Expatriate News

US edition

November 2004

On 22 October 2004, the President signed into law the American Jobs Creation Act of 2004. The Act contains a myriad of tax changes, the most significant of which for expatriates are discussed below.

Foreign tax credit carryforward and carryback

Old law

Under the old law, the amount of creditable taxes paid or accrued (or deemed paid) in any tax year which exceeds the foreign tax credit limitation could be carried back to the two immediately preceding tax years applied first to the earliest tax year; and any carryforward amount generated that was not carried back could be carried forward five years in chronological order.

New law

Under the new law, the amount of creditable taxes paid or accrued (or deemed paid) in any tax year that exceeds the foreign tax credit limitation can only be carried back to the immediately preceding tax year; and any carryforward amount generated that is not carried back can be carried forward ten years in chronological order.

Effective date

Comments & observations

The ten-year carryforward period for excess foreign taxes is effective for any tax year ending after 22 October 2004. Thus, the extension of the carryforward period will apply to any carryforward amounts that extends into tax years ending after 22 October 2004, but that do not expire in the current tax year.

The one-year carryback period of excess foreign taxes will be effective for tax years beginning after 22 October 2004.

Reduction of foreign tax credit baskets

Old law

The foreign tax credit limitation is calculated separately for the nine different baskets of foreign source income listed below:

- Passive income
- High withholding tax interest
- Financial services income
- Shipping Income
- Certain dividends from noncontrolled section 902 corporations
- Certain dividends from a DISC or former DISC
- Taxable Income attributable to foreign trade income
- Certain distributions from a FSC or former FSC
- Income other than described above (general category income)

New law

The number of baskets will be reduced to the following two:

- Passive category income
- General category income

The new passive category income includes the old passive basket, as well as dividends from a DISC, distributions from a FSC and taxable income attributable to foreign trade income. Income from financial services also are included in the passive category unless earned by a member of a financial services group or any other person that is

predominately engaged in the active conduct of a banking, insurance, financing or similar business. All other income is included in the new general category.

Effective date
Comments & observations

The new baskets apply for tax years beginning after 31 December 2006.
Foreign taxes carried forward to a tax year ending on or after 31 December 2006 will be assigned to one of the two new basket as if the new rules were in effect when the foreign taxes were paid or accrued. Treasury is authorized to issue new regulations to allocate taxes carried back from a post-effective year to a pre-effective year.

Foreign tax credits under Alternative Minimum Tax (AMT)

Old law

Under the old law taxpayers were subject to an alternative minimum tax (AMT), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit. The AMT foreign tax credit for any taxable year generally could not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit was limited to 90 percent of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit.

New law

Under the new law the AMT foreign tax credit is no *longer* limited to 90 percent.

Effective date
Comments & observations

Tax years beginning after 31 December 2004.

Expatriation of Individuals

Old law

Expatriating U.S. citizens or long term green card Holders (namely, citizens who relinquish their US citizenship, or residents who surrender their green cards), who have or are presumed to have a primary purpose of tax avoidance, are subject to an alternative tax regime under Section 877, for the ten tax years immediately following the year of expatriation. Under this regime, the individuals are subject to U.S. tax on an expanded category of U.S. source income, generally at tax rates applicable to U.S. citizens. A tax avoidance motive is presumed for individuals with an average federal tax liability of $124,000 for the 5 preceding years, or whose net worth is $622,000 or more. Certain individuals who fall within these rules can submit a ruling request to the Internal Revenue Service regarding whether tax avoidance motivated the expatriation.

Under the gift tax rules, an expatriating individual with an actual/presumed motive of tax avoidance, who makes gifts within 10 years of expatriation, is subject to gift tax on gifts of U.S. situated intangibles. Furthermore, under the estate tax rules, if an expatriating individual dies within the 10 year period, he must include certain closely held foreign corporation stock in his gross estate. Expatriating individuals must provide the Internal Revenue Service with information about their assets at the date of expatriation.

