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Lawmakers Unroll Further Tax Reforms

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US tax practitioners and advisers to international families worldwide are watching and waiting as federal lawmakers in Washington DC slowly unroll tax reforms. Most recently, on May 17 2006 President Bush signed into law the Tax Increase Prevention and Reconciliation Act 2005. The act does not contain changes to the estate tax law; nor does it introduce an exit tax on expatriates - two topics being hotly debated in Washington. Instead, it extends the reduced capital gains tax rate which benefits US beneficiaries of foreign trusts and modifies the housing expense calculation for US citizens living abroad.

Extended Capital Gains Tax Rate

The act extends the 15% tax rate for dividends and capital gains through 2010. Reduced from 20% for capital gains incurred on or after May 6 2003, the 15% rate was originally scheduled to last through 2008. It is generally available when a capital asset has been held for more than 12 months.

In the case of a foreign non-grantor trust, distributable net income includes capital gains, as well as foreign-source income and income otherwise exempt by treaty. The distributable net income calculation, together with the distribution deduction, is the means by which non-grantor trusts pass

through items of income and deductions to beneficiaries for US tax purposes. 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.

Therefore, US beneficiaries receiving distributions that include current year capital gains will benefit for two additional years from the reduced tax rate. Tax practitioners are well advised to consider the lower tax rate in timing distributions to US beneficiaries. Any capital gain accumulated in a foreign trust will lose its tax character as such and, to the extent distributed in a later year, will be taxed to the US beneficiaries as ordinary income (for further details please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates").

Higher Taxes for US Citizens Living Abroad

US citizens are taxable on their worldwide income regardless of where they live and work (for further details please see the Overview (March 2006)). However, qualified individuals living abroad can exclude a specified amount of certain foreign-earned income from their US income tax base ($82,400 for tax year 2006) and certain housing expenses in excess of a base housing amount. Under the act the base housing amount is now 16% of the taxpayer's foreign-earned income exclusion amount (rather than 16% of a specified government employee's annual salary amount) and the total housing expense exclusion is limited to 30% of the foreign-earned income exclusion amount. The US citizen's resulting taxable income is then subject under the act to US income tax starting in the tax rate bracket that would apply to such income if no amounts had been excluded. The result of these changes is higher taxes for citizens working abroad, effective this year.

Reduction of Estate Tax

Because of what was not included in the act, lawmakers are expected to consider a second major tax bill this year. The bill may include charitable reforms and incentives, and some extensions of expiring provisions that did make it into the act, although it is still unlikely to include estate tax repeal.

Instead, lawmakers will likely consider a bill to reduce the federal estate tax. The Senate is expected to vote this week on a previously introduced estate tax repeal bill. According to Senate Republican Chairman Jon Kyl, support for full repeal is weakening and a compromise reduction is the most likely outcome this year. Kyl and other Republican lawmakers have argued for an increased estate tax exemption amount so that only estates in excess of $5 million would be subject to the estate tax ($10 million for a couple) at a decreased rate of 15%. Democrats would likely favour a lower exemption amount in the $3 million to $5 million range and a top tax rate of between 30% and 45%. (For a detailed discussion of the current estate tax law and scheduled repeal for tax year 2010 only, please see the Overview (March 2006).)

Exit Tax on Expatriates

Senate Bill S2020, approved on November 18 2005, would impose an exit tax (or mark-to-market tax) on US citizens who renounce citizenship and long-term US residents who relinquish their green cards. The bill proposes to tax certain expatriates on the net unrealized gain in their assets to the extent they exceed $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom expatriate), as if those assets were sold the day before expatriation for fair market value. There has been no movement on the bill since its approval, so family advisers must continue to watch and wait.

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