Overview (March 2018)

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Private Client & Offshore Services, USA

Introduction

US citizens and US residents are subject to income, gift and estate taxes. Non-US persons are subject to tax on certain US income and property transfers. Advisers to international families must be able to recognise when a family member has come in contact with the US tax net and plan accordingly. This will often mean seeking advice from competent US tax counsel. Even if no tax is due, running the gauntlet of US reporting obligations requires specialised knowledge. The Internal Revenue Service (IRS) is able to detect failures to report or pay tax because information on foreign accounts of US persons is gathered under the Foreign Account Tax Compliance Act (FATCA) from non-US financial institutions with US accountholders.

Gift tax

US citizens and US residents

US citizens, regardless of where they are resident, and non-citizens resident in the United States for transfer tax purposes are subject to federal gift tax on gifts valued in excess of an annual exclusion of $15,000 per donee (for tax year 2018, indexed annually for inflation). A taxpayer's annual exclusion amount can be doubled (to $30,000 for tax year 2018) by filing a gift tax return and electing to split the gift with the taxpayer's spouse, provided that both spouses are US citizens or residents. The gift tax is levied on gifts of real, tangible and intangible property, wherever located. However, gifts made by direct payments to a medical or educational service provider are exempt from gift tax. A charitable deduction is available for gifts to qualifying domestic or foreign charities. A marital deduction is available for gifts to a US citizen spouse.

Although a gift may be taxable, a tax payment may not necessarily be due. For gifts in excess of the annual exclusion amount, US citizens and residents are allowed a tax credit that shelters up to nearly $11.2 (the 'exclusion amount') of lifetime gifts from tax. Application of the exclusion amount to lifetime gifts then reduces the credit available to use against the estate tax at death. The Tax Cuts and Jobs Act, signed into law on December 22 2017, doubled the exemption amount to $10 million. The exemption amount is indexed for post-2011 inflation, bringing the exclusion amount to nearly $11.2 million for gifts made in 2018 and for the estates of decedents dying in 2018. This increased exclusion amount is set to expire on December 31 2025, after which date the exemption will revert to the $5 million exclusion amount provided under prior law. The gift and estate tax rates are unified, with a top tax rate of 40%. Additional gift tax may be imposed by state taxing authorities.

Non-resident aliens

Individuals who are not US citizens and are not resident in the United States for transfer tax purposes (non-resident aliens) are subject to US gift tax only on gifts of real property and tangible personal property located in the United States. Thus, gifts of intangible property by non-resident aliens are not subject to US gift tax, even if the intangibles are US property (eg, stock in a US company). Advisers to international families will want to seek competent US tax advice on the possible conversion of property from taxable property (eg, tangible US situs property) to tax-free property (eg, intangible stock) before making the gift.

US gift tax on taxable gifts made by non-resident aliens can be substantial due to the following limitations on credits, exclusions and deductions, as compared to gifts by a US citizen or resident:

- No credit against gift tax is available to a non-resident alien (unlike estate tax, where a credit shelters assets worth $60,000 from tax in the estate of a non-resident alien).
- A non-resident alien is entitled to the gift tax annual exclusion that allows tax-free gifts of $15,000 per year per donee (for tax year 2018, indexed annually for inflation), but the non-resident alien cannot double this amount using the election to split gifts with the donor's spouse, even with a US citizen spouse.
- The non-resident alien's charitable gifts of US property qualify for a gift tax deduction only if made to a domestic US charity.
- The US gift tax marital deduction is also likely to be limited for non-resident aliens as a practical matter:
    - Non-resident aliens are entitled to tax-free transfers under the US gift tax marital deduction, just as a US citizen, but no such deduction applies if the recipient spouse is not a US citizen, regardless of the transferor's status. Thus, gifts of US situs real property and tangibles to a US citizen spouse are not subject to gift tax; but if the spouse is not a US citizen, annual tax-free gifts are limited to an annual exclusion amount of $152,000 in 2018.
    - The nearly $11.2 million exclusion amount is not available to shelter gifts of US situs property by non-resident aliens from gift tax, so tax advice is needed for a non-resident alien making gifts of US situs homes and artwork.
    - Gifts free of trust will usually qualify for the increased annual exclusion amount for gifts to a non-citizen spouse. However, careful planning is needed for gifts in trust, since the spouse's interest must be both a deductible interest under marital deduction concepts and a gift of a present interest under the annual exclusion rules.

Return filing

The donor of a taxable gift must file a federal gift tax return (Form 709)**(1)** no earlier than January 1 of the year following that in which the reportable gift was made and no later than April 15. It is possible to extend the time to file the return, but this does not extend the time to pay any gift tax due. The recipient of the gift generally has no tax liability and no filing requirement, with the exception of a US recipient of a taxable gift from a non-US person. If the US recipient receives gifts of more than $100,000 from a non-resident alien individual or estate (or $16,111 from a foreign corporation in 2018, indexed annually for inflation), he or she must file Form 3520 to report the receipt of the gift, even though no gift tax is due.

Estate tax

US citizens and US residents

The worldwide estate of a US citizen or and any non-citizen resident in the United States for transfer tax purposes is subject to US estate tax. The Tax Cuts and Jobs Act, signed into law on December 22 2017, doubled the estate tax exemption amount to $10 million (indexed for post-2011 inflation, bringing the exemption amount to nearly $11.2 million for estates of decedents dying in 2018), to the extent not used to offset gift tax on lifetime transfers. This exclusion amount is set to expire on December 31 2025, after which date the exemption will revert to the $5 million exclusion amount provided under prior law. The maximum estate tax rate is 40%. A charitable deduction is available for bequests to qualifying domestic or foreign charities. A marital deduction is available for bequests to a US citizen spouse. Additional estate or inheritance tax may be imposed by state taxing authorities.

'Portability' is available for a deceased spouse's unused exemption amount to the estate of the surviving spouse. A portability election must be made at the death of the first spouse. The deceased spouse's unused exemption amount may then be applied with respect to the surviving spouse's gift and estate tax. However, reliance on portability in succession planning does not necessarily produce the most tax-advantageous result.

Non-resident aliens

For non-resident aliens, a significantly broader list of property is subject to US estate tax, as compared to gift tax. In general, the property is subject to US estate tax if it has a US situs. US real estate and tangible property physically located in the United States, and securities or obligations issued by US persons or entities, are US situs property and subject to tax unless specifically excluded by the Internal Revenue Code. Determining situs can be tricky. For example, cash in a US bank deposit account is excluded from being a US situs asset for estate tax purposes, but non-bank deposits, such as cash accounts with US brokerage firms, are considered US situs property.

