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Kozusko Harris Duncan | Private Client & Offshore Services - USA

DON KOZUSKO, JENNIE CHERRY

US citizens and non-citizens who are resident in the United States are subject to US gift and estate tax on their worldwide assets, and to US income tax on their worldwide income. The gift and estate taxes are sometimes referred to together as a transfer tax, since they apply to transfers during life or at death. In determining whether a non-US citizen is resident in the United States, the test for residence is very different for income tax purposes as compared to the transfer tax.

Individuals who are not residents or citizens of the United States ('non-resident aliens' (NRAs)) are generally not subject to the US transfer tax system. The estate tax does not apply to transfers of non-US property, such as stocks or bonds of non-US companies, owned by NRAs at death, even if those companies are offshore mutual funds and personal investment companies that invest in US securities. The gift tax does not apply to gifts of stocks and bonds, whether of US or non-US companies, and other intangible property made by NRAs. Moreover, modern treaties broadly protect residents of the treaty country from transfer tax on their US investments, generally by exempting even direct investments in US securities from tax.

As with the transfer tax, the reach of the US income tax system is limited for NRAs. Generally speaking, it reaches only US source income. Capital gains and so-called 'portfolio interest' are exempt, even if from US sources. Most commonly, the tax applies to dividends, rents, income from active businesses and compensation for services, with the result that many investment income sources available to NRAs are not subject to US tax.

Gift Tax

US citizens and US residents
Transfers of property - whether real property, tangibles or intangibles, and wherever located - by US citizens and US residents are subject to US gift tax. There is a small annual exclusion for gifts up to $11,000 per donee (for tax year 2004, indexed annually for inflation). The US donor may increase this annual exclusion to $22,000 (for tax year 2004) by filing a gift tax return and electing to split the gift with his or her spouse. A gift tax credit shelters $1 million worth of lifetime gifts from tax, but then reduces the credit available to use against the estate tax at death. 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.

NRAs
Transfers of intangibles by NRAs are not subject to US gift tax, even if the intangibles are US property (eg, stock in a US company). As a result, only real property and tangible personal property located in the United States are subject to the US gift tax when transferred by an NRA. 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) prior to making the gift.

The results can be severe if the US gift tax applies to an NRA, due to the following limitations on credits, exclusions and deductions, as compared to gifts by a US citizen or resident:

- There is no credit against gift tax available to an NRA (unlike the estate tax, where a credit shelters assets worth $60,000 from tax in the estate of an NRA);

- An NRA is entitled to the gift tax annual exclusion that allows tax-free gifts of $11,000 per year per donee (for tax year 2004, indexed annually for inflation), but the NRA cannot double this amount using the election to split gifts with the donor's spouse, even with a US citizen spouse;

- The NRA's charitable gifts of US property qualify for a gift tax deduction only if made to a domestic US charity; and

- The US gift tax marital deduction is also likely to be limited for NRAs as a practical matter. NRAs 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. A donor can make tax-free gifts to a non-citizen spouse of up to $114,000 per year (for tax year 2004, indexed for inflation). Gifts free of trust will usually qualify for this $114,000 exclusion. 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.

Thus, for an NRA, avoiding the US gift tax by avoiding gifts of US situs real property and tangible personal property is critical. Even if a treaty applies to the NRA, it is unlikely to change this outcome as most modern treaties generally allow the situs country to tax such transfers.

Estate Tax

US citizens and US residents

The worldwide estate of a US citizen or US resident is subject to US estate tax. An estate tax credit shelters up to $1.5 million from tax (for tax year 2004), to the extent not used to offset gift tax on lifetime transfers. 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.

NRAs

For NRAs, a significantly broader list of property is subject to US estate tax, as compared to gift tax. Generally, the property is subject to the 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.

Most importantly, however, US property includes stock in a US company but not stock in a non-US company. Thus, the NRA can avoid the estate tax by investing in US property through an offshore holding company or mutual fund. The US estate tax rules do not look through these offshore companies except in special circumstances. With careful planning, investments in US property by an NRA can be made through offshore companies, usually owned in turn by an offshore trust.

The offshore company must have the characteristics of a corporation and the form must be respected by the shareholder. Also, the company should acquire the US property, rather than having the shareholder (the NRA's trust) acquire the property and transfer it to the company. Otherwise, an NRA 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 prior to the settlor's death (by contribution to the non-US corporation) does not change the result under the literal language of the Internal Revenue Code.

