Private Wealth Newsletter 2023

Second Edition

TAX FROM EVERY ANGLE

Editors' note

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On behalf of Baker McKenzie's Global Wealth Management Practice Group we are delighted to share with our clients, friends, colleagues and readers from around the world the Second Quarter 2023 issue of the Private Wealth Newsletter.

This edition's featured article by Marnin Michaels contains a poignant retrospective on lessons learned from the 2008 financial crisis in light of the current status of the global banking market and considers what asset holders and wealth managers can do to prepare for uncertain futures.

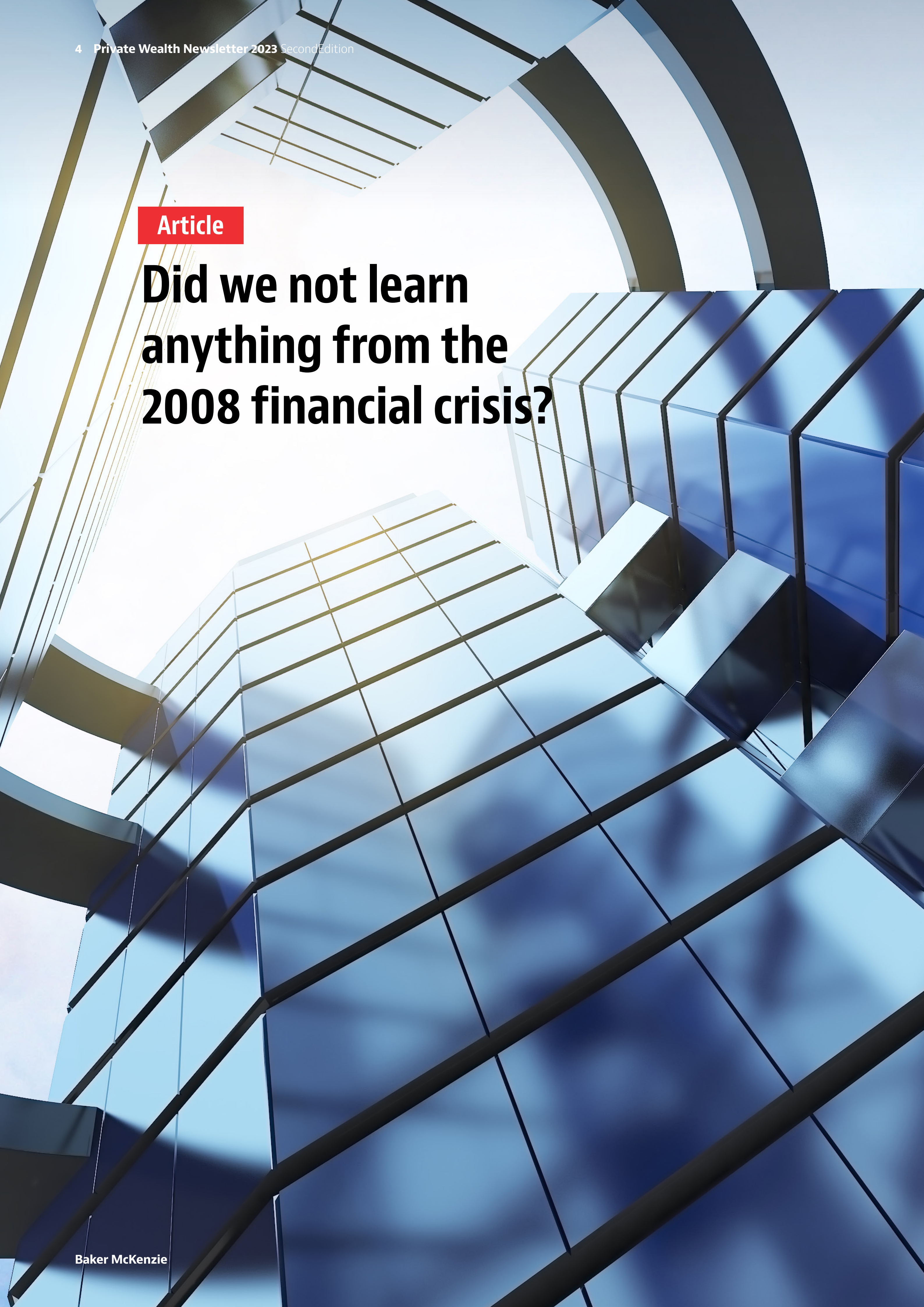
With a particular focus on cross border planning, this edition's other featured articles provide an overview of Malaysia's little-known strategic destination for wealth planning, and advice and considerations for US children born to non-US parents.

In keeping with the global move towards increased disclosure, we bring a topical update on the UK's new Mandatory Disclosure Rules in our featured articles, as well as an update on increasing transparency in Labuan in our around the world section.

Instability in global banking remains in the forefront of our minds, and planning for an uncertain future has never been more important. We see this borne out in discussions with our clients and their advisors who are more often than not seeking contingency and back-up plans, and this edition contains relevant global updates to help keep abreast of the international planning landscape.

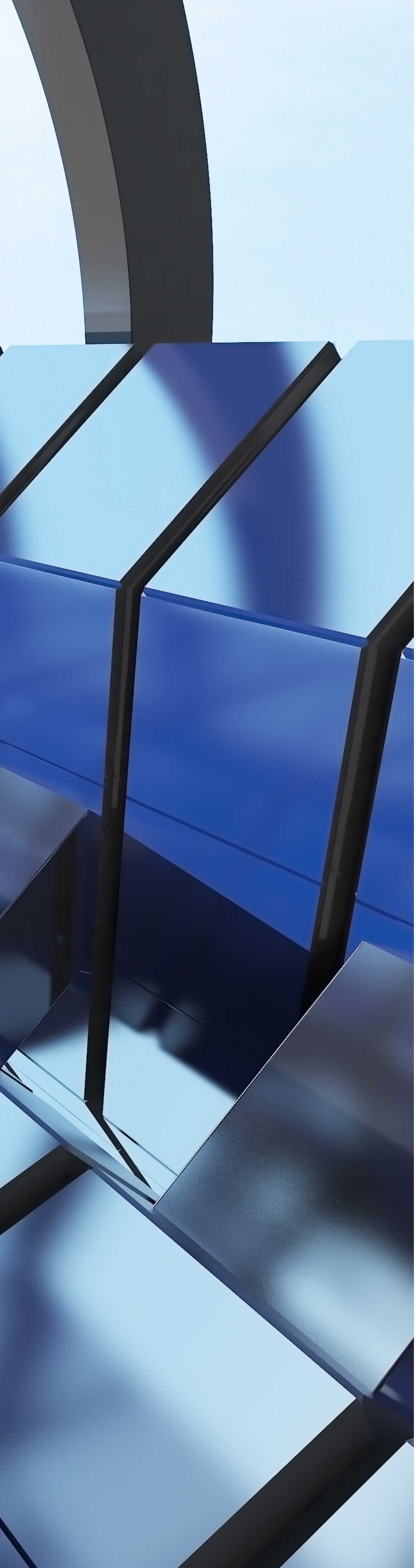
Our editors Elliott Murray and Phyllis Townsend, as well as any of the authors mentioned throughout this edition, can be reached for questions or comments.

Content



Article

Did we not learn anything from the 2008 financial crisis?