Most importantly, however, US property includes stock in a US company, but not stock in a non-US company. Thus, the non-resident alien may be able to avoid the estate tax by investing in US property through an offshore holding company or mutual fund. The US estate tax rules generally do not look through these offshore companies, except in special circumstances. With careful planning, investments in US property by a non-resident alien can be made through offshore companies, often owned in turn by an offshore trust. Except in limited circumstances, the offshore company must have the characteristics of a corporation and the form must be respected by the shareholder. In addition, the company should acquire the US property, rather than having the shareholder (ie, the non-resident alien or the non-resident alien's trust) acquire the property and transfer it to the company.

The use of offshore companies and trusts requires careful planning. Otherwise, a non-resident alien decedent who funded the trust with US property and retained the right to amend the trust or receive trust income may be subject to US estate tax on the value of the trust assets. The fact that the US property is later converted to non-US property before the settlor's death (eg, by contribution to the non-US corporation or by sale and investment in non-US property) does not change the result under the literal language of the Internal Revenue Code.

If the US estate tax applies, the non-resident alien's transfers at death are more severely taxed than those of a US citizen or resident. The threshold level for tax-free transfers is low and deductions are limited as follows:

- The $10 million exclusion amount, indexed annually for post-2011 inflation (currently nearly $11.2 million for estates of decedents dying in 2018) is not available to the estate of a non-resident alien decedent. Instead, the credit available to a non-resident alien's estate shelters only $60,000 from estate tax. That exclusion amount is not indexed for inflation and has not changed in more than 10 years.
- The deduction for debts and expenses of the estate of a non-resident alien is limited. Only a portion of recourse debts and the expenses of a non-resident alien's estate are deductible, based on the value of the US property and the value of the decedent's entire worldwide estate. The estate of a non-resident alien must disclose the decedent's worldwide assets to the IRS in order to take the full deduction in calculating US estate tax on the decedent's US situs property.
- The estate tax charitable deduction is also limited. The non-resident alien's charitable bequests qualify for an estate tax deduction only if made to a domestic US charity.

- Transfers to or for a surviving spouse can be sheltered completely from US estate tax by the marital deduction, just as for a US citizen – except that if the surviving spouse is not a US citizen, property must pass to a qualified domestic trust in order to qualify for the deduction, even if the spouse is resident in the United States.

The scope of the estate tax is reduced significantly for non-resident aliens who qualify as residents of treaty countries that have a modern treaty with the United States (eg, the United Kingdom, France and Germany). These modern treaties still allow the United States to tax its citizens wherever resident. However, residents of treaty countries who are not citizens of the United States benefit from the treaty because estate and gift taxation on their transfers is limited, in general, to transfers of US real estate and to amounts associated with a 'permanent establishment' located in the United States – a term of art akin to a fixed place of business of the decedent (eg, proprietorship or interest in a business partnership).

Thus, these persons can transfer US equities free of the US estate tax. They may also be entitled to a *pro rata* share of the estate tax credit available to US persons, based on the ratio of US property to all property. However, treaty protection does not mean that the assets of a non-resident alien will actually pass free of tax, since the estate is likely to be subject to estate or inheritance tax by the home country.

Persons who remain in the United States for an extended period are unlikely to obtain any such treaty relief, even if there is a treaty between the United States and their home country. As a practical matter, these individuals are unlikely to qualify under the treaty as residents of their original home country and, instead, would likely be considered as residents of the United States.

Return filing

The federal estate tax return (Form 706 or Form 706NA) is due nine months after the date of death. It is possible to extend the time to file the return, including an automatic six-month extension, but this does not extend the time to pay any estate tax due. In addition to reporting trusts created by the decedent and trusts under which the decedent possessed any power, beneficial interest or trusteeship, the executor must disclose the decedent's transfer to a trust of any interest in a partnership, limited liability company or closely held corporation. Executors must file the estate tax return at the Cincinnati Service Centre, regardless of whether the decedent was a US citizen residing in the United States, a resident alien or a non-resident US citizen.

Qualified domestic trusts

Property passing from a US spouse to a qualified domestic trust for the benefit of a non-citizen spouse is entitled to an estate tax marital deduction on the death of the US spouse. A qualified domestic trust ensures that trust principal will eventually be subject to tax, either upon the distribution of principal from the trust during the surviving spouse's lifetime or at the surviving spouse's death, as if it had been included in the estate of the US spouse. A qualified domestic trust can be established by the US spouse, the surviving non-citizen spouse or the executor of the deceased US spouse's estate. Only property which passes from the deceased US spouse to a qualified domestic trust, or which passes to the surviving non-citizen spouse and is then irrevocably transferred or assigned to the qualified domestic trust in a timely manner, qualifies for the estate tax marital deduction.

A trust is a qualified domestic trust only if:

- the trust instrument provides that at least one trustee is a US citizen or a US corporation;
- the trust instrument provides that no distribution of corpus may be made unless the US trustee has the right to withhold from the distribution the amount of estate tax;
- the trust meets any other requirements that the secretary of the treasury may impose to ensure the collection of estate tax; and
- the executor of the deceased US spouse's estate elects to have the qualified domestic trust provisions apply to the trust.

A qualified domestic trust is not necessary if the surviving spouse becomes a US citizen before the filing date of the decedent's estate tax return, provided that the surviving spouse has been a US resident on all days between the decedent's death and the date of citizenship. Following the formation of the qualified domestic trust, if the surviving spouse later becomes a US citizen, the spouse can, with certain conditions, receive unrestricted distributions from the qualified domestic trust.

Generation-skipping transfer tax

US citizens and US residents

When a US citizen or a non-US citizen who is resident for transfer tax purposes makes a transfer to a person two or more generations below that of the transferor (a 'skip person'), whether such transfer is made during life or at death, a generation-skipping transfer tax is imposed in addition to any gift or estate tax that may be due. The generation-skipping transfer tax exemption amount is unified with that of the gift and estate tax exemption amount. Thus, an exemption of $10 million (indexed annually for post-2011 inflation, bringing the amount to nearly $11.2 million for 2018) is available to shelter gifts or bequests from generation-skipping transfer tax. The generation-skipping transfer tax is calculated at a flat rate equal to the top transfer tax rate of 40%.

