

March 8 2007

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Changes to Credits, Exemptions, Exclusions, Rates and Filing Thresholds

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The US tax system is ever-changing. Each new year brings adjustments to the credits, exemptions, exclusions, rates and filing thresholds used to calculate the four taxes that affect US and non-US individuals alike: income tax, gift tax, estate tax and generation-skipping transfer (GST) tax. Some adjustments are driven by inflation or cost of living, while others are scheduled by statute. Practitioners must be aware that, as of January 1 2007, many of the tax credits, exemptions, exclusions, rates and filing thresholds with which they worked in 2006 have changed.

Estate Tax

Estates of US citizens, regardless of domicile, and estates of non-citizens domiciled in the United States at death are subject to estate tax on the value of the decedent's worldwide assets. The maximum estate tax rate for decedents dying in 2007 is 45%, down from 46% in 2006. The estate tax credit shelter remains unchanged at \$2 million.

Estates of non-resident aliens are subject to US estate tax on real property and tangible personal property located in the United States. In tax year 2007 the estate tax credit available to the estates of non-resident aliens continues to shelter only \$60,000 of US situs assets from estate tax.

The estate tax return (Form 706 or Form 706NA)⁽¹⁾ is due nine months after the date of death. The return has been revised as of October 2006. 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 also 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 (for further details please see the Overview (March 2006)).

Gift Tax

US citizens and non-citizens domiciled in the United States are subject to gift tax on lifetime gifts of property, regardless of where the property is located. Direct payments of medical and educational expenses are exempt from gift tax. The value of annual gifts per donee excluded from gift tax for 2007 is unchanged at \$12,000. The excluded value of annual gifts to a non-US citizen spouse has increased from \$120,000 in 2006 to \$125,000.

The gift tax credit for 2007 continues to shelter \$1 million of lifetime gifts from tax. Use of the gift tax credit during life reduces the credit available for use against estate tax at death.

Gifts of intangibles by non-resident aliens are not subject to 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 gift tax when transferred by a non-resident alien. The 2007 annual gift tax exclusion amounts are the same for gifts by non-resident aliens.

The gift tax return (Form 709) is an annual return filed not earlier than January 1 of the year following that in which reportable gifts were made and not later than April 15 (for further details please see the Overview (March 2006)).

Reporting Foreign Gifts and Bequests

US citizens and residents who receive a gift or bequest from a non-US person are required to report the date of the gift or bequest, a description of the property and its fair market value to the Internal Revenue Service (IRS). If more than \$13,258 is received from foreign corporations or partnerships and treated as gifts, the US recipient has a reporting obligation - the 2006 threshold was \$12,760. For gifts from foreign individuals and estates, the reporting threshold remains at \$100,000.

The return to report receipt of foreign gifts (Form 3520) is generally due on the same date as the individual's income tax return or the estate's estate tax return (for further details please see "Reporting Deadlines Draw Near").

GST Tax

When a US citizen or resident makes a transfer - whether by gift or bequest - to a person two or more generations below that of the transferor (a 'skip person'), GST tax is imposed in addition to any gift or estate tax that may be due. A transfer of non-US property by a non-resident alien is not subject to GST 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).

A GST tax exemption of \$2 million remains available to both US and non-US taxpayers to shelter gifts or bequests. GST tax is calculated at a flat rate of 45% for transfers made in 2007, down from 46% in 2006.

Schedules to the estate and gift tax returns (Forms 706 and 709) are used to report GSTs (for further details please see the Overview (March 2006)).

Scheduled Repeal of Estate and GST Tax

Under the Tax Relief Reconciliation Act 2001, amounts sheltered from estate tax are increasing and maximum tax rates are decreasing until 2010, when estate tax and GST tax are scheduled for repeal. In 2010 inherited property will be received with a 'carry-over basis' and will be subject to income tax on capital gain when later sold. Gift tax is not scheduled for repeal; instead, the maximum marginal gift tax rate is to be reduced for the year 2010 to the top income tax rate - 35% at present.

On January 1 2011 the estate, gift and GST tax provisions are scheduled to revert to those in effect before the 2001 act - that is, a credit that will shelter \$1 million from estate, gift and GST tax and a maximum tax rate of 55% (plus a 5% estate tax surcharge on certain large estates).