Perhaps I am naïve, but I am almost certain that, prior to February 2023, I had never heard of Silicon Valley Bank (SVB).[1] The first time I became cognitively aware of SVB was in early 2023, when many of my venture-capital friends in Israel started moving money out of the country in response to the Israeli government's proposed court overhaul that would give the government a larger voice in the selection of judges while limiting the Supreme Court's power to strike down legislation. Many investors and companies recognized that such reform would harm democracy and the economy, and thus made the decision to move their funds abroad.[2] Unlike the anecdotal stories I had been hearing that very little money was moving from Israeli banks to Swiss banks, it was the exact opposite for SVB.[3] Fast forward one month, and those same people who had moved their money out of large Israeli banks were panicking, because now they could not access the funds recently moved to SVB. Just two short weeks later, SVB, one of the leading private banking names in the venture capital arena, no longer existed.[4]

The collapse of Lehman Brothers and the 2008 financial crisis occurred less than 15 years ago. How and why did the fall of SVB happen so soon thereafter? The purpose of this article is not to relitigate what happened or how the Swiss government handled the matter (or how the banking situation devolved so fast). Rather, my purpose for writing this article originated when I looked at my Swiss Third Pillar Plan and questioned why it dropped so much despite my best efforts to maintain diversification. Then, and only then, I realized that one fund was heavily invested in bank stocks, and I started pondering whether I had learned any lessons from 2008. Did the wealth management industry, particularly the wealth owners, learn anything from 2008?

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1 SVB was formed in 1983 after co-founders Bill Biggerstaff and Robert Medearis came up with the idea during a poker game. SVB went public in 1988 and moved to Menlo Park in 1989 to establish a presence in the venture capital area. SVB nearly tripled in size between 2019 and 2022, when it rose from the 34th largest commercial bank in the US to the 16th largest. See Erin Gobler, "What Happened to Silicon Valley Bank," available at https://www.investopedia.com/what-happened-to-silicon-valley-bank-7368676.

2 See, for example, https://www.haaretz.com/israel-news/2023-02-01/ty-article/ceo-of-multibillion-dollar-startup-to-leave-israel-over-judicial-overhaul/00000186-0bf6-d9b4-afb7-0fff39480000.

3 On Thursday, 9 March 2023, in response to SVB's announced USD 1.8 billion loss on its bond portfolio, investors and depositors attempted to pull USD 42 billion dollars out of SVB. See https://fortune.com/2023/03/11/silicon-valley-bank-run-42-billion-attempted-withdrawals-in-one-day/. On 13 March, the Times of Israel reported that Israeli banks were able to transfer USD 1 billion from SVB to Israeli accounts before the bank was seized by government regulators. https://www.timesofisrael.com/tel-aviv-shares-drop-as-svb-failure-triggers-cash-flow-concern-for-israeli-startups/.

4 SVB was shut down by the California Department of Financial Protection and Innovation on 10 March 2023, two days after it announced its USD 1.8 billion loss on its bond portfolio and the plans to sell common and preferred stock to raise USD 2.25 billion. The following day, the stock of SVB's parent company, SVB Financial Group, crashed upon the market's opening, and more SVB customers began withdrawing and attempting to withdraw their money (approximately USD 42 billion in attempted withdrawals). On 17 March, SVB Financial Group filed for bankruptcy. First Citizens Bank acquired SVB on March 26. See Erin Gobler, "What Happened to Silicon Valley Bank," available at https://www.investopedia.com/what-happened-to-silicon-valley-bank-7368676.

My conclusion is that many did but may have since forgotten. I also realized that significant wealth has been created since the 2008 financial crisis by wealth owners too young to appreciate and learn from the 2008 crisis. In this article, I will discuss the impact of these two factors and recap some basic lessons that I believe will be beneficial to those wanting to be prepared in the future.

1 People remember 2008 but forgot the lessons

As a 50-year-old, I clearly remember the 2008 financial crisis. I remember seeing 40% of my limited investments wiped out (granted, I did not have that much), but a very wise man advised me: pay down your debt first and invest in your pension. That advice has served me well, and, in the aftermath, my resulting net loss was less than 3% of my total wealth in 2008. I know many others who were left far worse by the 2008 crisis, and many who subsequently lost their entire wealth in Bernie Madoff's and Allen Stanford's Ponzi schemes.

By 2010, the stock market started to rise again, and, for nearly 12 years, it seemed like the market was only capable of going in one direction. Even during the height of COVID-19, when the market corrected, six months later it again soared to new highs. Did people who were old enough to have money in 2008 learn the lesson? I believe they did. Investment strategies certainly changed, but, at the same time, so did the market. Artificial intelligence/pharma/tech superseded returns on all prior assets. Cheap money was king for almost 15 years. Even if people learned the lesson, the fall of SVB was not driven by bad investments, but instead by the impact of the rising interest rates that seem more in-line with historical norms. Perhaps the decisions to steadily increase the interest rates as a mechanism to combat inflation were hastily made without considering all potential negative side effects.

2 The wealth owner has changed

The most significant development in the last two decades is the age at which wealth is created. Leaving aside Sam Bankman Fried and Gary Wang, co-founders of FTX, 75% of the remaining billionaires on the "10 Under 40: The Youngest Billionaires On The 2022 Forbes 400" list earned their wealth in technology and have created their wealth since 2008.[5] They were not cognizant of the 2008 financial crisis and were too young and/or inexperienced to learn the lessons. The generational shift has also made a difference as to how the younger wealth owners view the past, as well as utilize debt. Ultimately, people who made money from technology stocks and venture capital funds had never experienced high interest rates and, therefore, had no base line for comparison.

So where does this leave us?

For people like me who remember 1991, 2001, 2008 and now, 2023, what is clear is that the following principles should remain a constant:

1 Diversification

Diversification does not mean only the diversification of assets into different investment classes but should include the diversification of where one keeps funds. For example, many people could not move money out of SVB and other failed banks, because they did not have another account readily available into which to move the funds. One should have at least two bank accounts in each jurisdiction in which they regularly transact business, and two bank accounts in a safe-haven jurisdiction. Just to illustrate that I practice what I preach, I maintain two bank accounts in each of the US, Switzerland and Israel.

Consistent with the most commonly understood meaning of diversification — not putting all eggs in the same basket — diversification also should include diversifying currencies,[6] brokers, etc. One might consider maintaining some cash reserves in the currency of a safe-haven jurisdiction or a neighboring jurisdiction for advantages that go beyond hedging inflation, for example, to provide a safety net in the event of an unexpected crisis, such as what we witnessed with those fleeing Ukraine after the Russian invasion last February.

Thus, the lesson: diversify asset classes, diversify funds, diversify brokers, diversify banks, diversify banking jurisdictions, diversify currencies — diversify, diversify, diversify!

2 Minimize debt

Each and every time there is a financial crisis, debt is always involved. People seem to lose big (as well as make big) on debt. In the end, debt is the great multiplier, but it is also the great destroyer. Could I actually have much greater net wealth than I do today if I utilized more debt? Of course, but I choose

5 Business Insider website

6 U.S. News, Money website

to pay down debt as quickly as possible, because I am always fearful that I will not be able to make a mortgage payment. (It is also very interesting to see how little one actually needs to live on when there is no mortgage to pay). One should consider utilizing debt to supply only the basic necessities in life and not as a mechanism to achieve greater wealth by taking on additional risks.