Non-resident aliens

The reach of the generation-skipping transfer tax for transfers made by non-resident aliens matches the reach of the estate and gift tax on the underlying transfer. Thus, a transfer by a non-resident alien of non-US property is not subject to the generation-skipping transfer tax, since it is not subject to estate or gift tax; but the tax applies when a non-resident alien transfers US property (other than intangibles transferred by gift).

Most importantly, the time for testing whether the tax applies is the same time as under the estate or gift tax, even though the 'skip' transfer would often occur later. Specifically, the character of the property and the non-resident alien status of the transferor are tested only at the time of the initial transfer as determined for estate tax purposes (at death) or for gift tax purposes (when the gift is complete). Thus, the generation-skipping transfer tax generally does not apply to transfers by non-resident aliens of property situated outside of the United States as of the time of the initial transfer.

The non-resident alien transferor is entitled to the same nearly $11.2 million (for tax year 2018) exemption from generation-skipping transfer tax as a US citizen or resident. However, given the limited reach of the tax to transfers by non-resident aliens, this exemption is much less valuable than it is in domestic estate planning. For non-resident aliens, when the generation-skipping transfer tax exemption is needed, its application is fairly straightforward, but some special rules apply. When the transfer by the non-resident alien is fully subject to the tax, the same principles apply as for US transferors, so the non-resident alien will generally decide when to allocate his or her exemption. When the transfer by the non-resident alien is not subject to the generation-skipping transfer tax at all, the exemption is not and cannot be allocated. The limited scope of the tax as applied to non-resident aliens can be summarised as follows:

- Non-resident aliens need not consider the generation-skipping transfer tax implications of their transfers unless the transfer otherwise requires the filing of a US gift or estate tax return. For instance, a non-resident alien grandfather who has made a gift of non-US property or intangibles worth $1 million to a US grandchild need not file a US gift tax return and need not allocate any generation-skipping transfer tax exemption because the tax simply does not apply.
- A bequest of non-US property avoids the estate tax and therefore the generation-skipping transfer tax, so the exemption is not needed.
- If the transfer is mixed, so that it is only partially subject to the generation-skipping transfer tax, a special rule for non-resident aliens applies to calculate the inclusion ratio of the transfer so that the tax can be imposed. The effect of this rule, as in the domestic context, is to encourage the creation of a separate trust in the amount of the allocated exemption, easing administration and minimising taxes.

Return filing

Schedules to the federal estate and gift tax returns (Forms 706 and 709) are used to report generation-skipping transfers.

Income tax

US citizens and US residents

A US citizen, regardless of where resident, and any non-citizen resident in the United States for income tax purposes will be subject to US income tax on his or her worldwide income (for further details please see "US citizens living abroad still face US tax and reporting obligations"). The Tax Cuts and Jobs Act decreased the top ordinary income tax bracket to 37% beginning in 2018. This applies to taxpayers with a taxable income of $500,000 and higher for single filers and $600,000 and higher for married couples filing jointly. The top capital gain tax rate is 20% for single taxpayers with incomes above $425,800 and married couples filing jointly with incomes exceeding $479,000. Personal exemptions have been eliminated. The standard deduction for single filers increased to $12,000 and $24,000 for married couples filing jointly. Taxpayers can no longer deduct miscellaneous itemised expenses such as adviser fees and tax preparation fees. The home mortgage interest deduction was modified to limit the deduction for interest on acquisition indebtedness taken out after December 15 2017 to $750,000 ($375,000 for married taxpayers filing separately). Deductions for state and local sales, income and property taxes are now limited to $10,000 in total ($5,000 for married taxpayers filing separately). Foreign real property taxes are not deductible. The Medicare surtax of 3.8% on net investment income, which includes capital gains, will continue to apply to taxpayers whose modified adjusted gross income exceeds $200,000 (for single filers) and $250,000 (for married filing jointly). The capital gain tax rate also applies to qualified dividends; and for taxpayers with incomes below the relevant threshold amounts, 0% and 15% tax rates are available for qualified dividends.

Qualified dividend income includes dividends from domestic corporations and from foreign corporations incorporated in a US possession or eligible for the benefits of a US income tax treaty, provided that the treaty includes an exchange of information provision. Dividends from foreign corporations will also qualify for the 15% or 20% qualified dividend tax rate, but only if the corporation's dividend-paying stock is readily tradable on an established US securities market. The qualified dividend rate is not available for dividends paid by a foreign personal holding company, a foreign investment company or a passive foreign investment company. Payments in lieu of dividends (eg, substitute dividends paid on stock loaned from margin accounts) also do not qualify for the qualified dividend tax rate.

The Tax Cuts and Jobs Act did not eliminate the alternative minimum tax structure, but it did raise the exemption amounts to $70,300 for single filers and $109,400 for married couples filing jointly. The alternative minimum tax attempts to ensure that certain taxpayers claiming certain exclusions, tax deductions and tax credits pay a minimum amount of tax, and requires those taxpayers to recalculate their income tax under alternate rules that include income otherwise exempt from tax and disallow certain exemptions, deductions and other preference items.

Non-resident aliens

A non-resident alien is generally subject to US income tax only on US source income. However, special exemptions for certain types of US source income earned by non-resident aliens have been enacted to promote investment in the United States, to facilitate enforcement or to avoid enacting rules that cannot be enforced. The following two exemptions are the most important.

Portfolio interest exemption

Interest on US bank accounts and on certain portfolio debt instruments is exempt from US income tax when earned by a non-resident alien. In general, portfolio interest is interest on a debt obligation issued by a US taxpayer to a holder whose status as a non-resident alien has been substantiated in a certain specified manner provided by the tax rules. The effect is that the interest is not subject either to regular US income tax or to withholding tax.

Capital gains exemption and foreign investment in Real Property Tax Act

The second important exemption is that capital gains are generally exempt from US income tax. However, capital gains on real estate or stock in US real estate holding companies are taxed at a graduated rate, as a result of the Foreign Investment in Real Property Tax Act (commonly referred to as FIRPTA). This act simply treats a non-resident alien's gains from US real estate as 'effectively connected' with a US trade or business, which means that the gains are subject to the same tax regime as domestic taxpayers. This tax is backed by a special withholding tax regime.