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

- The NRA's estate tax credit shelters only the first $60,000 from tax at the lowest tax brackets, rather than the first $1.5 million to which estates of US citizens and residents are entitled for tax year 2004;

- The deduction for debts and expenses of the estate of an NRA is very limited. Only a proportion of recourse debts and the expenses of an NRA'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 an NRA must disclose the decedent's worldwide assets to the Internal Revenue Service (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 NRA's charitable bequests qualify for an estate tax deduction only if made to a domestic US charity; and

- 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 qualified domestic trust is much more restrictive than the typical offshore trust used by NRAs. As a result, the marital deduction will continue to be much less important in estate planning for the assets of NRAs than for US persons. The same qualified domestic trust rules apply to transfers by both NRAs and US persons if the spouse is not a US citizen, but the practical limitations of these rules seem much more burdensome to an NRA, since the offshore company is a more useful and flexible vehicle.

The scope of the estate tax is reduced significantly for NRAs who qualify as residents of treaty countries that have a modern treaty with the United States (eg, the United Kingdom, France and Germany, as compared to Japan and Switzerland). 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 US benefit from the treaty because estate and gift taxation on their transfers is limited, generally, 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 - for example a 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 an NRA will actually pass free of tax, since the estate is likely 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, rather than as residents of the United States.

Qualified domestic trusts

Property passing 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, by the surviving non-citizen spouse or by 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 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.

Generation-Skipping Transfer Tax

US citizens and US residents

When a US citizen or resident 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 (GST) tax is imposed in addition to any gift or estate tax that may be due. An exemption of $1.5 million (for tax year 2004, indexed for inflation) is available to shelter gifts or bequests from GST tax.

NRAs

The reach of the GST tax for transfers made by NRAs matches the reach of the estate and gift tax on the underlying transfer. Thus, a transfer by an NRA of non-US property is not subject to the GST tax, since it is not subject to estate or gift tax; but the tax applies when an NRA 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 NRA status of the transferor is 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 GST tax generally does not apply to transfers by NRAs of property situated outside the United States as of the time of the initial transfer.

The NRA transferor is entitled to the same $1.5 million (for tax year 2004) exemption from GST tax as is a US citizen or resident. However, given the limited reach of the tax to transfers by NRAs, this exemption is much less valuable than it is in domestic estate planning. For NRAs, when the GST tax exemption is needed, its application is fairly straightforward, but some special rules apply. When the transfer by the NRA is fully subject to the tax, the same principles apply as for US transferors, so the NRA will generally decide when to allocate his or her exemption. When the transfer by the NRA is not subject to the GST tax at all, then the exemption is not, and cannot, be allocated. The limited scope of the tax as applied to NRAs can be summarized as follows:

- NRAs need not consider the GST tax implications of their transfers unless the transfer otherwise requires the filing of a US gift or estate tax return. For example, an NRA 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 GST tax exemption because the tax simply does not apply;

- A bequest of non-US property avoids the estate tax, and therefore the GST tax, so the exemption is not needed; and

- If the transfer is mixed, so that it is only partially subject to the GST tax, then a special rule for NRAs 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 minimizing taxes.

Temporary Repeal of Estate and GST Tax in 2010

Under the Tax Relief Reconciliation Act 2001 amounts sheltered from estate tax are increasing and maximum tax rates are decreasing until 2010, when the estate tax and GST tax are scheduled for repeal. For a detailed chart please see "Transfer Tax Rates and Credits". The 2001 act does not repeal the gift tax. Instead, the maximum marginal gift tax rate is to be reduced for the year 2010 to the top income tax rate, currently 35%. The act includes transitional rules for qualified domestic trusts.

Under the 'sunset' provision of the 2001 act, all provisions of the act are repealed as of January 1 2011. Thus, on January 1 2011 the estate, gift and GST tax provisions are scheduled to revert to those in effect prior to the act - that is, a credit that will shelter $1 million from transfer and GST tax and a maximum tax rate of 55% (plus a 5% estate tax surcharge on certain large estates). The exemption from GST tax would be indexed for inflation.

Income Tax

US citizens and US residents

A US citizen 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.

NRAs

An NRA is generally subject to US income tax only on US source income. However, special exemptions for certain types of US source income earned by NRAs have been enacted, either 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 interest on certain portfolio debt instruments are exempt from US income tax when earned by an NRA. In general, portfolio interest is interest on a debt obligation issued by a US taxpayer to a holder whose status as an NRA 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 the withholding tax described below.

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. This act simply treats an NRA's gains from US real estate as 'effectively connected' with a US trade or business, which means the gains are subject to the same tax regime as domestic taxpayers. This tax is backed up 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, based on rules that are generally (but not always) intuitively logical. Broadly speaking, this 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'.

