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Recent Tax-Related Developments

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Reduction in Withholding Tax Rate
Customer Identification Programme
Dispositions of US Real Property Interests
Tax-Motivated Expatriation under the US-UK Income Tax Treaty

Several noteworthy tax-related developments have recently taken effect in the United States:

- US withholding tax rate has been reduced to 28%;

- New government rulings require taxpayer identification numbers in situations where this was not previously mandated; and

- The new US-UK income tax treaty addresses former citizens and long-term residents who expatriated for tax avoidance purposes.

Reduction in Withholding Tax Rate

As discussed in "Taxation of Offshore Trusts and Impact of New Lower Tax Rates", the Jobs and Growth Tax Relief Reconciliation Act 2003 accelerated tax cuts scheduled for 2006. To correspond with the resulting income tax rate reductions, the withholding tax rate has been reduced to 28%, retroactive to January 1 2003 but climbing to 31% in 2011 unless Congress takes further action. The withholding tax rate was previously 30%. An analysis of the possible benefits of the new 15% tax rate on qualified dividends distributed to US beneficiaries of foreign non-grantor trusts must

still consider the effect of tax withheld on payment of such dividends to the foreign trust (for further details please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates").

Customer Identification Programme

On May 9 2003 the Department of the Treasury issued final regulations implementing the USA PATRIOT Act(1) requirement that all US financial institutions adopt a customer identification programme. The regulations require such a programme to be fully implemented by October 1 2003. The mandatory account opening procedures apply only to new accounts.

The regulations prescribe different requirements for customers that are US persons and those that are non-US persons. US persons must provide a US taxpayer identification number such as a social security number or employer identification number. Non-US persons can use one or more of the following:

- US taxpayer identification number;
- passport number and country of issuance;
- alien identification card number; or
- number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

The regulations affect foreign trusts because 'US person' is defined as an individual who is a US citizen or an entity established or organized under the laws of a state of the United States. This means that a trust established under the laws of a state such as Delaware will be required to obtain a taxpayer identification number to open a bank account even though that trust is a foreign trust for US tax purposes (for a discussion of the foreign trust test please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates").

Dispositions of US Real Property Interests

Effective for dispositions after November 3 2003, new Internal Revenue Service (IRS) regulations require the use of taxpayer identification numbers so that the IRS can properly identify foreign taxpayers seeking to reduce or eliminate tax on dispositions of US real property interests.

Non-resident aliens are subject to US income tax on any gain from the sale of a US real property interest. When a foreign owner of a US real property interest disposes of such interest, payment of the tax is insured by requiring the transferee to withhold, and pay to the IRS, 10% of the proceeds. Any gain is taxed to the foreign owner as if it were effectively connected with a US trade or business (for further details of the Foreign Investment in Real Property Tax Act please see the Overview (March 2003)).

Under prior regulations, the foreign transferor was not required to have a taxpayer identification numbers unless such transferor:

- had effectively connected income at any time during the tax year;
- had a US office, place of business, or fiscal or paying agent during the tax year; or
- filed a tax return, amended return or refund claim, excluding information returns.

The new regulations require foreign transferors to include taxpayer identification numbers on all returns, statements or other documents for dispositions occurring after November 3 2003.

Applications for withholding certificates and other notices and elections will be considered incomplete and generally will not be processed by the IRS unless the transferor's taxpayer identification number is provided. Even if the withholding amount has been paid, a receipt for such tax paid to the IRS will not be stamped to show receipt and will not be mailed to the transferor if the appropriate taxpayer identification numbers are not provided.

Tax-Motivated Expatriation under the US-UK Income Tax Treaty

On March 31 2003 the United States and the United Kingdom ratified a new income tax treaty. The saving clause in the treaty, allowing the United States to tax its citizens even if they are residents of the United Kingdom for treaty purposes, now applies to former US citizens or long-term residents who expatriated for tax avoidance purposes. Such a former citizen or resident is treated as though he or she had remained a US citizen or resident for 10 years following a tax-motivated expatriation, thus permitting full application of the US Internal Revenue Code provisions relevant to tax-motivated expatriates (for a discussion of those provisions please see the Overview (March 2003)).

The gains clause of the treaty, which generally gives only the resident country the right to tax gains not specifically covered by another treaty provision, now contains an exception allowing either country to tax a former resident on gains realized within six years of losing residency. In addition to accommodating the US tax laws, the exception recognizes the UK domestic law whereby a former UK resident who re-establishes residence in the United Kingdom within five years will remain subject to tax in the United Kingdom on any gains realized during the period of non-residence.

Although the treaty allows both the United States and the United Kingdom to apply their domestic anti-abuse rules, the treaty's foreign tax credit rules ensure that the primary right to tax remains with the country of residence. Accordingly, if the gains are earned while the former UK resident was a resident of the United States, then such gains are considered to be gains from sources within the United States and the United Kingdom is to grant a foreign tax credit for US tax imposed upon those gains.

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Endnotes

(1) Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act

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