Taxation of U.S. Citizens Investing and Doing Business Abroad

Audio Dial In:
(605) 772-3434, access code 591-586-432

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- Many topics will be covered quickly – Type your question on the Webinar panel for presentation to the panelists.
- This material is complex, so DO NOT act on any information presented here without obtaining appropriate professional consultation first.
- Copies of this presentation will be available on our web site after the conference.

U.S. Taxation Issues and Residence

- The U.S. Taxes U.S. citizens and residents.
- U.S. Citizens are subject to U.S. Tax law regardless of where they live.
- U.S. passport applications may be denied if tax returns have not been filed.
- U.S. citizens self employed abroad may be exempt from self employment (social security) tax in the U.S. if they live in a country with a Totalization Agreement.

Active and Passive Income

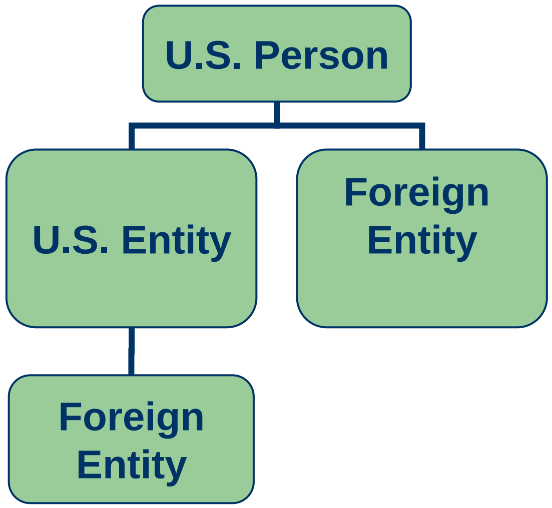
- Active income is the conduct of a trade or business venture. This may be done through a U.S. entity or through a foreign entity.
- Passive income includes net rentals, interest, dividend, capital gains and investment income.
- A foreign entity earning active income is normally only taxable in the foreign country.
- Passive income earned through a foreign entity controlled by U.S. persons is subject to subpart F of the Internal Revenue Code, and must be included in personal (1040) income of shareholders even if income is not distributed to you.
- Passive income earned abroad through a U.S. entity is dealt with according to U.S. rules (after foreign taxes are paid).

What is Subpart F –

- **Subpart F of the Internal Revenue Code requires US citizens & residents to include in personal income, the income of a "controlled foreign corporation".**
- **This means that all passive income (interest, dividends, net rental income) earned by a foreign corporation is included in your 1040 each year, REGARDLESS OF WHETHER THE AMOUNT HAS BEEN PAID OUT OF THE FOREIGN CORPORATION TO YOU.**
- **Form 5471 must be filed with your 1040 each year. ($10,000 fine per year if not.)**
- **Form 5471 discloses all details of income and expenses, assets and liabilities and other information regarding the foreign corporation.**
- **Direct and indirect (through a U.S. entity) investments are treated the same.**
- **Incorporating a foreign entity to provide personal services in the U.S. or in a third country triggers subpart F.**
- **The bottom line:** ***You cannot incorporate a foreign corporation to accumulate passive income without including that income on your 1040 each year.***

Direct and Indirect Investments

- U.S. person who owns a foreign entity directly – must file form 5471 and follow subpart F rules;
- U.S. entity and U.S. person both must file form 5471 due to indirect holdings of foreign entity.



US Tax Law and Foreign Entities

- U.S. rules, apply to U.S. citizens and residents who own foreign entities:
  - Accumulated earnings tax prevents accumulation of income abroad without being taxed in the U.S.
  - Like kind exchanges may not work in foreign countries.
  - Flow through rules may not work in foreign countries.
  - Watch for personal holding company tax in the U.S.

Using a U.S. Entity Abroad

- U.S. entity with a permanent establishment abroad may be subject to tax in foreign country.
- U.S. entity doing business abroad must file tax returns in the foreign county (as well as in the U.S.)
- U.S. entity normally needs to apply for permission to be recognized in a foreign country – (Important – Since you don't want to own property abroad through an entity the foreign country does not recognize.
- U.S. entity subject to audit by foreign authorities.