3 Live below your means

The one repeated pattern I have seen get people into trouble is living beyond their means. And to the point illustrated above regarding minimizing debt, some even use debt to live beyond their means. That always seems to lead to bad investment behaviors. For example, I recently witnessed someone go into default because they loved luxury living so much that when the SARON interest rate increased, they could not pay their mortgage. Just like with residences, the same rule holds true with cars and other large asset purchases. Do not try to swing a Ferrari on a Fiat budget, because you will likely be unable to do it without incurring substantial debt, in addition to the otherwise unaffordable, incidental costs of owning that asset (i.e., unaffordable maintenance, repairs, taxes, etc.). Living below your means will enable you to save money for future investments without having to incur additional risks beyond the funds invested.

4 Keep cash around

Having cash around provides opportunities in an economic downturn or in an unexpected emergency. However, what does cash mean? It does not necessarily always mean a fiat currency. Unless you are lucky to transact business with a bank that has every Swiss franc protected (like certain cantonal banks), you are always taking bank risk. But, if one selectively puts assets in short-term bonds, the risk shifts from bank risk to asset risk.

Additionally, keeping cash on hand enables one to plan for the possibility that their assets located in an unstable political environment might become frozen or even worthless. Yet in a world of currency controls, if one needs to run, one may not need to move funds quickly to restart. What is required is to have a few locations with money on hand to allow one to sustain oneself for an indefinite period.

5 Do not allow securities lending

The worst issue for average investors is not getting their assets returned. In the Lehman Brothers bankruptcy matter, the biggest issue was locating the assets that had been subject to securities lending. There are two primary risks with securities lending: (1) borrower default risk; and (2) cash collateral reinvestment risk. Such investments are just not worth the return or the risk. Do not permit securities lending.

6 Upskill

One never knows where the world is going. Always learn. Develop another skill or trade. Learn another language. Make options possible to earn that are not otherwise there. I have personally observed that if one does not have the personal skills to start again, it is nearly impossible to restart from scratch, especially in another country where one lacks sufficient language skills. Preparations for children should include learning sufficient language skills and seeking an education that is portable to other jurisdictions to enable them to rebuild anew.

7 Multiple residences

Another lesson from the pandemic and from the Russian invasion of Ukraine is that it is not good to wait until after a crisis hits to move to another location. Find options and have them ready in advance. Personally, if my wife and I had to live locked down together in a small apartment in Zurich during the pandemic, we might not have survived. Fortunately, we have a larger apartment in the mountains that we could each visit when we needed some quiet time and isolation. As a result of the demand for second residences, property prices exploded as everyone scrambled to move to the countryside.

8 Supply chain risk

Make sure you have a sufficient stockpile of necessities, especially medicine, on hand to address potential supply chain disruptions. During the height of the pandemic, many observed supply chain shortages with medicine, medical equipment and other basic necessities such as toilet paper and sanitizer. When these items became available, they were quickly hoarded by consumers who were lucky to be first in the stores when they hit the shelves. This continued for months. Everyone's necessities differ, so make a list of the items that you cannot live without and keep enough on hand in anticipation of future shortages.

Conclusion

A few years ago, there was a show on US television called Doomsday Preppers, which highlighted people stockpiling food, water, weapons,[7] ammunition, gas masks and whatever else they deemed necessary to survive life after doomsday. Initially, I thought the show was insane. In the end, however, my views have changed, and my behavior has changed. I now keep gas masks in the home, and I keep supplies of medicine. I also diversify my banks and assets. I have also learned to expect the unexpected. It may not always make the best practical or financial sense, but when something goes wrong, my family is protected.

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7 https://en.wikipedia.org/wiki/Doomsday_Preppers

Article

Labuan: Malaysia's hidden card

The historical fuss about Labuan

With a population of just over 100,000, Labuan is a small Malaysian island located off the coast of Borneo in Southeast Asia. Little known to most is that Labuan, a federal territory of Malaysia, has a special status as an International Business and Financial Centre (IBFC). Prior to its rebranding as an IBFC in 2008, in the 1990s Labuan was initially declared as an international offshore financial center.

In 2009, Labuan IBFC was categorized by the Organization for Economic Cooperation and Development (OECD) as a jurisdiction that was "not committed to the internationally agreed tax standard" in its progress report on the implementation of the international tax standard for the exchange of information. Consequently, the Labuan Financial Services Authority, the regulator responsible for the development and administration of Labuan IBFC, reinforced its commitment to the international standard for exchange of information, and to continuous cooperation with other competent tax authorities in curbing tax evasion and financial crimes. The Malaysian government initiated progressive, concrete steps toward ensuring that the legal and tax regimes in Labuan conform to the global shifts on transparency and compliance standards.

Route to global compliance

As part of the government's efforts in repositioning Labuan as a credible global and business financial hub, the Labuan Companies Act 1990 (LCA) was amended on 9 June 2022 via the Labuan Companies (Amendment) Act 2022 ("Amendment Act") to introduce various remedial measures.

First, the Amendment Act established a formal beneficial ownership reporting regime for Labuan companies, which is consistent with the framework under the Malaysian Companies Act 2016 (which came into force on 31 January 2017) (MCA). Labuan companies are now legally required to take steps to identify, keep records of and report its beneficial owners. A "beneficial owner" is defined under the LCA to mean:[8]

- [A] natural person who owns or controls a Labuan company [...], in whole or in part, through direct or indirect ownership or control of shares or voting rights or other ownership interest [...], or who exercises effective control and influence [...]

This amendment aligns Labuan's corporate compliance regime with the Financial Action Task Force's (FATF) recommendations on transparency over company ownership and control, which is evident in the FATF's recognition of Malaysia as a jurisdiction with robust anti-money laundering policies.

Second, the Amendment Act expressly prohibits the issuance of bearer shares or conversion of shares to bearer shares by Labuan companies. Bearer shares are unregistered shares where ownership is evidenced though the physical possession of the share warrant or certificate. This effectively enabled holders of bearer shares to remain anonymous, and enabled bearer shares to be infinitely transferrable yet untraceable. Due to the confidentiality they offered, bearer shares held a poor reputation for being an easy means of facilitating illegal activities such as tax evasion or money laundering. The prohibition of bearer shares brings the Labuan position on par with the existing Malaysian regime under the MCA, where such shares were already prohibited since 1965.

8 Section 108A of the LCA.

Third, Labuan companies are now mandated to appoint at least one Malaysia-resident director, which can be fulfilled by either a trust officer of a Labuan trust company, or an individual who is at least 18 years old and a citizen or permanent resident of Malaysia. This amendment effectively requires Labuan companies to have a certain degree of substance in Malaysia.

In terms of the tax regime, notwithstanding that Labuan is territorially part of Malaysia, Labuan entities are subject to a separate tax regime under the Labuan Business Activity Tax Act 1990 (LBATA). Prior to 2019, Labuan entities carrying out specified trading activities could opt to pay tax at a flat rate of MYR 20,000 (approximately USD 4,500) per year regardless of their net profits, instead of 3%. However, in line with Malaysia's commitment to combat harmful tax practices, Labuan has abolished the flat tax rate and introduced legislation mandating in-scope entities to demonstrate they have sufficient economic substance in Labuan.

Consequently, the new Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2021 ("2021 Regulations") require Labuan entities undertaking specific trading activities to comply with the relevant substance requirements to avail of the preferential tax regime under the LBATA. This can be achieved by hiring a minimum number of employees physically located in Labuan, and by incurring a minimum amount of operational expenditure in Labuan yearly, depending on the type and scope of activities carried out by the Labuan entity. If these prescribed minimum requirements are met, the Labuan entity can continue to be taxed at the rate of 3% on its net profits each year as reflected in its audited accounts.

