Commentary

July 2023

Tax considerations for US children born to non-US parents

In brief

For many non-US parents, it is a dream to have a US-born child. Just being born in the US may provide one with highly regarded opportunities. A US-born child not only can live, study and work in the US freely, but also can become a US president one day. However, is having a US-born child always a blessing to non-US parents?

This article appears in the second edition of the Private Wealth Newsletter 2023.

Contents

US citizenship

The US grants its citizenship on the basis of *jus soli*, i.e., birthright-based citizenship. This means that any person born within the territory of the US is a US citizen, regardless of the citizenship of their parents. The 14th Amendment, ratified in 1868, further enshrined this well-established principle. According to the amendment, "[a]ll persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside."

US citizens are entitled to enviable rights and benefits. Among them, the right to hold a US passport allowing visa-free travel to more than 180 countries in the world, access to the country's outstanding educational institutions at a lower cost, and the privilege of getting permanent residency (green card) for one's non-US parents, are regularly touted by the "birth tourism business" to many non-US expecting parents. As a result, a US birth certificate is often viewed as one of the best welcome gifts these parents can give to their child and themselves.

Birth tourism business

The "birth tourism business" has long operated in many states in the US, especially in California, New York and Florida. It isn't illegal to visit the US while pregnant. The operators who run the birth tourism business only sometimes attract the attention of law enforcement officials with one such operation resulting in federal agents raiding about three dozen sites used for the business in 2015 in California. Nineteen individuals were charged with visa fraud and conspiracy to commit immigration fraud.

Despite sporadic enforcement activities, the number of US children born to non-US parents has been on a steady rise. The Center for Immigration Studies estimated that 33,000 children are born to women on tourist visas each year.

It may be, then, that a non-US expecting mother comes to the country and stays for a few months to give birth and complete the child's birth certificate and passport paperwork. After that, the non-US child may be taken back to and grow up in the country where their non-US parents reside. When the child becomes an adult, they may return to the US or might never go back other than for short durations, if at all.

Potential tax liability

While the perceived benefits of a US passport may be substantial, some non-US parents may be unaware that their US children are liable for US tax filing and reporting obligations. As the only developed country that bases tax duty on citizenship rather than residency - the place where a person works or lives - the US taxes its citizens, including those with dual nationality, based on worldwide income, regardless of age.

Taxes can be levied on a US child if the child has both earned and unearned income totaling more than USD 12,400 in a year. In other words, the child must file taxes if their income exceeds the threshold. Being a taxpayer, the child may become subject to civil liability and criminal penalties for tax evasion and failure to file if taxes are not timely filed and paid.

Earned income

Like an adult, a child can work and earn money, be it mowing the lawn, babysitting or doing a summer internship. For US federal income tax purposes, the amount a child earns by performing services is included in the gross income of the child and not the gross income of the parent.

If John, a 16-year-old, earns less than USD 13,850, the threshold for 2023, from his part-time jobs, the income is exempt. Once he earns more than that amount in wages and has no unearned income, he must file a tax return.

Often, many non-US parents of US children are well off financially and socially in their home countries. Imagine that John, a US child born to a non-US couple who are celebrities in their own country, became a TV or movie star with substantial earned income owing to his parents' resources and connections. John would need to pay tax on the excess income over USD 12,950 unless he qualifies for foreign-earned income exclusion. In that case, John would only pay tax on the income above a much higher threshold, USD 120,000 for 2023.

Foreign earned income exclusion

To claim the exclusion, several criteria must be met. First, the foreign-earned income must be wages, salaries, professional fees or other amounts paid for the personal services rendered by the child. Second, employment in the foreign country is expected for an indefinite, rather than temporary, period. That is, if the child's abode remains in the US, where the child keeps closer familial, economic and personal ties, they will not qualify. Third, the child must be a bona fide resident of the foreign country for an uninterrupted period that includes an entire tax year or must be physically present in the foreign country for at least 330 full days during any period of 12 consecutive months.