Effectively connected income

'Effectively connected income' is income that is treated as attributable to the conduct of a trade or business in the United States. Broadly speaking, the concept is designed to distinguish between business income and investment income. Thus, effectively connected income is taxable at graduated rates on a net basis that allows related deductions to be used in determining the amount subject to tax, as with the income of a US citizen or resident. This result is considered by the tax law to be appropriate for income derived from assets that are used in an active US-based business or when such a business was a material factor in the production of the income – which essentially defines what is meant by 'effectively connected income'.

'Passive investment income' (ie, income that is not attributed to a US trade or business activity) is either exempt entirely from US tax under the special exceptions for capital gains and portfolio interest or otherwise taxed at flat rates (at 30% withholding on what is called 'fixed or determinable annual income').

Real estate assets often warrant a special election by the non-resident alien owner, because they may or may not be considered a trade or business for this purpose. Rent may thus be taxed as fixed or determinable income taxed at a flat 30% rate rather than as effectively connected income. Net taxation on effectively connected income will often result in lower tax, due to the benefit of deductions, as compared to the 30% withholding regime. This special election is the so-called 'net basis' election.

Withholding tax

Withholding tax refers to a 30% flat rate of tax collected at the source by the US payer of dividends, interest, rents, royalties and the like. The withholding tax is collected on a gross basis, without deductions, but generally reduced substantially by any applicable income tax treaty between the United States and the non-resident alien's home country. The US payer of this income is required to withhold the tax from each payment to the foreign taxpayer and then submit the withheld amount to the IRS. Since many other tax systems around the world have a similar concept, the issue of the rate is often addressed in treaties on a mutual basis. The regime for real property transactions subject to tax under the Foreign Investment in Real Property Tax Act is similar, but it applies different and varying withholding rates and rules depending on the type of payment.

Return filing

Federal income tax returns (Forms 1040 and 1040-NR) are generally due on April 15 for individuals. It is possible to extend the time to file the return, including an automatic six-month extension, but this does not extend the time to pay any income tax due.

Income tax residency and transfer tax domicile

Resident for income tax purposes

It is possible to become resident in the United States for income tax purposes without any deliberate decision to acquire that status. The following two tests are used to determine residence for US income tax purposes.

Green card test

A lawful permanent resident of the United States for immigration purposes (ie, a green card holder) is conclusively resident for income tax purposes.

Substantial presence test

US income tax residency will be acquired by an individual who regularly conducts business or otherwise maintains a physical presence in the United States, and who does not engage in very deliberate planning to avoid exceeding the limit on days spent in the United States, even if that person's permanent home is outside of the United States. The substantial presence test consists of two separate and alternative tests: the 183-day test and the three-year formula test.

Under the 183-day test, a person who is physically present in the United States for at least half of the year (ie, 183 days or more) in a given calendar year and who does not qualify for any special treatment as a student, teacher, diplomat or similar will be conclusively considered a US income tax resident, unless a treaty tie-breaker provision applies. Relief may be available to qualified residents of treaty countries. If a modern US tax treaty applies, the income tax residency of an individual who is considered resident by the domestic law of both countries can be resolved under a treaty tie-breaker rule that generally looks to the following factors in descending order:

- where the individual has a permanent home;
- the centre of vital interests;
- habitual abode; and
- citizenship.

A person who is a US income tax resident under the Internal Revenue Code but not under the treaty tie-breaker rule can claim non-resident status for all purposes of computing his or her US income tax liability, not just for treaty purposes.

It will still be difficult for the non-resident alien to avoid residency, even with fewer days of presence, once the limit under the three-year formula test is exceeded. The formula limit is exceeded if:

- the time spent in the United States is at least 31 days in the current calendar year; and
- the total days over the current year and the two prior calendar years exceed 183 days (after multiplying days in the immediately prior year by one-third and days in the next prior year by one-sixth).

If the formula limit is exceeded, the client will avoid US income tax residency only if he or she can qualify for a treaty tie-breaker or for the closer connection/tax home exception, which applies if the taxpayer maintained closer ties to another country for the year in question and files the required statement substantiating that claim.

Domiciled for transfer tax purposes

In the gift and estate tax context (sometimes referred to together as the 'transfer tax'), 'residence' means domicile, and a non-US citizen acquires a US domicile when physically present in the United States with the intention to reside there permanently. Once acquired, the person may move from the United States while continuing to be considered domiciled in the United States. In general, this means that the immigrant must also have become a lawful permanent resident of the United States for immigration purposes, but that is not necessarily determinative. US citizens are subject to US gift and estate tax regardless of where they reside.

Domicile, unlike income tax residency, is based on facts and circumstances in all cases. Most importantly, domicile is presumed to continue in the foreign jurisdiction until it is established in the United States. The location of business or employment activities does not necessarily determine domicile. Since domicile is less clearly related to current income-producing activities than the US income tax concept of residency, it may be easier to maintain a foreign domicile in a country to which the client currently has no prohibitively expensive tax-producing affiliation. A treaty may also provide relief from the application of the US transfer tax regime. Modern treaties (eg, those with the United Kingdom, France and Germany) provide a tie-breaker rule much like the income tax treaties, but also provide special protection (of varying degrees) for citizens of one country who were not present in the other country for a substantial period of time before the gift or death.

Anti-avoidance rules

US shareholders of foreign corporations

Several special US tax provisions address ownership in non-US corporations by US persons. Since the United States generally does not tax non-US corporations on foreign source income, these special tax rules are designed to prevent US persons from using non-US corporations to avoid tax by accumulating income offshore. The rules require that certain types of passive income of controlled foreign corporations and passive foreign investment companies be taxed to their existing US shareholders, whether or not distributions are made to them. The effect of these rules can be particularly disruptive if, for instance, a non-US trust in a tax-haven jurisdiction owns one or more such passive investment corporations and the trust has one or more US beneficiaries governed by these rules. Similarly, a non-resident alien shareholder's plan to immigrate to the United States triggers a need for US tax planning.

Temporary loss of residency

The US tax laws contain a special anti-avoidance rule that applies to certain non-US citizens who temporarily abandon their status as a US income tax resident alien. This provision applies to any alien individual who is resident in the United States for at least three consecutive years and thereafter ceases to be resident, but subsequently becomes a resident again before the close of the third calendar year after the close of the initial residency period.