On the other hand, Labuan non-trading entities (such as those carrying out investment holding activities only) may continue to enjoy a 0% tax rate each year under the LBATA if they meet the prescribed substance requirements in Labuan, which are less onerous. For example, a Labuan pure equity holding company is only required to prove that management and control is exercised in Labuan, but it is not required to hire full-time employees in Labuan.

Labuan entities that fail to comply with the prescribed economic substance requirements under the 2021 Regulations will be taxed at a higher rate of 24% on their net audited profits for the particular year, which is the same corporate tax rate applicable to Malaysian companies incorporated under the MCA. Additionally, the tax would be imposed on all accounting profits of the errant Labuan entities, which may include capital gains and dividend income.

Following the legislative amendments discussed above, the Labuan financial services regime has been designated by the OECD's Forum on Harmful Tax Practices as "not harmful," indicating that the Labuan tax framework is now compliant with global standards.

Labuan: a good option?

Labuan can be an attractive wealth management destination for many reasons, including its physical location. Being strategically located in the center of the Asia Pacific region, Labuan shares the same time zone with key Asian cities and financial hubs such as Singapore and Hong Kong.

Moreover, Labuan remains a tax-efficient jurisdiction. Other than the competitive tax rates outlined above, where the prescribed substance requirements are met, Labuan entities currently have access to the benefits under most of Malaysia's extensive network of double tax treaties. Individuals and families setting up cross-border wealth-planning structures in Labuan may also benefit from the tax exemptions available to non-residents for withholding tax on dividends, interest and other payments from Labuan entities. Notably, stamp duty is also exempt on all instruments executed by a Labuan entity in connection with a Labuan business activity, on constituent documents and on transfer of shares in a Labuan company.

In addition, Labuan provides high-net-worth individuals and families with many wealth management and succession planning tools and vehicles. For example, Labuan is the first common law jurisdiction in Asia to offer the civil law concept of a private foundation. Foundations, being self-owned, corporate bodies with separate legal personality, can be a suitable option to hold assets for charitable and non-charitable purposes.

At the same time, Labuan has adopted modern trust legislation, which enables families to establish trusts that can accommodate the succession planning needs and preferences of the present-day settlors. This includes the setting up of purpose trusts, reserved powers trusts and trusts with no perpetuity period — all of which are not viable under the common law trust concepts that Malaysia adopts. There is also an option for those seeking Shariah-compliant solutions to set up Islamic trusts and foundations.

Furthermore, Malaysia continues to maintain liberalized foreign exchange control rules, which are issued by the Central Bank of Malaysia pursuant to the Financial Services Act 2013. These rules prescribe some limits in relation to dealings between (and among) Malaysian residents and non-residents, in Malaysian ringgit and foreign currency. Although Labuan is geographically considered part of Malaysia, Labuan entities are regarded as non-residents for the purposes of the Malaysian foreign exchange control regime, and may freely transact with other non-resident entities without limits.

Conclusion

Labuan IBFC has been promoted as an international business and financial center and, from a tax and legal perspective, has positioned itself as a jurisdiction worthy of consideration for various wealth and succession planning initiatives. Armed with an informed understanding of the revamped legal and tax regime, Labuan could be an ideal jurisdiction for certain private clients and their advisers wishing to set up wealth management structures in the Asia Pacific region.

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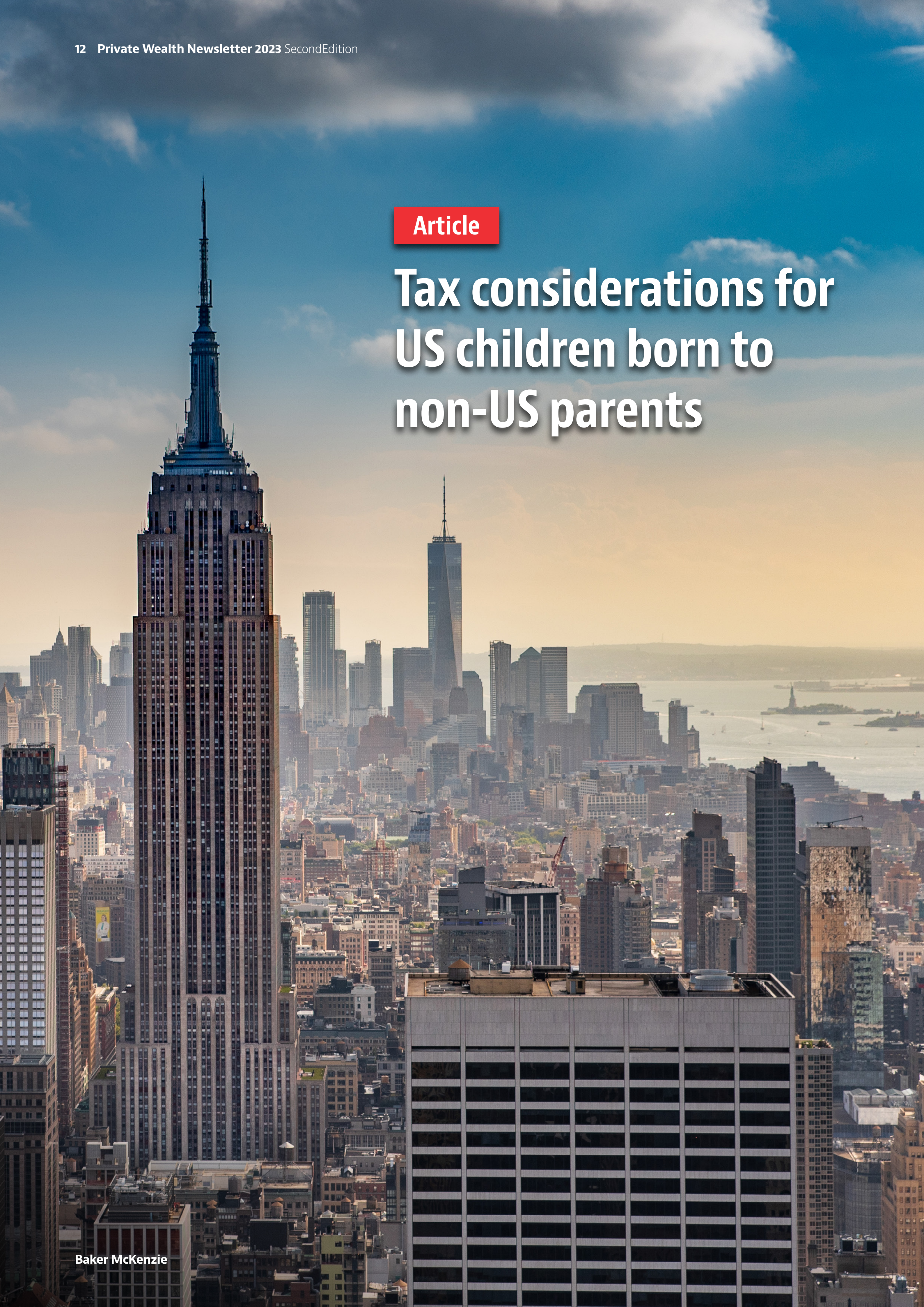

Article

Tax considerations for US children born to non-US parents

For many non-US parents, it is a dream to have a US-born child. Just being born in the US may provide one with highly regarded opportunities. A US-born child not only can live, study and work in the US freely, but also can become a US president one day. However, is having a US-born child always a blessing to non-US parents?