Incorporating a Foreign Entity

- Each country has it's own set of laws pertaining to corporations – and they are not always consistent with U.S. law.
  - ie: Local resident director requirements; control by local residents.
- Your U.S. entity can own a foreign entity.
- If "mind and management" of the foreign entity is in the U.S., then you may be able to pay a management or administration fee to the parent entity. This reduces the taxable income of the foreign entity.
- Management fees and other payments may be subject to non resident withholding tax – depending on our Treaty with that country.
- Management fees and other payments cannot be arbitrary, and must be justified – by amount of work or benefit provided to the foreign entity.
- Most Treaty countries have a preferred rate of withholding on dividends paid to a controlling parent corporation.
- Foreign entity files taxes locally and is subject to liability law locally.
- Losses incurred in a foreign entity likely cannot be used in the U.S.

Basis of Taxation – Review

United States

- The U.S. Taxes U.S. citizens and residents.
- U.S. Citizens are subject to U.S. Tax law regardless of where they live.
- U.S. persons who own foreign corporations are subject to subpart F of the Internal Revenue Code – and must file form 5471.
- U.S. Citizens who own foreign investments – U.S. Tax law applies to foreign corporations.

Other Countries

- Most countries base taxation on residence, not citizenship.
- Spending > 183 days in a country likely means you are a resident – and taxable there on world income.
- Important to define active vs. passive income earned abroad.
- A U.S. corporation can be considered a resident of a foreign country.

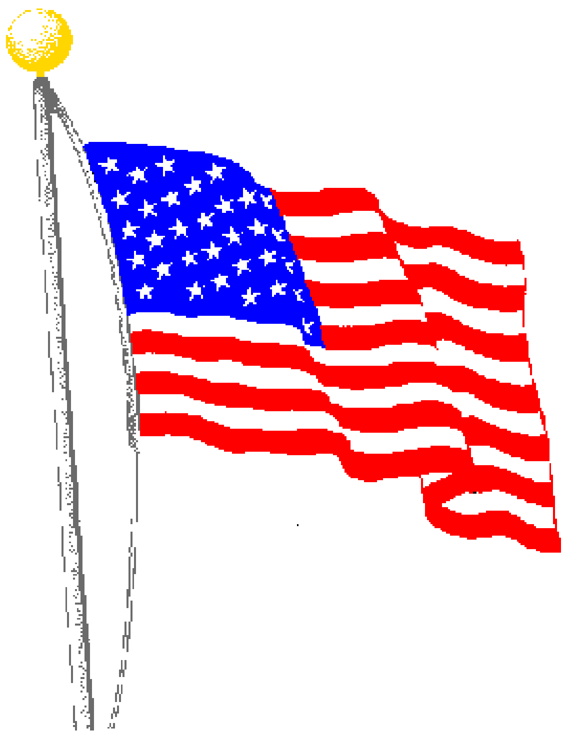
Factors Determining Residence

Factors Determining Tax Residential Status Abroad
(Can determine if you are taxable in foreign country):

- Permanence and purpose of being abroad.
- Residential ties to foreign country:
  - Location of dependents.
  - Banking arrangements.
  - Investments.
  - Drivers License.
  - Health Insurance.
  - Club Memberships.

- Residential ties abroad
  - Visa status in foreign country
  - Source of income
- Regularity and length of visits to foreign country;
- You must be resident somewhere
- Treaty – Tiebreaker provisions used.

Claiming Foreign Tax Credits



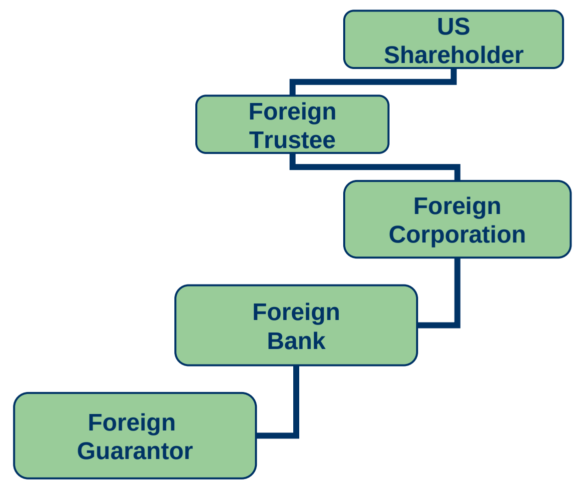
- Foreign taxes may either be deducted or claimed as a credit on form 1116;
- Credit is better – foreign tax deducted from U.S. tax liability.
- Tax credits are only available on the same class of income the tax was paid on;
- Credit may not be claimed on excluded income (Sec 911);
- Unused foreign tax may be carried forward for 6 years.

