In anticipation…What will the next six months hold for personal taxation in the US

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US foreign compliance rules and other developments

Since the credit crunch there has been an increase in legislative activity around the world, with governments seeking to counter tax evasions and avoidance. In particular across the Atlantic, there is one significant piece of legislative action and one significant piece of legislative inaction, which will affect a broad range of taxpayers.

It now seems very likely that foreign compliance provisions, which go back some years to the Stop Tax Haven Abuse Act and which more recently were included in the Foreign Account Tax Compliance Act, have now been included in the Hiring Incentives to Restore Employment ("HIRE") Act which has been passed in different versions by both the House and the Senate. In addition, somewhat surprisingly, US federal estate tax has been repealed in the US for one year.

Another Withholding Tax

For non-US investors in US securities and other US investments this legislation represents a major overhaul of the withholding tax rules. The US currently boasts at least two main systems of withholding tax but soon there could be a third. This new system, which incorporates the usual 30% withholding tax on dividends and interest, would apply a 30% withholding tax on the gross proceeds of sale of securities and other investments.

Note that this is a withholding tax and not a mainstream tax, and therefore there is no change in the US underlying position that most non-resident alien investors are not taxed on capital gains. However under the new system non-resident alien investors would suffer a withholding tax on the proceeds of sale that could be reclaimed only by filing a US income tax return. This is a move away from the exemption system of withholding tax to a refund system, which is a change in US tax policy in this area.

The 30% withholding tax would not apply to securities held through financial institutions (defined broadly) which enter into an IRS information agreement. The agreement would require financial institutions to maintain full records of their customers, and to provide directly to the IRS information about all US beneficial owners. Essentially this is enhanced W-8BEN reporting. We envisage that most foreign financial institutions would wish to enter into information agreements but note that these agreements must apply to all branches of that institution. It is unclear how these new provisions would mesh with the US treaty obligations. We predict that this may change the way many investors invest in the United States and may make direct investment less attractive. As always, the devil is in the detail and we will need to await the final version of the legislation which will emerge from conference as well as IRS interpretation.

US Beneficiaries of Foreign Trusts

US beneficiaries of foreign trusts should note that the legislation also includes a provision which has long been on the Treasury Departments wish list. Since 1995 the Treasury has wanted to tax US beneficiaries of foreign trusts on the benefit of occupying real estate or enjoying chattels owned by foreign trusts. If enacted, US beneficiaries will be taxable on the uncompensated use of such property. Trustees will need to take urgent action, in the short run probably to charge rent, and in the medium term to restructure foreign trusts owning houses and chattels, either into US domestic trusts or into trusts which have no taxable income.

US Estate Tax Repeal

While Congress has been busy with US healthcare and foreign compliance legislation, one area where much heralded change has not been forthcoming is US federal estate tax. Those with long memories will recall that in 2001 Congress abolished estate tax for 2010 only. Most observers expected Congress to repeal the repeal, as both the administration and the leadership of the House and the Senate announced they would act to reinstate estate tax before the repeal took effect at the beginning of this year. However as a result of the legislative log jam in Congress nothing happened in 2009 with the result that federal estate tax is no longer in effect. Congress has indicated that it wishes to reverse this, but it is unclear whether that can be done retrospectively. If Congress continues its policy of inaction, then the federal estate will remain abolished throughout 2010 and will be reintroduced in 2011 at 2001 rates. That is, the federal estate tax exemption will be $1 million instead of $3.5 million and the top rate will be 55% instead of 45%.

Although the abolition of federal estate tax is seen by most as an unexpected benefit, it carries an equally unexpected price tag for those US testators leaving gifts of assets or trust interests to non-US beneficiaries. Along with the abolition of estate tax comes the removal of the basis step-up for appreciated assets. Therefore for American beneficiaries the price of not paying estate tax on your legacy is that you take a carry over basis in appreciated assets. For non-US beneficiaries the legislation has more immediate consequences because Congress imposes an immediate

tax on any capital gains on legacies passing on to non-US beneficiaries. As can be imagined this has a complicated effect on estate planning, but many clients' enthusiasm for redoing their estate plans is somewhat tempered by the knowledge that any planning could be entirely academic after the end of this calendar year at the latest.

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