

For Your Consideration: Residency Determines Tax Liabilities *By Scott Harty*

When a foreign person becomes a U.S. resident, the entire U.S. tax code becomes relevant. For foreign business owners, no other portion of the tax code may be more relevant than the provisions governing U.S.-owned foreign corporations (commonly referred to as “Subpart F”). At the risk of extreme oversimplification, Subpart F may require the U.S. owner(s) of foreign corporations to pay tax on phantom income. More specifically, if U.S.-owned foreign corporations earn certain types of income, or make certain types of U.S. investments, the U.S. shareholders may be required to recognize U.S. taxable income even though the foreign corporation makes no actual distribution to the shareholders.

The Fundamentals of Subpart F

The rules under Subpart F are exceedingly complex, and a thorough discussion of them is well beyond the scope of this article. However, an overview of those rules is necessary because of the significance of the effects

of Subpart F on prospective U.S. residents who own foreign businesses.

Generally, Subpart F is an anti-deferral tax regime designed to frustrate attempts by U.S. residents to avoid paying U.S. tax on income earned outside the United States through foreign corporations. The Subpart F rules come into play when one or more U.S. shareholders (defined as U.S. residents who each own, directly, indirectly or constructively, 10 percent or more of the total voting stock of the foreign corpora-

tion) own more than 50 percent of the stock of a foreign corporation. Such foreign corporations are termed “controlled foreign corporations” or “CFCs.”

U.S. tax advisors have become skilled at devising structures to avoid triggering the application of the then-current rules of Subpart F. As a result, Subpart F has become increasingly complex to adapt to the changing landscape of the law and to the variety of structures implemented by tax advisors.

continued on Page 12



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Tax Liabilities *continued from Page 11*

Subpart F is designed to apply to income that is easily manipulated through artificial arrangements between related corporations that produce inappropriate tax deferral. For example, Subpart F generally requires that passive income (e.g., dividends, interest and royalties) earned by a CFC be subject to current U.S. income tax because passive income can be artificially structured to be earned in a low-tax jurisdiction. Likewise, Subpart F requires current U.S. income tax on certain investments that a CFC may make in the United States. For U.S. tax purposes, such investments are treated as repatriated earnings that are currently taxable to the U.S. shareholders as dividends.

Unintended Sandwich Structures

Due to its complexity, Subpart F can have unexpected and detrimental tax consequences to U.S. residents. One of the more common and unexpected consequences for recent U.S. residents is the creation of what is known as a corporate “sandwich” structure. These structures involve foreign persons who own a foreign corporation that may do business in the United States either directly or through a U.S. subsidiary. If the foreign corporation becomes a CFC when the foreign person becomes a U.S. resident, then the sandwich structure is in place. The result is that a U.S. resident is conducting business in the United States indirectly through a foreign corporation -- an inefficient and costly tax structure.

For example, assume a Japanese foreign national owns a Japanese manufacturing business with several subsidiaries throughout the world (including the United

States). The foreign national acquires a green card and moves to the United States as a U.S. resident. As a result, the Japanese manufacturing company becomes a CFC, and the Subpart F rules



apply to its operations. One of the CFC's investments is its U.S. subsidiary, which it is continuing to expand due to its profitable U.S. operations. Unbeknownst to the Japanese individual, each additional investment by the Japanese manufacturing company in the U.S. subsidiary triggers a constructive dividend to him, resulting in current U.S. tax liability. Consequently, the Japanese individual has phantom income (i.e., U.S. taxable income with no corresponding cash).

Equally disturbing is the taxation of dividends paid by the U.S. subsidiary of the CFC. If the Japanese resident of the United States owned the U.S. subsidiary directly, dividends would generally be subject to a 15 percent U.S. income tax. However, under this structure, dividends must be paid first to the Japanese manu-

facturing company (which will most likely incur a tax in Japan) before they reach the Japanese individual (the dividend to the Japanese company would not itself be subject to U.S. tax under

the terms of the U.S. income tax treaty with Japan). Any Japanese income taxes paid by the manufacturing company on dividends received from the U.S. subsidiary would not be allowed as tax credits in the United States.

Therefore the Japanese individual is in a potentially triple tax structure (i.e., U.S. income tax on the U.S. subsidiary's income, Japanese tax on dividends paid by the U.S. subsidiary, and U.S. tax on dividends paid by the Japanese manufacturing company).

While pre-residency planning is always preferable to avoid an impending sandwich structure, post-residency measures may be taken as well to minimize this costly impact. Once again, it is critical

continues on Page 13

Tax Liabilities *continued from Page 12*

to be aware at an early stage that U.S. residency may carry with it unexpected consequences, and the best protection is to seek in timely fashion the advice of competent U.S. tax counsel.

Implications of U.S. Residency on Foreign Pensions and Retirement Savings

U.S. residency can have significant implications on how earnings from retirement savings accounts are taxed. Income tax treaties that the United States has concluded with other countries generally provide rules to govern

the taxation of distributions from pensions and retirement savings accounts. In addition, the United States has concluded 21 bilateral agreements (referred to as “Totalization Agreements”) to address dual Social Security coverage when persons have connections to two countries. Any applicable Totalization Agreement should be consulted to determine what, if any, impact U.S. residency may have on the resident’s Social Security obligations in the United States and abroad.

Conclusion

U.S. residency brings with it a

labyrinth of legal consequences, many of which are not apparent or intuitively obvious. It is highly advisable for any foreign national who anticipates becoming a U.S. resident to seek early advice from legal counsel to make sure that the potential adverse consequences of U.S. residency are addressed in advance. ROI

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