US citizenship

The US grants its citizenship on the basis of *jus soli*, i.e., birthright-based citizenship. This means that any person born within the territory of the US is a US citizen, regardless of the citizenship of their parents. The 14th Amendment, ratified in 1868, further enshrined this well-established principle. According to the amendment, "[a]ll persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside."

US citizens are entitled to enviable rights and benefits. Among them, the right to hold a US passport allowing visa-free travel to more than 180 countries in the world, access to the country's outstanding educational institutions at a lower cost, and the privilege of getting permanent residency (green card) for one's non-US parents, are regularly touted by the "birth tourism business" to many non-US expecting parents. As a result, a US birth certificate is often viewed as one of the best welcome gifts these parents can give to their child and themselves.

Birth tourism business

The "birth tourism business" has long operated in many states in the US, especially in California, New York and Florida. It isn't illegal to visit the US while pregnant. The operators who run the birth tourism business only sometimes attract the attention of law enforcement officials with one such operation resulting in federal agents raiding about three dozen sites used for the business in 2015 in California. Nineteen individuals were charged with visa fraud and conspiracy to commit immigration fraud.

Despite sporadic enforcement activities, the number of US children born to non-US parents has been on a steady rise. The Center for Immigration Studies estimated that 33,000 chidren are born to women on tourist visas each year.

It may be, then, that a non-US expecting mother comes to the country and stays for a few months to give birth and complete the child's birth certificate and passport paperwork. After that, the non-US child may be taken back to and grow up in the country where their non-US parents reside. When the child becomes an adult, they may return to the US or might never go back other than for short durations, if at all.

Potential tax liability

While the perceived benefits of a US passport may be substantial, some non-US parents may be unaware that their US children are liable for US tax filing and reporting obligations. As the only developed country that bases tax duty on citizenship rather than residency — the place where a person works or lives — the US taxes its citizens, including those with dual nationality, based on worldwide income, regardless of age.

Taxes can be levied on a US child if the child has both earned and unearned income totaling more than USD 12,400 in a year. In other words, the child must file taxes if their income exceeds the threshold. Being a taxpayer, the child may become subject to civil liability and criminal penalties for tax evasion and failure to file if taxes are not timely filed and paid.

Earned income

Like an adult, a child can work and earn money, be it mowing the lawn, babysitting or doing a summer internship. For US federal income tax purposes, the amount a child earns by performing services is included in the gross income of the child and not the gross income of the parent.

If John, a 16-year-old, earns less than USD 13,850, the threshold for 2023, from his part-time jobs, the income is exempt. Once he earns more than that amount in wages and has no unearned income, he must file a tax return.

Often, many non-US parents of US children are well off financially and socially in their home countries. Imagine that John, a US child born to a non-US couple who are celebrities in their own country, became a TV or movie star with substantial earned income owing to his parents' resources and connections. John would need to pay tax on the excess income over USD 12,950 unless he qualifies for foreign-earned income exclusion. In that case, John would only pay tax on the income above a much higher threshold, USD 120,000 for 2023.

Foreign earned income exclusion

To claim the exclusion, several criteria must be met. First, the foreign-earned income must be wages, salaries, professional fees or other amounts paid for the personal services rendered by the child. Second, employment in the foreign country is expected for an indefinite, rather than temporary, period. That is, if the child's abode remains in the US, where the child keeps closer familial, economic and personal ties, they will not qualify. Third, the child must be a bona fide resident of the foreign country for an uninterrupted period that includes an entire tax year or must be physically present in the foreign country for at least 330 full days during any period of 12 consecutive months.

In John's case, he is paid salaries or professional fees for his acting gigs in the non-US country where he lives with his parents. His parents' place is his only home. He has no intention of returning to the US in the foreseeable future. Besides being born in the US, John has no other ties with the US. Under the circumstances, John will likely qualify for the exclusion. That is, John will only be liable for tax on his income portion above USD 120,000 for 2023. If John makes less than that amount, no tax liability is triggered.

Kiddie tax

By contrast, a child's unearned income includes interest, dividends or capital gains. The kiddie tax was enacted to discourage wealthy parents from conveying assets to their children to take advantage of the children's lower rates. A child's unearned income is subject to the kiddie tax if the child falls within the scope of the tax regime. Earned income is not subject to the kiddie tax.

The kiddie tax applies to children who are either: (a) 17 years old or younger at the end of the tax year; (b) 18 years old at the end of the tax year only if their earned income is less than or equal to 50% of their "support;" or (c) 19 to 23 years old if their earned income is less than or equal to half of their "support" and they are a full-time student.

The imposition of the kiddie tax is as follows: in 2023, the first USD 1,250 worth of a child's unearned income is generally tax-free, covered by the kiddie tax's standard deduction; the next USD 1,250 is taxed at the child's marginal tax rate; anything above USD 2,500 is taxed at the parent's marginal tax rate.

Let us assume that John received USD 2,600 of taxable interest and dividend income during a year that he didn't work. He must file a tax return because he has unearned income only, and his gross income is more than USD 1,250. He must also complete and attach Form 8615, Tax for Certain Children Who Have Unearned Income, to his Form 1040 or 1040-NR.

Parent's election

When the kiddie tax applies to a child with US parents, the parents can elect to include the child's income in their tax return using Form 8814, Parent's Election to Report Child's Interest and Dividends, when certain requirements are met. The child will then be treated as having no income for the year and need not file a separate return.

Because John is only 16 (under 19 years old) and single, and his gross income of USD 2,600 is only from interest and dividends in the amount of less than USD 11,000, his parents may elect to include his income on their tax return instead of separately filing his return.

On the other hand, if John's parents are non-US persons, who do not live in the US or derive any income from the US, they will not incur any US tax liability or need to file a US tax return. In this case, the regulations do not provide whether or how the parents can use the election to include John's kiddie tax.

Foreign gifts

Gifts to US children born to non-US parents can sometimes cause complications. For instance, an account is set up in John's name to fund his college education. Each of his four non-US grandparents contributes USD 30,000 and deposits USD 120,000 in cash and stock into the account.

The gifts are foreign because the grandparents are non-US citizens. Generally, the receipt of foreign gifts is not subject to US federal income tax. However, the total of the unearned income, i.e., the interest income from the cash, dividends from the stock or capital gains from the stock sale, is potentially subject to the kiddie tax.

Aggregation rule
If a US person knows that the gifts received are from related parties, they must aggregate them. If these gifts exceed USD 100,000, the child must file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, to fulfill their reporting obligations.

Although each grandparent, a non-US individual, only gifts John USD 30,000, the related party rule applies here: the separate amounts must be aggregated. John is required to report the foreign gifts totaling USD 120,000 to the Internal Revenue Service (the "IRS") on Form 3520.

Penalty
If a US person fails to file Form 3520 for foreign gifts, the IRS may determine the income consequences of receiving the foreign gift or bequest. In addition, it may assess a penalty of 5% of the gift value for each month in which the gift is not reported, not to exceed 25% of the gift, unless the taxpayer has reasonable cause for the failure to file. Interest can be charged on any unpaid penalty. There is no criminal liability for non-compliance.

As stated above, John needs to report the gifts from his grandparents. Failing to do so, he can be subject to a penalty of up to USD 30,000.

The report of Foreign Bank and Financial Accounts (FBAR) (FinCEN Form 114)

Under the Bank Secrecy Act of 1970(BSA), a US citizen must file FinCEN Form 114 if they own, control or have signatory authority over the foreign bank and financial accounts with a combined value over USD 10,000 at any time during the calendar year. The report aims to prevent US citizens from hiding assets overseas and committing tax evasion or money laundering.