This anti-avoidance rule can have a serious effect. An alien individual who falls within this provision will generally be subject to tax in the same manner as a resident alien on all US source income or gains derived during the intervening period of non-residence – including, for this purpose, all of the special source rules applicable to expatriated citizens and long-term residents. Thus, US income tax will apply to interest income on portfolio debt and any gains from the sale or exchange of property situated in the United States and securities of US issuers.

In computing gain, the IRS has allowed a special step-up provision to apply, so the original pre-residency appreciation can avoid tax. Additionally, gains on US property cannot be avoided by exchanging the property tax free for non-US property, and certain income in controlled foreign corporations will be attributed to the alien.

The principal purpose of this anti-avoidance provision is to prevent resident aliens from avoiding tax on non-recurring US source capital gains by temporarily abandoning resident status. Apart from this rule, US domiciliaries or income tax residents who are not US citizens or long-term residents can immediately shift from worldwide taxation to the limited taxation applicable to non-resident aliens. This rule is of particular importance for persons who have not invested in US real estate and who can leave the United States for a longer period of time and thus avoid the rule.

US citizens and green card holders living abroad

US citizens and green card holders are taxed on their worldwide income, regardless of where they live and work. A credit for foreign taxes paid may offset a portion of the US income tax or, alternatively, the taxpayer living abroad may be entitled to a foreign-earned income exclusion, which is adjusted annually for inflation. The amount eligible for exclusion in 2018 is $104,100. Income over this amount is taxed at the marginal tax rates applicable as if the exclusion did not exist, instead of applying the lower tax rates.

An individual who elects to use the foreign income exclusion may also exclude a portion of housing costs. The base excludable housing cost is 16% of the foreign earned income exclusion. Housing costs less than this base amount are not excludable. There is a cap on the excludable housing costs of 30% of the foreign earned income exclusion. The difference between these two amounts is generally the maximum excludable housing costs. The IRS can adjust the 30% cap on excludable housing costs on the basis of geographic differences in housing costs relative to costs in the United States. For example, for 2017 the cap in Hong Kong is set at $114,300 and the cap in London at $68,700.

Expatriation

Exit tax

US citizens and long-term residents who relinquished their citizenship or terminated their US residency on or after June 17 2008 may be subject to mark-to-market deemed sale rules, often referred to as an 'exit tax'. Previously, an expatriating individual who had complied with the required notice and tax filing requirements was thereafter subject to either the US income tax imposed on non-resident aliens or the 10-year alternative income tax imposed on expatriates who met specified income tax or net-worth criteria (for more details please see the "Overview (March 2008)").

Covered expatriates

The current exit tax rules are found in Section 877A of the Internal Revenue Code and are applicable only to covered expatriates. A 'covered expatriate' is an individual:

- whose average annual net income tax for the period of five taxable years ending before the date of the loss of US citizenship is greater than $165,000 (for tax year 2018, subject to an annual cost-of-living adjustment);
- whose net worth is $2 million (not indexed for inflation) or more, as of the date of the loss of US citizenship; or

- who fails to certify under penalty of perjury that he or she has met the requirements of the Internal Revenue Code for the five preceding taxable years, or fails to submit evidence of compliance as required by the IRS.

A covered expatriate is not:

- a dual national from birth where, following expatriation, the individual continues to be a citizen and tax resident of the other country, provided that he or she has not been resident in the United States (under the income tax substantial presence test, discussed above) for more than 10 of the last 15 years; or
- a person under 18-and-a-half years of age who has not been a US resident for more than 10 years under the income tax substantial presence test.

A covered expatriate may spend time in the United States without becoming taxable as a US person, unless he or she becomes a US tax resident under the substantial presence test.

Deemed sale rule

The exit tax rules treat most of a covered expatriate's worldwide property as if it had been sold for its fair market value on the day before expatriation. The covered expatriate will owe income tax on any resulting recognised gain in excess of a $600,000 exemption amount (adjusted annually for inflation and set at $713,000 for 2018), but only with respect to appreciation that occurred while he or she was a US citizen or a US lawful permanent resident. There are special rules with respect to eligible deferred compensation items (eg, most interests in pension or similar retirement plans, certain annuity plans and property to be received in connection with the performance of services) and specified tax deferred accounts (eg, individual retirement accounts and health savings accounts) (for further details please see "New tax law applicable to expatriates").

Grantor and non-grantor trusts

If a covered expatriate is treated as the owner of a trust (or a portion thereof) under the grantor trust rules, then the assets held by that trust (or portion of the trust) are subject to the deemed sale rule upon expatriation. The deemed sale rule does not generally apply to non-grantor trusts (see below for an explanation of when a trust is considered a grantor or non-grantor trust for US tax purposes).

In the case of a non-grantor trust, before making a direct or indirect distribution to a covered expatriate, the trustee must deduct and withhold an amount equal to 30% of such part of the distribution portion that would have been includable in the covered expatriate's gross income if he or she were still subject to US income tax. The covered expatriate is treated as having waived any right to a treaty reduction in the amount withheld. If the trustee distributes appreciated property to a covered expatriate, the trust is treated as having sold the property for its fair market value and must thus recognise any gain.

If a non-grantor trust converts to a grantor trust, the covered expatriate – who is considered the trust's owner – is treated as having received a distribution from the trust, which will trigger the 30% withholding tax. If a grantor trust converts to a non-grantor trust after the individual expatriates, such trust will continue to be treated as a grantor trust for purposes of the deemed sale rule. The impact of the deemed sale rule on the change of a trust's tax status is important because the expatriation of the trust's grantor can cause a grantor trust to become classified as non-grantor for US income tax purposes.

Election to extend time for payment

A covered expatriate may irrevocably elect to extend the time for payment of the tax resulting from the deemed sale on a property-by-property basis, provided that he or she is willing to provide the IRS with a bond or other form of security. The tax will thereafter be due when the applicable items of property are actually disposed of (or on the date of such covered expatriate's death, if earlier). The covered expatriate must also waive any right to claim treaty benefits with respect to such tax liability in order to qualify for the election. Interest on the deferred tax will be charged at the individual underpayment rate (currently 4%).

Tax on gifts and bequests from covered expatriates

In addition to the exit tax to be paid by the covered expatriate, Section 2801 of the Internal Revenue Code imposes a transfer tax on US persons who receive gifts or bequests from the covered expatriate.

