

Investment Hurdles Faced by Americans Living in Israel

It is estimated that more than seven million American citizens reside abroad, and more than a hundred thousand of them live in Israel. Although taxpayers are required to file US income tax returns regardless of their residency status, a minority of them do so. The reporting requirements are complex, but it is important for US citizens residing outside of America to be familiar with them, and to ensure that their financial affairs are reported accurately and on time. I will try to highlight certain issues that US persons face in this regard.

A US tax-payer who has a financial interest or signatory right over financial accounts with an aggregate value exceeding \$10,000 in a country outside the US at any time during the taxable year must file a **Report of Foreign Bank and Financial Account**. Known as the FBAR, this must be filed with the IRS on or before 30th June the following year, even if no tax is due. Failure to file an FBAR form on time and voluntarily may result in steep penalties.

In addition to the FBAR obligations, US taxpayers are also obligated to inform the IRS about any investments they may have in so-called **Passive Foreign Investment Companies** (PFICs), which include foreign companies, partnerships, mutual funds and trusts. US persons invested in PFICs must pay income tax on all distributions and appreciated share values, regardless of whether capital gains tax rates would normally apply. An extra tax form (Form 8621) must be submitted annually for each PFIC held. These strict guidelines are clearly intended to discourage ownership of PFICs by U.S. investors.

Many expatriate Americans have been frustrated recently by the fact that some banks and investment companies in the United States will not allow them to open accounts if they have a foreign residence and cannot provide a valid American address. They base this on the extra compliance requirements that US financial institutions face under the **US Patriot Act**. This has resulted in many US expatriates seeking investment solutions outside of the US.

This led to the **Foreign Tax Compliance Act** (FATCA), signed into law in 2010 by President Obama as part of the US jobs bill known as the HIRE Act, and intended to crack down on the use of overseas accounts for tax evasion purposes by American citizens. FATCA will add significantly to the tax reporting burdens for American citizens, foreign owners of US investments and income-generating assets, and all non-American financial services institutions - such as banks, trusts and investment firms - that have American account holders. Effective from 1st January 2013, foreign financial institutions and banks are obligated to identify any US persons who are account-holders and report their accounts to the IRS.

As part of the US authorities' quest to obtain information about the assets of US persons, from January 2012 any US persons with foreign financial assets worth more than \$50,000 will also have to start filing **Form 8938**, listing the assets that they have held since 1 January 2011. This form requires a US taxpayer to supply "the maximum value" of their assets during the taxable year in question, as well as various other details about the asset or account.

The solutions for US persons residing in Israel include:

- Ensuring their tax reporting is up-to-date
- Ensuring they do not have any PFICs in their investment portfolios
- Ensuring that the financial institutions hosting their accounts provide proper year-end reporting (**Form 1099 - Summary of Income and Form 8938**) so that their annual income tax return can be prepared easily.
- Ensuring that their portfolio-manager is **SEC-regulated**
- Ensuring that they work with professionals in Israel that are **licensed by the Israel Securities Authority**

We do not expect Israeli banks or investment companies to be willing to fulfill these new requirements, and some have already started to turn away American customers. These problems are not going to go away, and **accountants are advising American clients to move into US-compliant investments as soon as possible**, so as to avoid crisis situations when it comes to filing US tax returns.

Hayarden Boulevard 120/10, Ramat Beit Shemesh, Israel

✉ P.O. Box 90064, Ramat Beit Shemesh, 99190, Israel

☎ +972-2-992 1519 📠 +972-2-991 6901

Timeline for FATCA implementation – further IRS guidance (As at 18 July 2011)

The IRS has released additional guidance in the form of Notice 2011-53 (the “Notice”), announcing that the FATCA rules applicable to foreign financial institutions (“FFIs”) will be implemented in phases beginning in June of 2013.

The Notice comes as welcome relief to many institutions increasingly concerned that they will not be able to timely implement appropriate compliance measures; however, a number of significant issues remain unresolved and there is much work still to be done.

Treasury and the IRS continue to work on proposed regulations and draft FFI agreements, and the Notice indicates that proposed regulations are scheduled for release in December of 2011, to be finalized by the summer of 2012. It is also anticipated that draft versions of the FFI Agreement and required reporting forms will be circulated by the summer of 2012.

The Notice provides the following timeline for implementation of the FATCA regime:

- **FFI Agreements**

The IRS will begin accepting applications from institutions wishing to become participating FFIs on January 1, 2013.

The effective date of FFI Agreements entered into at any time before July 1, 2013 will be July 1.

FFIs must enter into FFI Agreements with the IRS by June 30, 2013 in order to ensure that they will be identified as participating FFIs not subject to withholding.

FFIs that enter into an FFI Agreement after June 30, 2013, but before January 1, 2014 will be participating FFIs in 2014, but might not be identified as participating FFIs in time to prevent withholding on January 1, 2014.

- **Withholding**

30% Withholding on US source FDAP payments such as dividends and interest paid to non-participating FFIs will begin on January 1, 2014.

30% Withholding on all other “withholdable payments,” including gross proceeds, will commence on January 1, 2015.