The FBAR goes to the Financial Crimes and Enforcement Network ofthe US Treasury Department (FinCEN), not the IRS. It must be filed separately from the tax return but has the same deadline as the return, with an automatic extension to 15 October of the tax year.

Although the FBAR is only an informational report, the non-filing penalty is steep: USD 10,000 for each failure to file the FBAR; if the failure were determined to be willful, the fine would be greater of USD 100,000 or 50% of account balances. Criminal penalties, up to 10 years'imprisonment, may also apply.

I n our above scenario, if the cash in John's account is in foreign currency, the currency has to be converted to US dollars for the calculation of the amount. With the assets valued at or above USD 120,000 in a reportable foreign financial account, John would be obligated to file the FBAR each year.

Foreign Account Tax Compliance Act (FATCA)

Similar to the FBAR, FATCA aims to combat offshore tax evasion. A US-born child living outside the US must complete Form 8938, Statement of Specified Foreign Financial Assets, if the foreign assets they own exceed either USD 200,000 at the end of the year or USD 300,000 at any time during the year. Unlike the FBAR, this form must be attached to the taxpayer's annual IRS tax return by the income tax due date. An automatic extension to 15 October is also available to citizens living abroad.

The non-filing of Form 8938 may lead to severe penalties as well. Initially, there is a fine of up to USD 10,000 for failure to disclose, then another USD 10,000 every 30 days after receiving the notice from the IRS, up to the maximum fine of USD 50,000. Criminal penalties may also apply.

Where the grandparents gifted John USD 120,000, an amount less than USD 200,000, filing Form 8938 is optional in the absence of any other assets.

Trusts

Usually, a trust fund is a great tool to guarantee the financial stability of other family members, including children and grandchildren. It may provide safe and secure protection for vulnerable individuals who have disabilities, learning difficulties or financial issues that they cannot control. For US taxpayers, it also helps to ensure that assets are transferred in the most tax-efficient way.

Let's assume that John's non-US grandparents decide to establish a foreign trust (non-US) for the benefit of all their grandchildren (trust beneficiaries), including John and, for credit protection purposes, make this trust irrevocable.

1 Trust accounting

Regardless of how a trust itself is taxed under the US federal tax rules, once a US-born child directly or indirectly obtains a beneficial interest in the trust, the trust is required to keep its books and records in accordance with the US tax accounting rules and principles. The trust will calculate the taxable gains and losses according to US rules.

Moreover, all income and assets of the trust will have to be reported in US dollars. Any sale or exchange of assets in a currency other than the US dollar would result in currency exchange gains (or losses) that should also be taxable and reportable. The US tax accounting rules will apply not only to the trust but also to any entities owned by the trust.

In our example, this rule will result in an additional administrative cost to the trust, which would not have been the case if John was not a US person.

2 Accumulation distribution penalty

The accumulation distribution penalty is an anti-deferral regime applicable exclusively to US beneficiaries of foreign trusts, like the one discussed in our scenario above. To understand the penalty, two concepts need to be introduced.

First, distributable net income (DNI) is the trust's taxable income for US federal income tax purposes. For foreign trusts, DNI includes ordinary income, whether from US or non-US sources, and realized capital gains. Second, when DNI is not fully distributed in the year it is generated, the undistributed portion will turn into an undistributed net income (UNI) in the following year.

The penalty is imposed where UNI has accumulated for a long time. The US beneficiary is liable for the applicable tax plus interest charge when UNI distribution is made.

3 Use of trust property by US beneficiary

A US beneficiary may become subject to US federal income tax where the trustee permits them to use trust property without proper compensation.

Use of trust property includes both the use of the physical assets, such as dwellings and artwork, and loans of cash or marketable securities, either to US beneficiaries[9] or people related to those beneficiaries, unless the fair market value for such use is paid to the trust within a reasonable period. Otherwise, the US beneficiary is treated as receiving a trust distribution equal to the fair market value of the use of the property.[10]

Once a US beneficiary is treated as receiving a distribution from the trust because of gratuitous use of trust property, any later transactions between the trust

9 A person is treated as related to a US beneficiary if such person is the US beneficiary's: sibling, spouse, spouse of sibling, ancestor, spouse of ancestor, lineal descendant and spouse of lineal descendant, a corporation that is a member of the same controlled group or a fiduciary of the trust.

10 There is no guidance on what constitutes "a reasonable period of time" to compensate a trust for use of its property, but most likely a written agreement between parties specifying how the property will be handled and on what terms may assist in providing the answer on whether a period of time was reasonable, if challenged.

and the US beneficiary (such as a cancellation of debt) will be disregarded for US federal income tax purposes.[11] The matter can get even more complicated when a foreign trust owns underlying entities that generate passive income. However, this topic is beyond the scope of this article.

Therefore, if the trust discussed earlier, of which John is a beneficiary, owns an apartment, which he uses while attending college without paying rent, the fair market value of the rent will be considered a distribution to John, subject to US tax, and, if certain conditions apply, subject to punitive taxation as described earlier.

Covered expatriate

A US citizen who does not intend to live in the US may consider renouncing their US citizenship if they have another nationality, i.e., expatriation. Unfortunately, renunciation is not always as easy, especially if one is classified as a "covered expatriate."

Covered expatriates are US citizens whose average tax liability during the past five years stood at USD 190,000 in 2023 ("tax liability test"); or whose net worth exceeds USD 2 million ("net worth test"); or who failed to certify tax compliance with the IRS during the five years preceding the expatriation ("certification test").

All property owned by a covered expatriate is treated as sold on the day before the expatriation date at its fair market value pursuant to the "mark-to-market" rules. Covered expatriates must pay tax at normal income tax rates on all unrealized gains from the deemed sale that exceed USD 821,000 (inflation-adjusted figure for 2023) on their worldwide assets ("exit tax").

A US citizen may expatriate without any tax liability if they are a non-covered expatriate, by not meeting any of the above tests, or if they expatriate before turning 18-and-a-half years old, or if they are a dual national from birth.[12]

Interestingly, the law does not specify a minimum age or mental capacity for renunciation. It appears that consuls apply common law principles to such cases. Children under 16 are presumed not to have the requisite maturity and knowing intent to relinquish citizenship; children under 18 are provided additional safeguards during the renunciation process, and the Department of State affords their cases very careful consideration to assess their voluntariness and informed intent.[13] Importantly, parents are prohibited from renouncing the US citizenship of their children.

If John, at 16 to 18, has decided to connect his future with the country he was raised in, he is confident that he would not want to relocate anywhere other than for college, and even then, with the intention to return home upon graduation, he should be aware of his US tax obligations as a US person and his options, including the possibility of renunciation of his US citizenship.

Conclusion

While the choice of nationality ultimately remains with the child, non-US parents need to understand the implications of having children holding a US passport. It's a question that begs the parents to answer: do the benefits (actual and perceived) of having US citizenship outweigh the significant US tax burden while the child builds a life elsewhere with no other ties to the US?