In John's case, he is paid salaries or professional fees for his acting gigs in the non-US country where he lives with his parents. His parents' place is his only home. He has no intention of returning to the US in the foreseeable future. Besides being born in the US, John has no other ties with the US. Under the circumstances, John will likely qualify for the exclusion. That is, John will only be liable for tax on his income portion above USD 120,000 for 2023. If John makes less than that amount, no tax liability is triggered.

Kiddie tax

By contrast, a child's unearned income includes interest, dividends or capital gains. The kiddie tax was enacted to discourage wealthy parents from conveying assets to their children to take advantage of the children's lower rates. A child's unearned income is subject to the kiddie tax if the child falls within the scope of the tax regime. Earned income is not subject to the kiddie tax.

The kiddie tax applies to children who are either: (a) 17 years old or younger at the end of the tax year; (b) 18 years old at the end of the tax year only if their earned income is less than or equal to 50% of their "support;" or (c) 19 to 23 years old if their earned income is less than or equal to half of their "support" and they are a full-time student.

The imposition of the kiddie tax is as follows: in 2023, the first USD 1,250 worth of a child's unearned income is generally tax-free, covered by the kiddie tax's standard deduction; the next USD 1,250 is taxed at the child's marginal tax rate; anything above USD 2,500 is taxed at the parent's marginal tax rate.

Let us assume that John received USD 2,600 of taxable interest and dividend income during a year that he didn't work. He must file a tax return because he has unearned income only, and his gross income is more than USD 1,250. He must also complete and attach Form 8615, Tax for Certain Children Who Have Unearned Income, to his Form 1040 or 1040-NR.

Parent's election

When the kiddie tax applies to a child with US parents, the parents can elect to include the child's income in their tax return using Form 8814, Parent's Election to Report Child's Interest and Dividends, when certain requirements are met. The child will then be treated as having no income for the year and need not file a separate return.

Because John is only 16 (under 19 years old) and single, and his gross income of USD 2,600 is only from interest and dividends in the amount of less than USD 11,000, his parents may elect to include his income on their tax return instead of separately filing his return.

On the other hand, if John's parents are non-US persons, who do not live in the US or derive any income from the US, they will not incur any US tax liability or need to file a US tax return. In this case, the regulations do not provide whether or how the parents can use the election to include John's kiddie tax.

Foreign gifts

Gifts to US children born to non-US parents can sometimes cause complications. For instance, an account is set up in John's name to fund his college education. Each of his four non-US grandparents contributes USD 30,000 and deposits USD 120,000 in cash and stock into the account.

The gifts are foreign because the grandparents are non-US citizens. Generally, the receipt of foreign gifts is not subject to US federal income tax. However, the total of the unearned income, i.e., the interest income from the cash, dividends from the stock or capital gains from the stock sale, is potentially subject to the kiddie tax.

Aggregation rule

If a US person knows that the gifts received are from related parties, they must aggregate them. If these gifts exceed USD 100,000, the child must file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, to fulfill their reporting obligations.

Although each grandparent, a non-US individual, only gifts John USD 30,000, the related party rule applies here: the separate amounts must be aggregated. John is required to report the foreign gifts totaling USD 120,000 to the Internal Revenue Service (the "IRS") on Form 3520.

Penalty

If a US person fails to file Form 3520 for foreign gifts, the IRS may determine the income consequences of receiving the foreign gift or bequest. In addition, it may assess a penalty of 5% of the gift value for each month in which the gift is not reported, not to exceed 25% of the gift, unless the taxpayer has reasonable cause for the failure to file. Interest can be charged on any unpaid penalty. There is no criminal liability for non-compliance.

As stated above, John needs to report the gifts from his grandparents. Failing to do so, he can be subject to a penalty of up to USD 30,000.