Covered gifts and bequests

The tax applies to certain gifts and bequests in excess of the $15,000 annual exclusion amount (adjusted annually for inflation). Gifts and bequests to a US citizen spouse or US charity are not subject to the tax. Covered gifts and bequests do not include property on which the covered expatriate, or his or her estate, is otherwise subject to gift or estate tax and which is reported on a timely filed gift or estate tax return. Tax on covered gifts and bequests will be imposed at the highest gift or estate tax rate which is in effect at the time (40% for tax year 2018), less any foreign gift or estate tax paid.

Transferor who, at the time of the transfer, is a covered expatriate

A 'covered gift or bequest' is defined in Section 2801(e) as:

"*any property acquired by gift directly or indirectly from an individual who, at the time of such acquisition, is a covered expatriate, and any property acquired directly or indirectly by reason of the death of an individual who, immediately before such death, was a covered expatriate.*"

The reference to the individual being a covered expatriate "at the time of such acquisition" or "immediately before such death" seems to say that the income and net-worth tests are to be applied at the time of the transfer, regardless of whether the transferor was a covered expatriate at the time of expatriation. However, Section 2801(f) says that the term 'covered expatriate' is to have the meaning given to it by Section 877A(g)(1), which states that the term means an expatriate who meets the requirements of Section 877(a)(2). When one follows this trail, it leads back to the income and net-worth tests, which are to be determined as of the date of the loss of US citizenship.

Thus, when an individual relinquishes US citizenship and meets the income or net worth test so as to be considered a 'covered expatriate', thereafter any covered gift or bequest received by a US person from that covered expatriate will be subject to tax at the highest rate of transfer tax (currently 40%). Even wealth earned following expatriation is subject to the tax. For example, an individual may have left the US with a net worth of $2 million and paid the exit tax, but then lived for years outside the United States amassing wealth far in excess of that original $2 million. Such individual's US heirs will pay a flat 40% tax, reduced by any tax paid to a foreign country, on the entire fortune received.

Domestic and foreign trusts

The trustee of a domestic trust who receives a covered gift or bequest must pay the tax from the trust, unlike the trustee of a foreign trust, who does not. Instead, the US beneficiary of the foreign trust pays the tax when he or she receives a distribution attributable to such gift or bequest. A foreign trust may elect to be treated as a domestic trust for purposes of the gift and estate tax.

Taxation of trusts

The term 'grantor trust' is used to describe a trust in which the settlor is taxed for US income tax purposes as if he or she still owned the trust property. This result is true even though the settlement is valid and irrevocable under relevant trust law. The settlor of a grantor trust has retained certain rights, benefits or powers over the trust. A complex and technical set of statutory rules replete with exceptions, and exceptions to exceptions, governs the circumstances where the settlor will remain taxable on income from trust property.

Non-grantor trusts, on the other hand, rather than allocating income to the settlor, are treated as taxable entities that can pass through items of income and deductions to the beneficiaries (see below). Income not passed through to the beneficiaries is taxed to the trust itself.

US settlors

A US citizen or resident settlor who is treated as the owner of a trust under the grantor trust rules is generally subject to income tax on the trust's worldwide net annual income and capital gains. This is the case regardless of whether the grantor trust is foreign or domestic. The rights and powers that result in a US citizen or resident settlor being taxable on income from the trust include:

- any retained reversionary interest exceeding 5% of trust value;
- the power to control the beneficial enjoyment of trust property;
- the power to revoke the trust;
- certain administrative powers, including the power to borrow trust funds and vote stock of closely held companies; and
- any interest in trust income.

The retained powers giving rise to grantor trust status may relate to all or only a portion of the trust. Benefits and rights granted to spouses are treated as held by the settlor. Moreover, a settlor who is a US citizen or resident will be treated as the owner of trust property under the grantor trust rules with respect to any property transferred to a foreign trust which has or may have US beneficiaries, even if the settlor has no retained rights or powers. Even when such a trust is prohibited from making distributions to US persons, transfers of appreciated assets to the trust by a US citizen or resident will be subject to income tax on any unrecognised gain at the time of the transfer.

The grantor trust rules are similar to, but not the same as, rules that determine when a settlor has given up sufficient control for a transfer in trust to be considered complete for gift and estate tax purposes. Consequently, it is possible for a US citizen or resident to create a trust that is complete for estate and gift tax purposes, but nonetheless is taxable to the settlor for income tax purposes. This mismatch provides numerous tax-planning opportunities, as well as pitfalls.

Non-US settlors

A non-resident alien settlor of a grantor trust, on the other hand, is subject to US income tax only on the trust's income and gain from US sources. Again, this is the result regardless of whether the grantor trust is foreign or domestic. If the settlor is a non-resident alien, the trust is considered a grantor trust only if:

- a power to revest (eg, revoke) absolutely title to trust property in the settlor exists which is exercisable solely by the settlor without the consent of any other person, or with the consent of a related or subordinate party subservient to the settlor; or
- the only amounts distributable (whether income or corpus) during the lifetime of the settlor are distributable to the settlor or the spouse of the settlor.

If neither of these conditions is satisfied, a trust with a non-resident alien settlor is taxed as a non-grantor trust rather than a grantor trust.

Classification of trusts as foreign or domestic

Whether a trust is foreign or domestic affects the income tax liability of a non-grantor trust. A US domestic non-grantor trust, like a US citizen or resident individual, is generally subject to US federal income tax on worldwide income and gains derived from all sources. A foreign non-grantor trust, on the other hand, like a non-resident alien individual, is generally subject to tax only on income and gains derived from US sources. As discussed below, the status of a trust as foreign or domestic also dictates reporting obligations of US settlors and beneficiaries, regardless of whether the trust is a grantor trust or non-grantor trust for income tax purposes.

A specific two-part test is used to determine foreign trust status for US tax purposes – the 'court test' and the 'control test'. A trust that satisfies both tests is a domestic trust; a trust that fails one or both tests is a foreign trust.

Court test

A trust satisfies the court test if a US court can exercise primary supervision over the administration of the trust. A court can exercise primary supervision over a trust if that court has or would have the authority under applicable law to render orders or judgments resolving substantially all issues regarding the administration of the entire trust. The administration of a trust is the carrying out of duties imposed on a transfer by the terms of the trust instrument and applicable law, including maintaining books and records, filing tax returns, defending the trust from suits by creditors and determining the amount and timing of distributions. If both a US court and a foreign court can exercise primary jurisdiction over the administration of a trust, that trust will satisfy the court test.

