



Welcome to the winter edition of Focus. The closing months of 2009 were particularly busy in regard to US legislation and in this edition we look into an array of areas including IRS guidance on the new exit charge which although has happily clarified certain areas, it has muddied the waters in others. There is also an update on the introduction of new US tax legislation, as well as changes to US estate taxes.

On the UK front the majority of news was reported in the Pre-Budget Report we issued on 14 December 2009 (www.frankhirth.com/pdfs/budget/prebudget_report_2009.pdf). We have included in this issue updates on HM Revenue & Customs' (HMRC) view on the ever changing world of UK residency for tax purposes following a recent case at the commissioners. We also look at the impact of the new 50% higher tax rate that comes into effect from April 2010 moving the UK back into the world of being considered a high tax jurisdiction.

Moving on to developments within Frank Hirth itself, we are delighted to announce the continuing development and excellence of our staff passing professional exams. Since our last edition we have seen one of our personal tax managers, Gillian Everall, pass her Society of Trust & Estate Practitioners (TEP) exams. The following members of staff have passed their US Enrolled Agent (EA) exams: Terry Heatley, Rebecca Singleton, Loran McCarthy, Glenn Snow, Alasdair Hedger, Alex Straight, Tracy Ng and Thomas Morris. We also congratulate Lisa Holland on achieving Fellowship to the Institute of Administrative Management.

Well done to one and all on their personal achievements!

Last but by no means least, we would like to inform you that we have a number of staff taking part in the London Marathon on 25 April this year. The FH Marathon Team are running for two very deserving charities which are Whizz-Kidz (www.whizz-kidz.org.uk) and Children with Leukaemia (www.leukaemia.org). The Frank Hirth staff undertaking this task are, for Whizz Kidz, Lucy Townsend, Gareth Lambe, Rebecca Singleton, John Bull, Matthew Norris, Mark Allsopp, Holly Creed, Rick Sherman and Luke Keaveny, and for Children with Leukaemia, Lisa Usher. I am sure you will join us in wishing them all the very best of luck as they toil with punishing training regimes over the coming months.

With the introduction of a 50% tax rate we are now only weeks away from the UK moving back to the realms of a high tax country

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IRS GUIDANCE ON THE NEW EXIT CHARGE RULES CLARIFIES SOME AREAS AND OBSCURES OTHERS

Congress's enactment in June 2008 of new anti-expatriation rules was reported in our July 2008 edition of Focus (www.frankhirth.com/pdfs/focus/focus_july_2008.pdf). The new rules, applicable to former citizens and long-term permanent residents, not only tax an expatriate on unrealised appreciation of his assets at the time of his change of status (the so called exit charge) but also impose a substitute for gift and estate tax on US donees of covered expatriates (donee tax). Comprehensive guidance on the new provisions had been promised by as early as November 2008, but such guidance was not in fact issued until 15 October 2009 in Internal Revenue Service (IRS) Notice 2009-85, and covers only the exit charge with guidance on the donee tax promised for later.

From the standpoint of clarifying the exit charge rules, Notice 2009-85 was largely a non-event mainly restating the provisions of the statute, but there are two areas covered in the Notice which are important. These relate to (i) the effective date of the new rules and (ii) the Internal Revenue Service's questionable interpretation of anti-avoidance rules concerning transfers to foreign trusts as effectively creating another exit charge when a trust settlor becomes a non-resident alien.

(i) Effective Date of the New Rules

Legislation adopting the new anti-expatriation rules stated that the rules took effect for individuals whose expatriation date occurred on or after the date of enactment (17 June 2008). While the term 'expatriation date' was defined in the new rules, there was some uncertainty about how the term would be applied to a long-term permanent resident in circumstances where he was deemed to have expatriated by reason of claiming relief from US tax as a resident of another country under the dual resident provisions of that country's income tax treaty with the US. A long-term permanent resident is an individual who has had greencard status for eight or more of the preceding fifteen years.