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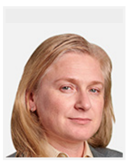

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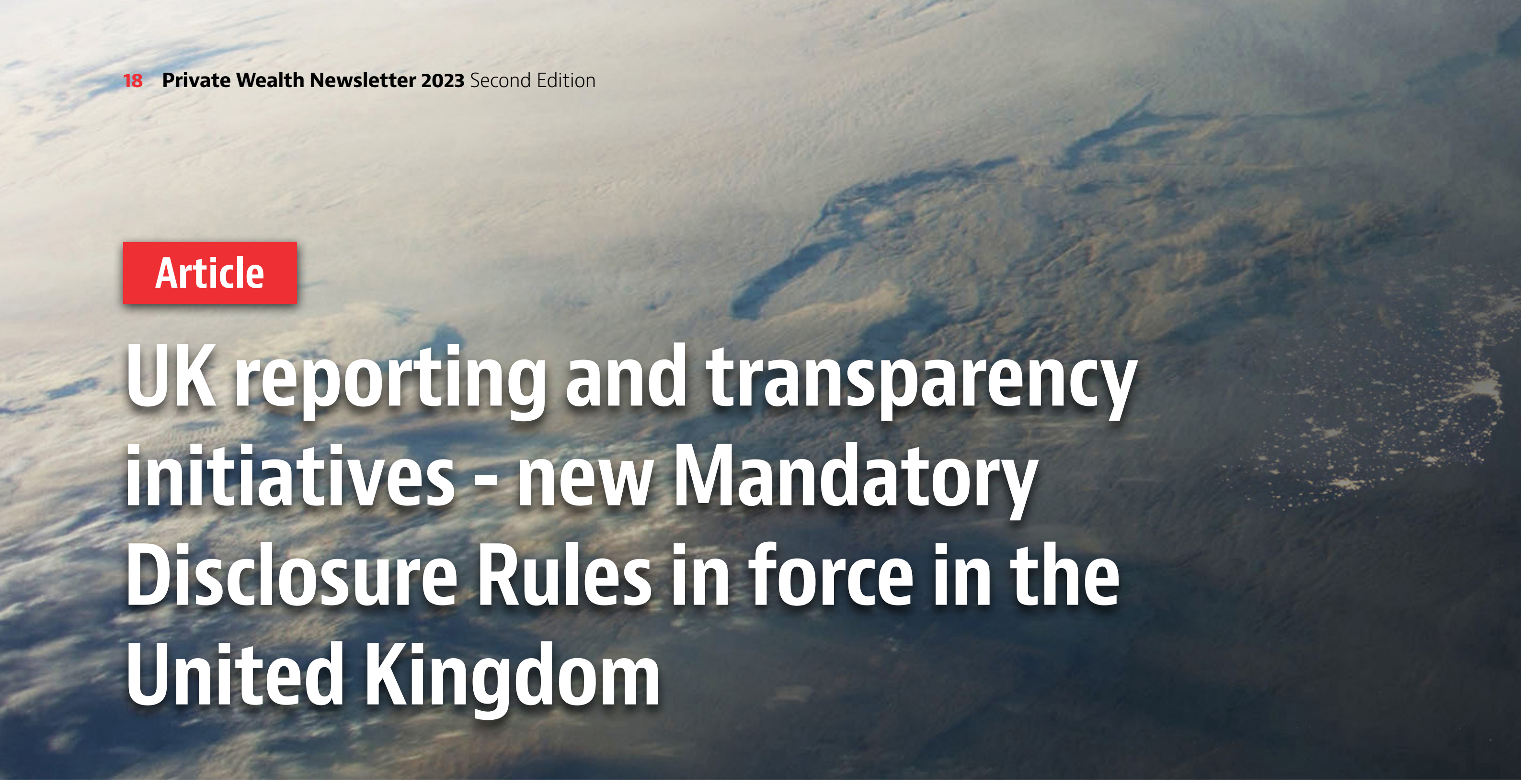
11 IRC § 643(i)(3).

12 A US citizen who: 1) is a dual citizen since birth; 2) continues to retain the other citizenship; 3) is taxed as a resident of that other nation; and 4) has been a resident of the US for 10 or fewer years during the 15 years immediately before the expatriation.

13 U.S. Department of State website



Article

UK reporting and transparency initiatives - new Mandatory Disclosure Rules in force in the United Kingdom

The so-called UK Mandatory Disclosure Rules (MDR) came into force in the UK on 28 March 2023. They comprise new cross-border tax avoidance arrangement disclosure rules that implement the OECD Model Mandatory Disclosure Rules.

Notably, the rules have global application, provided the taxpayer or their intermediary has a UK nexus and so are of considerable importance to many private clients who have implemented structures designed to protect their information from disclosure. Private clients and their advisers and other intermediaries should therefore consider the UK MDR carefully in the context of asset holding structures, including non-UK company, trust and other structures.

The new regulations are intended to replace the latest iteration of the DAC 6 rules, which were implemented in the UK. In-scope arrangements made available by intermediaries or implemented by taxpayers after 28 March 2023 must be reported to the UK tax authority, HMRC, within 30 days. Pre-existing arrangements will need to be reported within 180 days after the rules are implemented (i.e., by 25 September 2023). The look-back period for reporting pre-existing arrangements is 25 June 2018 (the same as DAC 6).

Scope of the rules

The scope of the UK MDR is limited to the two categories of arrangements described below. This reflects the way DAC 6 was implemented in the UK from 2021 whereby its application was limited to arrangements falling under Hallmark D of the EU Directive. However, the UK MDR extends the territorial scope such that certain arrangements that may not have been reportable under the UK DAC 6 regulations are reportable under the UK MDR. In particular, there will be no territorial limitations to the application of the UK MDR, resulting in in-scope arrangements and structures being reportable to HMRC, regardless of which jurisdictions are involved, as long as the intermediary or taxpayer has a UK nexus. A UK nexus may simply be where an intermediary provides services from a UK branch or office, or where the intermediary or taxpayer is tax resident in the UK. This will therefore be of particular note to international private clients who use UK-based advisers.

The new rules require intermediaries (for example, law firms or asset managers) that are incorporated, resident or have a place of management in the UK to make a report to HMRC with respect to one or both of the following if they make the structure or arrangement available for implementation or provide relevant services in relation to it through a branch or office located in the UK:

1. "OECD Common Reporting Standard (CRS) avoidance arrangement"; or
2. Opaque offshore structure.

"CRS avoidance arrangement" captures any arrangement "for which it is reasonable to conclude that it is designed to circumvent or is marketed as, or has the effect of, circumventing CRS legislation or exploiting an absence thereof." There is an exemption from the look-back period in relation to CRS avoidance arrangements, where the amount involved is less than USD 1 million.

An opaque offshore structure is defined as being a passive offshore vehicle held through an opaque structure. This broadly covers entities that do not carry out any substantial economic activity supported by adequate staff in their country of residence and are designed to or have the effect of disguising or hiding the persons with beneficial ownership over it. Similarly, as under DAC 6, the question is whether beneficial ownership has been made "unidentifiable." For these purposes, ownership does not need to be publicly available. Draft HMRC guidance confirms that ownership will not be made unidentifiable where the relevant tax authorities have mechanisms by which they can obtain this information. This should be carefully assessed on a case-by-case basis.

In addition, an exemption applies where relevant information has already been provided under DAC 6 and an intermediary is not required to disclose any information to the extent it is subject to legal professional privilege (but the taxpayer would be required to report).

How will this affect clients?

The introduction of the UK MDR is of particular importance to private clients and their structures, particularly given certain planning that may have been done in light of (often legitimate) concerns regarding the disclosure of beneficial ownership information in the public domain. However, clients need to be aware of potential reporting obligations on intermediaries or themselves (as reportable taxpayers), as well as the reporting obligations of intermediaries providing relevant services to them. Given the look-back period, it is important that all reporting obligations (even in respect of historic structures) are met by intermediaries and reportable taxpayers where appropriate.

Please click the link below for a more detailed overview of the new rules.