Control test
A trust satisfies the control test if US persons control all substantial decisions of the trust. Substantial decisions include:

- whether and when to distribute income and corpus;
- the amount of any distributions;
- the selection of a beneficiary;
- the power to make investment decisions;
- whether a receipt is allocable to income or principal;
- whether to terminate the trust;
- whether to compromise, arbitrate or abandon claims of the trust;
- whether to sue on behalf of the trust or to defend suits against the trust; and
- whether to remove, add or replace a trustee.

'Control' means having the power, by vote or otherwise, to make all substantial decisions of the trust, with no other person having the power to veto substantial decisions. Accordingly, if a trust has two trustees that must agree on all trust decisions, one of which is a US person and the other foreign, the trust will be taxed as a foreign trust, regardless of its place of administration. Ministerial decisions that are not considered substantial include bookkeeping, the collection of rents and the execution of investment decisions.

A trust will automatically fail the court test if the trust instrument provides that an attempt by a US court to assert jurisdiction over the trust will cause the trust to migrate from the United States. A trust will also automatically fail the control test if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust no longer to be controlled by US persons.

A trust that fails either the court test or the control test will be treated as a foreign trust for US federal income tax purposes, although that status does not prevent the trust from having a US situs and being administered in the United States. Under these circumstances, however, care must be taken to ensure that the trust is not considered a local trust for state income tax purposes.

Distributable net income
Non-grantor trusts pass through items of income and deductions to the beneficiaries for US tax purposes by means of a distribution deduction and distributable net income (DNI) calculation. Income not passed through to the beneficiaries is taxed to the trust itself. The calculation of DNI is somewhat modified for a foreign non-grantor trust.

Distribution deduction
A unique aspect of trust taxation is the method by which double taxation of trust income and capital gains is avoided. Non-grantor trusts are taxed like individuals, but allowed a deduction from taxable income for distributions made to beneficiaries, and beneficiaries pay tax on income so distributed. If the trustee retains trust income, the trust pays tax on the income based upon rates that are independent of the beneficiaries. In this way, income earned by the non-grantor trust is taxable either to the trust or to the beneficiaries in proportion to any distributions received by them.

A foreign non-grantor trust is also subject to the distribution deduction method designed to avoid double taxation in domestic trusts. The trust will be regarded for income tax purposes as a conduit, to the extent that it distributes (or is deemed to distribute) amounts to the beneficiaries. The tax treatment will flow through to the beneficiary, and the beneficiary will be taxed in roughly the same manner as if the beneficiary had earned that distributed income directly.

Distributable net income
To accomplish the pass-through tax nature of a non-grantor trust, DNI is calculated to measure the amount of income that a trust can deduct because of distributions to beneficiaries and that is to be reported by such beneficiaries as income. It

also stipulates the character of the distributed income for purposes of the trust's distribution deduction and the beneficiary's income.

The calculation of DNI is a matter of specific and technical rules in the Internal Revenue Code. For most US domestic trusts, DNI will be equal to taxable income determined without the distribution deduction or the personal exemption, less net capital gains, plus tax-exempt income reduced by expenses (and any charitable deduction) allocated to such income.

Since the concept of DNI provides that distributed amounts will retain their tax character in the hands of the beneficiary, taxation to the beneficiary may be avoided where it would not have occurred in the absence of the trust. Thus, while a US citizen or resident beneficiary is subject to US tax on all items of distributed income, a non-resident alien beneficiary is subject to US tax only on items of distributed income and gain derived from US sources. The collection of such tax is accomplished through the US withholding regime.

In addition, non-resident alien beneficiaries of a domestic non-grantor trust benefit from deductions otherwise unavailable to non-resident alien individuals. This is because taxation of income distributions by a trust to its beneficiaries is limited by the trust's DNI, which in turn relates to taxable income. In effect, deductions are taken into account automatically and the beneficiaries are taxed on net rather than gross income.

Capital gains included in DNI of foreign non-grantor trust
In the case of a foreign non-grantor trust, DNI includes capital gains, as well as foreign-source income and income otherwise exempt by treaty. This does not lead to taxation of these income items to the foreign trust, but instead preserves the taxability of income items distributed to the beneficiaries.

The inclusion of capital gains in the calculation of a foreign trust's DNI results in the beneficiaries being liable for tax on distributed gains. This is in contrast to the case of a domestic trust, where the domestic trust is generally liable for such tax. Any capital gain accumulated in a foreign trust will lose its tax character as such and, to the extent distributed in a later year, be taxed to the beneficiaries as ordinary income.

Undistributed net income

When a trust does not distribute all of its available income to the beneficiaries, but instead accumulates ordinary income or realised capital gains, such accumulations are characterised as undistributed net income (UNI). The calculation of UNI no longer affects the taxation of domestic trusts which are themselves subject to US tax on recognised capital gains and undistributed income. UNI can have a big impact, however, on foreign non-grantor trusts, which generally escape US tax on undistributed income (with the exception of income from US sources).

Accumulation distributions
If UNI is present in a foreign non-grantor trust and the trust makes a distribution in a subsequent year which is greater than the greater of the current year's DNI or income (as defined by the Internal Revenue Code), such excess is considered an accumulation distribution and the beneficiary is subject to the throwback rules. These rules no longer apply to distributions from domestic trusts.

Under the throwback rules, an accumulation distribution is treated as a distribution of UNI from prior years of the trust and is included in the income of the beneficiary. The beneficiary's tax rate, the amount of the accumulation distribution and the tax years of the beneficiary to which the tax is applied are all determined by a complex formula set out in the Internal Revenue Code.

Interest charge
In addition to the tax on such an accumulation distribution, the beneficiary of a foreign non-grantor trust is subject to an interest charge. For UNI derived from tax years beginning after December 31 1995, the interest charge is computed in the same manner as interest applicable to underpayments of tax. For UNI derived from previous tax years, the interest charge is 6% simple interest.