It was our conclusion that the expatriation date for such a treaty based expatriation had to be the date when the treaty benefits commenced, even though in normal circumstances the IRS would not be advised of the claim under the treaty until the year following the commencement of benefits when the tax return was filed. However, this implied that long-term residents eligible for treaty relief could decide after the enactment of the new rules to avoid them by back-dating the treaty claim

affording more flexibility than would normally be associated with an anti-avoidance provision such as the anti-expatriation rules. Furthermore, it was possible to interpret the definition of expatriation date to support a treaty based expatriation as occurring only when the claim of treaty relief was notified to the IRS, although this interpretation created numerous problems in applying the new rules.

In Notice 2009-85 the IRS announced its intention to treat the expatriation date of a long-term resident expatriating resulting from a treaty claim as occurring on the date treaty relief commences. Therefore long-term permanent residents commencing to be eligible for relief from US tax under a treaty any time prior to 17 June 2008 (who claim such relief after that date) will nonetheless achieve an expatriation prior to the effective date of the new rules. Although the deadline (even with extensions) for timely filing a US income tax return reflecting a pre-17 June 2008 claim of treaty relief has now passed, there is nothing in the new legislation or Notice 2009-85 to suggest that the claim of treaty relief must be made with a timely tax return. Therefore in the example of a long-term greencard holder who has resided outside the US and fallen behind in his US tax compliance, Notice 2009-85 may provide a basis to shed resident status without triggering the exit charge.

(ii) Potential IRS Exit Charge on the Change of Status of the Settlor of a Foreign Trust

As the very existence of the new anti-expatriation rules implies upon an individual's change of status from citizen/resident alien to non-resident alien, there would generally be no requirement to recognise unrealised gains on appreciated assets. This is consistent with the fact that the US will tax a citizen or resident alien on the entire gain from a disposal of property, notwithstanding that some or all of the increase in property value may have occurred when the individual was a non-resident alien.

When a US taxpayer makes a gift of property to a foreign trust that is not considered owned by that taxpayer (which usually is the case only if the trust cannot benefit any US person), Internal Revenue Code Section 684 provides a charge. The taxpayer is then deemed to have disposed of the property in a sale at fair market value and must recognise any unrealised gain. This is an exception to the general rule that gifts of appreciated property, even to non-resident alien individuals, are not considered to give rise to recognition of gain. This deemed charge does not apply to a transfer to a foreign trust where the transferor is still considered to own the trust assets for the simple reason that from a tax point of view nothing has happened, and the IRS is still in a position to tax the transferor if the asset is subsequently sold at a gain.

In order to prevent avoidance of the Section 684 charge, the IRS is given authority to issue regulations imposing tax on deemed transfers from a US person to a foreign trust. One example of a deemed transfer is a case where a domestic trust considered not to be owned by any person becomes a foreign trust (for example the appointment of a foreign trustee). In this case the regulations provide that there is a deemed transfer from the domestic trust to a foreign trust immediately prior to the change of status. The trustees will then be considered to have made a taxable transfer to a foreign trust under Section 684 that must be reported on the trust's final tax return.

Where a US person who has settled property on a foreign trust (which he is considered to own) becomes a non-resident alien, it is quite possible that he will cease to be treated as owning the trust assets because of special rules restricting the circumstances in which a non-resident alien is considered to own the assets of a trust. While this is in effect a deemed transfer to a foreign trust not owned by the former US person, given the general principle that there is no exit charge on a change of status, there appears to be no reason why a taxable disposal should be deemed to occur simply because relevant assets have been held in a transparent foreign trust. The IRS deemed transfer regulations do not appear to call for a deemed transfer in these circumstances; however, because the issue is not expressly addressed in the regulations it has always been considered an area of some uncertainty.



This leads us to Notice 2009-85 where the IRS has stated its view that a Section 684 deemed disposal is triggered where a trust previously owned by a US citizen, or former long-term resident, becomes a foreign trust not considered as owned following expatriation. For this reason the deemed disposal is taxable under Section 684 rather than under the exit charge provision of the anti-expatriation rules which normally will result in a somewhat greater liability. However, the IRS's position goes well beyond the effect of the anti-expatriation rules because, logically, if a gain is triggered under Section 684 upon expatriation of a citizen or long-term resident, it must also be triggered whenever any other US person becomes a non-resident alien.