The report of Foreign Bank and Financial Accounts (FBAR) (FinCEN Form 114)

Under the Bank Secrecy Act of 1970(BSA), a US citizen must file FinCEN Form 114 if they own, control or have signatory authority over the foreign bank and financial accounts with a combined value over USD 10,000 at any time during the calendar year. The report aims to prevent US citizens from hiding assets overseas and committing tax evasion or money laundering.

The FBAR goes to the Financial Crimes and Enforcement Network ofthe US Treasury Department (FinCEN), not the IRS. It must be filed separately from the tax return but has the same deadline as the return, with an automatic extension to 15 October of the tax year.

Although the FBAR is only an informational report, the non-filing penalty is steep: USD 10,000 for each failure to file the FBAR; if the failure were determined to be willful, the fine would be greater of USD 100,000 or 50% of account balances. Criminal penalties, up to 10 years' imprisonment, may also apply.

In our above scenario, if the cash in John's account is in foreign currency, the currency has to be converted to US dollars for the calculation of the amount. With the assets valued at or above USD 120,000 in a reportable foreign financial account, John would be obligated to file the FBAR each year.

Foreign Account Tax Compliance Act (FATCA)

Similar to the FBAR, FATCA aims to combat offshore tax evasion. A US-born child living outside the US must complete Form 8938, Statement of Specified Foreign Financial Assets, if the foreign assets they own exceed either USD 200,000 at the end of the year or USD 300,000 at any time during the year. Unlike the FBAR, this form must be attached to the taxpayer's annual IRS tax return by the income tax due date. An automatic extension to 15 October is also available to citizens living abroad.

The non-filing of Form 8938 may lead to severe penalties as well. Initially, there is a fine of up to USD 10,000 for failure to disclose, then another USD 10,000 every 30 days after receiving the notice from the IRS, up to the maximum fine of USD 50,000. Criminal penalties may also apply.

Where the grandparents gifted John USD 120,000, an amount less than USD 200,000, filing Form 8938 is optional in the absence of any other assets.

Trusts

Usually, a trust fund is a great tool to guarantee the financial stability of other family members, including children and grandchildren. It may provide safe and secure protection for vulnerable individuals who have disabilities, learning difficulties or financial issues that they cannot control. For US taxpayers, it also helps to ensure that assets are transferred in the most tax-efficient way.

Baker McKenzie.

Let's assume that John's non-US grandparents decide to establish a foreign trust (non-US) for the benefit of all their grandchildren (trust beneficiaries), including John and, for credit protection purposes, make this trust irrevocable.

Trust accounting

Regardless of how a trust itself is taxed under the US federal tax rules, once a US-born child directly or indirectly obtains a beneficial interest in the trust, the trust is required to keep its books and records in accordance with the US tax accounting rules and principles. The trust will calculate the taxable gains and losses according to US rules.

Moreover, all income and assets of the trust will have to be reported in US dollars. Any sale or exchange of assets in a currency other than the US dollar would result in currency exchange gains (or losses) that should also be taxable and reportable. The US tax accounting rules will apply not only to the trust but also to any entities owned by the trust.

In our example, this rule will result in an additional administrative cost to the trust, which would not have been the case if John was not a US person.

Accumulation distribution penalty

The accumulation distribution penalty is an anti-deferral regime applicable exclusively to US beneficiaries of foreign trusts, like the one discussed in our scenario above. To understand the penalty, two concepts need to be introduced.

First, distributable net income (DNI) is the trust's taxable income for US federal income tax purposes. For foreign trusts, DNI includes ordinary income, whether from US or non-US sources, and realized capital gains. Second, when DNI is not fully distributed in the year it is generated, the undistributed portion will turn into an undistributed net income (UNI) in the following year.

The penalty is imposed where UNI has accumulated for a long time. The US beneficiary is liable for the applicable tax plus interest charge when UNI distribution is made.

Use of trust property by US beneficiary

A US beneficiary may become subject to US federal income tax where the trustee permits them to use trust property without proper compensation.