Treaties and Real Estate Sales

- Real property interests are considered separately from other capital gains.
- Real property dispositions are always taxable first in the country where the property is, and then in the U.S.
- Foreign tax credits apply to U.S. taxes if foreign capital gains tax was paid.
- Foreign capital gains rates and rules may not be the same as those in the U.S., so:
  - You may not get credit for all of the foreign tax paid (since it is higher than the U.S. capital gains rate;
  - You may have unused foreign taxes available for carryover.

Offshore Tax Shelters?

- Most “offshore tax shelter” plans involve earning passive income in a foreign entity
- The link between the U.S. shareholder and the foreign corporation is hidden through the use of a “trustee”.
- Most of these schemes are illegal since they require that you not disclose your real relationship with the investment.
- Proper disclosure gives rise to subpart F income.
- RISK: Loss of investment or serious tax penalties.
- DON’T DO IT



Foreign Earned Income Exclusion

- Can exclude up to $82,000 for 2007;
- Earned income only;
- Each spouse may claim a separate exclusion;
- Must establish Bona fide residence or meet physical presence test;

Bona Fide Residence & Physical Presence Test

Bona Fide Residence

- Must be in foreign country for at least one calendar year;
- Must have intent to live in foreign country;
- Temporary trips home will not affect qualification;
- Must be a tax resident and subject to tax in foreign country to qualify.

Physical Presence

- Must be present abroad for 330 out of 365 days;
- Same overlapping months may be used to qualify;
- For example.. Period 1 is May through March of next year, and period 2 is January through December of year 2.
- Proportional exemption claimed for part year away.

Summary: Eliminating Double Taxation

- Treaty Provisions override income tax laws.
  - Forms must be filed (8833) to disclose the Treaty provision being relied on – and to explain the tax rule overridden.
- Foreign Tax Credits are available to prevent double taxation on the same income;
- Foreign Earned Income Exclusion – only available if you live outside the U.S.;
- Do you claim FTC or Earned Income Exclusion –(Now EIE comes off the bottom of your income leaving higher taxed income intact)?
- Watch out for Alternative Minimum Tax.

Summary of Pitfalls: Investing Abroad

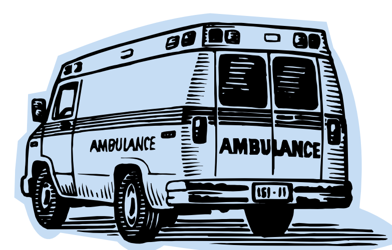
- Use of a foreign entity to earn passive income can result in subpart F income inclusion;
- Many countries have "deemed disposition" rules triggering capital gains earned while in country (when you depart) – regardless of whether you sell the asset.
- Don't expect that all investment rules and laws are the same as at home.
- Make sure you have the appropriate visa to operate in the foreign country – failure to so may result in a loss of your investment.
- Follow all local licensing rules.

Revoking U.S. Citizenship

- Not so fast.. IRC 877 taxes U.S. citizens for 10 years after citizenship revoked.
- IRC 877 only applies where expatriation is due to tax.
- If assets > $500K or tax liability >$100K then tax reason is assumed by IRS.
- Specially modified return listing all assets in year of expatriation.

Estate Taxation

- U.S. Estate taxation applies to expatriate estates and world assets.
- Fair market value of foreign entity is included in your gross estate.
- No foreign tax credit for foreign capital gains tax on death – but tax may be deducted from gross estate.



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Question Period

Question Period: Please type your question on the control panel to have it presented to all participants.

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