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JENNIE CHERRY

Tax Law Changes under the American Jobs Creation Act 2004

Kozusko Harris Duncan | Private Client & Offshore Services - USA

President Bush signed the American Jobs Creation Act 2004 on October 22. Although primarily aimed at the taxation of corporations and businesses, several provisions of the act are relevant to tax professionals advising former US citizens and former long-term US residents, trustees of offshore trusts with US beneficiaries, US persons making foreign investments and non-US persons making US investments.

Expatriation Tax Rules

As discussed in the Overview (September 2004), a non-resident alien has a continuing US tax exposure for 10 years after a tax-motivated loss of citizenship or long-term residence. A tax avoidance motive was presumed if the individual met specified income or net worth thresholds. To overcome the presumption, certain taxpayers could request a ruling by the Internal Revenue Service (IRS) that expatriation did not have tax avoidance as a principal purpose.

The act replaces the subjective determination of tax motivation with objective rules. The expatriate can no longer avoid the 10-year tax regime by means of a ruling request. All former citizens and former long-term residents are now subject to the 10-year tax regime following loss of citizenship or residency termination, unless the following can be established or certified:

- Average annual net income tax for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004);

- Net worth does not exceed $2 million;

- All federal tax obligations for the preceding five years have been complied with; and

- Proper notice of expatriation has been given.

Limited exclusions apply for dual citizens and minors, provided that they have no substantial connections with the United States (again measured with objective rules) and are in compliance with any federal tax obligations. Generally, the 10-year tax regime will not apply in any year in which the expatriate is physically present in the United States, at any time during the day, for more than 30 days. Instead, such individual will be subject to US income, estate and gift tax as if he or she were a US citizen or resident for that taxable year.

The act expands the gift tax to apply to an expatriate's gift of stock of certain foreign corporations. It also requires the expatriate to file an annual return for each year in which the expatriate is subject to the 10-year tax regime, regardless of whether federal income tax is due. Failure to file is subject to a penalty of $10,000 unless due to reasonable cause and not to wilful neglect.

The act's changes to the taxation of expatriates are effective for individuals who relinquish citizenship or terminate long-term residency after June 3 2004.

Foreign Personal Holding Company and Foreign Investment Company Rules

Offshore trusts with US beneficiaries are often subject to various US anti-deferral tax rules. These rules impose tax on certain income earned by US persons through controlled foreign corporations, passive foreign investment companies, foreign personal holding companies and foreign investment companies. Stock of such foreign corporations owned by a foreign non-grantor trust (for details of the grantor trust rules please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates") is considered as owned proportionately by its beneficiaries. Overlap among the anti-deferral rules made compliance difficult. The act:

- repeals the rules applicable to foreign personal holding companies and foreign investment companies;

- makes the personal holding company rules inapplicable to foreign corporations; and

- adds to a foreign corporation's so-called subpart F income personal services contract income that was subject to the now repealed foreign personal holding company rules.

These changes are effective for taxable years of foreign corporations beginning after December 31 2004, and for taxable years of US shareholders with or within which such taxable years of foreign corporations end.

Although repeal of the foreign personal holding company rules and foreign investment company rules may be welcome, the other anti-deferral regimes remain. In particular, the passive foreign investment company rules and the subpart F rules applicable to controlled foreign corporations might still apply to offshore trusts and their US beneficiaries.

Failure to Report Interests in Foreign Financial Accounts

A US person who has a financial interest in, or signature or other authority over, any financial accounts in a foreign country, if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year, must report those accounts each year by filing Form TD F 90-22.1 with the Department of the Treasury on or before June 30 of the succeeding year (for further details please see "Reporting Deadlines Draw Near").

The act adds to existing penalties for failure to file TD F 90-22.1 a civil penalty of up to $10,000 that can be imposed without regard to wilfulness. The penalty will not apply if income from the account has been properly reported on the US person's income tax return and there was reasonable cause for the failure to report. In the case of a wilful violation, however, the new penalty increases to the greater of $100,000 or 50% of the account balance.

This civil penalty is effective for violations occurring after October 22 2004.

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. A non-resident alien earning US 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. For further details please see the Overview (September 2004).

The act expands foreign-source income of a non-resident alien that is treated as US effectively connected income to include economic equivalents of certain foreign-source rents and royalties, dividends and interest, and income on sales or exchanges of goods in the ordinary course of business. These economic equivalents will now be treated as US effectively connected income in the same manner as the foreign-source income itself. For example, foreign-source dividend and interest equivalents will be treated as US effectively connected income if they are attributable to the US office of: (i) a foreign person in the active conduct of a banking, financing or similar business within the United States; or (ii) a foreign corporation whose principal business is trading in stocks or securities for its own account.

The inclusion of economic equivalents is effective for taxable years beginning after October 22 2004.

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

Alternatively, contact Stephen Vetter at Kozusko Harris Vetter Wareh LLP's Washington, DC office by telephone (+1 202 457 7200) or by fax (+1 202 457 7201) or by email (svetter@kozlaw.com).