United Kingdom: Mandatory Disclosure Rules Come Into Force

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Around the world

APAC - Malaysia

Malaysian Premium Visa Programme (PVIP)

On 1 September 2022, the Ministry of Home Affairs of Malaysia launched a new residence by investment programme, the Malaysian Premium Visa Programme ("PVIP"), which enables investors, entrepreneurs, and foreign talents to live and work or study in Malaysia. A PVIP holder is granted a multiple-entry pass to stay in Malaysia for up to 20 years. Applicants may also apply to bring dependents into Malaysia under the programme, subject to meeting additional financial requirements.

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Further updates regarding taxation of foreign-sourced income

Since the publication of our client alert in relation to the taxation of foreign-sourced income (FSI) in Malaysia (linked here), the government has issued two income tax exemption orders on 19 July 2022 respectively governing (i) the exemption of all types of FSI for individuals (except income from a partnership business in Malaysia); and (ii) the exemption of foreign-sourced dividends received by qualifying persons.
In this alert, we summarise details of the income tax exemption orders and the relevant implications for taxpayers.

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Americas - Argentina

New list of non-cooperative jurisdictions in the regulatory decree of the Income Tax Act

Decree No. 48/2023 (the "Decree") was published in the Official Gazette on 27 January, 2023, approving a new revised text of the regulatory decree of the Income Tax Act.
The Decree establishes certain jurisdictions that will be considered as non-cooperative in the exchange of tax information.
The list of non-cooperative jurisdictions will be applicable as of 27 January 2023.

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Non-application of the income tax perception on certain exportations of goods carried out through international intermediaries located in countries or jurisdictions that are not the countries or jurisdictions of the final recipients of the goods

General Resolution 5322, published in the Official Gazette on 2 February 2023, amended General Resolution 830 establishing that exporters subject to the income tax perception set forth by General Resolution 3577 ("Resolution") will be entitled to apply for an income tax perception exemption certificate.
The Resolution established an income tax perception on certain exportations of goods carried out through international intermediaries located in countries or jurisdictions that are not the countries or jurisdictions of the final recipients of the goods.

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Americas - Brazil

For the first time, São Paulo's Tax Authorities provide analysis on the levy of Estate and Gift Tax on Irrevocable Trusts

On 4 April 2023, a response to the tax private ruling no 25343/2022 was published. For the first time ever, São Paulo's Tax Authorities ("**Sefaz-SP**") released an answer regarding the levy of Estate and Gift Tax (ITCMD) on Irrevocable Trusts dealing with Brazilian residents.

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Provisional Measure N. 1,171/23: Changes on the taxation of financial investments, controlled companies and trusts owned by Brazilian tax residents (individuals)

On 30 April 2023, Provisional Measure 1.171/23 ("**MP**" or "**MP 1.171/23**") was published, bringing some changes on the taxation of Brazilian tax residents (Individuals), especially regarding: (i) the taxation of financial investments abroad, and (ii) the creation of "anti-deferral" rules for foreign controlled entities owned by Brazilian individuals. In addition, for the first time, this MP deals with the taxation of foreign trusts.
MP 1.171/23 also changed the bracket amounts of the ordinary income tax progressive rates and revoked some specific tax provisions, including specific exemptions applicable to individuals.

The new rules shall be applicable from 1 January 2024 ahead (assuming the timely conversion of the provisional measure into law, as required in Brazil).

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*Trench Rossi Watanabe and Baker McKenzie have executed a strategic cooperation agreement for consulting on foreign law.

EMEA - France

Tax treaty between France and the United States: the mutual assistance clause for the collection does not have a similar scope to the Directive 2010/24/EU (Tax Court of Appeal of Paris, 10 November 2022, No. 21PA01182)

The Tax Court of Appeal of Paris judges, in a dispute concerning the statute of limitations for tax collection, that the United States does not have a legal instrument on mutual assistance for tax collection that is "equivalent" to the one provided for by Council Directive 2010/24/EU 16 March 2010. Such an interpretation of the tax treaty concluded between France and the U.S. could have consequences on other tax regimes, and in particular on French exit tax.

READ MORE

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New Non Cooperative States and Territories: update of the French and European lists

A decree dated 3 February 2023 updated the French list of Non Cooperative States and Territories (NCST) within the meaning of article 238-0 A of the FTC: the Bahamas and the Turks and Caicos Islands have been added to the previous list (issued by the decree dated 2 March 2022).[1]

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1 The list resulting from the decree of 3 February 2023 therefore includes the following 14 States: British Virgin Islands, Seychelles, Anguilla, Panama, Bahamas, Turks and Caicos Islands, Vanuatu, Fiji, Guam, U.S. Virgin Islands, Palau, American Samoa, Samoa, Trinidad and Tobago.

EMEA - France

Mutual tax agreements on remote working for border and cross-border workers concluded between France and Switzerland (Mutual Tax Agreement dated 22 December 2022 concluded between France and Switzerland)

On 22 December 2022, France and Switzerland concluded agreements concerning the taxation of border and cross-border workers who carry out part of their activity in their State of residence. These agreements replace the mutual agreement dated 13 May 2020, concluded in the context of the pandemic and which aimed to avoid any tax impact due to remote working for the worker. This agreement expired on 31 December 2022.

READ MORE

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EMEA - Spain

Spanish Wealth Tax - A new amendment allows the taxation of shareholders of non-resident companies whose assets are mainly composed of real estate located in Spain

On 28 December 2022, the Spanish Government decided to amend the Spanish Wealth Tax Law with effect as of FY 2022 allowing that non-resident entities whose assets consist, directly or indirectly, of at least 50% of real estate located in Spanish territory must be subject to this tax. This is a very significant change given that the position of the Spanish Tax Administration, up to date, did not subject them to tax.

READ MORE

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EMEA - Germany

No limited Inheritance Tax liability when acquiring German real estate by means of a foreign bequest/legacy

Real estate located in Germany can be transferred tax-free if the testator bequeaths the real estate to the beneficiary by means of a foreign bequest. This was decided by the Federal Fiscal Court (BFH) in its decision of 23 November 2022 - II R 37/19, published on 28 February 2023. The requirements are that neither the deceased nor the beneficiary of the bequest is a German citizen, and both live abroad. German citizens can also benefit from this rule if they live abroad for more than five years.

READ MORE

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German Federal Fiscal Court on consecutive gifts in the context of succession planning

Consecutive gifting ("Kettenschenkung") continues to be an attractive way of optimizing the use of tax brackets and personal tax allowances which depend on the nature of the relationship between the parties. The potential for tax optimization is not limited to private assets but can also be used for tax planning in the context of business succession. The German Federal Fiscal Court commented on this in its recent ruling (dated 28 July 2022 - II B 37/21) and clarified whether and under which conditions the concept of consecutive gifting can apply. Since the personal allowances under the German Inheritance and Gift Tax Act are higher among family members than among third parties, consecutive gifts can be effectively utilized in order to keep the gift tax burden low and to preserve family assets.

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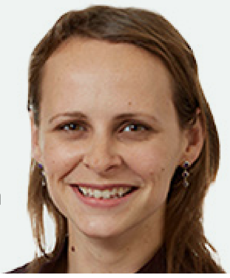

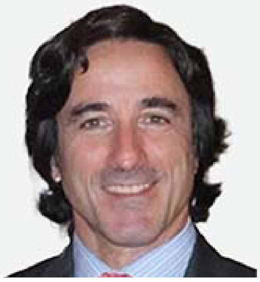

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