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Latest transfer tax and FATCA developments

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February 14 2013

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Introduction

The United States has three transfer taxes – gift, estate and generation-skipping – which were set to revert to lower exemption amounts and higher rates as of January 1 2013. Congress waited until the last possible day to address the expiring transfer tax laws when it passed the American Taxpayer Relief Act 2012, which was signed into law by the president on January 2 2013. The final transfer tax exemption amount and rates have now been set and are no longer scheduled to expire at a future date. This provides some certainty for international families as they address their succession planning and begin to move wealth to the next generation. Further, on January 17 2013 the Internal Revenue Service (IRS) issued final regulations regarding implementation of new provisions added to the Internal Revenue Code in 2010 by the Foreign Account Tax Compliance Act (FATCA). These final regulations provide clarification, but the full impact on foreign trusts and their offshore trustees is still being determined.

Gift tax

US citizens and residents
Transfers of property – whether real property, tangibles or intangibles, and wherever it is located – by US citizens and residents are subject to US gift tax. There is a small annual exclusion for gifts up to $14,000 per donee (for tax year 2013, indexed annually for inflation). Gifts to US citizen spouses are not subject to gift tax, while tax-free gifts to non-US citizen spouses are limited to $143,000 in 2013. Direct payments of medical and educational expenses are always exempt from gift tax (for further details on the gift tax charitable deduction please see the Overview (August 2011)). The US donor may double the annual exclusion amount (to $28,000 for tax year 2013) by filing a gift tax return and electing to split gifts with his or her spouse, provided that both spouses are US citizens or residents.

For gifts in excess of the annual exclusion amount, pursuant to the American Taxpayer Relief Act US citizens and residents are allowed a tax credit that shelters up to $5 million (the 'exclusion amount') of lifetime gifts from tax. Application of the exclusion amount to lifetime gifts then reduces the credit available to use against the estate tax at death. The exemption amount is indexed for inflation and anticipated to be $5.25 million for gifts made in 2013 and for the estates of decedents dying in 2013. The gift and estate tax rates are unified, with a top tax rate of 40% under the American Taxpayer Relief Act.

Non-resident aliens
Transfers of intangibles by non-resident aliens 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 a non-resident alien. The annual exclusion amount ($14,000 for gifts in 2013) is available to non-resident aliens, but gift-splitting with a spouse to double that amount is not. Gifts of US situs real property and tangibles to a US citizen spouse are not subject to gift tax, but if the spouse is not a US citizen the tax-free gift is limited to $143,000 in 2013. The $5 million exclusion amount is not available to shelter gifts of US situs property by non-resident aliens from gift tax, so tax advice is needed for a non-resident alien making gifts of US situs homes and artwork (for further details of transfer tax domicile please see the Overview (August 2011)).

Estate tax

US citizens and residents
The worldwide estate of a US citizen or resident is subject to US estate tax. Under the American Taxpayer Relief Act, a credit against estate tax shelters up to $5 million from tax (indexed for inflation and anticipated to be $5.25 million for estates of decedents dying in 2013), to the extent not used to offset gift tax on lifetime transfers. A marital deduction is available for bequests to a US citizen spouse. A maximum estate tax rate of 40% is now in effect.

The act also made permanent the 'portability' of a deceased spouse's unused exemption amount to the estate of the surviving spouse. A portability election must be made at the death of the first spouse. The deceased spouse's unused exemption amount may then be applied with respect to the surviving spouse's gift and estate tax. However, reliance on portability in succession planning does not necessarily produce the most tax advantageous result.

Non-resident aliens
For non-resident aliens, a significantly broader list of property is subject to US estate tax, as compared to gift tax. In general, property is subject to US estate tax if it has a US situs. US real estate and tangible property physically located in the United States, as well as securities or obligations issued by US persons or entities, are US situs property and subject to estate tax. Thus, US property includes stock in a US company, but not stock in a non-US company.

The $5 million exclusion amount enacted under the American Taxpayer Relief Act is not available to the estate of a non-resident alien decedent. Instead, the credit available to a non-resident alien's estate shelters only $60,000 from estate tax. That exclusion amount is not indexed for inflation and has not changed in more than 10 years. The deduction for debts and expenses of the estate of a non-resident alien is very limited (for further details please see the Overview (August 2011)).