Effectively connected income is generally subject to the same graduated tax rates as apply to all the income of US citizens and residents: 25%, 28%, 33% and 35%, in effect from January 1 2003 until 2010. There is a 15% tax rate on most long-term capital gains. Qualified dividends earned since January 1 2003 are subject to a 15% tax rate, as least through 2008. 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 the treaty includes an exchange of information provision. Dividends from foreign corporations will also qualify for the 15% rate 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, such as substitute dividends paid on stock loaned from margin accounts, also do not qualify for the 15% rate.

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

Real estate assets often warrant a special election by the NRA 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 NRA'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. There is a roughly similar regime for real property transactions subject to tax under the Foreign Investment in Real Property Tax Act, but it applies different and varying withholding rates and rules depending on the type of payment.

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. Thus, the rules for becoming a US income tax resident are of special importance. 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 (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 the United States. This is the result of the 'substantial presence' test. 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 one-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 NRA 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 (i) the time spent in the United States is at least 31 days in the current calendar year, and (ii) 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, 'residence' means 'domicile', and a person acquires a US domicile when physically present in the United States with the intention to reside there permanently. Ordinarily this means that the immigrant must have also become a lawful permanent resident for immigration purposes, but not necessarily.

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. These rules require that certain types of passive income of controlled foreign corporations, foreign personal holding companies and passive foreign investment companies be taxed to their US shareholders currently, whether or not distributions are made to them. The impact of these rules can be particularly disruptive if, for example, 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, an NRA 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 (i) is resident in the United States for a period of at least three consecutive years, and (ii) 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 impact. 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 (i) property situated in the United States, and (ii) 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, as is true for US persons who surrender their US citizenship, 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 NRAs described above. 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.

Expatriation

Additional US tax exposure applies to an NRA for 10 years after a tax-motivated loss of citizenship or long-term residence. A long-term US tax resident is someone who terminates US income tax residency after holding a green card for at least eight of the last 15 years, ending with the year of expatriation.

An individual is presumed to have expatriated for tax avoidance purposes if either (i) the individual's average annual net federal income tax liability for the five taxable years preceding the date of expatriation is greater than $122,000, or (ii) the individual's net worth on the date of expatriation is $622,000 or more (indexed threshold amounts for tax year 2004). To overcome the presumption, the taxpayer can request, up to one year after the date of expatriation, a ruling by the IRS that expatriation did not have tax avoidance as a principal purpose, if that taxpayer:

- became at birth a citizen of the United States and a citizen of another country, and after expatriation continues to be a citizen of that other country;

- becomes, within a reasonable time after expatriation, a citizen of the country in which the individual was born, or in which the individual's spouse was born, or in which either of the individual's parents were born;

- was present in the US for 30 days or less in each year of the 10 years prior to expatriation; or

- renounces US citizenship before age 18.

To obtain a favourable ruling, the expatriate must show to the satisfaction of the IRS that tax avoidance was not a principal motive in expatriating. The IRS will not necessarily issue a ruling in each case and reserves the right to revisit the matter on audit. Taxpayers who have submitted a complete and good-faith ruling request may take the position that they are not subject to expatriation tax rules.

During the 10-year period following a tax-motivated expatriation:

- US source income is taxed in the United States at the normal US income tax rates if (as is normally the case) that usually produces a higher tax than the typical 30% flat tax imposed on US gross income earned by NRAs;

- the exemption from US capital gains tax for NRAs does not apply to a sale of US situs property or US-issued securities;

- a non-US corporation controlled directly or indirectly by a tax-motivated expatriate NRA will be treated as transparent at death, so that any US situs assets then owned by the company would trigger US estate tax as if owned directly by the NRA; and

- the gift tax will apply during the 10-year period following expatriation to all actual US situs property, with no special exclusion for intangibles.

US taxes generally cannot be avoided by a post-departure, tax-free conversion of assets producing US source income into assets producing non-US source income. However, the 10-year tax-motivated expatriation rule generally does not tax income and assets that do not have a US source or situs, or that were not derived from such assets through a tax-free restructuring (eg, contribution to a foreign holding company). The tax-motivated expatriate may also be able to avoid the US estate tax if, for example, he or she is willing to incur US income taxes to convert US property to non-US property prior to death.

For further information on this topic please contact Jennie Cherry at Kozusko Lahey Harris LLP by telephone (+1 212 980 0010) or by fax (+1 212 202 4484) or by email (jcherry@kozlaw.com).