It is still thought likely that changes will be made to these tax laws before the 2010 repeal, although with the Democratic Party holding a majority of seats in the House of Representatives and the Senate, a full repeal of estate tax is unlikely to be proposed in 2007. It is more likely that bills will be introduced proposing an exemption amount between \$3 million and \$5 million and a top tax rate of between 30% and 45% (for further details please see "Transfer Tax Rates and Credits").

Income Tax

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. The top income tax rate for 2007 remains at 35% on income over \$349,700, up from \$336,550 in 2006. The US income tax system includes an alternative minimum tax structure that is likely to affect more US citizens in 2007 than ever before, making it a priority tax policy issue. The alternative minimum tax requires taxpayers to recalculate their income tax under alternate rules that include income otherwise exempt from tax and to disallow certain exemptions, deductions and other preference items.

US domestic trusts and estates also pay income tax, generally on undistributed income. The top income tax rate for estates and trusts remains at 35%, but that rate is applicable to income over \$10,450, up from \$10,050 in 2006.

The tax rate for qualifying dividends and long-term capital gains remains at 15%. 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.

A non-resident alien is generally subject to income tax only on US source income, although exemptions apply to certain types of income. The tax is withheld at source by the US payer of dividends, interest, rents, royalties and similar income. The withholding tax rate continues to be a flat 30% for 2007, but may be reduced by treaty agreement.

Income tax returns (Forms 1040, 1040-NR and 1041) are generally due on April 15 for individuals and calendar-year estates and trusts (for further details please see the Overview (March 2006)).

Reporting Foreign Bank Accounts

On February 27 2007 the IRS released Fact Sheet FS-2007-15 to remind taxpayers that the Bank Secrecy Act requires US citizens and residents who own a foreign bank account, brokerage account, mutual fund, unit trust or other financial account to file Form TD F 90-22.1, Report of Foreign Bank and Financial Authority (FBAR). FBAR reporting is required if the aggregate value of such financial accounts exceeds \$10,000 at any time during the calendar year, even if the accounts do not generate taxable income.

Although it acknowledges that 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. The FBAR must be filed on or before June 30 and requests for a filing extension will not be granted. As it is not an income tax return, the FBAR is filed on its own and not with income tax returns (for further details please see "Reporting Deadlines Draw Near").

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, but may be entitled to a foreign-earned income exclusion, which is adjusted annually for inflation. The amount eligible for exclusion in 2006 is \$82,400. The 2007 exclusion amount has not yet been released (for further details please see "Lawmakers Unroll Further Tax Reforms").

Expatriates

US citizens who relinquish citizenship and long-term residents who relinquish their green cards are subject to alternative income tax rules for 10 years following expatriation, unless the individual can certify that all federal tax obligations have been complied with for the preceding five years and that: (i) his or her average annual net income tax for the preceding five years does not exceed \$124,000 (increased by a cost-of-living adjustment for calendar years after 2004); and (ii) his or her net

worth does not exceed \$2 million. The adjusted average annual net income tax amount for 2006 is \$131,000. The 2007 amount has not yet been released.

Every individual who has expatriated or terminated US residency status must file Form 8854, Initial and Annual Expatriation Information Statement. The form must also be filed in order to comply with annual information reporting requirements if the expatriate is subject to tax under the 10-year alternative income tax rules. A \$10,000 penalty may be imposed for failure to file the form when required. According to its website, the IRS is sending notices to expatriates that have not complied with the Form 8854 requirements, including the imposition of a \$10,000 penalty where appropriate (for further details please see "Details of New Tax Laws Applicable to Expatriates").

Although expatriates are subject to the 10-year alternative income tax rules mentioned above, the idea of an exit tax is still being discussed by lawmakers. Most recently, Senate Bill S346, introduced on January 22 2007 and referred to as the Small Business and Work Opportunity Act 2007, proposed amendments to the Internal Revenue Code that would:

- tax covered expatriates on net unrealized gains as if they had sold their property for its fair market value on the date of expatriation, reduced by a \$600,000 exclusion, with the option to post adequate security and defer payment until the property is sold or to elect to continue being taxed as a US citizen;
- tax gifts and inheritances of property received from a covered expatriate as ordinary income;
- set forth rules for the tax treatment of an expatriate's retirement plans and interests in trusts; and
- amend the Immigration and Nationality Act to deny re-entry to expatriates who fail to comply with their tax obligations.

This bill has been referred to the Senate Finance Committee. It is in the first stage of the legislative process and will likely be modified.

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Endnotes

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

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