The scope of the estate tax can be reduced significantly for estates of non-resident aliens who were residents of countries that have an estate and gift tax treaty with the United States (eg, the United Kingdom, France and Germany) (for further details please see the Overview (August 2011)).

Generation-skipping transfer tax

US citizens and 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 tax (commonly referred to as the GST tax) is imposed in addition to any gift or estate tax that may be due. The American Taxpayer Relief Act unified the generation-skipping transfer tax exemption amount with that of the gift and estate tax exemption amount. Thus, an exemption of $5 million (indexed for inflation and anticipated to be $5.25 million for 2013) is available to shelter gifts or bequests from generation-skipping transfer tax. The generation-skipping transfer tax is still calculated at a flat rate equal to the top transfer tax rate, which has been set at 40% by the act.

Non-resident aliens
The reach of the generation-skipping transfer tax for transfers made by non-resident aliens matches the reach of the estate and gift tax on the underlying transfer. Thus, a transfer by a non-resident alien of non-US property is not subject to the generation-skipping transfer 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) (for further details of the time for testing whether the generation-skipping transfer tax applies, please see the Overview (August 2011)).

Foreign Account Tax Compliance Act

The US taxing authorities have increasingly focused on reporting. A stated policy of FATCA is to combat US tax evasion through increased information reporting. The US government has long collected information from US financial institutions on the financial transactions of its US taxpayers. The United States also collects information through its system of international agreements, including tax treaties and bilateral agreements which provide for the exchange of information related to tax enforcement under appropriate circumstances. Now, through FATCA, foreign financial institutions and certain other foreign entities will be required to identify US accountholders and owners and report certain information to the IRS or be subject to a 30% withholding tax on certain US-source payments, which will begin to phase in as of January 1 2014.

The FATCA rules, even after the issuance of final regulations, are extremely complicated. Advisers to international families must be aware of the extensive reach of these rules and the impact on foreign trusts and foreign holding companies.

US-source payments subject to Foreign Account Tax Compliance Act withholding

The FATCA withholding tax is levied on 'withholdable' payments. These generally include payments of US-source dividends, interest and other fixed or determinable annual or periodic income and gross proceeds from the disposition of property of a type that can produce US-source dividends or interest.

Income effectively connected with a US business is generally exempt from FATCA withholding. Nor will the mere transfer of money from an individual in the United States to an individual in a foreign country trigger FATCA withholding (eg, where a US family member sends money to a non-US relative).

Foreign trusts with individual trustees versus those with trust company trustees
The FATCA rules require foreign financial institutions to provide the IRS with information on certain US persons invested in accounts outside the United States and for certain non-US entities to provide information about any US owners. The final FATCA regulations include changes and clarifications from the proposed regulations to the definition of 'foreign financial institution' (FFI), some of which are relevant to offshore trusts. Perhaps most importantly, private trusts are now exempt from treatment as FFIs as long as they are not managed by an FFI such as a professional investment manager or trust company. Thus, if an individual is a trustee of the family's foreign trust and that trustee does not hire any entity as a third-party service provider to invest, administer or manage funds, the trust will be treated as a non-financial foreign entity rather than an FFI. On the other hand, where a foreign trust company, as trustee, manages and administers the assets of the family's foreign trust in accordance with the terms of the trust instrument for the benefit of the trust beneficiaries, the trust itself will be classified as an FFI.

A family's foreign trust that is not an FFI will still need to provide US withholding agents with certification regarding substantial US owners, but will not have to enter into an FFI agreement itself and comply with extensive FATCA due diligence requirements. A family's foreign trust that is an FFI may also be able to avoid full FATCA reporting obligations if its trust company trustee is a participating FFI that is FATCA compliant.