New law

Under the new law, the rules applicable to expatriating individuals are revised as follows;

- Expatriating U.S. citizens or long term green card holders are subject to the alternative tax regime under Section 877, UNLESS:
  - a) Their average annual income tax liability for the prior five years is $124,000 or less (adjusted for cost of living); AND
  - b) Their net worth is less than $2 million.

  In addition, expatriating individuals must certify under penalties of perjury that they have complied with U.S. tax laws for the prior five years, and be able to provide evidence upon request.

- Expatriating U.S. citizens or long term green card holders will be treated as U.S. citizens/residents until they give notice of

the act of expatriation/termination of residency to the Secretary of State or the Secretary of Homeland Security, together with a statement containing personal and financial information required under Section 6039G.

Section 6039G is amended as follows:

– The scope of information required to be disclosed is expanded
– The same information is also required for any subsequent year in which the individual is subject to tax under this alternative regime
– The Penalty for failure to provide this information is increased to $10,000.

- An expatriated individual who is subject to tax under this regime will be subject to full U.S. federal tax for any tax year during the ten year period in which he is present in the U.S. for more than 30 days. Therefore, he would be taxable in the U.S. on his worldwide income, subject to gift tax in respect of any transfers by gift, and estate tax on worldwide assets should he die during that year.

  For certain individuals who are present in the U.S. by virtue of performing services for an unrelated employer, up to 30 days of U.S. presence is disregarded, provided that they can show strong ties to a foreign country by virtue of birth or marriage, or, provided that they have minimal prior physical presence in the US.

- An expatriated individual subject to tax under this regime, who within the ten year period, makes a gift of certain closely held foreign corporation stock, will be subject to gift tax, based on the proportion of the corporation's assets that are situated in the US. Likewise, individuals who die while subject to tax under this regime, must include in their U.S. taxable estate interests in certain foreign corporations that they control, to the extent that the corporation holds assets situated in the US.

- Expatriated individuals subject to tax under this alternative regime are required to file an annual tax return for each applicable year, even if no U.S. federal tax is due.

Effective date
Comments & observations

These provisions apply to individuals who relinquish their U.S. citizenship or terminate their long term residency after 3 June 2004.

Deduction of state and local sales taxes

Old law

No itemized deduction is permitted for any State and/or local sales taxes.

New law

Taxpayers that itemise their deductions may elect to deduct either State and/or local income taxes or State and/or local sales and use taxes. Taxpayers may use either actual sales tax records or sales tax tables the IRS will provide increased by the sales tax on large purchases, such as a car.

Effective date
Comments & observations

Effective for taxable years beginning on or after 1 January 2004 and before 1 January 2006

This election is especially significant to taxpayers who reside in Florida, Alaska, Nevada, South Dakota, Texas, Washington and Wyoming, which do not have an income tax.

For further information on any of the topics covered in this Newsletter, please contact your local BDO Member Firm, or the international BDO Centre of Excellence Expatriate Services, whose representatives are:

Chris Maddock Chris.Maddock@bdo.co.uk - BDO Stoy Hayward LLP
Marc Verbeek marc.verbeek@bdo.be – BDO Belgium G.I.E.
Amanda Sullivan Amanda.Sullivan@bdo.co.uk – BDO Stoy Hayward LLP
Gerlinde Seinsche gerlinde.seinsche@bdo.de – BDO Deutsche Warentreuhand AG
Jan Van Langendonck jan.vanlangendonck@bdo.be – BDO Belgium G.I.E.
Armand Lahaije armand.lahaije@bdo.nl – BDO Accountants & Adviseurs
Niek De Haan niek.de.haan@bdo.nl – BDO Accountants & Adviseurs
Roslyn Innocent r.innocent@advis.fr – BDO Marque & Gendrot SA
Carol-Ann Simon csimon@bdo.com – BDO Seidman, LLP

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