their home countries due to the various tax and financial reporting requirements placed on foreign financial institutions serving U.S. citizens. Finally, the U.S. State Department also charges an individual $2350 to renounce their U.S. citizenship. Certain U.S. citizens may also be subject to an exit tax at expatriation.[18]

Foreign professionals with limited ties to the United States should carefully consider the ramifications of having a child in the United States during a temporary residency.

Long-lasting Tax Consequences

While a foreign professional coming to the United States for a short-term assignment will typically have limited exposure to the U.S. tax system relative to a U.S. citizen or Green Card holder, there's still the risk of significant and long-lasting tax consequences. By thinking ahead and engaging in very basic planning, a foreign professional may avoid some of the hidden pitfalls of the U.S. tax system.

Endnotes

1. Internal Revenue Code Section 61.
2. IRC Section 7701(b)(1)(A)(ii)-(iii).
3. Section 7701(b)(3). Weighted 3-year period is the sum of: (1) the total days in the current year (if at least 31 days), (2) one-third of the days in the first preceding year and (3) one-sixth of the days in the second preceding year. Certain days aren't counted for the substantial presences test, such as days present in transit between other countries, medical emergencies and COVID-19. Individuals temporarily present in the United States as a student, teacher, researcher, professional athlete, government official, etc. under the terms of their specific visa are "exempt individuals" not required to count certain days present in the United States. Section 7701(b)(5).
4. Section 7701(b)(4).
5. Treasury Regulations Section 301.7701(b)-4(b)(1).
6. Treas. Regs. Section 301.7701(b)-4(b)(2).
7. *See* IRC Section 83.
8. *See* IRC Section 861.
9. Treas. Regs. Section 20.0-1(b)(1).
10. IRC Section 2101(a); IRC Section 2103.
11. Treas. Regs. Section 20.6325-1(b)(1)(i).
12. IRC Section 1291.
13. IRC Section 1296.
14. IRC Section 1295.
15. Notice 97-34.
16. IRC Section 6039F(c).
17. *www.cnn.com/2018/10/31/politics/birthright-citizenship-world-intl/index.html.*
18. IRC Section 877A. Dual citizens at birth may be able to avoid "covered expatriate" status at expatriation. Section 877(c)(2).