Intergovernmental agreements
The final FATCA regulations also include an intergovernmental approach to achieving the policy goal of increased information reporting to curb tax evasion. The non-US jurisdiction (referred to in the final regulations as a 'partner jurisdiction') may enter into a reciprocal agreement with the IRS to adopt local laws under which FFIs will identify and report information about US accounts to the partner jurisdiction tax authority. The partner jurisdiction will then pass that information on to the IRS. An FFI complying with local laws in a jurisdiction with a reciprocal-type agreement is deemed to have complied with the FATCA withholding and reporting requirements. Alternatively, the partner jurisdiction can enter into a non-reciprocal agreement assenting to direct and enable FFIs to register with the IRS and report information regarding their US accounts directly to the IRS. An FFI located in a jurisdiction with this type of agreement must still enter into an FFI agreement with the IRS and comply with the FATCA regulations, except to the extent modified by the intergovernmental agreement. To date, the United Kingdom, Mexico, Denmark, Spain, Ireland, Switzerland and Norway have signed or initialled agreements with the United States. The Treasury Department reports that it is engaged in discussions with more than 50 countries and jurisdictions to conclude intergovernmental agreements.

Substantial US owners of a foreign trust
Unless offshore trust jurisdictions such as Bermuda, the Bahamas and the Cayman Islands enter into reciprocal intergovernmental agreements regarding FATCA, offshore trust companies, which serve as trustee to many offshore trusts, will need to seek advice regarding the online FATCA Registration Portal being developed by the IRS, through which an FFI can register with the IRS, enter into an FFI agreement to the extent applicable and make periodic certifications required by the final FATCA regulations. Similarly, the FFI trusts for which the offshore trust company serves as trustee will need to provide the trust company with information on substantial US owners so that the trust can qualify as a certified deemed compliant FFI and void the need to enter into its own FFI agreement with the IRS.

Even in the case of an offshore trust with an individual trustee, withholdable payments made to that non-financial foreign entity will be subject to FATCA withholding by the payor. For the non-financial foreign entity to avoid such withholding it must certify to the withholding agent that it has no substantial US owners, or, if it does, it must disclose the identities of such owners to the withholding agent. No credit or refund will be allowed to the non-financial foreign entity unless the entity provides the IRS with information necessary to determine whether it is a "United States owned foreign entity" and identifies its "substantial United States owners".

In the case of a trust, the final FATCA regulations define a 'substantial US owner' as any specified US person (which includes a US citizen or resident and a US domestic trust or company) who is treated as an owner of any portion of a the trust under the grantor trust rules or that holds, directly or indirectly, more than 10% of the beneficial interests of the trust. A person has a beneficial interest in a foreign trust if the person has the right to receive directly or indirectly (eg, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust. The beneficial interest is more than 10% if the beneficiary receives, directly or indirectly, only discretionary distributions from the trust and the fair market value of the currency or other property distributed, directly or indirectly, from the trust to such person during the prior calendar year exceeds 10% of the value of either all of the distributions made by the trust during that year or all of the assets held by the trust at the end of that year.

New and revised reporting forms to be released

The IRS has said that it will release new Form W-8BEN-E – Certificate of Status for Beneficial Owner for US Tax Withholding (Entities) – for use by entity beneficial owners and a draft version of revised Form W-8BEN – Foreign Status of Beneficial Owner for US Tax Withholding – for use by individual beneficial owners. Also expected is a new FATCA report, Form 8966, to be used by FFIs (including qualified intermediaries, withholding foreign partnerships and withholding foreign trusts). With respect to the FATCA registration portal, the IRS intends to issue a revenue procedure on the registration and reporting process. Finally, revised Form 1042 – Annual Withholding Tax Return for US Source Income of Foreign Persons – and Form 1042-S – Foreign Person's US Source Income Subject to Withholding – are anticipated.

Comment

In addition to the new transfer tax laws and the IRS final FATCA regulations, Congress may address the following previously proposed changes to several estate and gift tax planning techniques:

- limiting grantor-retained annuity trust terms to 10 years and abolishing so-called 'zeroed-out' grantor-retained annuity trusts altogether;
- ignoring valuation discounts for interests in family-owned entities such as family limited partnerships and limited liability companies;
- restricting the term of a trust exempt from generation-skipping transfer tax to 90 years; and
- changing the rules with regard to defective grantor trusts to cause them to be classified as non-grantor trusts if established by a completed gift.

The year 2013 rang in a changing tax and reporting landscape for international families and their succession planning structures.

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