While we believe that the IRS position is not supported by its regulations and cannot be justified as good tax policy, it remains a potential trap for individuals outside the scope of anti-expatriation rules who become a non-resident alien. In particular, the IRS's position could apply to the not unusual case of an individual who, while a US person, has settled property on a domestic trust of which he is a trustee and which he is considered to own for tax purposes. His change of status to non-resident alien may not only cause him to cease to be treated as the owner of the trust but may also cause the trust to become a foreign trust due to his position as trustee.

An individual, who anticipates ceasing to be a US person, in particular if he is not subject to the anti-expatriation rules where these facts may be on point, should request professional tax assistance to walk through these complex issues. The individual should consider unwinding any trust structures that could fall foul of the IRS's interpretation of Section 684 before his change of status takes place.



but they remain in temporary form because from a budgetary standpoint the government cannot afford to make them permanent. Leaders of the House Ways and Means Committee and Senate Finance Committee have stated that they expect the extenders bill to be enacted early in 2010 with effect from 1 January 2010 to seamlessly extend the expired provisions, and presumably FATCA will become law at the same time. We will set out the provisions of FATCA in detail in a future issue of Focus if and when it becomes law.

FATCA was originally part of the international tax package announced by President Obama in May 2009. The substantive provisions of that package which would mainly affect US multi-nationals continues to be actively pursued by the administration but are far less certain of enactment.

Another legislative shoe that did not drop in 2009 was the expected reversal of the one-year repeal of the US estate tax for 2010, discussed below.

Of more general impact will be the revenue provisions of the health care reform legislation if and when enacted. Competing versions were passed in the House and Senate before the end of 2009, which incorporated significantly different approaches to funding the costs of the reform. Again, the revenue provisions of any final enactment will be addressed in a future issue of Focus.

LEGISLATIVE UPDATE: WATCH THIS SPACE

We had anticipated reporting in this issue of Focus the final provisions of some important pieces of US international tax legislation expected to have been enacted by year-end. However, Congress failed to enact any of the expected legislation and we have been left with promises of retrospective enactments in 2010.

The legislation which seemed most likely to succeed was the Foreign Account Tax Compliance Act (dubbed FATCA), which was introduced in identical form in both Houses of Congress in November 2009. As its name suggests FATCA is mainly concerned with information gathering rather than any change in the substantive taxation rules. Perhaps the most far-ranging proposal is one to effectively require all foreign financial institutions receiving US source interest or dividend income to report to the IRS similar information concerning their US direct and indirect account holders/investors as would be required of a domestic financial institution. While foreign financial institutions are not directly subject to the jurisdiction of the IRS, compliance would be necessary to avoid 30% withholding tax on US source income paid to the foreign institutions. Concerns have been expressed about the adverse impact the provision might have on the attractiveness of US financial markets for foreign institutions. Americans who are resident overseas could find that the new rules, if enacted, impinge on their ability to open and maintain foreign bank and financial accounts, which is already under pressure. Another part of FATCA with particular relevance for overseas Americans would be a significantly expanded requirement for reporting foreign holdings.

FATCA's enactment was delayed because it was attached as a revenue offset to a bill of tax extenders prolonging the effective dates of various tax provisions, beneficial to the taxpayer, which expired on 31 December 2009. Most of these provisions have been in effect for many years and reflect settled tax policy,

ESTATE TAX REPEAL

We wave goodbye to many things now that 2009 is behind us and due to the effort that Congress devoted to health care reform for twelve months only we can potentially include US Federal estate tax and Generation Skipping Tax (GST) in this list. However, Congressional leaders have promised that estate tax reform is on the agenda for 2010 and that they intend to make any such reform retroactive to 1 January 2010, but then we also received assurances last year from Senator Baucus, chair of the Senate Finance Committee, that Congress would act in 2009 to prevent the scheduled estate tax repeal from coming into effect.

UK INCOME TAX RATE HIKE

As a reminder the Economic Growth and Tax Relief Reconciliation Act of 2001 phased in an increase in the estate tax lifetime exclusion (which had risen to \$3million for 2009) and the reduction of the maximum estate, GST and gift tax rates (to 45%) culminating in the repeal of the estate tax and GST for decedents dying and transfers occurring in 2010. For budgetary reasons, the repeal was only temporary and under the 2001 Act the estate tax and GST are to be reinstated in 2011 at the exemption levels and rates in effect for 2001, i.e., \$1million exemption and 55% maximum tax rate.