The withholding obligations of participating FFIs with respect to “pass-thru” payments will begin on January 1, 2014 with respect to FDAP, and on January 1, 2015 with respect to other withholdable payments. The previously proposed pass-thru payment rule would require FFIs to withhold on both recalcitrant account holders (account holders refusing to provide any required due diligence information) as well as any non-participating FFI investing via the FFI based on the proportion of the FFI's US assets versus its non-US assets, thus some amount of withholding would apply to all recalcitrant account holders and non-participating FFIs regardless of whether they themselves had any US investments.

- **Account Due Diligence**

Participating FFIs will be required to implement procedures with respect to new accounts (as described in Notice 2010-60 and the anticipated regulations) to identify US accounts opened on or after the effective date of their FFI Agreements.

So called private banking relationship accounts in excess of \$500,000 will have to be identified, with all required due diligence completed, within one year of the effective date of entering into an FFI Agreement.

A Participating FFI will be required to complete due diligence for all other accounts associated with a private banking relationship (i.e., accounts less than US\$500,000) by the later of December 31, 2014 or the date one year after the effective date of its FFI Agreement.

It remains uncertain whether trustees will be subject to the stricter private banking due diligence requirements, but language in the prior Notice implies that such treatment seems likely. A Participating FFI will be required to complete due diligence procedures for all other pre-existing accounts by the date two years after the effective date of its FFI Agreement.

Accounts identified as US accounts (or as having an entity owned by one or more substantial US owners) by June 30, 2014 must be reported to the IRS by September 30, 2014; however, reduced reporting obligations will apply.

Reporting with respect to recalcitrant account holders identified by June 30, 2014 will also be required by September 30, 2014.

- **Coordination with QI Regime**
 All Qualified Intermediary (“QI”), Withholding Foreign Partnership (“WFP”) and Withholding Foreign Trust (“WFT”) agreements of entities qualifying as FFI that expire on December 31, 2012 will be automatically extended until December 31, 2013 and any FFI that enters into an FFI Agreement on or before December 31, 2013 will be deemed to have renewed its QI, WFP or WFT agreement.

US Trust Issues : Grantor Trusts and Non-Grantor Trusts?

Grantor trusts and non-grantor trusts are the two main types of US trusts.

All trusts have a *grantor*, the person who creates the trust. All trusts also involve trustees, beneficiaries, and remaindermen. The relationship of the grantor to the other individuals involved in the trust determines whether a trust is a grantor trust or a non-grantor trust. A third type of trust, the intentionally defective grantor trust, contains elements of both grantor and non-grantor trusts.

The trustees, beneficiaries, and remaindermen each play an important role in the trust:

- **Trustee:** The trustee is the person that holds and administers the assets of a trust for the benefit of another.
- **Beneficiary:** The beneficiary is the person who receives a benefit from the trust.
- **Remaindermen:** The remaindermen is the person who receives what’s left of the trust’s property when it ends.

Grantor trusts: What happens when the grantor has control?

In grantor trusts, the grantor retains certain powers over the trust administration. These powers include the power to revoke (amend or terminate) the trust. The grantor also keeps control over the property inside the trust.

For a grantor trust, the grantor is usually also a trustee and beneficiary of the trust’s income and *principal*. The principal refers to the property funding the trust. Items of income and deduction are generally declared on the grantor’s income tax return. The trust doesn’t have a tax identification number (TIN) or file its own return.

Non-grantor trusts: What happens when the grantor has no control?

In non-grantor trusts, the grantor has given up all right, title, and interest in the principal. Only the trustee may revoke or terminate the trust. In a non-grantor trust, the grantor cannot be named as a trustee, beneficiary, or a remainderman.

Grantor trusts and intentionally defective grantor trusts become non-grantor trusts at the grantor’s death. A tax identification number for the trust must then be obtained. On December 31 of the year of the grantor’s death, the administrator becomes responsible for filing a Form 1041 for this non-grantor trust.

Intentionally defective grantor trusts

In an intentionally defective grantor trust (IDGT), the grantor makes an irrevocable gift of property into a trust, usually set up for the grantor’s children, and names someone else as trustee. The grantor retains the right to substitute other property of equal value for the property initially gifted. This is a type of estate-planning strategy.

Unlike grantor trust income tax rules that make the income includible on the grantor’s Form 1040, the property is effectively transferred out of the decedent’s estate and into the trust. Gift tax is paid on the value of the property when it is transferred into the trust. No estate tax is due when the grantor dies.

When administering an IDGT, you must obtain a TIN and file a Form 1041 every year. On the face of the Form 1041, you must write: “Under the terms of the trust instrument, this is a grantor trust. In accordance with Sections 671-678 IRC, 1986, all income is taxable to the Grantor. Statements of income, deduction, and credits are attached.” The grantor then includes all those items on his or her personal return.



Trusts & PFIC Issues

- Only an entity that is treated as a corporation for US tax purposes can be a PFIC. Thus a Trust arrangement is not considered a PFIC.
- A Non-Grantor Trust with US beneficiaries should avoid owning PFIC's, due to the tax consequences arising, as this trust would be a US tax reporting entity.
- An non-US resident settlor Grantor Trust does not have an issue holding PFIC's within it, as it is not a US tax reporting entity. Once the settlor dies, and the Trust is no longer considered a Grantor Trust, PFIC's should be avoided if there are US beneficiaries. (Note: PFIC's within a Non-Grantor Trust are a practical problem because one doesn't know when a settlor will die and once the death happens the Trust can be in a situation where it is then difficult to dispose of the PFIC without US tax ramifications.)

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