Increased reporting obligations for US citizens and residents

Reporting foreign gifts, bequests and distributions from foreign trusts

US citizens and residents who receive a gift or bequest from a non-US person must report to the IRS, on Form 3520, the date of the gift or bequest, a description of the property and its fair market value. If more than a specified amount ($16,111 in 2017) is received from foreign corporations or partnerships and treated as gifts, the US recipient has a reporting obligation. For gifts from foreign individuals and estates, the reporting threshold is $100,000. A US recipient's receipt of a distribution from a revocable trust that is considered to be owned by a foreign person is treated as a gift to the US recipient and reported as such. However, if the trust is a foreign trust, the US recipient has an obligation to report the receipt of the distribution regardless of the amount received.

The US recipient of a distribution from a foreign trust must file Form 3520 with the IRS to report the distribution, regardless of the amount of the distribution received or its tax consequences to the recipient (there is no such reporting requirement for distributions from a US domestic trust). The use of property held in a foreign trust after March 18 2010, by a US grantor or US beneficiary (or any US person related to a US grantor or US beneficiary), will be treated as a distribution to the US grantor or US beneficiary of the fair market value of the use of the property. This deemed distribution rule will not apply to the extent that the foreign trust is paid the fair market value for the use of the property within a reasonable period of such use.

Form 3520 is generally due on the same date as the recipient's income tax return (for further details please see "New guidance and forms to report foreign accounts and use of trust property").

Reporting foreign bank accounts

US citizens and residents with financial interests in or signature authority over foreign bank accounts, securities accounts and other financial accounts must file a foreign bank account report (FBAR). Trusts with a US resident trustee (even if classified as foreign for US income tax purposes) and US limited liability companies (even if disregarded for income tax purposes) are also required to report foreign bank accounts. FBAR reporting is required if the aggregate value of such financial accounts exceeds $10,000 at any time during the prior calendar year, even if the accounts do not generate taxable income. Although there are many legitimate reasons to hold foreign financial accounts, the IRS stresses that account holders who do not comply with the reporting requirements may be subject to civil penalties, criminal penalties or both. Beginning with tax year 2016, the FBAR due date is April 15 and can be extended up to six months to October 15. Filing must be done electronically through an e-filing system at bsaefiling.fincen.treas.gov. As it is not an income tax return, the FBAR is filed on its own and not with income tax returns.

Reporting specified foreign financial accounts

Separate from the FBAR filing requirement, individuals must report interests in specified foreign financial assets when filing their federal income tax returns. Individual taxpayers must disclose annually on Form 8938 any interest in a "specified foreign financial asset" for any year in which the aggregate value of such assets is greater than specified reporting thresholds based on marital status and whether the individual is living in the United States or abroad. Form 8938 asks for detailed identifying information on each specified foreign financial asset being reported and its maximum value during the tax year. 'Any interest in a foreign entity' includes not only an interest in non-US companies, but also an ownership interest in a foreign trust as grantor under the US grantor trust rules and an interest in a foreign trust as a beneficiary (for a detailed discussion please see "IRS releases new form to report specified foreign financial assets").

Reporting by US owners of foreign corporations

US persons owning, directly or through a trust, more than 10% of a foreign corporation must file Form 5471 with their income tax return. US persons investing, directly or through a trust, in a passive foreign investment company (PFIC) must file Form 8621 upon the disposition of stock, receipt of a distribution or making of certain elections. There is an annual PFIC reporting requirement as well, also on Form 8621.

Reporting by foreign-owned LLCs

Beginning in 2018 a limited liability company (LLC) created under the laws of a US state that is wholly owned by a single non-US person will be required to report transactions with its non-US owner and related parties to the Internal Revenue

Service (IRS) on Form 5472. A single-member LLC is a disregarded entity for US tax purposes but, when foreign owned, is treated as a corporation solely for the purposes of the Form 5472 filing obligation (for further details please see "Completing and filing Form 5472 for foreign-owned US LLC").

FATCA

FATCA was enacted to obtain information from foreign financial institutions. It allows the IRS to check whether the US taxpayer has filed the various reports described above, thereby preventing tax avoidance by US citizens and entities that hold financial assets through offshore trusts and holding companies. The FATCA rules are dizzyingly complex and far reaching. Non-US trusts and holding companies will suffer a 30% withholding tax on certain US payments unless they provide details regarding their US beneficiaries and grantors, and one or more of the offshore entities in a family's structure may need to register with the IRS (for further details please see "Practical FATCA and CRS compliance for family trust structures").

In a nutshell, FATCA treats every non-US entity as either a foreign financial institution (FFI) or a non-financial foreign entity (NFFE). Generally speaking, trusts with a professional trust company as trustee or a professional investment manager are classified as FFIs. An FFI, unless it is otherwise deemed compliant, must register with the IRS and report its "US accounts". An NFFE, unless it registers to report directly to the IRS, must disclose its substantial US owners to US withholding agents. Even a trust settled by a non-US individual, with no US beneficiaries and no US investments, needs to know its FATCA classification so that it can provide the certificate necessary to prevent withholding or an account being marked as recalcitrant. Such a trust has no reporting obligation, but if it cannot provide a FATCA certificate – Form W-8BEN-E or W-8IMY - it cannot invest or transact business globally.

Intergovernmental agreements between the United States and offshore jurisdictions where international families often establish trusts include a deemed compliant status for trusts with professional trust companies as trustee. This status provides that the trustee will carry out the FATCA due diligence and reporting, if necessary, on behalf of the trust and the trust itself will not be registered with the IRS. As a "trustee-documented trust" the trust will be able to provide a W-8BEN-E or W-8IMY and avoid the adverse impacts of FATCA. The trustee will report to the IRS on distributions to US beneficiaries. International families with succession planning structures utilising trusts should check with their trustees and advisers to determine whether the structures are FATCA compliant, regardless of whether there are US beneficiaries or US investments (for further details please see "Time for non-US trustee companies and their trusts to prepare for FATCA").

The United States has not yet agreed to implement the Common Reporting Standard (CRS). Nevertheless, unless a trust structure is established in the US and holds only US accounts and entities, a US domestic trust investing outside the US and FATCA-compliant foreign trusts will need to comply with the CRS (for further details please see "Common Reporting Standard considerations for FATCA-compliant trusts").

For further information on this topic please contact Jennie Cherry or Gordon P Stone III at Kozusko Harris Duncan by telephone (+1 212 980 0010) or email (jcherry@kozlaw.com or gstoneiii@kozlaw.com). The Kozusko Harris Duncan website can be accessed at www.kozlaw.com.

Endnotes

(1) Tax forms are available from www.irs.gov.

Jennie Cherry Gordon P Stone III