While it appears there is a consensus among Democrats in Congress that the estate tax repeal should not come into effect there was disagreement about the provisions that should operate in its place, with a majority favouring simply continuing the rates and exemptions in place for 2009 and a small minority supporting a further reduction in the 35% rate and a further increase in the lifetime exemption.

Two of the collateral consequences of the estate and GST tax repeal are discussed below. Presumably if the repeal is retroactively eliminated these collateral changes also will become retroactively inapplicable.

Adjustment in Basis

One of the principal collateral consequences of a repeal of the estate tax is that assets will not receive an adjustment in basis to the date of death fair market value in the hands of the beneficiary, and instead there will be a carry over basis for 2010 which will generally be the same basis as when it was owned by the decedent. Thus, although estate tax will be avoided, on a future disposal of assets received from the estate the unrealised appreciation of the decedent may be taxed. (To prevent avoidance of this tax in the case of property left to a non-resident alien, also new for 2010, there would be a deemed realisation of gain by the decedent on assets left to a non-resident alien.) Executors will be able to increase the basis of estate assets by up to \$1.3million for property passing to any beneficiary and an additional \$3million in the case of property passing to a surviving spouse.

The adjustment in basis regime will be reinstated for 2011 when the repeal of estate tax is due to expire.

Gift Tax

In addition, the Federal gift tax will remain in place during 2010 with a \$1million lifetime exclusion, but the maximum rate for taxable gifts will be reduced to 35%.

There is uncertainty as to if and when legislation will be enacted in 2010 regarding the repeal, whether it will be retroactive to 1 January 2010 and whether any legislation will be permanent or temporary. This uncertainty makes it difficult to advise clients on the best course of action for their tax planning. For example, the repeal of the GST may provide opportunities to pass assets to grandchildren and younger generations but one must bear in mind the threat of possible retroactive legislation imposing the charge.

State Estate Tax

State estate, gift and GST tax laws are not affected by the Federal changes and still need to be considered.

Non-Taxable Gift Amounts For 2010

As in 2009, you can make annual gifts of up to \$13,000 (or \$26,000 if you are married to a US person and your spouse consents to split gifts) to an unlimited number of recipients. These gifts will not reduce your lifetime gift tax exclusion.

In 2010, the amount that you can give annually as a non-taxable gift to a spouse who is not a US citizen has been increased to \$134,000.

As we have entered 2010 and with the introduction of a 50% tax rate we are now only weeks away from the UK moving back to the realms of a high tax country.

There has been much discussion about how the full impact can be averted with some individuals making plans to leave the UK altogether. As we have written about recently even steps to become non-resident have in themselves become more difficult (see the following article on the case of Lyle Dicker Grace).

A reminder of the primary new rules:

- The new top income tax rate of 50% applies to those with incomes over £150,000 from 6 April 2010.
- There is a phased elimination of personal allowances reaching zero for those with incomes exceeding £112,950.
- The national insurance employee rate rises and for individuals from 6 April 2011 this will be increased to a 2% levy in place of the current 1% on income above the main table rate. For employers the rate of charge increases to 13.8%.
- The effective marginal rate where UK national insurance, as well as income tax, is due will rise in the next year or so from 41% to 52%!

The ability to shelter from the full consequences of this charge is being further diminished. The generous UK tax relief on pension contributions that has been available since April 2006 has been restricted significantly for those with incomes of at least £150,000 per annum. Whilst these rules apply from 6 April 2011, measures were introduced alongside this to discourage increasing contributions beyond regular patterns in place at the last Budget day (22 April 2009). The Pre-Budget Report followed up in December 2009 to bring about further changes that bring taxpayers within these special anti-forestalling rules where income exceeds £130,000.

For these measures (and for the banking sector) the payroll tax has had a significant impact on the thinking of individuals, businesses, and advisors looking again at what can be done to mitigate this higher tax charge.

Each of the actions that may be considered could form the basis of an article in themselves so please discuss with your usual Frank Hirth advisor the applicability of any prospective ideas or solutions to your particular circumstances.



