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On the Move: U.S. Pre-Immigration Planning

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Global clients face unique and complex challenges as they build their wealth across multiple borders.

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Your phone rings first thing on a Monday morning. It's your biggest client. He's decided that he is moving his family to the U.S. at the end of the month to explore new business opportunities and be closer to his children who are attending university there. He needs your advice. And he needs it quickly.

This is, in fact, a scenario that is probably not too far removed from the truth. You could count yourself lucky that the call came before he had actually made the move. Starting a life in a new country is always a time of excitement although it invariably brings with it a plethora of issues that need to be considered; from the vital, such as where to live, to the more mundane and trivial like whether they sell the kids' favorite cereal. But your client needs your advice on one thing - how much tax is he going to have to pay?

The Minefield that is U.S. Taxation

The U.S. has one of the most complex tax systems in the world. It is one of the few remaining countries that impose tax on its citizens on a worldwide basis – i.e. regardless of where they reside. On the face of it, therefore, it might seem that there is little that can be done for immigrants seeking to legitimately organize their affairs so as to reduce their tax burden.

In fact, the opposite is true, but before we look at pre-immigration planning solutions, it is important to understand the basis upon which the U.S. levies its taxes. From a U.S. perspective, an important distinction must be made between income tax and transfer taxes (the generic term used for estate, gift and generation skipping transfer taxes).

The initial concern for most immigrants is income tax. By satisfying either the substantial presence test or the green card test, an immigrant will be considered resident for income tax purposes and, therefore, subject to income tax. The green card test is met once a green card holder enters the U.S. on a green card.

If an individual is physically present in the U.S. for either 183 days in any one year or for at least 31 days in the current year and 183 days over a three year period, they will meet the substantial presence test. This takes into account each day of presence in the current year, one third of each day of presence in the first preceding year and one sixth of each day of presence in the second preceding year.

The transfer tax regime is applicable once an individual becomes domiciled in the U.S.; the test for which is based on facts and circumstances. In establishing domicile, there must be an intention to permanently reside in the U.S. and a person's existing domicile will continue until this is established. Individuals who are not U.S. domiciled are only exposed to gift and estate taxes on U.S. situs assets.

So, the implications for clients moving to the U.S. are broad. They will more than likely be there long enough to be considered resident for income tax purposes on their worldwide income and, if they decide to stay long term, they are potentially exposing their worldwide assets to estate and gift taxes as well.

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Trusts

So, what can you do to placate your client who has many other considerations on his mind? The answer itself is not straight forward and will depend very much on the specific circumstances. However, there are certain well regarded planning opportunities that are likely to be at the forefront of any initial advice. For an individual moving to the U.S. for an indefinite period of time, it is probable that he will be deemed a U.S. resident for income tax purposes and taxed accordingly. However, an opportunity will likely exist to reduce exposure to transfer taxes, namely estate and gift taxes.

This objective is most commonly achieved through the use of an irrevocable completed gift international discretionary trust, or "drop off" trust as it is commonly referred to. As the name implies, a "drop off" trust allows your client to drop off assets not needed for day to day lifestyle expenses into a trust based in another jurisdiction, before taking up residence in the U.S..

These assets will not form part of the estate of the person (the settlor/grantor) creating the trust because the transfer of legal ownership is done at a time when he was not a resident of the U.S.. As a result, he will not be subject to gift tax on the transfer of assets into trust because the property is outside of the U.S., and neither will he be subject to estate tax as the assets were transferred out of his estate prior to becoming resident.

Planning should always be done well in advance of the client's departure date. If the trust can be established five years prior to the client moving to the U.S., then there can be even greater tax benefits by reducing exposure to income tax, as well as estate and gift tax. In this scenario, the grantor will not be taxed on income generated within the trust, even after he becomes a U.S. resident.

The manner in which a client can reduce exposure to income, estate and gift tax stems from the way in which the U.S. characterizes trusts. The IRS distinguishes between grantor trusts and non-grantor trusts. Grantor trusts are trusts in which the settlor/grantor retains certain rights benefits or powers over the trust, such as the power to revoke, control beneficial enjoyment of trust property, hold certain administrative powers, a reversionary interest exceeding 5% of the trust value or any interest in trust income. The settlor of such a trust is considered the owner of the assets for income tax purposes. While the grantor trust will only be able to eliminate exposure to estate and gift taxes, it will, in most circumstances, deliver a wide range of other non-tax related benefits, such as asset protection, privacy and succession planning.

Conversely, non-grantor trusts are trusts over which the settlor has relinquished benefits and control. In this case, the settlor will not be treated as the owner of the trust assets for U.S. income tax purposes and, therefore, will not be exposed to income tax, or estate and gift taxes. Unless your client establishes such a trust more than five years before moving to the U.S., it will automatically be deemed a grantor trust and, as such, will be subject to tax on its income and gains.

Annuities and Insurance Policies

Let's suppose that your client's date of departure is set in stone. The exposure to income tax will obviously be a concern and your client will wonder what can be done, especially if he does not intend on staying in the U.S. long term.

While your client will be deemed resident for income tax purposes, there are opportunities to reduce resultant income tax liabilities, one of which involves the use of a U.S. tax qualified variable annuity program. This form of planning involves the purchase of a variable annuity by the trust that will provide for the build up of income in the policy. Such a policy offers the investment and tax deferral benefits of a U.S. domestic program, but potentially provides a greater selection of investment options and lower policy costs as it is sourced through offshore providers.

While your client could receive the same benefits if he chose to take part in the program in his personal capacity, doing so through an offshore trust created before he moves to the U.S. ensures that any exposure to estate and gift taxes is removed. Furthermore, if your client is only staying for a certain number of years, the annuity won't be subject to U.S. tax if the policy is surrendered subsequent to your client leaving the U.S..

If your client does have intentions to stay long term, then the use of a tax compliant universal life insurance policy in substitution can produce long ranging income and estate and gift tax benefits along the same lines. The policy will again be held by a trust to achieve tax free leveraging of trust assets, as well as long term cash value growth free of U.S. income tax and a death benefit that is generally tax free.

Succession Planning

There are other planning opportunities if your client is looking to establish a trust to provide for future generations. If the trust is established at a time when your client is U.S. resident, it could result in exposure to generation skipping transfer tax, which is a tax imposed by the IRS to prevent the transfer of assets between generations without tax being paid at each generation. By establishing a trust that exists in perpetuity, your client can transfer foreign assets that will not be subject to gift or estate tax.

Simplistic considerations such as equalization of the ownership of wealth between spouses should be looked at so that once your client becomes U.S. resident, each spouse has an equal opportunity to take advantage of domestic gifting exemptions. Realization of gains and disposing of troublesome assets should also be taken into account before becoming U.S. resident.

Final Thoughts

Any planning that is undertaken needs to not only concern itself with the implications from a U.S. perspective, but the ramifications in your client's home jurisdiction. The impact of any tax treaty that exists between the two jurisdictions should also be reviewed, in order to ensure your client doesn't suffer any undue exposure to double taxation.

Of course, there is no silver bullet. Each and every client will have their own set of circumstances and objectives that will necessitate different planning. But a common theme running for all clients will be the need to plan ahead. That reminds me, I must pick up some cereal for the kids on the way home!

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