Use of trust property includes both the use of the physical assets, such as dwellings and artwork, and loans of cash or marketable securities, either to US beneficiaries[1] or people related to those beneficiaries, unless the fair market value for such use is paid to the trust within a reasonable period. Otherwise, the US beneficiary is treated as receiving a trust distribution equal to the fair market value of the use of the property.[2]

Once a US beneficiary is treated as receiving a distribution from the trust because of gratuitous use of trust property, any later transactions between the trust and the US beneficiary (such as a cancellation of debt) will be disregarded for US federal income tax purposes[3]. The matter can get even more complicated when a foreign trust owns underlying entities that generate passive income. However, this topic is beyond the scope of this article.

Therefore, if the trust discussed earlier, of which John is a beneficiary, owns an apartment, which he uses while attending college without paying rent, the fair market value of the rent will be considered a distribution to John, subject to US tax, and, if certain conditions apply, subject to punitive taxation as described earlier.

Covered expatriate

A US citizen who does not intend to live in the US may consider renouncing their US citizenship if they have another nationality, i.e., expatriation. Unfortunately, renunciation is not always as easy, especially if one is classified as a "covered expatriate."

Covered expatriates are US citizens whose average tax liability during the past five years stood at USD 190,000 in 2023 ("tax liability test"); or whose net worth exceeds USD 2 million ("net worth test"); or who failed to certify tax compliance with the IRS during the five years preceding the expatriation ("certification test").

All property owned by a covered expatriate is treated as sold on the day before the expatriation date at its fair market value pursuant to the "mark-to-market" rules. Covered expatriates must pay tax at normal income tax rates on all unrealized gains from the deemed sale that exceed USD 821,000 (inflation-adjusted figure for 2023) on their worldwide assets ("exit tax").

A US citizen may expatriate without any tax liability if they are a non-covered expatriate, by not meeting any of the above tests, or if they expatriate before turning 18-and-a-half years old, or if they are a dual national from birth.[4] Interestingly, the law does not

[1] A person is treated as related to a US beneficiary if such person is the US beneficiary's: sibling, spouse, spouse of sibling, ancestor, spouse of ancestor, lineal descendant and spouse of lineal descendant, a corporation that is a member of the same controlled group or a fiduciary of the trust.

[2] There is no guidance on what constitutes "a reasonable period of time" to compensate a trust for use of its property, but most likely a written agreement between parties specifying how the property will be handled and on what terms may assist in providing the answer on whether a period of time was reasonable, if challenged.

[3] IRC § 643(i)(3).

[4] A US citizen who: 1) is a dual citizen since birth; 2) continues to retain the other citizenship; 3) is taxed as a resident of that other nation; and 4) has been a resident of the US for 10 or fewer years during the 15 years immediately before the expatriation.

specify a minimum age or mental capacity for renunciation. It appears that consuls apply common law principles to such cases. Children under 16 are presumed not to have the requisite maturity and knowing intent to relinquish citizenship; children under 18 are provided additional safeguards during the renunciation process, and the Department of State affords their cases very careful consideration to assess their voluntariness and informed intent.[5] Importantly, parents are prohibited from renouncing the US citizenship of their children.

If John, at 16 to 18, has decided to connect his future with the country he was raised in, he is confident that he would not want to relocate anywhere other than for college, and even then, with the intention to return home upon graduation, he should be aware of his US tax obligations as a US person and his options, including the possibility of renunciation of his US citizenship.

Conclusion

While the choice of nationality ultimately remains with the child, non-US parents need to understand the implications of having children holding a US passport. It's a question that begs the parents to answer: do the benefits (actual and perceived) of having US citizenship outweigh the significant US tax burden while the child builds a life elsewhere with no other ties to the US?

[5] https://travel.state.gov/content/travel/en/legal/travel-legal-considerations/us-citizenship/Renunciation-US-Nationality-Abroad.html, last accessed on 14 November 2022.

Contact Us

Ida Varshavsky
Associate
Ida.Varshavsky@bakermckenzie.com

Lily Kang
Associate
Lily.Kang@bakermckenzie.com