Amongst possible solutions that may be considered is the advancement of income or profit shares pre-5 April 2010. Where scope exists this might involve designing subsequent deferral mechanisms into Employee Benefit Trusts (EBTs) and Employer Funded Retirement Benefit Plans (EFRBs). For some organisations this may mean maximising share incentives where capital gains (currently at 18%) can be maximised either under approved plans, or by designing incentive restrictions with a relatively small income tax burden at present, in favour of longer term capital gains tax on growth thereafter.

Those who are now or have in the past been taxable in the UK on the remittance basis have the opportunity to accelerate income through making remittances to the UK before 6 April. Particularly where that income has already been subject to US tax, the UK savings that can be achieved through remitting before 6 April can be substantial, but the issues involved may be complex and so we urge that this type of year-end planning be addressed as soon as possible.

The ability to plan against the full exposure to the new higher rates has become more difficult but the desire to pursue a capital gains tax rate of 18% in the UK becomes more powerful whilst this increased differential between income tax and capital gains tax rates lasts.



- he retained a house in the UK;
- he was on the electoral roll in the UK as a resident;
- post was sent to him at his UK address;
- he kept a car in the UK;
- he had a bank account in the UK into which his salary from British Airways was paid;
- he was registered with a dentist in the UK;
- he had no relatives in the UK;
- his ex-wife and daughters lived in the UK but he had no contact with his children for over 30 years; and
- he was a member of UK professional body.

HMRC have argued that Mr Grace did not break his UK residency at any stage given the extent of his visits to the UK and the nature of his continuing links to this country. Indeed the many volumes of case law support the idea that a UK tax resident is unlikely to have left the UK unless there has been a definite break in his pattern of life. In the absence of a statutory residence test (along the lines of the US and Ireland) planning to make a definite break requires careful consideration of non-statutory residence factors as outlined above.

In the case of an individual who has been resident in the UK, the making of a distinct break in his pattern of life, including establishing a residence elsewhere, may mean that even lengthy or regular visits to this country may not amount to continued or resumed residence. What is clear in this case, and one or two others, is that established practice is no longer as clear and distinct as it may have appeared for many years. The lack of a statutory residence test makes planning for non-residency status more challenging.

STOP PRESS

Phishing & Scam Emails

We have seen an increase in the number of scam emails purporting to be from the IRS or HMRC over the past year. It is important to remember that neither the IRS nor HMRC will initiate correspondence with a taxpayer via email. Also, they will certainly not ask for personal details or reference numbers to be confirmed over email.

If you receive email correspondence from either tax authority that you think may be suspicious, both have sections of their websites devoted to stamping out these problems (links to which are below):

IRS: <http://www.irs.gov/privacy/article/0,,id=179820,00.html?portlet=1>

HMRC: <http://www.hmrc.gov.uk/security/index.htm>

If you have any questions on this subject, please seek further advice from your usual Frank Hirth contact.

THE CURIOUS CASE OF LYLE DICKER GRACE AND THE FACTORS FOR DETERMINING UK TAX RESIDENCY

The complexities of how to interpret rules on loss of UK tax residency was most recently illustrated in the case of *Grace v The Commissioners for HM Revenue & Customs* on 28 October 2009.

The case concerned whether Lyle Dicker Grace was resident in the UK for tax purposes and has once again highlighted that there is no statutory definition of residence for tax purposes. In the absence of a statutory residence test, there is an increasing need for greater clarity and certainty around the non-statutory residence tests used by the courts to develop a series of guiding factors when considering tax residence. The Revenue's practice notes have been reinterpreted by them with a succession of cases seeking to challenge any established understanding.

The background to this particular case makes for curious reading and illustrates the challenges. At the heart of the case is the question of in what circumstances (when a long-standing UK tax resident moves abroad) can an individual be certain they have in effect achieved a clean break from being resident for UK tax purposes.

Mr Grace had lived in the UK for ten years until 1997 at which point he moved back to Cape Town. Therefore the enquiry had to assess:

- the nature of the visits to this country, including:
 - the duration of his presence in the UK, and
 - the regularity and frequency of his visits.

Equally, the enquiry had to take into account his continuing links to this country and his connection with South Africa, including his ownership and use of a house there, his activities, ties and other connections. His ownership and use of a house in South Africa was not considered conclusive that he did not reside in the UK, but it was a relevant factor to be taken into account along with, in this case, the following list of factors about his UK ties:

