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The New **Expatriation** Tax Regime

Individuals who sever ties to the United States pay a price.

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Recent changes to the tax rules applicable to U.S. citizens and lawful permanent residents (i.e., green card holders) who expatriate may make cutting ties with the United States significantly more costly. The Heroes Earnings Assistance and Relief Tax Act of 2008 introduced a new regime of taxation that applies to "covered expatriates," certain individuals who give up their U.S. citizenship or terminate their status as permanent residents. The new rules are contained in Sections 877A and 2801 (all "Section" references are to the Internal Revenue Code).

Section 877A imposes an exit tax on the worldwide property of covered expatriates, and Section 2801 imposes a tax on U.S. citizens and residents who receive gifts or bequests from covered expatriates. On Oct. 15, 2009, the Internal Revenue Service (IRS) issued Notice 2009-85, which provides welcome guidance about the exit tax. The new tax regime, which constitutes a major departure from prior law, applies to individuals who expatriate on or after June 17, 2008.

Prior Law

The new exit tax represents a fundamental change from the way expatriates have been taxed for decades. Under prior law, individuals who expatriated before June 17, 2008, whose income or net worth exceeded certain levels are subject to an alternative tax regime that applies for the 10-year period following expatriation. It is important to understand the prior law because it continues to apply to expatriates who have not yet completed their 10-year period.

In general terms, the alternative tax regime imposes income tax on the U.S.-source income of expatriates during the 10-year period at the same rates that apply for U.S. citizens. U.S.-source income for this purpose includes a broader range of income items than those nonresident aliens are taxed on. Additionally, if an expatriate makes gifts or dies during the 10-year period, U.S. gift or estate tax will be imposed on any transferred property that is deemed to be situated in the United States. Once the 10-year period has ended, the alternative tax regime ceases to apply and expatriates are taxed in the same manner as nonresident aliens.

In 2004, a provision was added that subjects an expatriate to tax on his worldwide income in the same manner as a U.S. citizen in any year during the 10-year period in which he spends more than 30 days in the United States. In addition, if an expatriate dies or makes gifts during any such year, he will be subject to estate tax on his worldwide assets or gift tax on the gifted property. The 30-day rule was eliminated under the new law and does not apply to individuals who expatriate on or after June 17, 2008.

Covered Expatriates

The new exit tax provisions apply to "covered expatriates." A "covered expatriate" is a U.S. citizen who renounces his citizenship or a permanent resident who terminates his status after having a green card for at least eight of the last 15 years, if such individual either: (1) has an average annual net income tax liability in the five years preceding expatriation that exceeds $145,000 for 2010 (adjusted for inflation); (2) has a net worth of $2 million or more as of the date of expatriation; or (3) fails to certify compliance with all federal tax obligations for the five years preceding expatriation. Limited exceptions from the exit tax are available for certain individuals who hold dual citizenship from birth or who give up their citizenship prior to age 18½.

Mark-to-Market Tax

The new law imposes a mark-to-market tax pursuant to which all property of a covered expatriate will be treated as sold for its fair market value on the day before expatriation. Expatriates are subject to tax on gains arising from the deemed sale of their property to the extent such gains exceed an "exclusion amount" of $627,000 for 2010 (indexed for inflation). The exclusion amount must be allocated pro rata to each item of appreciated property.

The IRS Notice clarifies that an expatriate is deemed to own, as of the expatriation date: (1) any interest in property that would be taxable in his gross estate for federal estate tax purposes as if he had died a U.S. citizen on the day before expatriation; and (2) any beneficial interest in a trust even if it would not be taxed in his gross estate. Based on the Notice, it is unclear whether assets held in a grantor trust of which the covered expatriate was treated as the owner for income tax purposes prior to expatriation would be subject to the mark-to-market tax if the covered expatriate had no beneficial interest in the trust and it would not be taxable in his gross estate.

The fair market value of an expatriate's property will generally be determined under the same valuation principles that apply for federal estate tax purposes. Gains and losses are reported on the expatriate's U.S. income tax return for the portion of the year that includes the date of expatriation. For purposes of calculating this mark-to-market tax, a step-up in basis is available for any property held by a nonresident alien prior to becoming a resident equal to the property's fair market value on the date residency was acquired.

Deferral Elections

A covered expatriate may irrevocably elect to defer payment of the mark-to-market tax on an asset-by-asset basis. In order to make a deferral election, a covered expatriate is required to provide adequate security and waive rights under any U.S. treaty that would prevent collection of the tax. The adequate security requirement will only be satisfied if the covered expatriate enters into a tax deferral agreement with the IRS. Interest will accrue on any deferred tax.

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Payment of the tax and accrued interest may be deferred until (1) the asset is sold or otherwise disposed of, or (2) the expatriate's death, whichever occurs first. It may be difficult for covered expatriates with illiquid appreciated assets who want to make deferral elections to provide security that will be considered "adequate" by the IRS. If the IRS refuses to accept the offered security, a covered expatriate may be forced to sell such illiquid assets for less than full value to pay the tax.

Other Property

The mark-to-market tax does not apply to certain property, including deferred compensation items (e.g., qualified retirement plans), specified tax deferred accounts (e.g., individual retirement accounts) and interests in nongrantor trusts. These items are subject to either a 30 percent withholding tax on future distributions or an immediate tax on the present value of the entire interest or account as of the day before expatriation.

With respect to "eligible deferred compensation items" no immediate tax is imposed. Rather, the payor of an item of eligible deferred compensation is required to withhold 30 percent of any taxable payment to a covered expatriate. An item of deferred compensation will be "eligible" if: (1) the payor is either a U.S. person or a non-U.S. person electing to be treated as such for these purposes; and (2) the covered expatriate notifies the payor of his status and waives any right to claim treaty benefits.

If a covered expatriate does not comply with the procedures for notifying the payor and waiving treaty benefits, or if he is unable to comply because a non-U.S. payor refuses to be treated as a U.S. person for these purposes, deferred compensation that could otherwise qualify as "eligible" for tax deferral will instead be treated as "ineligible" and subject to immediate taxation.

In the case of any "ineligible deferred compensation item," an amount equal to the present value of the accrued benefit or account is treated as having been distributed to a covered expatriate on the day before expatriation and will generally be included in his gross income for the part of the year including such date. Specified tax-deferred accounts are taxed in a similar manner. The $627,000 exclusion amount may not be applied to deferred compensation items or specified tax-deferred accounts. For covered expatriates with interests in "ineligible" pension plans, it may be difficult to come up with the funds needed to pay the tax because they are being taxed on income they have not received.

Beneficial interests held by covered expatriates in nongrantor trusts are also excluded from the mark-to-market tax. A "nongrantor trust" is any domestic or foreign trust of which the covered expatriate is not treated as the owner for federal income tax purposes under the "grantor trust rules." The trustee must withhold 30 percent of the taxable portion of all future distributions made from a nongrantor trust to a covered expatriate.

If any appreciated property is distributed from a nongrantor trust to a covered expatriate, the trust must recognize gain as if such property had been sold to the covered expatriate. A covered expatriate will be treated as having waived any potentially applicable treaty benefits in connection with future trust distributions unless he makes an election to be treated as having received the full value of his interest in the nongrantor trust on the day before expatriation.

If a covered expatriate is treated as the owner of a domestic grantor trust prior to expatriation and, as a result of expatriating, such trust becomes a foreign trust, then appreciated property in the trust will generally be subject to gain recognition under Section 684. Gain that is subject to tax under Section 684 will not be taxed under the mark-to-market regime.

Covered Gifts and Bequests

Section 2801 imposes a tax on any gift or bequest received by a U.S. citizen or resident from a covered expatriate (a "covered gift or bequest") at the highest gift or estate tax rate then in effect. The tax is payable by the U.S. citizen or resident receiving the covered gift or bequest. The tax will be reduced by any gift or estate tax paid to a foreign country in connection with the transfer. This tax does not apply to: (1) gifts that do not exceed the annual exclusion from gift tax (currently $13,000); (2) gifts or bequests that qualify for a marital or charitable deduction; (3) taxable gifts that are reported on a U.S. gift tax return; and (4) property that is included in the gross estate of a covered expatriate and reported on a U.S. estate tax return. In addition, no generation-skipping transfer tax is imposed on covered gifts or bequests to grandchildren or more remote descendants. No gift or estate tax exemptions are available to reduce the tax on covered gifts and bequests. Guidance has not been issued on the application of Section 2801.

Under the **new law**, if a covered expatriate has significantly appreciated assets, the **exit tax** will result in an immediate tax bill unless deferral elections are made. However, if a **covered expatriate** has only minimally appreciated assets, the exit tax may not be overly burdensome.

Covered gifts or bequests made to a domestic trust are taxed in the same manner as transfers to U.S. citizens and residents, except the trust is obligated to pay the tax. In the case of covered gifts or bequests made to a foreign trust, subsequent distributions to U.S. beneficiaries that are attributable to the covered gifts or bequests are subject to tax in the same manner as if such distributions were covered gifts or bequests made directly to the U.S. beneficiaries. A foreign trust may elect to be treated as a domestic trust for purposes of the tax on covered gifts and bequests.

Filing

A covered expatriate is required to file a dual-status income tax return for the year of expatriation if he was a U.S. citizen or resident for less than the entire year. A dual status return consists of filing Form 1040NR with Form 1040 attached as a schedule. In subsequent years a covered expatriate may be required to file Form 1040NR to report any U.S.-source income not subject to withholding.

All individuals who expatriate are required to file Form 8854 to certify compliance with all federal tax laws during the five years preceding expatriation. Certain tax elections and waivers of treaty benefits are also made by covered expatriates on Form 8854. Covered expatriates with interests in eligible deferred compensation items or nongrantor trusts must file Form 8854 annually to report whether any distributions were made.

Covered expatriates with deferred compensation items, specified tax deferred accounts or interests in nongrantor trusts must also file Form W-8CE with any relevant payors. Reporting obligations for U.S. persons receiving a covered gift or bequest have been deferred until guidance is issued under Section 2801. The IRS has indicated a new Form 708 will be issued for reporting covered gifts and bequests.

Planning Considerations

For non-U.S. citizens considering a move to the United States or already living here, it may be preferable to maximize time spent here on a visa (e.g., E-1, E-2, O-1, H1-B or L-1 visas) before obtaining a green card in an effort to defer commencement of the eight-year residency period triggering covered expatriate status. It may be worthwhile for current green card holders thinking about leaving the U.S. to leave prior to reaching the eight-year mark.

For individuals considering expatriation, it may make sense to expatriate when asset values are depressed and capital gains tax rates are low. For covered expatriates with potentially "eligible" deferred compensation items, it may be preferable to defer tax by electing withholding treatment. Trustees of nongrantor trusts may choose to distribute cash or assets with little or no gain to covered expatriate beneficiaries to minimize gain recognition by the trust on distributions of appreciated property.

Conclusion

The new exit tax and tax on covered gifts and bequests may result in a higher tax burden on wealthy individuals who expatriate from the United States. Under prior law, a covered expatriate could attempt to minimize taxes by waiting to sell appreciated assets when possible until after the 10-year post-expatriation period ended. In addition, once the 10-year period was over, a covered expatriate was free from the expatriation tax rules.

Under the new law, if a covered expatriate has significantly appreciated assets, the exit tax will result in an immediate tax bill unless deferral elections are made. However, if a covered expatriate has only minimally appreciated assets, the exit tax may not be overly burdensome. Under prior law, an expatriate could avoid U.S. transfer taxes if he did not make gifts or die during the 10-year period. By comparison, under the new law, gifts and bequests received by U.S. citizens or residents from covered expatriates will continue to be subject to taxation, no matter how many years have passed since expatriation.

Even if there is no federal estate tax in effect, it appears that covered bequests will still be subject to tax at the highest rates applicable to gifts. The tax on covered gifts and bequests may make expatriation an unattractive option for many individuals. For some U.S. citizens and permanent residents considering expatriation, it may not be worth giving up the benefits and protections of citizenship or residency given the tax costs of leaving and the possibility of transferring assets to U.S. family members in the future.